DEBT-FOR-DEVELOPMENT SWAPS AND THE POTENTIAL ROLE OF THE WORLD BANK

TECHNICAL NOTE [1]

Executive Summary

The aim of this note is to help stakeholders optimize their decision-making on when, where, and how to use debt-for-development swaps ("debt swaps"), ensuring they bring the intended benefits to all parties involved. It also proposes new approaches to structure these mechanisms, making them less transaction-heavy and more sustainable while maintaining accountability in fulfilling policy and spending commitments. In doing so, it explores modalities for the World Bank Group's involvement.

Debt swaps are agreements between a government and one or more of its creditors to replace existing sovereign debt with one or more liabilities that include a spending commitment towards a specific development goal. These goals may include nature conservation, climate action, education, nutrition, support for refugees, among others. The spending commitment is often associated with the country's decision to pursue an important development policy. This note provides a framework for evaluating and enhancing debt swaps and the World Bank's potential role in supporting these transactions. It focuses on three critical aspects: (1) appropriateness of the use of debt swaps, that is, in what debt situations and countries are debt swaps useful? (2) adequate and enhanced design of the expenditure program commitments, from the standpoint of fiscal policy and sectoral programs, and (3) the potential role of the World Bank Group in debt for development swaps.

Appropriateness of the Use of Debt for Development Swaps. Each proposed debt for development swap should undergo a comprehensive evaluation to validate whether it is viable and beneficial for the country. From a debt and financial perspective, key criteria include: (i) the country's initial debt position and the swap's effects on debt sustainability, (ii) the net financial gains for the debtor, (iii) the country's debt management capacity and commitment to transparency; and (iv) the opportunity costs for the borrower and donors.

Countries that are potentially good candidates for swaps are those at "moderate" or "high" risk of debt distress with a sustainable debt outlook that are facing temporary liquidity pressures. In that context, they usually apply to smaller economies, and where the transaction can be impactful in providing critical short-term relief and improving debt sustainability prospects. For those countries, debt swaps can help smooth debt amortization profiles and represent sound liability management, while supporting high-impact development projects. Countries need to have strong debt management capacity to record and report on the swap, and grasp the transaction's financial, fiscal, spending management, legal, and operational implications. Swaps are intrinsically complex, and all parties involved need to be committed to providing the highest levels of transparency to adequately assess the benefits of swaps, and to provide for scrutiny by relevant stakeholders, including civil society.

[1] This note was prepared by the World Bank Group staff. The Note provided a basis for the *Joint World Bank-IMF Debt for Development Swaps: An Approach Framework* paper.

Countries with unsustainable debt levels or those requiring (or already undergoing) comprehensive debt restructuring are not suitable candidates for debt swaps, which are not appropriate tools for restoring debt sustainability. In these cases, substantial debt reduction from all creditors and a fully funded macroeconomic adjustment program are necessary. However, debt swaps could be considered as a "top-up" measure after restructuring.

For countries with strong credit and low risk of debt distress, buyback swaps (where market debt is bought back with lower-cost debt) are likely inefficient as the cost difference between existing and new debt is likely to be small while transaction costs are high. Nevertheless, bilateral swaps (where official bilateral debt is written off or exchanged) may still be viable options.

Adequate and Enhanced Design of Expenditure Program Commitments. The key criteria for making adequate spending commitments while enhancing the efficiency and effectiveness of debt-for-development swaps are the alignment of the expenditure program with national priorities, adequacy from an expenditure efficiency perspective (including allocative efficiency), and fiscal sustainability within the country's broader expenditure envelope. Additionally, it may be warranted in some cases to examine the benefits from a global public goods perspective, especially when the selected spending would not occur without the debt swap.

Debt-for-development swaps can be applicable to a wide range of public expenditure programs. A key objective is to ensure that spending commitments are fully aligned with the country's development goals and strategies. It is crucial that these new spending commitments maintain or improve the overall efficiency of the budget. Beyond these primary considerations, three additional aspects should be evaluated for each potential transaction to reduce the burden on debtor countries while maintaining accountability: first, the degree of expenditure earmarking, second, the implementation arrangements, and third, the mechanisms for monitoring, verification, and accountability. These factors help ensure that debt swaps not only provide financial relief but also contribute effectively to sustainable development without imposing undue constraints on the debtor country.

This note proposes a new, more flexible approach to spending commitments that aims at development results and outcomes rather than focusing on inputs. It also advocates for greater reliance on country systems for supervision and monitoring**, including through WB PforRs support as well as that of other third parties.** On a continuum of design options ranging from strict ring-fencing of resources to more flexible earmarking under country programs and non-earmarking modalities based on results achieved, this note supports more frequent use of the latter. Many countries have made significant progress in their public financial management governance and monitoring systems, and new approaches to debt-for-development swaps should recognize this progress while implementing mechanism to ensure adequate use of resources and results.

Overall, greater dependence on country systems and institutions, with support from International Financial Institutions such as the World Bank and continued support from NGOs and other agencies, are likely to enhance country ownership. This, in turn, should lead to better implementation, results, and ultimately sustainability of the desired programs over time, even

beyond the contractual period. Such transactions would also be less costly, thereby improving the value proposition of debt for development swaps

Potential Role of the World Bank Group. IBRD/IDA and MIGA can support countries to develop innovative, integrated financing solutions to facilitate debt for development swap transactions that are tailored to their macro-fiscal conditions and sectoral development priorities. The World Bank's involvement in debt swaps will be guided by (i) development benefit of the intervention, (ii) client demand, and (iii) subject to existing country programs (including IDA allocations and exposure limits for IBRD countries).

The World Bank is uniquely equipped to assist developing countries at different stages of debt swap transaction, including with analytics on the design, financing, technical assistance, and capacity building to the debt management office, and facilitating financial and implementation support.[2] The analytical support is critical to enable a good design of the overall debt relief of the swap and that of the expenditure program committed. Since swaps compete for scarce donor and MDB resources, it is paramount to select transactions which ensure maximum benefit to borrower for a given amount of capital deployed.

WBG financing support. The World Bank Group can be involved in direct financing support of the swap transaction and by doing so, maximize efficiency of such transactions, monitoring, and help ensure strong development results. The Bank has a full suite of instruments to support debt for development swaps.

In the case of **commercial debt swaps** involving outstanding bonds or commercial loans, a straightforward way would be to provide direct budget support loan or a credit enhancement (guarantee) through a development policy financing (DPF) operation. In the case of budget support operation, the lower cost, longer-term loan from IBRD/IDA would refinance the more expensive commercial outstanding debt. The realized debt service savings related to lower interest payments on the loan could be used for a spending commitment by the government toward a development goal. The DPF prior actions could also provide support for relevant institutional and policy changes needed to achieve the goal, as needed. In the case of a credit enhancement operation, the new instrument issued in the context of a buy-back swap would be guaranteed by the WB (through a PBG or a combination of a PBG and a MIGA guarantee) to lower its cost and improve its terms. Finally, innovative financing tools, such as **World Bank Capital at Risk (CAR) notes** can be deployed to facilitate debt buyback and generate debt service savings for a debtor country.

In the case of **bilateral debt swaps**, the WB financing would come into play in a different form. The bilateral lender would forgive its debt to a sovereign based on development results over time and those results can be funded by a WB lending operation. Given the gradual debt reduction over a certain period of time, the WB could explore supporting such debt swaps transactions in tranches via a Program for Results (PforR) loan to the country to accompany the expenditure program committed, support capacity building, and monitor and verify specific results/outcomes.

Other WBG support. IBRD's innovative **outcome bonds** could also be used to accompany debt

[2] The Bank's support across different stages of the swap would consider potential conflict of interest implications.

swap transactions, as a way to leverage expenditure programs supported by the debt swaps. The feasibility of this and the design of the transaction will need to be assessed and developed on a case-by-case basis. Moreover, existing trust funds for debt and debt service reduction support, could be deployed with other financing modalities to further soften the financial terms for debtor countries.

