Piloting a debt-for-climate swap in Mozambique

Concept note - August 2023

Summary

This note describes the concept for a Debt-for-climate swap proposal in Mozambique that will be supported by Belgium through its bilateral agency, Enabel.

The Debt-for-climate swap is "*an instrument whereby debtor countries* (in this case Mozambique) *are relieved from their contractual debt obligations* (in this case toward Belgium) *in return for local climate-related spending commitments*[1], being in this case complementary actions to the new bilateral portfolio on "Loss and damage".

Piloting a debt-for-climate swap in Mozambique will generate a triple win :

- **For Mozambique** : by testing an innovative instrument to tackle debt level and climate concerns simultaneously. The "debt" funds will stay in Mozambique "for Mozambican development" rather than being reimbursed to Belgium, and the capacity of Mozambican institutions will be reinforced;
- **For Belgium** : by strengthening climate and green investments and spearheading innovative forms of international development and climate finance (political announcement foreseen at the next COP in December 2023), the new innovative concept will lead to larger scale initiatives with other countries;
- **For Enabel** : by putting our 2030 "Beyond aid agenda" into practice by developing new financing models that are not only dependent on grants, but also facilitating access to innovative financing instruments to our partner countries and Belgian expertise. The debt amount will be pooled with and added to the new bilateral portfolio (+ 2.4 M€).

[1] Essers, D., Cassimon, D., Prowse, M., 2021. Debt-for-climate swaps: Killing two birds with one stone? Global Environmental Change 71, 102407. https://doi.org/10.1016/j.gloenvcha.2021.102407

Key data on the debt-for-climate swap opportunity in Mozambique

- **Total amount of the debt** : 5,674,595.81 €[2]
- **Potential amount for the debt swap** : 2,423,317.34 €, i.e. the total outstanding debt to be repaid between 15 December 2023 and 31 December 2028 (see annex 1)
- **Time frame** : 5 years (2023- 2028) (refund until 31/12/2028 at the same rate as the normally foreseen repayment of the government debt)
- **Key actors** :
    - MOZ : Ministry of Finance, Ministry of Foreign Affairs and National Institute of Disaster Risk Reduction and Management (INGD);
    - BE : Ministry of Finance, DGD, diplomatic office in MOZ, Enabel;
- **Topic** : Loss and damage
    - **Sub-topic**: Early warning systems, integrated territorial planning and disaster risk reduction.
- **General and Specific Objectives and Results** : aligned with bilateral portfolio with a focus on loss and damage
    - **General Objective** : To support and institutionally strengthen Mozambique so that the transition to a climate-resilient and low-carbon economy can be achieved in an inclusive way with consideration of vulnerable communities in both rural and urban areas.
    - **Specific Objective** : Mozambican authorities and communities, including women, youth, and other vulnerable groups, are strengthened to anticipate and prepare the risks of loss and damage.
    - **Result :**
        - **R1** - Integrated Early Warning Systems are deployed and modernized and information on loss and damage is disseminated
        - **R2** - Preparedness to hazardous events is increased through development of an integrated forecasting system for floods, cyclones, and hydrological droughts in a selected territory
        - **R3**- Governance in the loss and damage sector is improved (transversal result)
- **Geographic focus**: Gaza, Nampula, Zambezia and/or Manica. A geographical prioritization will be made in the inception phase according to criteria such as : (i) absence of early warning system in place in the districts, (ii) presence of other partners working on the topic (coordination)
- **Implementation modalities** : aligned with bilateral portfolio with specificities linked to the debt-for-climate swap architecture (Implementation 66 months)

[2] on the 09/05/2023

Context analysis

General context : loss and damage in Mozambique

Mozambique has already experienced several climate disasters in the past few years with a significant impact on the economy. **Loss and damage** (L&D) of extreme weather events including cyclones, droughts and floods are estimated at $3billion in 2019[3]. A large share of Mozambican current and future population will face more frequent and intense climate events due to its geographic location and high levels of exposure and vulnerability to climate hazards.

