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Nature-linked Sovereign Debt Instruments: 10 Key Considerations for Sri Lanka

CSF recently hosted a panel discussion with three national and international experts on the role of nature-linked sovereign debt instruments in Sri Lanka's economic recovery, amidst debt distress and acute environmental pressures. This conversation builds on CSF's ongoing work on climate finance, under our research thematic of 'Nature, Climate, and the Economy'.

The session, led by CSF Director Anushka Wijesinha, featured Lucy Emerton (Environmental Economist), Deshal De Mel (Economic Advisor to the Ministry of Finance), and Ranga Pallawala (EU SWITCH- Asia Programme Climate Change Policy expert).

The session discussed the role that nature-linked sovereign debt instruments can play in Sri Lanka's economic recovery and unlocking new sources of finance. The experts shared their views on how Sri Lanka may best position itself to take advantage of nature-based financing, with a particular focus on Debt-for-Nature-Swaps.

The session is part of a collaborative media series with Echelon Media on a 'Nature-Positive Economic Recovery for Sri Lanka'. The full video is available to watch here.

This Analytical Note is based on the views that emerged in the discussion with the panel, and summarizes ten (10) key themes that Sri Lanka needs to consider.

Disclaimer: The views expressed in this Note may not necessarily reflect the views of CSF.

1. Debt-for-Nature Swaps are feasible in a post-debt restructuring scenario

Challenge: Sri Lanka has a chequered history manging debt and with it comes a heightened anxiety about managing a complex nature-linked sovereign debt instrument. Any big-ticket debt financing harbours inherent suspicion, especially in a context where public debt management is weak. Moreover, creating a new set of institutional arrangements while Sri Lanka's overall financial management is already in a fair degree of flux, may be adding another layer of difficulty. Sri Lanka has hitherto been unable to translate any green fiscal initiatives into concrete outcomes – for instance, previous attempts to introduce a 'Carbon Tax' which fell short due to poor design.

Opportunity: Debt for Nature Swaps (DFNS) are feasible in a post-restructuring scenario as technical capacity has emerged within pockets in Ministries. While the default has heightened debt sustainability concerns, the nearly-complete restructuring process, the introduction of new fiscal disciplinary governance measures such as the establishment of the Public Debt Management Office and an independent role for the Monetary Authority, provides an opportune moment to put the building blocks in place for a sustainable and wholistic fit-for-purpose financial and institutional framework. Sri Lanka should avoid reliance on the existing outdated institutional structures that will lead to transactional and piecemeal approaches and poor outcomes over the longer term.

"Being able to deal with instruments such as sovereign debt instruments that are linked to climate and nature in a wholistic manner needs a framework...If you don't have that institutional framework in place, you are not really going to have a sustainable approach to this" – Deshal de Mel.

2. Factor in global conditions when Sri Lanka returns to international capital markets

Challenge: Sri Lanka is pegged to return to debt markets in 2027. Globally, increasing debt distress in developing countries is limiting public spending on the environment. Internationally markets are tight, compared to 2007 when Sri Lanka first issued bonds. Liquidity was high and cheap financing was available. It will not be easy to raise finance in the way Sri Lanka was accustomed to and with the added challenge of financing a multitude of environmental and climate targets within a narrow window of time.

Opportunity: Despite the challenging outlook, there are ways to unlock finance through mechanisms like DFNS and other nature-linked sovereign instruments that tap into a larger pool of sustainable finance that is emerging, possible at competitive coupon rates.

3. Build national institutions and capabilities that encourage inclusive and multi-disciplinary approaches

Challenge: Designing and administering a DFNS (or other nature-linked sovereign instrument) requires harnessing many different subject matters specialists working together in a multidisciplinary setting and with a common understanding. For example, building project pipelines that consider multiple targets and benefits such as climate, biodiversity and pollution and linking these to a workable DFNS is complex due the number of stakeholders (both within government and external stakeholders) and institutions that need to cooperate. The institutional entry points for this diverse set of stakeholders varies based on the stages of development - from negotiating the transaction, to pipeline development. Without inclusive institutions, even the best designed mechanism may fail.

Opportunity: As noted above, before readying to return to international capital markets, Sri Lanka can build on the emerging capacities and new institutions to create a new, multi-stakeholder, multi-disciplinary, and agile institutional framework.

4. Adopt an integrated approach to the use and management of proceeds

Challenge: Sri Lanka has some overall environmental targets in place (NDC, CBD, plastics treaty, etc.,), but there is a need for an integrated financial and planning strategy to optimise the use of proceeds. Without it, Sri Lanka will not effectively leverage the benefits of the different financial instruments.

Opportunity: Sri Lanka must be futuristic in thinking about how the funds raised from a bond issuance under a swap, can be mobilised to unlock co-financing from different investors. An integrated strategy can support this. Moreover, by embedding an integrated, wholistic approach that debt proceeds can meet multiple environmental and climate objectives.

"The entire landscape has changed; the environmental challenges have changed. The use of proceeds should be very futuristic...how that vehicle can contribute or mobilise to unlock more finance form different other investors is quite important. How you can work with other donors and investors is important. This wholistic approach is very crucial. It is not to just serve a simple swap or single transaction." – Ranga Pallawala.

5. Foster discipline and good governance in administering earmarked funds

Challenge: Based on how Sri Lanka's public finances and budgets function, earmarked funds often fail to achieve their objectives. The funds raised do not meet the intended purpose as most funds are reallocated for interest payments, salaries, pensions and essential welfare payments, etc. Sri Lanka does not have structural discipline to have earmarked finance, but it is something that can be worked on.

Additionally, good governance on the application of proceeds is critical. Poor governance and politicisation of use of proceeds can undermine the entire effort, a criticism that has arisen in some past asset-linked swaps undertaken in other countries.

