
Innovative Financing Structures as Game Changers for Nature and Climate



**NATURE
FINANCE**

Low-and middle-income (LMI) countries harbour a significant portion of the world's biodiversity and are home to unique and endemic species. At the same time, these countries suffer from high levels of public debt and face restricted access to international debt markets. As shown through the set of biodiversity-loss-adjusted sovereign ratings developed by the **AIIB** (Asian Infrastructure Investment Bank), the impact of nature and biodiversity loss (e.g. leading to the collapse of marine fisheries and wild pollination) has significantly negative consequences on issuer GDP and credit ratings.

Twin climate and biodiversity crises pose both immediate and long-term risks to countries' economies, citizens and investors. LMI countries face further deterioration of their credit ratings, economies, livelihood opportunities and biodiversity. **S&P Global** has warned of a "poverty trap" for low-income countries hit by climate change. Partly, because having to invest in disaster relief and recovery means there are fewer funds to make existing infrastructure more resilient. Physical climate risks add to sovereign debt risk and costs, further eroding fiscal space to invest in resilience, carbon neutrality and nature conservation.

From **vicious cycle** to **virtuous cycle**

Sustainability-linked sovereign debt is one important example of an innovative financial approach which can address the triple challenge of public debt distress, climate shocks and nature degradation. It includes government-issued debt instruments which work by allowing investors to accept a lower return on a government's national debt in return for the government's commitment to their sustainable development goals by investing in nature restoration, greenhouse gas emissions cuts, and climate resilience. Critical to the concept is a functioning set of material and quantifiable key performance indicators (KPIs), that investors can lend against. KPIs, and related performance targets, will capture improvement in nature-based infrastructure, and links to economic resilience.

This is distinct from the more established "green bonds," where proceeds are ring-fenced to a particular project.

Sustainability-linked sovereign debt works by measuring these KPIs within a certain period, and adjusting the terms of the debt (e.g. interest rates) based on performance against those goals. In other words, if nature continues to be lost, and a sustainability target is not met, this can cause negative consequences on the sovereign debt rating. Lenders accept lower rates because they expect that the borrower's investments will boost infrastructure resilience and the wider economy. Nature investments may also generate new revenue streams, for example, from nature tourism, which in return improves fiscal performance, wider socio-economic outcomes, further reducing sovereign risk and borrowing costs. By integrating nature-positive initiatives into the \$65 trillion sovereign debt market, there is a real potential to scale. Nature Finance estimates that the issuance of nature-related, sustainability-linked sovereign bonds could reach up to \$400 billion by 2030, from \$3.5 billion today.

Examples of Sustainability-Linked Bonds (SLBs)

Uruguay SLB

The Inter-American Development Bank (IDB) worked with Uruguay's Ministry of Economy and Finance (MEF) to prepare the framework for issuing its first sustainability-linked sovereign bond with a coupon tied to sustainability indicators. This is a \$1.5 billion bond which matures in 2034 and includes a symmetrical step-up/step down coupon feature. Its interest rate is tied to the achievement of certain environmental KPIs, including greenhouse gas emissions and a forested area.

Chile SLB

In 2023, the Government of Chile, through the Ministry of Finance, completed the placement of its first Sustainability-Linked Bond (SLB) in Chilean pesos in the global financial market, being the first country in the world to issue sovereign debt of this type in local currency. The transaction was for an amount in local currency equivalent to about \$2,200 million US dollars. Chile issued bonds in both local currency and in international.

Development Bank of Rwanda SLB

In 2023, the Development Bank of Rwanda (BRD) issued its first SLB, setting several precedents along the way, including being the first development bank globally to do so and the step-down only structure. This move, backed by the World Bank, opened new avenues for private capital mobilisation and sustainable development allowing it from diversify its funding sources away from government dependency.

The Indonesia Coral Bond (example of an outcome bond)

This is an innovative financing instrument launched by the World Bank, seeking to enhance ocean biodiversity and manage over 5 million hectares of marine protected areas (MPAs) in Indonesia. Project success will be measured according to pre identified coral reef health and management effectiveness targets. By leveraging private capital for environmental outcomes, this outcome-based bond, developed in collaboration with the Government of Indonesia, IUCN, GEF, and BNP Paribas, aims to improve coral reef health and economic benefits from fisheries and tourism.

The benefits of **nature restoration** for **sovereign debt**

The cost of debt can be reduced through multiple nature restoration revenues. Nature restoration can therefore concretely benefit bond issuers and boost economic resilience. For example, tree planting in the northern counties of China has reduced dust and sandstorm incidents in counties further south (AIIB, 2023). In Indonesia, mangroves have been found to reduce losses from tidal floods. Wetlands in Bangladesh support critical primary industries and livelihoods. By investing in such assets, countries can de-risk countries credit profiles, and so cut borrowing costs, further stimulating national growth.

Other **options** include revenue streams from natural assets, which could be developed and integrated into countries' debt management frameworks and/or specific sovereign debt instruments to enhance their credit ratings and thereby unlock their development potential. They can be used as collateral, to guarantee the repayment of specific sovereign bonds or loans, providing an additional layer of credit enhancement, on top of a partial guarantee obtained from a multilateral development bank (MDB).

An example of a debt-for-nature swap is a 2023 agreement between Cape Verde and Portugal to swap part of Cape Verde's debt to the Portuguese state, for investments in an environmental and climate fund.

An example of a debt-for-nature refinancing is a \$150 billion loan to Barbados, guaranteed by the IDB and TNC, which was used to pay off more expensive outstanding debt, where the savings were invested in the Barbados Environmental Sustainability Fund, for marine conservation.

Embedding nature and climate into global sovereign financing at scale will require market reforms, further proofs of concept and strengthened collective action. However, where sustainability-linked bonds depend on revenues from nature credit markets, these markets will have to develop further and scale up. This will certainly also require technical assistance, on structuring bonds, to satisfy investors.

GLOSSARY

Sustainability-linked Bonds: A bond whose financial and structural characteristics, usually the coupon, are linked to previously defined sustainability goals.

Sustainability-linked Loans: A loan whose financial and structural characteristics, usually the coupon, are linked to previously defined sustainability goals.

Outcome bonds or sustainability performance-linked bond: These bonds link investor returns to sustainable development project outcomes, with outcomes measured through sustainability KPIs.