Loss and damage , are defined by the Intergovernmental Panel on Climate Change (IPCC) as "*the observed impact and projected risks of climate change that have not been, or cannot be, avoided through mitigation and adaptation efforts*". While loss and damage are often considered in relation to sudden-onset disasters and their economic costs, the terms also include the impact of slow-onset processes and non-economic loss and damage.

The past decade has confirmed that the natural variability of Mozambique´s water resources is progressively being exacerbated by climate change. Storms, droughts, and floods occur more frequently and more severely. The cyclones Idai and Kenneth, and recently Freddy, as well as the collateral devastating floods caused the loss of many lives and livelihoods and caused tremendous damage. Also, the prolonged dry spells are becoming more and more damaging. Climate change is impacting on almost all economic and social sectors: agriculture, water management, drinking water supply and sanitation, housing, health, fisheries, transport, education, the environment, tourism, energy, etc.

In this context, a spectrum of actions exists in responding to and preventing climate impacts. It becomes increasingly important to strengthen actions to **prevent further economic and non-economic loss and damage** for the country because of climatic events. **Focusing on pre-emptive action** and **contingency measures** is an area of intervention that could be built upon to support the Government of Mozambique in its efforts to effectively combat climate action. This will be aligned with national strategies or initiatives.

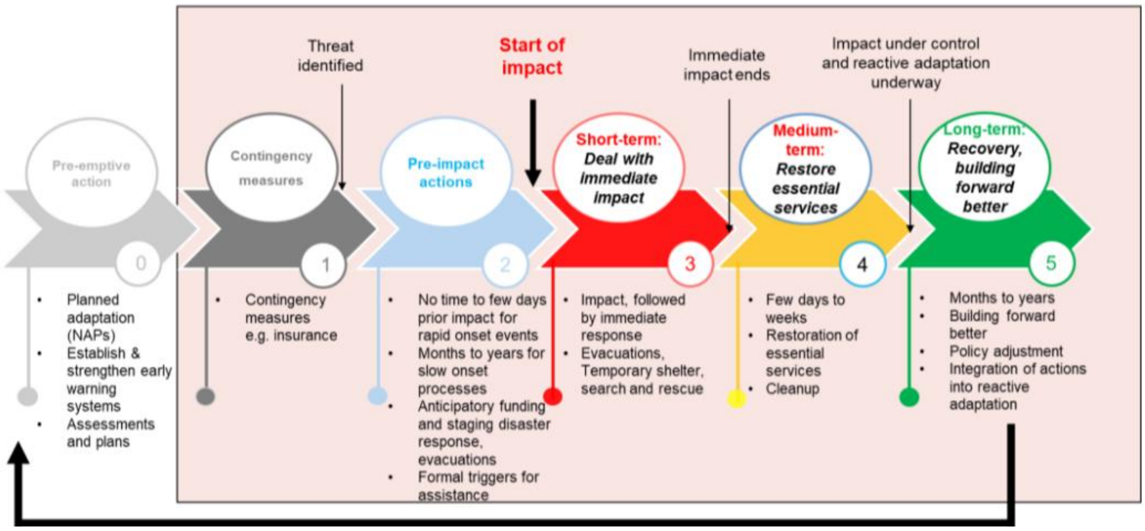


Figure 1 : Spectrum of illustrative actions in responding to climate impacts.

[3] World Bank.2021. Mozambique Country Programme Evaluation, approach paper.

Debt for climate swap potential

About debt swaps

Debt swaps refer to agreements between a creditor and a debtor, wherein the existing debt is replaced by a new instrument or commitment, entailing some financial relief for the debtor and a reallocation of cash flows towards targeted objectives.

Because of their (i) potential positive impact on debt metrics and (ii) associated commitment to pursue SDG-related objectives, debt swaps are getting increased attention from international financial institutions.

Debt for-climate swaps

Debt-for-Climate (DFC) swaps are a type of debt swap in which the debtor nation, instead of continuing to make external debt payments in a foreign currency, makes payments in local currency to finance climate projects domestically on agreed upon terms.