The WBG support to countries with these options would be based on: (i) a clear identification of development benefits for client countries; (ii) the Bank's policy that guide WBG instruments; (iii) existing country programs and IDA allocations and IBRD exposure limits; (iii) strong macro-fiscal where needed, avoiding weakening incentives for prudent policies; and (iv) burden sharing considerations.

DEBT FOR DEVELOMENT SWAPS AND THE POTENTIAL ROLE OF THE WORLD BANK
TECHNICAL NOTE

Background

1. Debt for development swaps ("debt swaps") are agreements between a government and one or more of its creditors to replace sovereign debt with one or more liabilities that entail a spending commitment over time towards a development goal, for example, nature, conservation, climate action, education, nutrition, support to refugees, among others.

2. The spending commitment funds are usually required to be ringfenced, typically through the establishment of a new government trust fund or entity to manage projects funded by the earmarked commitment spending. Debt stocks are reduced and, if the new expenditure commitments are lower than the original debt service[3], claims on budgetary resources (and thus liquidity pressure) are reduced. Replacing debt service in foreign currency by expenditures with a high local content can also improve the Balance of Payments and stimulate the local economy, though similar effects would also apply to grants. The appeal of swaps is that they propose to tackle two pressing global challenges simultaneously: high indebtedness resulting from multiple shocks and increasing interest rates, and the pressing need to invest in climate action and other development objectives.

3. However, these transactions are often complex, administratively costly, with upfront financial arrangement fees, and heavily reliant on donor subsidies through grants, concessional financing, or guarantees/credit enhancements – which have typically limited their size.[4] The total face value of debt treated with swaps annually between 1987 and 2021 averaged 100 million a year, with many of the transactions below USD10 million. This rendered an even smaller amount allocated to the intended development commitment earmarked. Considering the increasing global effort to better align international finance with climate goals, interest on these transactions has been growing, and the last three years has seen more transactions, including in Barbados, Belize, Ecuador, and Gabon.

4. The debt for development swaps considered in this note can be classified into two categories, depending on the type of creditor of the debt being swapped: (i) *bilateral debt swaps* – when the official bilateral debt is written-off or swapped in exchange for a commitment toward expenditures on specific nature or other development objectives, and (ii) *commercial debt (or buyback) swaps*, which target debt held by private creditors.[5] The latter may include bonds or commercial loans. An example of a bilateral swap is the US-Peru debt-for-nature swap[6], whereby debt service to the US will be partially redirected to a fund that is investing in environmental initiatives. Swaps done recently by Barbados, Belize, Ecuador, and Gabon are examples of commercial swaps of internationally traded sovereign bonds. These countries contracted credit-

[3] Alternatively, when the new liabilities are lower than the old liabilities.
[4] All recent debt swaps have required full MDB/DFI guarantees of the newly issued debt. The need for large guarantees makes these transactions costly and not very efficient.
[5] This note does not consider swaps of domestic debt or debt to multilateral development banks and other IFIs.
[6] For details, see "United States Signs $20 Million Debt Swap Agreement with Peru to Support Amazon Conservation"

enhanced debt and used the proceeds to buy back bonds in capital markets, committing part of the debt service savings (the difference in debt service between the old and new debt) toward conservation. This type of swap thus involves the exchange of one unsecured debt liability (bonds) for two (or more) new liabilities (new guaranteed debt and expenditure commitments).

5. This note provides a framework for evaluating debt for development swaps and considers the World Bank's potential role in debt for development transactions. Specifically, the note focuses on three critical aspects: (1) appropriateness of the use of debt for development swaps - in what debt situations and countries are debt for development swaps useful; (2) adequate and enhanced design of the expenditure program commitments, from the standpoint of fiscal policy and sectoral expenditure programs, and (3) the potential role of the World Bank Group in debt for development swaps at different stages of debt swap transactions.

Key considerations in evaluation of debt for development swaps

(1) Appropriateness of the use of debt for development swaps—in what debt situations and countries are debt development swaps useful?[7]

1. Criteria that need to be considered in determining the appropriateness of debt for development swaps include (i) the country's initial debt situation and the swap's impact on its debt sustainability outlook, (ii) the net financial benefits related to the debt swap transaction, (iii) the country's debt management capacity and commitment to transparency, and (iv) opportunity costs for the borrower and donors given the swaps complexities and transactions costs. These criteria, which are described below are also operationalized through the application of an implementation framework, comprising a decision tree and a quantitative formula measuring net benefits of debt swap transactions for countries.

(i) Country's initial debt position and the swap's effect on debt sustainability

2. Swaps are generally not appropriate when a country's debt situation is such that a comprehensive and deep debt restructuring is likely required to restore sustainability. These transactions could be an obstacle to debt restructuring, rather than help in those situations. Moreover, given their relatively limited size, swaps would likely not be sufficient to make a meaningful contribution to restoring the debt sustainability of a country with a solvency problem. In addition, expenditure earmarking associated with a swap increases budgetary rigidity at the time when countries typically undergo a significant fiscal retrenchment, potentially complicating consolidation efforts. Swaps may also divert attention of policy makers away from the real sources of debt distress and delay timely policies aimed at restoring adequate macroeconomic policy framework. For the restructuring process, a swap with one or a few creditors would complicate creditor coordination and burden sharing. In the case of a default on the new debt issued in a buyback swap, any financial gains achieved by the swap become largely irrelevant.[8]

[7] This section is based on the Rivetti, D., Mihalyi, D. (2024), Debt for Development Swaps – A Financial Assessment Framework, World Bank Working Paper Series (forthcoming).

[8] For bilateral swaps, the Paris Club may - based on past precedents - consider preferential treatment of bilateral creditor claims that already underwent some form of debt treatment prior to the start of the restructuring.

3. The treatment of the expenditure commitment liability is also challenging. There are cases (such as the recent Belize swap) where a default on the expenditure commitment triggers default on the new debt, activates the guarantee, and generates direct debt.[9] Given the presence of credit enhancements in all the recent buyback swaps, a default also alters creditor composition, which complicate the use of multilateral banks' guarantees in countries facing an impeding debt restructuring process.

4. In some cases, however, swaps can be integrated in a debt restructuring process provided they are a top-up to the debt reduction required to restore debt sustainability (a practice followed, for example, by the Paris Club) or in a post-restructuring situation. For example, if a bilateral creditor agrees to a 50 percent haircut as part of comprehensive debt restructuring at a first stage, it may later restructure again the loan to swap of part of the remaining 50 percent for commitments to development spending.

5. In some circumstances, predominantly for small or countries facing liquidity pressures, swaps may help improve debt sustainability. This requires a meaningful impact by swapping a sufficiently large share of debt stock with simultaneous requirement to devote a relatively smaller share of debt service savings toward a development spending compared to the share that directly benefits debt sustainability goal (reduces spending and hence reduces the fiscal deficit). In countries with potential solvency concerns ahead, this would require mobilizing sufficient resources to simultaneously retire a large part of the debt portfolio, provide meaningful commitments towards conservation/development, and sufficiently reduce claims on future revenues to improve sustainability. Except for small economies such resources are likely to be substantial, limiting the applicability of swaps in reducing debt risks.

6. For countries at moderate or high risk of debt distress with a sustainable outlook, and where risks are primarily related to high near-term debt service rather than solvency concerns, swaps of sufficient size and which provide short-term liquidity relief can be helpful. In such cases, the cash flow commitments for development spending need to be spread out over a longer period than the service on the debt being swapped. This also suggests targeting shorter maturities in buyback swaps to alleviate the liquidity crunch, even if discounts on longer-dated securities may be larger.[10]

7. Countries considering debt swaps should take into account budgetary implications such as the rigidities created by expenditure earmarking, the budget fragmentation generated by the use of Special Vehicles and fully ring-fenced offshore trust funds, and the related impact on the transparency and monitoring of budget execution.