Opportunity: The overall fiscal reform measures being put in place can help strengthen the discipline needed to ensure earmarked marked funds are utilised for the intended purpose. Additionally, Sri Lanka can learn lessons from other countries faced with similar issues when managing proceeds. For example, establishing special purpose vehicles in the form of conservation trust funds and co-financing instruments with stronger checks and balances.

6. Create greater flexibility in use and management of proceeds

Challenge: The Government will need to depart from traditional methods that are used when managing proceeds from traditional bond issuances. While any funds raised from a sovereign issuance in Sri Lanka will continue to be governed by the same national laws, there will be a greater degree of flexibility needed in the way proceeds are managed. Existing Treasury-led processes may be limiting and narrow.

Opportunity: Sri Lanka can adopt structures that give the required flexibility to meet the instruments' environmental objectives, while maintaining good governance required of public finance. More creative or innovative ways of managing funds (not limited to the consolidated fund), are needed, which allows for proceeds to be governed by a structure outside the standard administrative process, as demonstrated internationally.

7. Think about instruments more broadly and build a bigger toolbox beyond DFNS

Challenge: It is a mistake to assume that a DFNS will resolve all our conservation financing - and indeed debt - problems. DNFS is an important tool, but will likely only be part of the solution for Sri Lanka. For example, ratings agency Fitch finds that bond-backed debt restructuring is supplementary and complementary to existing conservation finance. The Taskforce on Nature Markets found that of US$17 billion of nature financing in 2021 only 1% (US$190 million) was debt restructuring.

Opportunity: Sri Lanka should build a diverse toolbox that better utilises public finance, leverages private finance and generates more financial flexibility for the public sector. It must also influence the private sector to be nature positive and allocate community funds at the grassroots level.

The public budget will remain a core tool as conserving nature is a public good and already many fundamental services are provided. However, Sri Lanka can look at environmental fiscal transfers; biodiversity offset markets; biodiversity credit markets; and sustainable supply chain measures. By growing the toolbox, Sri Lanka can expand and diversify the finance base, which brings in more players.

8. Bridging gaps in understanding among professional communities

Challenge: Polarization between the environmental conservation community and finance and economics community in Sri Lanka on their understanding of nature-linked sovereign instrument makes it difficult to come mutually beneficial positions. In Sri Lanka, bankability, commercialisation and markets, in relation to nature are seen as something bad for public interest investments such as conservation.

Opportunity: Understanding is growing however more work needs to be done to bridge the gap. It is important to remind stakeholders that DFNS is not a new concept. From the late 80s to 90s there were 140+ debt for nature swaps raising US$4 billion. The model was a swap - buying off debt and using the proceeds to capitalise a trust fund. What we see now is still debt but managed a bit differently. Countries now refinance debt on private capital markets through bonds, at higher volumes. Sri Lanka can raise awareness of how nature-based debt instruments have been successfully implemented internationally as well as lessons learned from failed attempts, to help bridge the gap in understanding and foster common positions.

> "As soon as you use the word debt, it is very loaded. If you are coming from a background where the nuances of public debt and how it is used as a tool for economic management is not so clear, it leads to a lot of inherent suspicion. On the other hand, there are elements in the conservation community that see it as a sliver bullet" - Lucy Emerton.

9. Stakeholder engagement to address fears around loss of sovereignty

Challenge: Members of the international community (e.g., conservation NGOs, philanthropies, etc.) are almost always on the board of directors of SPVs such as conservation trusts, which sometimes lead to worries around national sovereignty. A lesson from a failed 2001 attempt at a US$5 million DFNS proposed by the US government was the lack of civil society and NGO consultation and buy-in. There was fear of loss of sovereignty and loss of forest resources.

Opportunity: The involvement of the international community is beneficial when carefully negotiated. Tapping into international capital may also encourage Sri Lanka to be more imaginative when developing mechanisms that allow for proceeds to be managed domestically. There are now well-established and trusted mechanisms for involving international players, which Sri Lanka can learn from.

10. Clever identification of investors and what they are looking for

Challenge: Without understanding the investor profiles and their risk appetites, Sri Lanka will struggle to attract finance in this new space. Different groups of investors have different motivations, and it is important to understand what the best combination of instruments are to attract investors. For instance, investors are unlikely to fund renewable energy projects under a DFNS, compared to a plain-vanilla green bond.

Opportunity: Global public pressure has resulted in divestments from socially and environmentally-harmful activities. Investors are going beyond purely looking at ROI and risk assessment criteria is changing. Sri Lanka needs to present credible selection criteria and sound pipelines of projects.

Key Overall Takeaways

- Sri Lanka has a traditional outlook on nature-based finance, and this will limit the way proceeds can be utilised and managed. Innovative and integrated environmental, financial and development planning approaches are needed, embedded into the institutional framework.
- The post-debt restructuring environment, with more rigorous fiscal governance measures, is the ideal time to place the required building blocks ahead of Sri Lanka's return to capital markets in 3-4 years.
- Existing public budget mechanisms led by the Treasury and anchored to the consolidated fund will need to be complemented by well-governed and inclusively managed special purpose vehicles like conservation trust funds that can allow for greater diversity of instruments and funding sources.
- Through this, Sri Lanka can broaden the investor and beneficiary base and increase the impact of cross-cutting environmental and climate projects.
- Sri Lanka must be mindful of unresolved community-environment tensions, weak public financial management, gaps in understanding of instruments and use of proceeds, and negative perceptions of private capital in conservation.
- Underpinning the success of any sustainable finance mechanism will be the genuine and holistic engagement of people who have a stake in DFNS and related instruments.