Under a debt-for-climate swap, creditor countries (e.g. Italy, Belgium, Portugal, Spain ...) allow debtor governments (e.g. Mozambique) to reduce their contractual debt obligations (contributing to debt sustainability) in return for a commitment to devote the freed-up resources to local climate-related spending (contributing to climate change mitigation and/or adaptation and/or loss and damage).

DFC swaps can reduce the level of indebtedness as well as free up fiscal resources to be spent on green investments.

They have figured prominently in the public debate in recent years as a potential scalable solution to help address debt, climate, and biodiversity crises, and to provide additional financing towards the achievement of the SDGs.

Debt for climate swaps are in line with Belgium's position note on debt relief elaborated in 2022 [4].

Structure of DFC Swaps

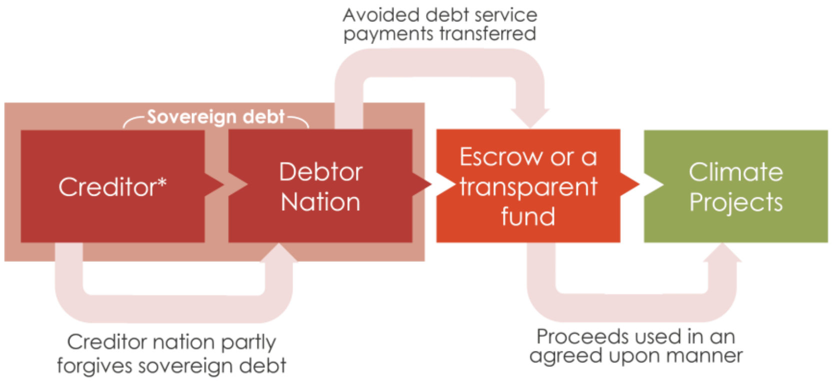


Figure 2 :Illustration of DFC swaps mechanism

While each transaction will vary, a generic structure of a DFC swap agreement is represented by the following instrument mechanics (see figure 2).

Alternatively, new debt can be issued by a debtor nation to replace existing debt with a commitment to use proceeds to address climate change through mutually agreed performance-linked incentives such as lower interest rates, grants, carbon offsets to service interest, etc.

[4] Schuldverlichting ten gunste van ontwikkelingslanden in de strijd tegen Covid-19 – Belgisch standpunt

In the perspective of a DFC, several options exist regarding the recipient entity. Based on examples from some countries (France, Spain, Italy, Germany, etc.) with respect to other countries (Seychelles, Bolivia, etc.), two options exist for this type of operation:

- A debt cancellation or debt swap is possible under a Paris Club agreement or an international agreement.
- A debt swap would be possible outside of the Paris Club agreement or an international agreement if some conditions (to be defined by the creditor country and with the debtor country) are fulfilled.

In this case, Belgium has decided in principle to register this debt swap under a Paris Club agreement.

Furthermore, a positive advice of the international monetary Fund (IMF) for this Debt for Climate Swap formula was received (see quote hereunder from 23 may 2023): " […] *The transaction seems beneficial to Mozambique, as instead of making payments in hard currency to an external creditor it would be making expenditures that presumably enhance its resilience and would have a large local content (so it helps through local multipliers effect, as well as relieving pressures on the BOP). […].*"

Debt for loss and damage swap

To respond to the magnitude of loss and damage, there is a need to develop innovative finance tools. During COP 27, several innovative instruments were proposed including international taxes, a dedicated finance facility for loss and damage and **debt for loss and damage swap**[5]. While debt for loss and damage swaps have never been piloted, there is a growing consensus that it could become a powerful instrument to cover loss and damage needs in the coming decades.