(ii) Net financial gains for the debtor

8. The net financial benefits of swaps need to be accurately assessed and found to be significant. A key consideration of whether swaps are appropriate is whether they provide financial

[9] This type of budget rigidity may be required by the donors facilitating the transaction or providing the guarantee to ensure that the fiscal space created by the swap is targeted to the intended use.

[10] In Gabon, proceeds of the "blue bond" were used to repurchase mainly (80%) the 2031 maturities, as opposed to only 20% of the 2025 maturities. While this increased nominal debt service savings (2031 maturities could be repurchased at 15% below par rather than 3% below par for the 2025), the debt sustainability benefits were lower.

gains to the countries that undertake them. The financial benefits of swaps have typically been measured as the total debt service savings generated by replacing the old debt with new one. But this approach is simplistic. It hinges on calculations based on nominal savings, failing to factor in the time value of money, acknowledge that a future default event would drastically reduce or nullify the gains from the swap, and consider the high transaction costs. Net benefits should be calculated as the present value of debt service savings including all transaction costs, while considering possible (positive or negative) financial spillovers and the risks that eventual restructuring would impact realized benefits. Meaningful benefits require the new instruments trading at a premium relative to the debt being bought back that is commensurate with the value of the guarantee being provided. For countries with low risk of debt distress, discounts in market securities would be insignificant, and the potential savings or benefits of a buyback swap are likely to be exceeded by transaction costs (this applies to commercial debt swaps).

9. Swaps can have positive or negative spillovers to a country's creditworthiness as assessed by the credit rating agencies. Positive spillovers would come from a reduction in debt vulnerabilities that may be achieved in certain circumstances. If the swap reduces debt vulnerabilities along with the positive effect of reducing the debt stock, it also reduces the cost of debt for future issuances by the country. Such positive spillover would argue for the efficiency of the swap mechanism. Negative spillovers can emerge if the swap is seen as a distressed exchange, leading to negative ratings actions and possible further deterioration of risk sentiment if the swap was unable to sufficiently reduce liquidity or solvency risks. Overall, credit rating agencies assess commercial debt-for-development (climate/nature) swaps the same way that they assess other debt exchanges. The debt exchange is classified as distressed, rather than opportunistic, when two criteria are simultaneously met: (i) there is a material reduction in terms, i.e., situations when the investor receives less value than promised when the original debt was issued, and (ii) the exchange is designed to avoid a conventional payment default. While the first criterion is generally always met, the second one considers factors such as the rating level on the entity in advance of the debt exchange, assessment of liquidity (e.g., FX reserves) and solvency, and the impact of transaction on liquidity and solvency (size). Careful and well-planned market soundings and communication are key to avoid negative consequences.

(iii) Country's debt management capacity and commitment to transparency

10. Swaps (especially buyback swaps) are complex to analyze, record, and report on. Therefore, countries undertaking swaps need to have strong debt management capacity. The cash management component is also time-consuming as, depending on the structure, multiple accounts need to be maintained. Especially in low-capacity environments, they may divert resources from core debt management functions. Swaps are therefore more appropriate to settings where the debt management office (DMO) has or is committed to build sufficient capacity.

11. In many cases, the country will need to report not only on the debt aspects of the swap, but also the development commitments (e.g., expenditures and outcomes of the conservation projects) on an ongoing basis.[11] The authorities need to ensure coordination among the relevant ministries

[11] Using outcomes rather than expenditures reduces rigidities and can improve ownership. But it can also create risks if outcomes are not reached due to other intervening factors.

to make this data available to the different parties in the swap. Finally, DMOs undertaking swaps must be capable of designing and implementing adequate debt management strategies (DMS) and ensuring the swap is aligned with its medium-term DMS.

12. The sheer complexity of swaps may introduce some opacity. Therefore, it is essential that the parties involved in swaps provide the highest level of transparency in terms of their structure and related costs including fees, commissions, and interest differentials. Without transparency, it is impossible to adequately assess the true benefits of swaps. Historically, buyback swaps have arguably lacked sufficient transparency. For example, a repurchased debt that included marketable instruments with standard financial terms and detailed public prospectuses that is swapped with a privately placed bond by a special purpose vehicle.

(iv) Opportunity costs for the borrower and donors

13. The opportunity costs of debt for development swaps need to be evaluated and assessed against other form of potential support by the sponsor of the transaction (the official bilateral creditor in the case of bilateral swaps, or the provider of credit enhancement in the case of buyback swaps). For example, for bilateral swaps, it is important to note that a debt for development swap is, to a first order approximation, financially equivalent to (a) the debtor repaying the bilateral debt in full, (b) the bilateral creditor simultaneously giving a series of grants to the creditor over time equivalent to the amount of debt service, some fraction of which is tied to achieving the specific development outcome, and the remaining fraction is untied. Such combination carries fewer transaction costs – both financial and operational, compared to a new swap transaction, but may not always be preferred from the point of view of political economy.

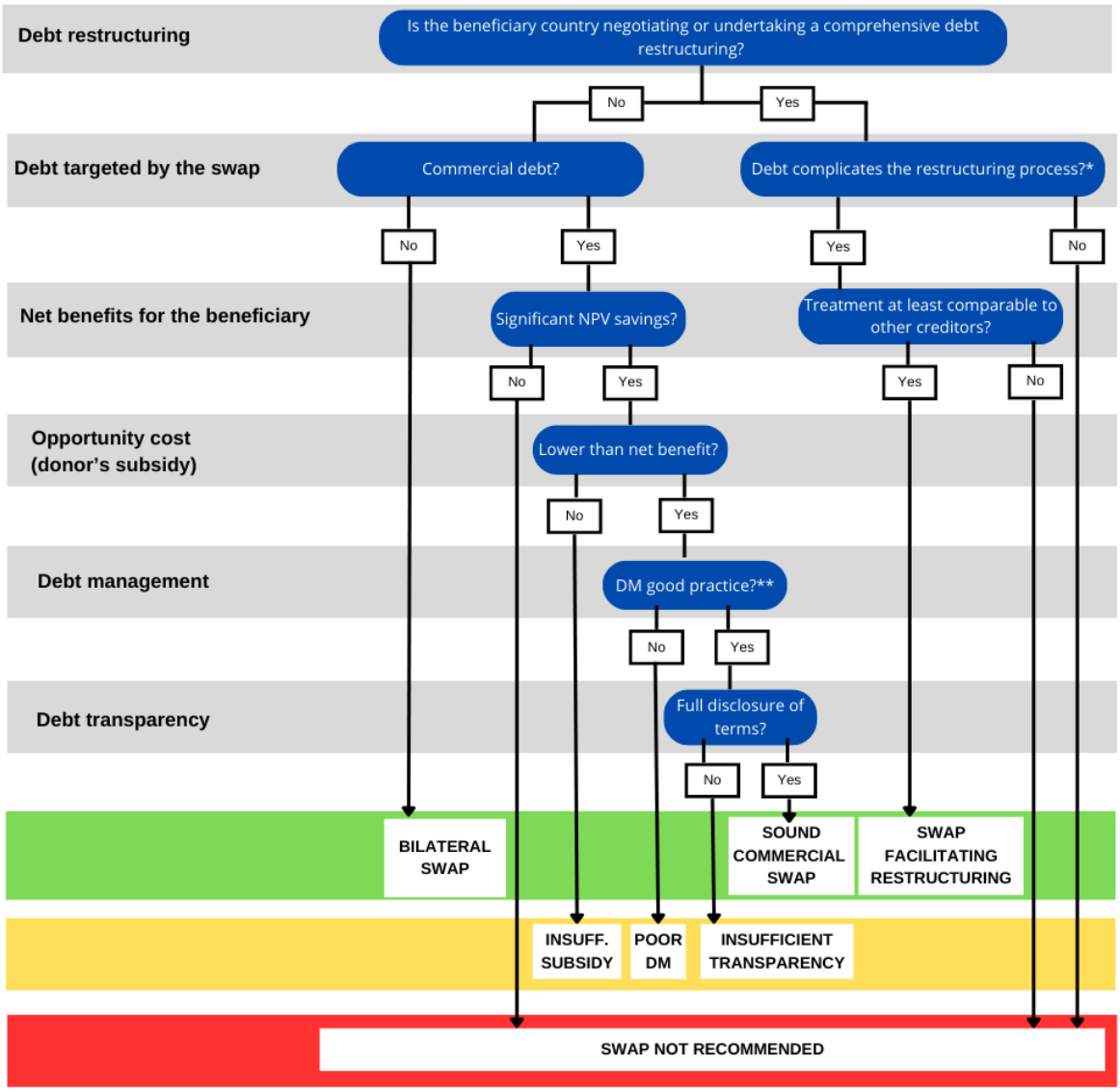
14. Swaps compete for scarce donor and MDB resources. Absent positive spillovers, the additional resources provided by swaps (i.e., the difference between the present value of debt service on the old debt and new expenditure commitments) are typically generated by an element of a subsidy – either through direct donor subsidies, or indirectly through MDB participation, for example in the provision of credit guarantees. To the extent such subsidy could be mobilized for purposes other than the swap, this represents an opportunity cost to both borrower and donor, particularly when higher-return projects may be available. The opportunity costs or benefits of donor support can also be analyzed and considered as part of prioritization of swaps as opposed to other instruments such as direct financing of projects. For the borrower, a key consideration is the extent to which the guarantee reduces a predetermined country envelope made available to the borrower by the entity providing the guarantee.

