SUSTAINABILITY-LINKED
SOVEREIGN DEBT
HUB

Technical Annex: Sustainability-Linked Sovereign Debt

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Concept Summary

Low-income countries are suffering from a triple crisis of unsustainable debt burdens, escalating costs of climate change mitigation and adaptation, and adverse economic impacts of climate shocks and biodiversity loss. Countries increasingly cannot afford to address nature- and climate-related imperatives due to mounting debt service bills and reduced access to financing amid high market interest rates and constrained development funding. According to the World Bank, almost 60% of low-income countries are at high risk of or already in debt distress, with most of their external debt owed to private creditors. Of particular concern are the 58 countries of the Vulnerable Twenty (V20) whose economies and 1.5 billion people are especially exposed to climate change while facing $435 billion in debt payments by 2028.

Sustainability-linked sovereign debt (SLSD) is a performance-based financial instrument that commits its issuer to achieving certain predefined and forward-looking sustainability targets. Unlike labelled use-of-proceed (UoP) debt instruments (e.g., green, social or blue bonds), SLSD is not project-based, and the issuance proceeds can be used for general budgetary purposes, meaning they need not necessarily be directed towards specific projects. Sustainability performance targets (SPTs) set out the overarching goals that the issuer seeks to achieve, which may already be specified in existing climate or nature conservation policies, or pledges such as the Paris Agreement's Nationally Determined Contributions (NDCs). The targets should be ambitious and represent a material improvement in sustainability performance beyond "business as usual." Progress towards achieving these targets is assessed through select key performance indicators (KPIs), which are relevant, material, quantifiable, externally verifiable metrics that can be benchmarked reliably. Finally, measurement, reporting, and verification (MRV) comprise the data and processes whereby performance is tracked and validated by investors and third parties.

Sustainability-linked sovereign financing can help to address the triple crisis. Sustainability-linked bonds (SLBs) and debt-for-nature conversions/swaps (DNSs) enhance the credibility of countries' international commitments by embedding material financial incentives to achieve sustainability targets, along with key performance indicators to assess progress. They lower the cost of borrowing by mitigating long-term sources of sovereign default risk and by appealing to the growing base of ESG-oriented (environmental, social, governance) investors.