Piloting a debt for loss and damage swap in Mozambique

Mozambique is one of the country's most vulnerable to climate change and is not able to afford structural investment to strengthen climate resilience because their budgets are burdened by debt. It is proven that the more a country is subject to climate change, the more debt-for-climate swap become relevant[6]. Recent discussions between Mozambique and Belgium have identified an opportunity to pilot a debt-for-climate swap in Mozambique. This debt swaps provide opportunities for raising capital to address loss and damage and support green growth.

The total amount of the debt is 5,674,595.81 € and the potential amount dedicated for the debt swap will be 2,423,317.232 €, i.e. the total outstanding debt to be repaid between 15 December 2023 and 31 December 2028. The time frame for the payment will be 5 years (from 2023 to 31/12/2028). Key actors involved in the process are Ministry of Finance, Ministry of Foreign Affair and INGD on the Mozambican side and Ministry of Finance, DGD, diplomatic office and Enabel in Mozambique.

The rationale for piloting a debt- for- climate swap related to loss and damage is the following:

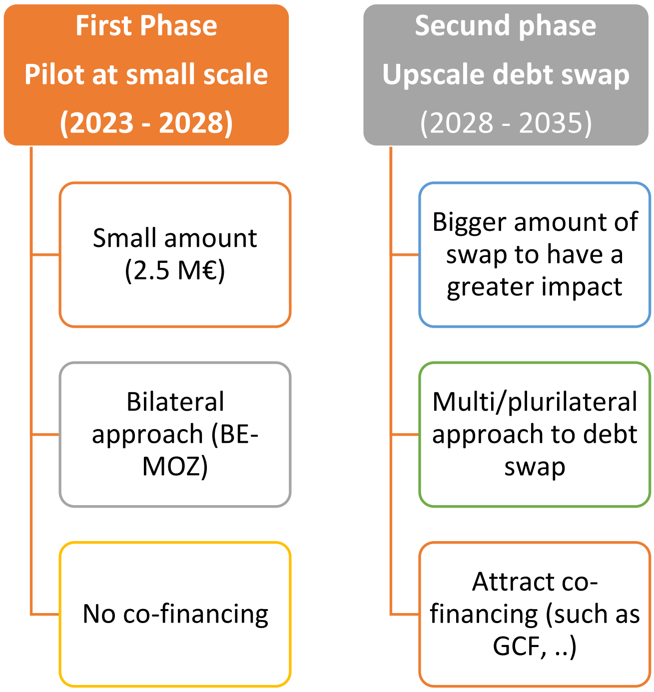
- Government of Mozambique has made disaster prevention and mitigation a policy priority;
- There are still many shortcomings in the process of collecting, assessing, managing, and disseminating data related to loss and damage;
- Government of Mozambique has also taken various steps to increase financial protection against sudden-onset disasters, but funding gaps for disaster response, recovery, and

[5] See https://www.unep.org/news-and-stories/story/what-you-need-know-about-cop27-loss-and-damage-fund
[6] ECDPM.2023. Upscaling Debt Swaps for greater impact

reconstruction remain significant (e.g., resource deficit for post-disaster reconstruction in 2013 and 2014 was at least MZN 8 billion (US$ 132 million));

- Lots of needs at local level (communities) regarding anticipation of sudden-onset disasters and slow-onset processes are not considered.

The choice has been made to **pilot a small-scale debt-for-climate swap** in a first phase with the ambition to upscale it in a second phase as shown in the figure here below. The pilot phase is seen as an initial small-scale implementation that is used to test and improve the viability of the concept. The objective of the upscaling is to address some of the main limitations of debt swaps[7] (such as lack of scale) and maximize sustainable development impact.



Strategic orientations

The strategic orientations will be :

- Alignment to national policies and strategies and comprehensive policy dialogue
- Support capacity building in climate finance (debt-for-climate swap) and loss and damage sector
- Triple anchorage : actions are implemented at the local level (‘operational’ level), national level (public institutions) and international level (at the level of fostering dialogue/collaboration with global initiatives/actors)
- Inclusion and gender equality
- Harmonization and search for synergies with Mozambican and Belgian expertise (Belgian expertise hub)
- Piloting and promoting Action Research and learning.