15. Risks and benefits related to credit enhancements need to be adequately assessed: credit enhancement is necessary both for the swap to generate debt service reductions (i.e., savings) and to enlarge the investor base because many investors require investment-grade ratings. The benefits of credit enhancements in making larger volumes of financing available are viable as well as crowding in green or blue investors. But that needs to be weighed against direct financing that can be provided with the same capital exposure of the donor or MDB as well as other efforts to develop sustainability-linked financing. In some cases, the larger volumes afforded by partial guarantees could allow countries to realize larger nominal savings, but in others, guarantees reduce instrument liquidity and their full value is not realized, suggesting that direct lending may be more efficient.

16. Implementation framework. The criteria mentioned above can be encapsulated into a decision tree that can help guide the process of determining the appropriateness of a debt for development swap for a specific country. The decision tree is supplemented with quantitative inclusion criteria to measure and select potential countries that could be good candidates for debt for development swap initiatives. While such exercise allows to identify cases where swaps have the largest likelihood of being beneficial for debtor countries, more analysis of each individual transaction is needed for specific cases.

17. ***Decision tree***: the swap decision tree can be a useful tool which can help guide the decision process and identify the deals that have unambiguously positive or negative impact for the country, as well as those that may need to be improved in their design (Figure 1).

Figure 1. Debt swap decision tree



Notes:

**For example: collateralized debt, long-standing arrears, bonds without CACs.*
*** For example: swap aligned with the debt strategy objectives; debt management office with the capacity and systems to assess the legal/financial implications, record, and report on the swap.*
Source: World Bank.

18. ***Quantitative assessment*** can be carried out using the following formula, which can help to capture net benefits for the debtor country:

Net Benefits (NB) = [PV (N - N')] + $\Sigma_{t+1..t+3}$ PV n (y-y')] * (1-PD') + [ΔPD (CD – PV(N)]

- (i) Direct benefits (ii) Financial Spillover (iii) Non-default (iv) Lower PD

Where:

- N= cash flows pre-swap (debt service)
- N' = cash flows post-swap, including debt service and all one-off and recurrent transaction costs and fees
- y= yield pre-swap
- y'= yield post-swap
- n = net commercial borrowing (per year)
- PD'= probability of default post-swap
- ΔPD = difference in probability of default post-swap
- CD = costs of default

This framework leads to the following indicative criteria for inclusion:

CRITERIA FOR INCLUSION	INDICATIVE THRESHOLDS	
	BONDS	LOANS
Meaningful savings from credit-enhanced financing after transaction costs (i)	Spreads above 200 bps	Original interest rate higher than 6% (cost of the new instrument) in case of prepayment AND market price well below face value for buyback
Possible positive impact on probability of default / future cost of funding (ii) and (iv)	Preference given to countries closer to rating upgrade	
Transaction would alleviate liquidity pressures (ii) and (iv)	Bonds or loans falling due in the coming years	
Minimum size to offset transaction costs and improve sustainability (i), (ii) and (iv)	USD [50] million (indicative minimum size to trigger spillover will depend on total debt volumes); size considerations will have to be balanced with instrument and spending goals	
Risk of default not too elevated (iii)	Spreads below 1000 bps	Rating B- or above

Note: Thresholds are indicative. Each transaction needs to be evaluated separately considering country specific circumstances and market conditions at the time of the swap.

Institutional assessment considers debt management capacity, transparency, and governance arrangements.

CRITERIA FOR INCLUSION	THRESHOLDS	
	BONDS	LOANS
Debt Management capacity	Swap aligned with the debt strategy objectives; IT systems in place to record and report on the swap; preference given to countries with previous experience in liability management operations	
Transparency	Regular debt data disclosure to the World Bank's Debtor Recording System and publication of debt statistics over the last two years (source: World Bank Debt Reporting Heat Map)	
Governance	To minimize risks of default on the expenditure commitments, solid governance is required as assessed by World Bank and IMF instruments.	

(2) Adequate and Enhanced Design of Expenditure Program Commitments

19. The most recent debt for development swaps focused on investments and programs supporting climate and nature. However, debt for development swaps can have much broader coverage and include other development priorities, like education, health, nutrition, refugees, infrastructure development, among other. The decision on the design of the spending commitments reflects donor and debtor priorities, and the debtor's implementation capacity, including Public Financial Management (PFM), and fiduciary arrangements. Up to now, debt for development swap programs have been heavily ringfenced, including using trust funds administrated outside the debtor country. The arrangements have a substantial impact on the transaction costs associated with the debt swap and its cost-benefit analysis.

20. **This note proposes a new and more flexible approach to spending commitments**. One that relies more heavily in country systems with external monitoring and supervision. Some countries have made significant progress in their PFM governance and systems, and the new approaches taken for debt for development swaps should recognize that. Overall, more dependence on country systems and institutions, with support of IFIs such as the World Bank, including with their lending instruments and options, can be more effective in many countries that have a certain level of capacity and stronger implementation track record. Such transactions would also be less costly, thereby improving debt swaps value proposition.

21. Debt swaps typically involve earmarking funds for specific sectors or expenditures. However, they should focus on achieving sector or program results rather than just meeting spending commitments. To increase the likelihood of positive outcomes and sustainability, the design and execution of programs linked to debt-for-development swaps should align with certain criteria. The evolution of various approaches to support developing countries over recent decades offers important lessons on what strategies are most likely to succeed. These insights can inform more effective debt swap programs that prioritize results and long-term impact rather than simply allocating funds.

22. In assessing the adequacy of the given sector for increased development spending, several dimensions need to be considered, including: (i) the alignment of the expenditure program with the national priorities; (ii) adequacy from the expenditure efficiency perspective, including allocative efficiency, and (iii) fiscal sustainability of the broader expenditure envelope of the country. Additionally, it would be warranted in some cases to examine the benefits from the global public goods aspect. Apart from those critical considerations, there are three additional aspects that need to be evaluated for each potential transaction: (iv) the degree of expenditure earmarking – from fully earmarked spending to policy/outcome-based disbursement linked indicators and its implications; (v) the implementation arrangements (ringfenced from the budgetary and institutional structure of the government vs integrated into administrative and budgetary structures), and (vi) the mechanisms for monitoring, verification and accountability.

(i) Alignment of the expenditure program with national priorities

23. Debt for development swaps can be applicable to a wide array of public expenditure programs. The important goal is that they are fully in line with the country's development goals

and strategies. In this context, it is critical that the new spending commitments, through these transactions, maintain or improve overall spending efficiency of the budget.

