Debt-for-Carbon/Using Carbon Credits for Debt Relief: Environmental Defense Fund Report

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The Environmental Defense Fund ("EDF") announced the issuance of a report titled:

DEBT-FOR-CARBON: USING CARBON CREDITS FOR DEBT RELIEF ("Report").

The Report was prepared by EDF and Perspectives Climate Research.

Authors include:

- Igor Shishlov.
- Holly Pearen.
- Luisa Weber.
- Axel Michaelowa.
- Pedro Martins Barata.
- Sandra Dalfiume.
- Ziqun Jia.

The Report states that climate vulnerability and sovereign debt distress have converged in what is described as:

… one of the defining macroeconomic challenges of this decade.

The challenge is stated to be affecting developing economies because of:

- Rising climate change impacts constraining fiscal space/raising borrowing costs.
- Limited access to concessional finance hampers investment in resilience/low-carbon growth.

The gap is stated to be bridged on an increasing basis by governments and creditors are increasingly exploring debt-for-climate swaps. These are described as transactions that reduce or restructure debt in exchange for commitments to fund adaptation and mitigation. Nevertheless, the Report states that most:

… debt swaps remain small, complex, and opaque, offering limited macroeconomic impact.

The EDF Report proposes an evolution of the of the instrument. The focus are carbon credits generated under Article 6 of the Paris Agreement or high-integrity voluntary carbon market programs - into sovereign debt operations.

Carbon credits are argued to offer:

… measurable, verifiable, and tradable metrics of mitigation performance that can strengthen the financial attractiveness and environmental integrity of debt-for-climate swaps.

It is further argued that placing them in debt transactions can:

- Help streamline negotiations.
- Improve transparency.
- Align fiscal relief directly with mitigation targets of nationally determined contributions under the Paris Agreement.

Two options are explored in the Report:

- Option 1: “Debt forgiveness in exchange for carbon credits.”
- Option 2: “Debt-swap savings for carbon-crediting.”

The Report discusses various barriers and methods to address them such as:

- Building institutional capacity in debtor nations to manage carbon credits as financial assets;
- Adopting quality standards for eligible credits, especially for Article 6.2 and voluntary carbon market transactions;
- Raising awareness among creditors about carbon-market integrity, valuation, and risk management;
- Clarifying legal frameworks to treat verified carbon credits as a legitimate form of (in kind) payment rather than default; and
- Quantifying climate investment benefits for sovereign credit ratings and debt sustainability assessments.

A copy of the Report can be found here.