[7] For a detailed description of limitations and opportunities related to debt swaps see ECDPM.2023. Upscaling Debt Swaps for greater impact

Operational planning

The intervention will focus on what can be done to improve preparedness to avert, minimize and address loss and damage. Efforts will include (i) minimizing the exposure of lives, livelihoods, and assets to sudden-onset events and slow onset processes through mainstreaming climate resilience in public investments, territorial planning, and public finance (ii) increasing the resilience and reduce the vulnerabilities of exposed human and territory/natural systems to these events and (iii) building awareness and knowledge in this new field of action. The approach includes **risk management and resilience building** and **pro-active measures to better understand, avert and minimize risks of loss and damage.** In coordination with Mozambican institutions, two main areas of actions have been prioritized with the potential to impact more than 3000 people : 1) the deployment and/or modernization of integrated Early Warning Systems (Country initiative)[8] and (2) the dissemination of Integrated spatial planning to prepare to hazardous events.

1. **Deployment and/or modernization of integrated Early Warning Systems and dissemination of information**

Half of the countries globally do not have adequate early warning systems and even fewer have regulatory frameworks to link early warnings to emergency plans. The unprecedented flooding in Mozambique, Malawi, and Madagascar from Tropical Cyclone Freddy (March 2023) highlights once again that our weather and precipitation is becoming more extreme and that water-related hazards are on the rise. The worst affected areas have received months' worth of rainfall in a matter of days and the socio-economic impacts are catastrophic. Accurate early warnings combined with coordinated disaster management on the ground prevented the casualty toll from rising even higher. Besides avoiding damages, the weather, climate, and hydrological services are economically beneficial for agriculture, air, marine and ground transportation, energy, health, tourism, and various businesses.

Early warning systems are widely regarded as the "low-hanging fruit" because they are a relatively cheap and effective way of protecting people and assets from hazards:

- Early Warning Systems provide more than a tenfold return on investment.
- Just 24 hours' notice of an impending hazardous event can cut the ensuing damage by 30 per cent.
- The Global Commission on Adaptation found that spending just US$800 million on such systems in developing countries would avoid losses of $3 to 16 billion per year.

In March 2022, Mozambique launched a national initiative called 'One District, One Weather Station' to ensure national coverage of the country, through 154 districts, with early warning systems. This is an important contribution to the commitment to the implementation of the Master Plan for Disaster Risk Reduction 2021-2030. Following discussions with the National Institute of Disaster Risk Reduction and Management (INGD), as of January 2023, 66 districts remain without any type of early warning system or require rehabilitation for proper functioning. The focus will be on people-centered early warning systems, which incorporate local knowledge and capacities and consider the risks faced by women, youth, and other vulnerable communities if their barriers in terms of access to information and resources are not considered from the outset. Those systems, that are planned, tested, and maintained together with the population, have proven to work most effectively and be more sustainable.

[8] This action will be coordinated with other actors active in this field such as UNESCO

There is currently a lack of timely distribution of climate information to end users (community), therefore this action could also be supported by reinforcing dissemination efforts of district authorities so that risk information reaches those who most need in an understandable manner.

2. **Support and increase preparedness to hazardous events through development of an integrated forecasting system for floods, cyclones, hydrological droughts in selected territory**

Aligned with the deployment of early warning systems, integrated spatial planning and analysis can be adopted to map the flood risk areas and prepare development plans for infrastructure for protection and land use in the selected river basins. Integrated spatial planning is a critical tool to ensure adaptation and anticipate/prepare to hazardous events and could promote strengthened coordination between relevant sectors (IWRM, DDR, Climate, Agriculture). This will also ensure that the location of the infrastructures are optimized by using spatial information to understand the risks and the potential of a landscape and take appropriate decisions.

The implementation team will be composed of HR paid from the bilateral portfolio. A specific team is foreseen to develop the debt for swap intervention : IM, experts and support already foreseen in the bilateral portfolio will be supported by Intervention officers based in the province (to be added).

