Baker McKenzie.

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In The Know

Leveraged Finance Newsletter

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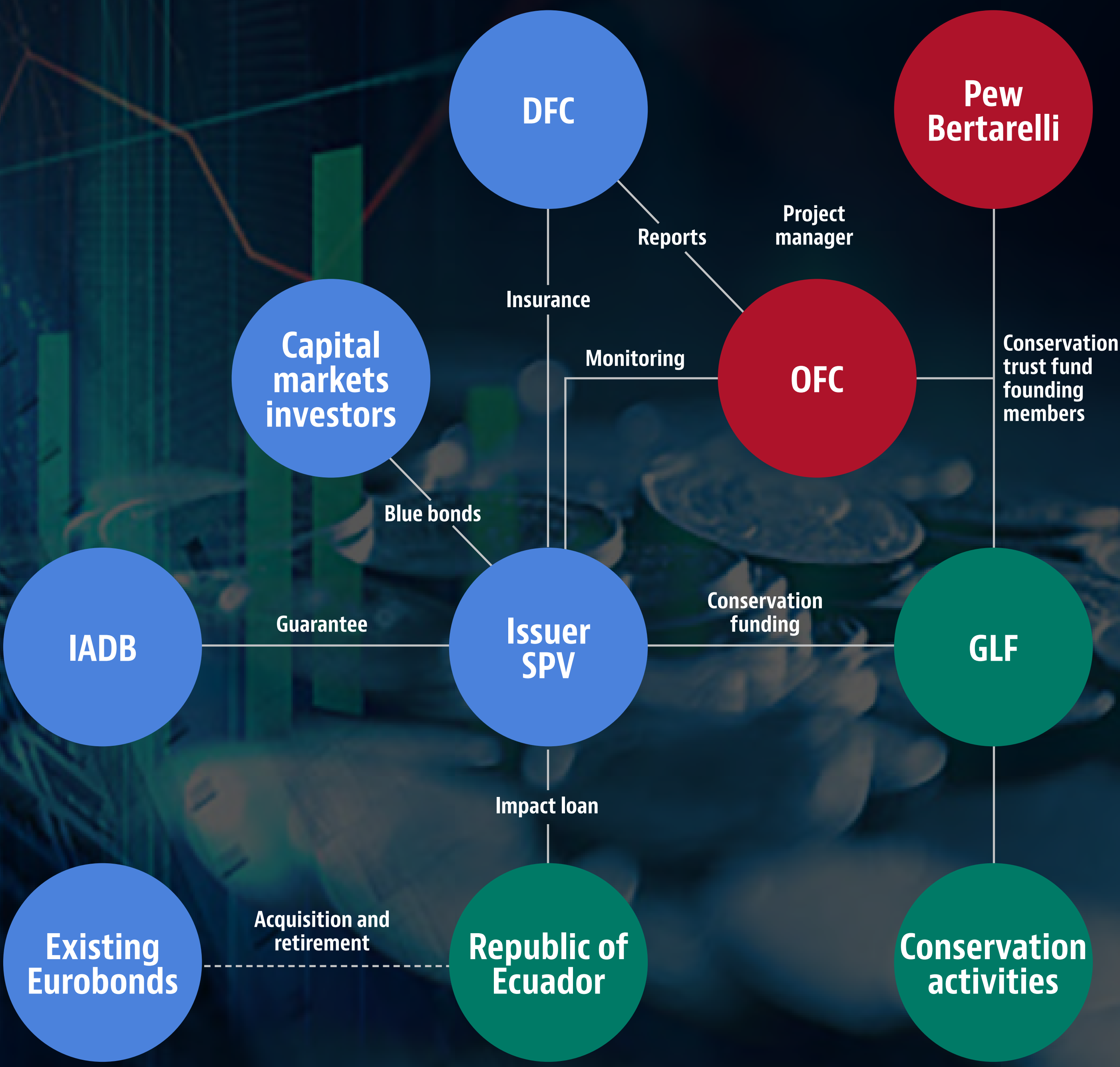
Debt for nature swaps: the critical role of the project manager

Much has been written about debt for nature swaps and an increasing number of market participants are looking to get involved. In this article, we highlight the critical role of the project manager, whose functions incorporate aspects of a traditional founder, sponsor, arranger and monitoring agent throughout the life of such transactions.