(ii) Adequacy from the expenditure efficiency perspective, including allocative efficiency

24. In examining a sector's adequacy for debt for development swap, the overall absolute and relative level of spending in the sector should be assessed from the point of view of fiscal affordability and in comparison, to relevant peer countries, efficiency and effectiveness of spending, the balance between current and capital spending, and the degree of budgetary rigidities. It is also critical to assess if the targeted sectors have adequate implementation capacity, given that failing to meet the expenditure (or conservation) commitment in a swap may be treated contractually as a sovereign debt default event.

(iii) Fiscal sustainability of the broader expenditure envelope of the country

25. While considering an expenditure commitment, countries should also analyze the overall size of public spending and ensure that the new spending commitment is fiscally sustainable and does not create obstacles to an ongoing expenditure-based fiscal consolidation.

26. While in most cases, debt for development swaps should not result in additional spending commitment (as it is "financed" by the reduction of debt service payments or savings), there can be (and have been) cases when swaps lead to additional spending to meet the expenditure commitments.

27. When assessing debt-for-development swaps, it is relevant to also consider the broader benefits of spending commitments through the lens of global public goods. For example, several past debt swaps have focused on funding conservation efforts. While spending on conservation provides a global public good, it often ranks lower on a country's own spending priorities. However, because the resources freed up by the debt swap are viewed as additional by the authorities (considering they would have been spent on debt service), there is greater willingness to commit to these aims. This instrument could be decisive in achieving important development outcomes, particularly in cases where spending in the selected area would not occur without the debt swap due to historical fiscal policy choices, donor preferences, or political economy factors in the country. Therefore, the evaluation of a potential swap should consider its broader positive global impact, beyond just the immediate financial benefits to the debtor country.

(iv) The degree of expenditure earmarking

28. When designing the program supported by the debt for development swap, both creditor and debtor will need to determine the degree of earmarking that is being used. **In a continuum of possible design options ranging from strict earmarking and ring-fencing of resources outside the country and more flexible earmarking in the context of country programs and non-earmarking modalities, this note supports a more frequent use of the latter two.** They would rely more on the debtor government contractual commitment to specific outputs and outcomes. In the absence of earmarking or commitment for new expenditures, debt service savings can help improve the overall fiscal position of the country, while the results foreseen in the swap

development program can be financed through efficiency improvements, within sector reallocation of resources, or other financing sources.

(v) Implementation arrangements

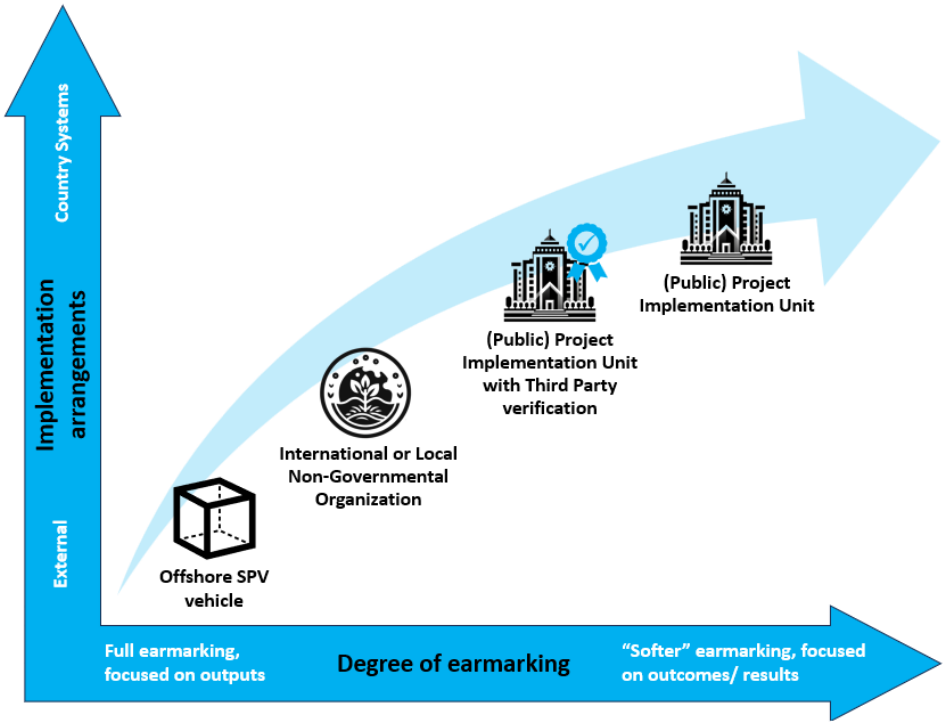
29. Implementation arrangements reflect donors/debtors'/other parties' interest in involving other national and international partners (e.g., NGOs, international agencies). Up to now, debt for development swap programs have been heavily ringfenced, including using trust entities administered outside the debtor country. The arrangements have a substantial impact on the transaction costs associated with the debt swap and its cost-benefit analysis.

30. For example, some recent debt swap experiences have utilized special purpose vehicles (SPVs) and fully ringfenced trust funds (TFs) established outside the debtor country. SPVs and TFs have been used to issue new bonds, finance the buyback of existing debtor bonds in secondary markets, and manage funds dedicated to spending commitment programs associated with the swaps.

31. The use of these entities places key debt swap fund flows and activities outside the debtor country's direct control, allowing creditors and stakeholders to establish rules and processes for fund administration and verification that meet their specifications, although SPVs/TFs can be managed by joint creditor-donor-stakeholder interests and offer independent administration of funds and activities. Trust funds used in debt swaps typically have strict rules for accessing funds, which are usually granted to the NGO or institution responsible for carrying out the expenditure commitment. These funds are kept separate from the debtor's national budget, ensuring dedicated management and oversight of the swap-related activities and finances. This fragmentation creates challenges from a PFM perspective.

32. The choice of the earmarking level, which in turn drives the implementation arrangement can be seen from different perspectives. First, implementation capacity matters. The more capacity displayed by the debtor country, the least ringfenced and straightjacketed the structure should be (Figure 2). Countries have made significant progress in their PFM systems, and that progress should be recognized when it corresponds with more trust in their country systems and budget process while strengthening accountability for results. Second, country ownership matters for good implementation and sustainability. When a reasonable level of implementation capacity is present in the debtor country, and a solid accountability framework can be put in place, relying on the country systems will increase implementation success through ownership. Moreover, it would also enhance the likelihood of sustainability of the commitment over time, even beyond the contractual period. TA can help fill capacity gaps. And last but not least, the Treasury and DMO should always be involved in the negotiation of the swap agreements and be able to monitor the transactions if failure to deliver on commitments could trigger guarantees or a default event.

Figure 2. Design Trade-offs



Source: World Bank staff.

(vi) Mechanisms for monitoring, verification, and accountability

33. The success of debt for development swaps, particularly of those with more flexible arrangements, depends on the attainment of the goals and results of the targeted development programs. The experience from recent swaps, points to the extensive use of the third-party verification systems. As monitoring and verification mechanisms are put in place, there are important considerations to decide between independent/external and in-house systems, including:

- Appropriate budget nomenclature to show the use of funds.
- Appropriate internal controls and internal audit.
- External oversight: need to report to the public, to partners, to creditors, and to parliament.
- Third party verification of results achieved (in case Key Performance Indicators are related to outcomes) – **this could connect to output-based aid, for example World Bank's Program for Results (PforRs) operations or equivalent**.
- Defined mechanisms in case of accountability issues, including when fiscal space is not helping the climate, education, or nature objective of the swap.