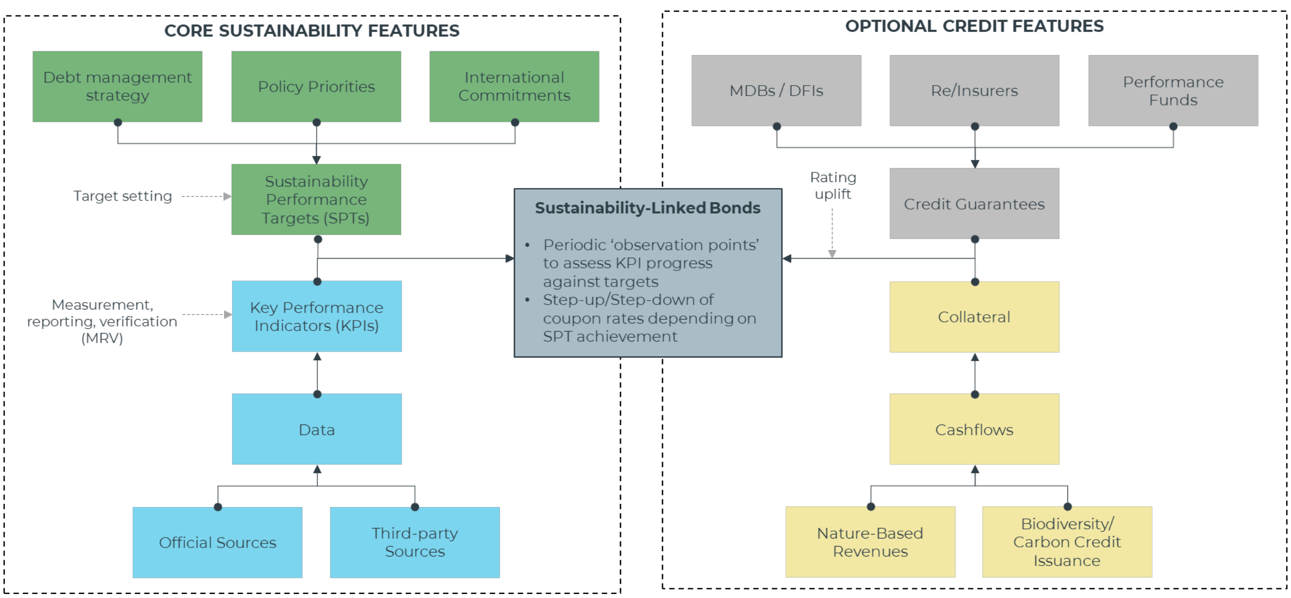
Track Record to Date

The SLSD market is still in its infancy. The inaugural SLB was issued by Chile in March 2022 with a US$2 billion 20-year offering, followed shortly thereafter by Uruguay in October 2022 with a US$1.5 billion SLB maturing in 2034. DNS transactions date back to the 1980s, but regained prominence in 2018 with the US$15m Seychelles DNS, followed in 2021 by the US$364m Belize DNS, and in 2022 by US$150m Barbados refinancing operation. In May 2023, Ecuador announced US$656m DNS that aims to channel at least US$12m per annum into conservation of the Galapagos Islands.

From the starting point of a mere US$3.5 billion at the end of 2022, the issuance of SLBs from emerging market and developing economy sovereigns has the potential to reach between US$250 billion and US$400 billion by 2030, according to NatureFinance estimates. Coming off a low base, the volume of issuance has the potential to grow approximately 100-fold over this period, driven by an anticipated easing of the demand and supply constraints. Under a baseline scenario, every sovereign with market access presently can be expected to issue at least two bonds during the seven-year forecast horizon. This performance would mirror the trajectory of the sovereign ESG debt issuance more broadly, which grew from under US$1 billion in 2016 to over US$120 billion of green, social, sustainable, and sustainability-linked (GSSS) bonds five years later.

Instrument Mechanics

Sustainability-linked sovereign financing can take many forms, but certain core building blocks and add-ons are sketched out below.



Source: SSDH

Scaling pathways

There are at least seven critical pathways to scaling the SLSD market. Modestly scaled deals, including refinancing of the whole debt stock of smaller sovereigns, have been effective in delivering proof of concept and policy engagement. Developing a self-sustaining market for SLSD instruments requires unblocking supply- and demand-side constraints, in particular:

1. **Credit enhancement** stimulates demand for SLSD, and by extension, lowers the borrowing costs of SLSD by de-risking transactions and crowding in private investors to multiply the impact of public funds.
2. **Climate/nature/disaster risk finance** initiatives can incorporate SLSD in their arrangements to strengthen the credibility of commitments and crowd-in private finance.
3. **Standardization** creates a common denominator for market participants to measure and evaluate performance, promote best practices and build trust between the contractual parties.
4. **Capacity building** covers the variety of efforts to make up for shortfall in technical and human capacity needed to structure and launch SLSDs on the issuer side, as well as campaigns to raise awareness and address misconceptions on the investor side.
5. **Enabling regulation and market development** encompasses rules set by financial and monetary authorities that can hinder or support market uptake and liquidity, as well as direct policy interventions to stimulate demand for SLSD instruments.
6. **Fiscal rules and frameworks** can encourage (or hinder) the adoption of SLSD instruments by sovereigns, and so impact the extent to which these instruments can be accommodated within longer-term budget plans and public financial management strategies.
7. **Nature market linkages** both expand the range of KPIs and SPTs available for SLSDs, and connect nature-based revenues that can support performance in pursuit of nature-related goals.