Implementation modalities

The implementation is carried out under the responsibility of Enabel in a logic of partnership with the national and local authorities concerned, also involving other actors in the (para)public sphere, the civil society, and the private sector. The implementation modalities are similar to the bilateral portfolio.

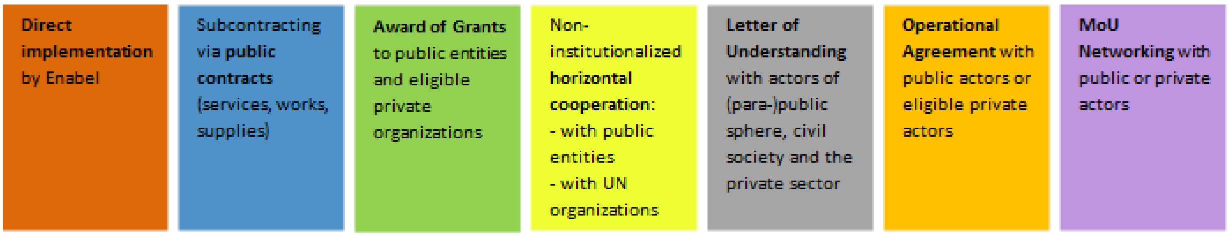


Figure 3: Implementation tools

In addition to direct implementation by its intervention teams and provision of expertise in various forms, and depending on the applicable legal and regulatory framework, Enabel can:

- subcontract operations (services, works and supplies) to economic operators via public contracts.
- resort to the award of grants for the implementation of portfolio components for which public or private organizations have a relevant mandate and appropriate capacity.
- resort to non-institutionalized horizontal cooperation through two instruments:
- cooperation agreements with public entities under Belgian or European public law in the areas of the portfolio for which these entities have specialized expertise with obvious added value;
- cooperation agreements with UN organizations for the implementation of portfolio components for which they have relevant mandate and appropriate capacity.

Three others contractual instruments[18] facilitate partnership relations within the framework of the Portfolio/interventions:

- The Letter of Understanding[19] formalizes the partnership between Enabel and the public institution(s) of the partner country involved in the coordination and/or implementation of the Portfolio/interventions, specifying the principles, structures, and methods of collaboration.
- The Operational Agreement between Enabel and an operational partner makes it possible to set the conditions under which certain Enabel support is made available or how Enabel involves certain actors in carrying out concrete activities.
- The Memorandum of Understanding (MoU) Networking expresses a convergence of will between Enabel and a partner, indicating a future common intention without constituting a binding legal commitment.

Except in the case of the operational agreement, which may provide for the financing of very specific and limited costs, these three instruments cannot give rise to a financial transfer.

Budget

Enabel

OS: Mozambican authorities and communities, including women, youth, and other vulnerable groups, are strengthened to anticipate and prepare the risks of losses and damages.