On 9 May 2023, it was announced that the government of Ecuador had completed a debt conversion that would (in addition to reducing the principal amount of Ecuador sovereign debt outstanding) provide more than USD 300 million for the financing of marine conservation in the Galápagos Islands. Through this transaction, the world's largest debt conversion for marine conservation (and largest "debt for nature swap", as described below) to date, Ecuador's existing sovereign bonds with a face value of over USD 1.6 billion were exchanged for a USD 656 million loan made from the proceeds of a marine conservation-linked bond, benefitting from political risk insurance and a guarantee from third parties. In this transaction, Baker McKenzie acted for Oceans Finance Company in its role as project manager, as described further **here**.

Overview of the Ecuador transaction



Debt for nature swaps are, and have been for several years, a hot topic in both international finance and conservation circles. Accordingly, there is no shortage of commentary by practitioners and observers on debt for nature swaps generally, spanning the gamut from enthusiastic boosterism to sceptical wariness. Other than a brief recap of the central concept, this short article does not aim to repeat the many worthy entries to this genre, but rather to focus in on the role of an oft-overlooked but absolutely central figure to these transactions.

The basics of a debt for nature swap such as Ecuador's are relatively straightforward. A sovereign whose debt trades at a discount to face value issues new debt at par for the purposes of funding the debt conversion. The amount generated is used to buy the existing debt at its discounted value.

The purchased debt is then exchanged, generating a saving for the government in an amount equal to the face value of the retired debt minus that of the new debt. The buyers of the new debt, as well as any credit support providers arranged for the new debt, benefit from certain obligations of the sovereign to use a portion of these savings for agreed purposes.

To date, in these structures, these purposes have largely been environmentally based, but in the future, these may more frequently include other agreed purposes, e.g. those set out in the United Nations Sustainable Development Goals, such as education (for which some smaller such swaps have completed) or gender equality.

Along with the sovereign and the arranging investment bank (which will run the tender for the existing debt and underwrite or place the new debt with investors), one of the central participants in debt for nature swaps such as Ecuador's is the project manager. Their role includes the following:

- Structuring the deal in conjunction with the sovereign and the investment bank
- Sourcing and liaising with third parties to obtain credit support for the sovereign's new debt (e.g. political risk insurance and guarantees), which provides for the necessary pricing differential between the "new" and "old" debt to make the transaction structurally feasible
- Constituting and providing the fund documentation (constitution and bylaws, investment guidelines, committees documents) for the entity that will be administering the conservation funds generated by the swap. While this does not necessarily have to be a charitable-status fund, for tax treatment it will often be so, as was the case in the Ecuador swap.
- Acting as a or the founding member of the conservation trust fund or similar entity, ensuring that the fund documents are adopted, the agreed additional members are appointed and committees are established
- Providing ongoing key monitoring and reporting services on the use of the sustainability-earmarked funds and achievement of targets for all financial stakeholders, which can include insurers and guarantors as well as credit investors
- In conjunction with the investment bank, assist in assembling the investor pool (either via the main debt-for-nature swap or in related transactions benefitting from the conservation apparatus being assembled)

As is clear from the above, the project manager's roles are wide ranging and require several different types of expertise. Accordingly, some of these roles may be fulfilled by specialist third parties (e.g. verification agents or director service providers), appointed and supervised by the project manager.

The documentation a project manager may be expected to sign will include certain key finance documents (e.g. documentation setting sustainability commitments and how these will be financed) but also appointment agreements for any such third parties, as well as documentation required by insurers/guarantors (whose participation in the transaction may be contingent on a particular trusted project manager being appointed, given their internal mandates for their credit support to only be provided to correctly managed/well-reported transactions).

As a key transaction party, and a signatory to the documents referred to above, the project manager will be expected to have its own legal representation. Upon the closing of the transaction, this representation may be combined with ongoing representation and assistance to the trust fund or other entity managing the sustainability-earmarked funds.

Given the vital importance of conservation, as well as the other potential projects which can be funded by similar swaps, it is to be hoped that debt-for-nature and similar swaps increase in both number and scale. For this to happen, there will be an increasing demand for the skills and experience of the relatively limited numbers of qualified project managers, whose expertise is absolutely vital for the deals to happen in the first place, as well as ensuring their correct functioning over their durations.

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