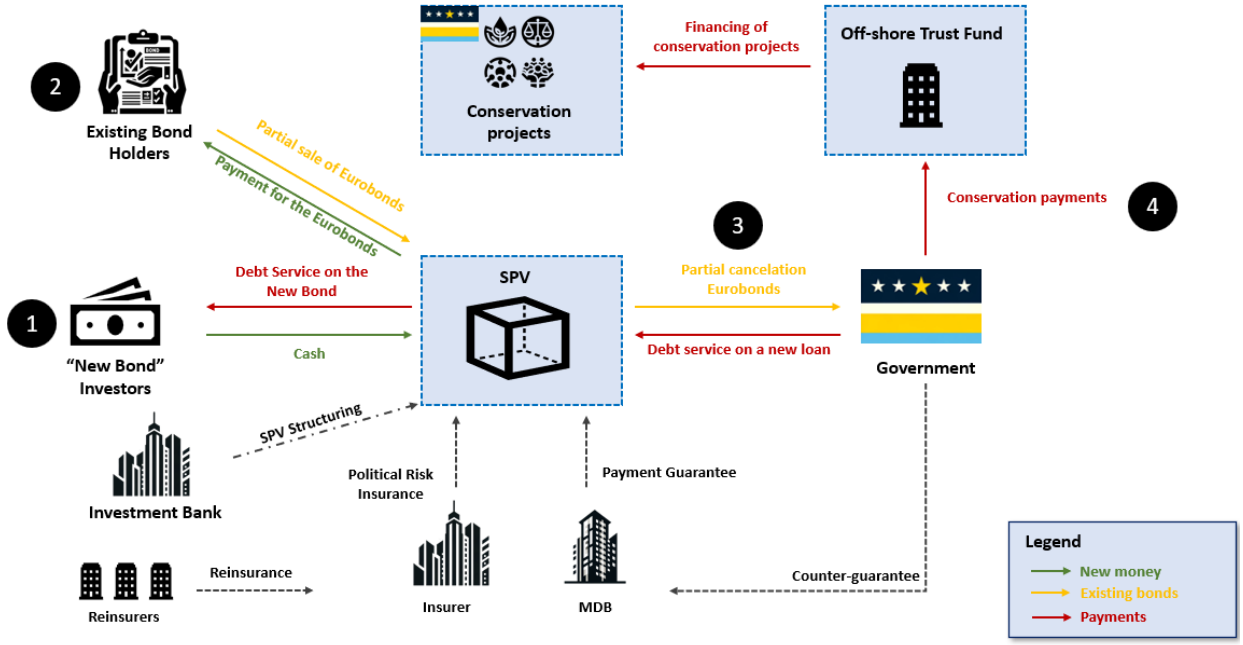
34. **A more flexible approach to spending commitments, aimed at results rather than inputs, and that relies more heavily on country systems could improve the effectiveness of debt swaps.** This could be achieved for example by drawing results frameworks, external monitoring, and supervision from parallel PforRs operations by the World Bank. Overall, less heavy-handed earmarking and more dependence on country systems and institutions, with support of the World Bank and other IFIs, including with their lending instruments, can be more effective

in many countries with a certain level of capacity and stronger implementation track record. Such transactions would also be less costly, thereby improving the value proposition of debt swaps. In evaluating different design options, stakeholders could rely on World Bank and IMF assessments, such as DeMPA, PEFA, and the Country Policy and Institutional Assessment (CPIA) in the areas of Quality of Budgetary and Financial Management, Quality of Public Administration, and Transparency, Accountability, and Corruption in the Public Sector.

(3) Potential role of the World Bank Group in debt for development swaps

35. The approach framework presented in this paper offers opportunities to simplify hitherto debt for development swap transactions, lower their administrative costs, and increase transparency (Figure 3). In addition, the World Bank Group involvement in swaps can also help increase reliance on country systems, improve institutions and build capacity.

Figure 3. Most common approach to the recent debt-for-nature swap transactions



Source: World Bank staff

36. ***Key considerations***. The WB support to debt for development transactions would be based on: **(i) a clear identification of development benefits for client countries; (ii) the Bank's policy that guides our existing instruments; (iii) existing country programs and IDA allocations and IBRD exposure limits; (iii) strong macro-fiscal and growth policies where needed, avoiding weakening incentives for prudent policies; and (iv) burden sharing consideration**.

37. IBRD/IDA and MIGA can support countries to develop innovative, integrated financing solutions to facilitate debt for development swap transactions that are tailored to their macro-fiscal conditions and sectoral development priorities. The World Bank is uniquely equipped to assist developing countries at different stages of debt swap transaction, including with: (i) analytics on the design, (ii) financing, (iii) technical assistance and capacity building to the debt management

office, and (iv) facilitating financial and implementation support and monitoring to the transaction. The nature of the role to be played by IBRD/IDA would be considered on a case-by-case basis and would depend on country circumstances, country debt portfolio, and the country's stage of debt swap transaction engagement. Conflicts of interest, actual or perceived, (such as one that might arise where IBRD/IDA plays an upstream and a downstream role) would be navigated in accordance with IBRD/IDA's usual approaches.

38. ***Analytics on the design*.** The analytical component is critical to enable a good design of the overall debt relief of the swap and that of the expenditure program committed. Analytical support can include determination of the appropriateness of country and sectoral circumstances for a debt swap transaction, assisting clients in the evaluation of financing options, and providing support for the efficient implementation of transactions. Analytical support might be also provided for the design and implementation of the sectoral programs and/or monitoring and verification process.

39. ***Financing*.** On the financing side, the World Bank Group has a full suite of available instruments to support debt for development swaps. The Bank can be involved in direct financing of the swap transaction and by doing so, maximize financial efficiency of such transactions and ensure strong development results (Table 1). Bank's financing instruments can also be used to support results in expenditure programs committed through the debt swap transactions.

40. In the case of ***commercial debt swaps*** involving outstanding bonds or commercial loans, a straightforward way would be to provide direct budget support loan or a credit enhancement (guarantee) through a development policy financing (DPF) operation.[12] In the case of budget support operation, the lower cost, longer-term loan from IBRD/IDA would refinance the more expensive outstanding commercial debt.[13] The realized debt service savings could be used for a spending commitment by the government toward a development goal. The DPF prior actions could also provide support for relevant institutional and policy changes needed to achieve the goal, as needed. In the case of a credit enhancement operation, the new debt instrument would be guaranteed by the WBG, through an IDA/IBRD Policy Based Guarantee (PBG) or a combination of a PBG and a MIGA guarantee, to lower its cost and improve its terms. Another option in this area would be a contingent investment financing (IPF DDO) to provide a first loss backstop.

41. In the case of ***bilateral debt swaps***, the WB financing would come into play in a different form. The bilateral lender would forgive its debt to a sovereign based on development results achieved over time and those results could be supported by a WB PforR operation (Figure 4). The WB would verify that the expenditure program is not reduced (or increased based on analysis and agreement) and would support and verify contractual periodic results/outcomes on the program. Given the gradual debt reduction over a specified period of time, the WB could explore supporting

[12] DPFs could be used only when policy requirements are met, in particular the member country has a robust program that promotes growth and sustainable poverty reduction, and the Bank has determined that the macroeconomic policy framework is adequate for budget support.

[13] DPF loans are not earmarked. However, there is the possibility (mentioned in the DPF policy) to use the DPF financial resources in support of loan restructuring, equity conversion, or interest rate swaps relating to debt not previously guaranteed by the Bank (DPF for debt and debt service reduction) based on specific conditions and in line with specific policy requirements.

such debt swap transactions in tranches via a Program for Results (PforR) operation to the country to accompany the expenditure program committed, support capacity building, and to monitor and verify specific results. If such PforR loan is part of country's envelope, it can successfully leverage expenditure program and lower transaction costs, benefitting both the debtor and the donor.

42. Both, in the case of commercial and bilateral swaps, the Bank's involvement in debt service savings monitoring through the PforR would not close the option of third-party verification/support to the program commitment by NGOs and other agencies, in the context of the flexibilization proposed in the note.