				PLANNING					
BUDGET in Euro			BUDGET TOTAL	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6 (6 months)
A		**Deployment and/or modernization of integrated Early Warning Systems and dissemination of information**	**810,000.00**	**132,500.00**	**132,500.00**	**132,500.00**	**132,500.00**	**120,000.00**	**160,000.00**
A	*01*	*Integrated Early Warning Systems are deployed and modernized and information on loss and damage is disseminated*	810,000.00	132,500.00	132,500.00	132,500.00	132,500.00	120,000.00	160,000.00
B		**Support and increase preparedness to hazardous events through development of an integrated forecasting system for floods, cyclones, hydrological droughts in selected territory**	**926,000.00**	**130,000.00**	**170,000.00**	**170,000.00**	**180,000.00**	**160,000.00**	**116,000.00**
B	*01*	*Preparedness to hazardous events is increased through development of an integrated forecasting system for floods, cyclones, and hydrological droughts in a selected territory*	526,000.00	50,000.00	90,000.00	90,000.00	100,000.00	100,000.00	96,000.00
B	*02*	*Governance in the loss and damage sector is improved*	400,000.00	80,000.00	80,000.00	80,000.00	80,000.00	60,000.00	20,000.00
Z		**General Means**	**427,675.30**	**66,282.00**	**60,682.00**	**60,682.00**	**69,182.00**	**105,562.00**	**65,285.00**
Z	*01*	*Human Resources*	349,680.00	50,520.00	50,520.00	50,520.00	50,520.00	98,400.00	49,200.00
Z	*02*	*Investments*	5,000.00	5,000.00	-	-	-	-	-
Z	*03*	*Operational Costs*	47,995.30	6,762.00	10,162.00	10,162.00	10,162.00	7,162.00	3,585.00
Z	*04*	*Audit- M&E and support*	25,000.00	4,000.00	-	-	8,500.00	-	12,500.00
TOTAL DIRECT COSTS			**2,163,675.30**	**328,782.00**	**363,182.00**	**363,182.00**	**381,682.00**	**385,562.00**	**341,285.00**
TOTAL INDIRECT COSTS			**259,642.04**	**39,453.84**	**43,581.84**	**43,581.84**	**45,801.84**	**46,268.44**	**40,954.20**
TOTAL BUDGET in Euro			**2,423,317.34**	**368,235.84**	**406,763.84**	**406,763.84**	**427,483.84**	**431,830.44**	**382,239.20**

Risks and Hypothesis

Description	Probability	Impact	Risk level	Mitigation measures
No clearance of MOZ and BE government to implement debt swap (documents not obtained)	Low	High	Medium	• Engage in a close dialogue with Minister of Finance and Foreign affair • Cooperation with other donors • Undertake feasibility studies of high quality
Limited interest and/or resistance to implement debt swap from institution, civil society, …	Medium	High	Medium	• Full-time long term technical assistance with adequate profile • Budget for activities and support devoted to sustain change processes • Involve partners in change processes • Swap designed in such a way that the Mozambique has sufficient ownership over the climate conditions
Insufficient capacity of MOZ to (re)pay the debt swap	Low	High	Medium	• Alignment of debt swap timing with original debt service schedule • Limited amount of money
Insufficient impact of the debt swap	High	Low	Medium	• Minimize transaction costs (by finding complementarities and economies of scale with bilateral portfolio) • Plan and design the upscaling of the debt swap (secund phase) • Engage a dialogue with other donors/partners to design a multilateral approach to debt swap • Identify co-financing opportunities

Annex

Annex 1- Debt between Mozambique and Belgium

Table 1.1 Debt specifications

Date of Signature	2002-06-10	2002-08-23	2004-07-24	2006-07-06	2008-03-31	2009-07-20
Period of grace	10 years	10 years	10 years	10 years	10 years	10 years
first payment date	2013-12-31	2013-12-31	2015-12-31	2017-12-31	2019-12-31	2020-12-31
final payment date	2033-12-31	2033-12-31	2035-12-31	2037-12-31	2038-12-31	2041-12-31
Amount of the loan	1 022 000	678 000	849 000	810 000	747 360	3 055 000
Amount used	1 022 000	678 000	849 000	810 000	747 360	3 055 000

Table 1.2 Summary of the yearly repayment foreseen to take into account (euros)

Year of repayment/date	Amounts in Euro	Yearly Repayment
2023		388.613,47
15 dec	30.545,47	
31 dec	358.068,00	
2024		419.158,94
15-juin	30.545,47	
15 dec	30.545,47	
31 dec	358.068,00	
2025		419.158,94
15-juin	30.545,47	
15 dec	30.545,47	
31 dec	358.068,00	
2026		419.158,94
15-juin	30.545,47	
15 dec	30.545,47	
31 dec	358.068,00	
2027		419.159,05
15-juin	30.545,47	
15 dec	30.545,58	
31 dec	358.068,00	
2028		358.068,00
31 dec	358.068,00	
TOTAL Repayment loan		**2.423.317,34**

Annex 2- Bibliography

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