43. **Other WB support options**. They may include expanding the scope, or "repurposing" existing trust funds for debt relief, debt, and debt service reduction support, or creating new trust funds/facilities.[14] Such trust funds could be deployed with other financing modalities to further soften the financial terms for debtor countries. In addition, trust fund proceeds could be used as grants that provide financial incentives to WB performance-linked loans used to refinance the more expensive market debt. This would be an additional incentive to the DPF, IPF, or P4R described above whereby the use of proceeds would cover the buyback and the grant funding buys down the interest of the associated loans that are funding the buyback.

44. Moreover, innovative financing tools such as the ***WB Capital At Risk notes*** could be deployed to facilitate debt swap transactions. This structure would involve IBRD issuing a World Bank Capital at Risk (CAR) note, whereby a portion of it is kept on the IBRD balance sheet, and the other portion is then used to passthrough to a sovereign for the purpose of buying back outstanding commercial debt. The sovereign will then commit to pay IBRD the interest and principal of this portion of the IBRD CAR note on agreed-upon terms. The sovereign's payment obligation to IBRD will be partially or fully guaranteed by donors or credit support providers, which would bring down substantially the cost of this obligation to the sovereign. A portion of the cost savings can be used to fund agreed-upon development activities.

45. IBRD's innovative **outcome bonds** could also be used to accompany debt swap transactions, as a way to leverage expenditure programs supported by the debt swaps. The feasibility of this and the design of the transaction will need to be assessed and developed on a case-by-case basis.

46. Overall, the Bank can use all available IBRD/IDA instruments to appropriately provide direct financing of the swaps, which would require a careful cost-benefit analysis and WB portfolio impact assessment and would be limited to countries that have an adequate macroeconomic framework.

47. Assessing WB financing options and tools would need to consider analyzing some additional factors:

[14] The IDA-administered Debt Reduction Facility (DRF), set up in 1989, has supported operations that helped extinguish US$10.3 billion of external commercial debt owed by 21 countries, providing a significant contribution in terms of commercial creditor participation under the HIPC Initiative and helping address litigation challenges. The outstanding balance of the trust fund is US$ 150 million.

- Costs to client: DPF is likely cheaper than market borrowing with a guarantee or (partial) credit enhancements.
- Complexity in setting up, ability to scale- the more innovative instruments will be harder to deploy.
- Envelope - DPF / IPF/ PBG comes from country envelope, limiting other priority engagements.
- Impact of default.
- Risk of guarantee on WB balance sheet.

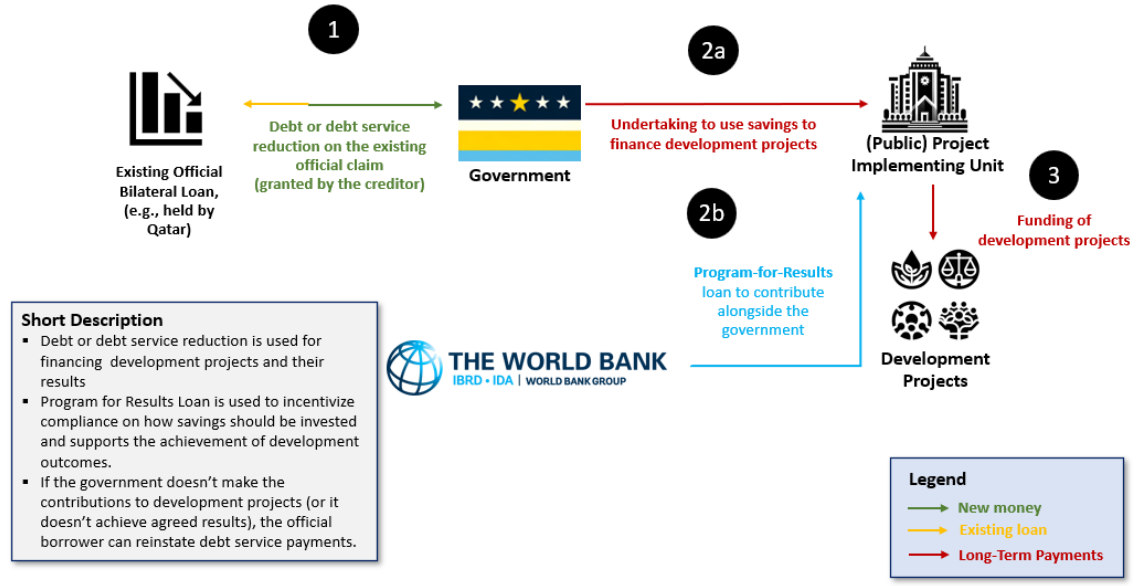
Table 1: WB Financial Instruments to Support Debt Swaps at Different Transaction Stages

Instrument	**Description**
Development Policy Financing (DPF) Loan	Allow for the flexible deployment of a DPF loan to a client to finance the buyback of outstanding commercial debt directly. (Figure 5)
Development Policy Financing (DPF) Guarantee	Provide a partial guarantee (policy-based guarantee) to credit enhance a client bond or loan issuance to enable the refinancing of more expensive outstanding commercial debt. (Figure 6)
Contingent investment Project Financing (IPF)	Provide a partial credit enhancement through a partial credit guarantee (IPF) for a client bond or loan to enable the refinancing of outstanding commercial debt.
Program for Results (PforR)	A Program for Results (PforR) loan can be earmarked to leverage expenditure programs supported by the swap in tranches based on the country achieving specified development outcomes. It could also facilitate monitoring and verification of the expenditure commitments or achievement of results. (Figure 4, Figure 5, Figure 6)
Performance-Linked Loan	With donor support (or funding from the repurposed DRF – see below), the WB can provide the principal funding for the debt swap through a performance-linked loan that financially incentivizes the achievement of development results through funding performance-based interest buydowns of a new WB loan. This type of loan could be structured as a DPF, IPF, or P4R operation.
Repurposing the Debt Reduction Facility (DRF)	Enable the DRF to use the available grant financing to provide a form of partial credit enhancement (e.g., first loss pool or cash collateral) to a client bond or loan issuance to refinance commercial debt. DRF resources could also be deployed as a source of funding for the advisory services needed for the swap design.
Co-Financing with other development finance institutions (DFIs)	Provide a PBG or DPF for one portion of the risk, with another DFI (and/or MIGA) covering a different portion to fully credit enhance a client bond or loan issuance to refinance more expensive existing debt (e.g., recent debt swap models). The cost-benefit of using WBG funds to fully credit enhance versus direct financing need to be carefully evaluated.
Capital at Risk (CAR) Notes Program[15]	IBRD issues a bond whereby a portion of the principal is passed through to a client country for purposes of retiring commercial debt. A portion of the debt service savings can then be earmarked for agreed upon expenditures. (Figure 7)

Note: The use of all World Bank's instruments will be guided by the requirements specified in their respective policies.
Source: World Bank Staff

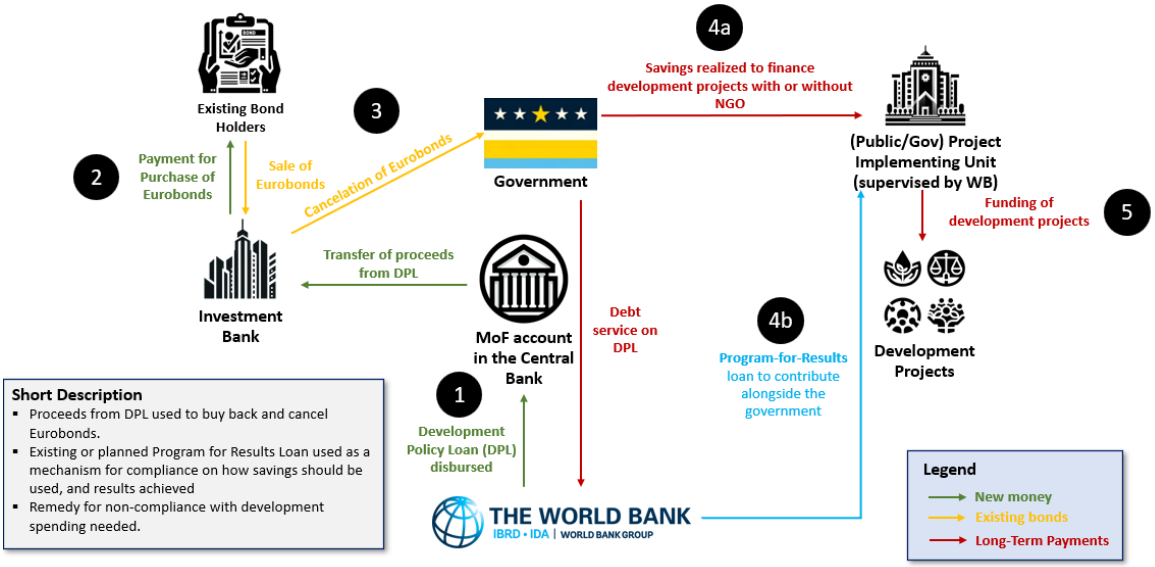
[15] For more, see: https://treasury.worldbank.org/en/about/unit/treasury/ibrd/ibrd-capital-at-risk-notes and https://thedocs.worldbank.org/en/doc/5bd3f2d8baa90de07a0fce4f508e4b6b-0340022021/original/IBRD-CAR-Prospectus-Supplement-2021.pdf

Figure 4. Bilateral Structure with a Program-for-Results Loan



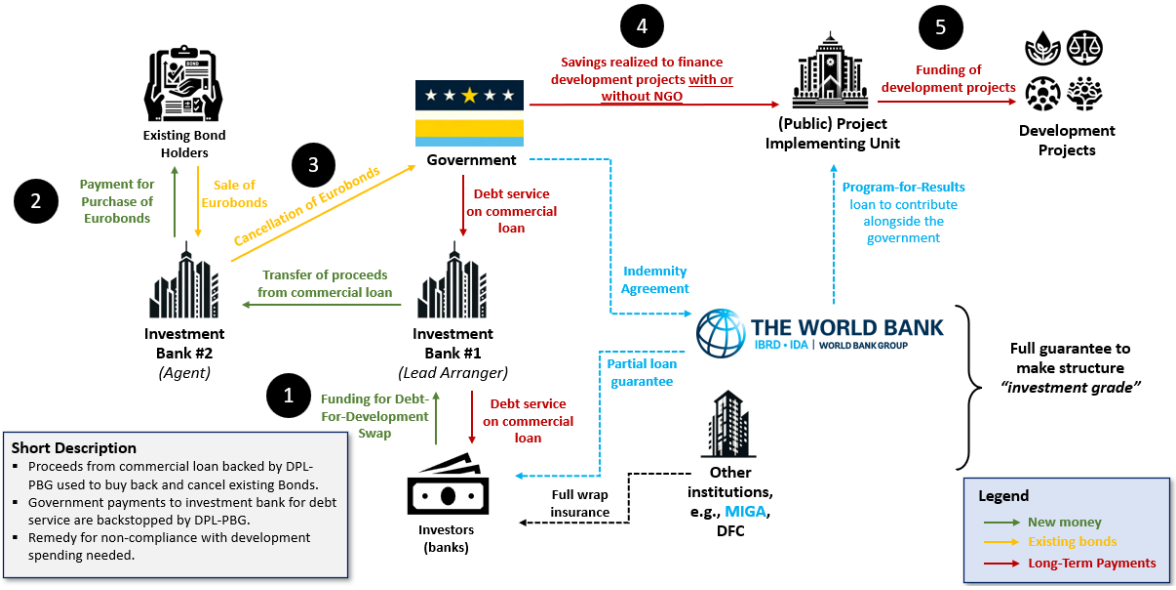
Source: World Bank staff

Figure 5. Multi-Party Structure with a plain vanilla Development Policy Loan and a complementary Program for Results Loan



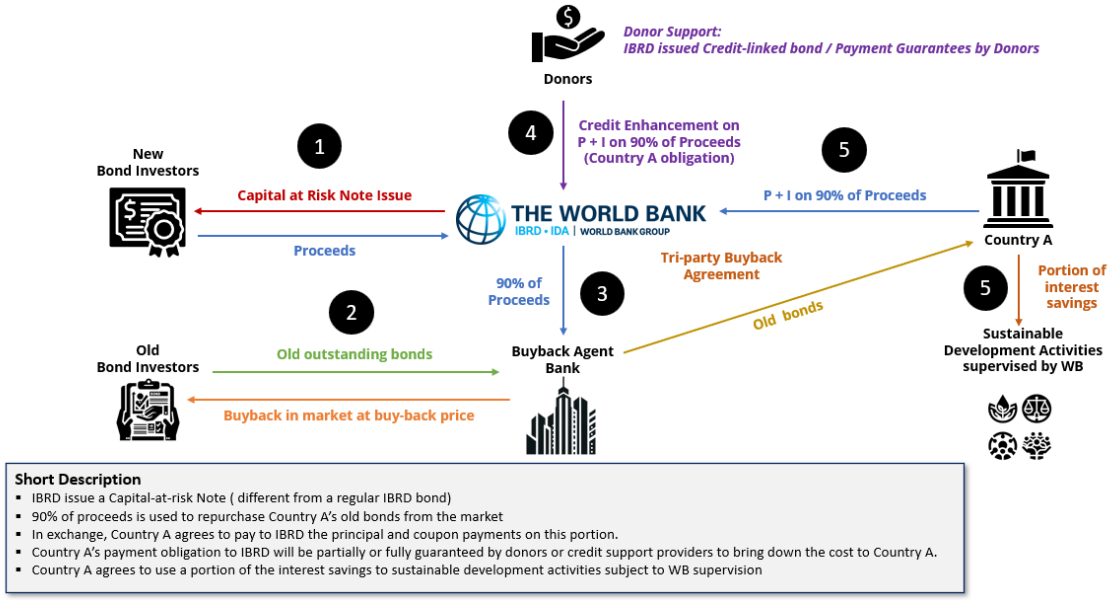
Source: World Bank staff

Figure 6. Multi-Party Structure with Policy-Based Guarantee on a commercial loan (to pay for outstanding bonds) and a complementary Program-for-Results Loan



Source: World Bank staff

Figure 7. Capital At Risk Note for Debt Swaps



Source: World Bank staff

48. ***Technical assistance and capacity building to the debt management office***. Swaps (especially debt buyback swaps) are complex operations. The World Bank can provide technical assistance on how to evaluate whether a debt swap has positive financial benefits for the borrower, which debt instruments are best candidates to buy back and how to structure the deal to ensure simplicity and alignment with the debt management strategy, analyze, record, and report on the

swap and support its cash management component. Once a debt swap is agreed, the DMO also needs the capacity to monitor the transaction over the life of the debt swap.

49. **Facilitating financial and implementation support and monitoring to the transaction:** The Bank can also provide overall transaction advisory support, including by assisting countries in the evaluation of financing options and providing support for the efficient implementation of transactions and acting as a public-private sector bridge and minimizing transaction costs.

Table 2: WB Support to Client Countries Considering Debt Swap Transaction

Role	Description
Analytics on the design	• Determine the appropriateness of debt for development swaps for the country • Assess the debt sustainability and debt composition • Determine the most suitable commercial or bilateral debt to swap/ buyback • Analyze the financial terms needed to make the debt swap favorable from a debt management perspective • Assist in designing and implementing development program at the sectoral level
Technical assistance and capacity building to the debt management office	• Support debt management offices (DMOs) on the process of debt swaps • Work with the DMOs to build understanding of the other ministries on debt swaps • Build the guidelines for the use of proceeds from the debt swaps • Craft the framework for a new bond issuance if it is through a green, social, sustainable, or sustainability-linked bond
Facilitating financial and implementation support and monitoring to the transaction	• Advise on potential parameters of a debt swap transaction, including provide guidance on the range of potential financial instruments available to underpin the refinancing transaction and which is most efficient • Help with the selection process for transaction arrangers and other advisors • Provide support to the monitoring and verification process

Source: World Bank staff