



## PACIFIC ISLANDS FORUM SECRETARIAT

PIFS(22)FEMM.6a

### FORUM ECONOMIC OFFICIALS MEETING

### FORUM ECONOMIC MINISTERS MEETING

10-12 August 2022

Port Vila, Vanuatu

## AGENDA ITEM 6A: CLIMATE CHANGE FINANCE

### Purpose and Recommendations

#### Purpose

This paper reviews the status of access for Forum Island Countries (FICs) and proposes a shift in the approach to accelerate investments and innovation for climate action, with increased focus on mobilising innovative and private financing opportunities.

#### Summary

Timely access to climate finance remains a critical priority for the Pacific. Forum Island Countries' efforts in the past decade had been predominantly focused on a few multilateral global climate funds, including the Green Climate Fund (GCF), Adaptation Fund (AF), the Global Environment Facility (GEF) and the Climate Investment Funds (CIF), in addition to bilateral sources.

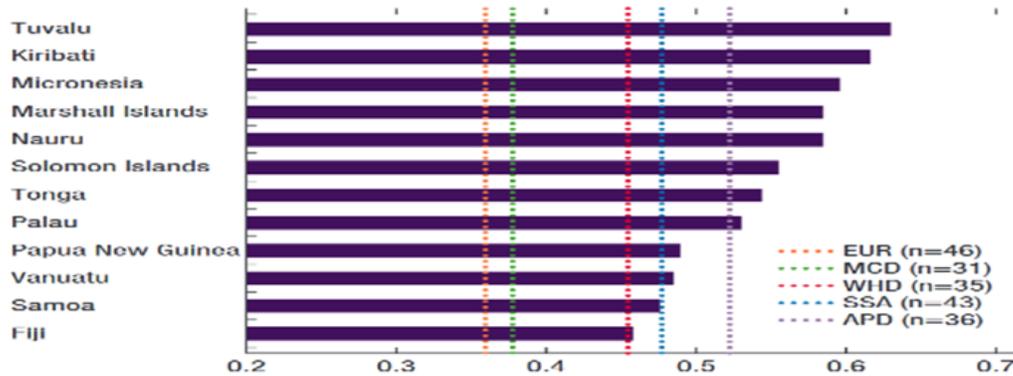
Whilst these multilateral sources continue to be a critical source of climate finance there have been recent global developments which offer new significant financing opportunities for the Pacific to tap into. To be effective in accessing and managing the new sources of financing, the key prerequisites include expanding the available climate finance landscape and options, the ability to mobilise private sector finance, robust public financial management (PFM) systems, prioritising capacity building and supplementation, and consolidating individual country efforts towards a regional approach.

This paper reviews the status of access to existing climate funds and proposes a shift in the approach to accelerate investments and innovation for climate action, including increased focus on mobilising innovative and private financing opportunities such as debt for climate swaps, green and blue bonds, carbon emissions pricing, micro-insurance, dedicated national climate (trust) funds and philanthropic foundations.

#### A. Problem/Opportunity Identification

The Pacific's geographic and socio-economic situation—low-lying islands, isolated location, small land area separated by vast oceans, high population concentration, and high costs of providing basic services exacerbate the region's exposure and vulnerability to climate change compared to other regions (Figure 1).

Figure 1. Index of exposure to climate change



Source: International Monetary Fund. 2021. Unlocking Access to Climate Finance for Pacific Island Countries. <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/09/23/Unlocking-Access-to-ClimateFinance-for-Pacific-Islands-Countries-464709>.

Notes: Notre Dame Global Adaptation Index (2018). Dotted lines show averages by IMF area departments and the number of countries is shown in parentheses. APD = Asia Pacific; EUR = Europe; MCD = Middle East and Central Asia; SSA = Sub-Saharan Africa; and WHD = Western Hemisphere.

2. This makes the region’s climate financing needs substantial, estimated at 6.5%–9.0% of GDP or almost US\$1 billion annually<sup>1</sup>. Unfortunately, current estimated financing of around US\$220 million<sup>2</sup> annually for FICs has fallen far short of the needs and access and implementation efforts have been uneven across the Pacific.

3. The International Renewable Energy Agency (IRENA) estimated that US\$16 billion<sup>3</sup> would be needed in 2030 by all Small Island Developing States (SIDS) to implement renewable energy targets set out in SIDS Nationally Determined Contributions (NDC), and of that, a total of US\$5.2 billion<sup>4</sup> will be needed by 2030 to implement renewable energy targets in the FICs NDC, of which 93% is conditional on external climate finance.

4. Addressing the substantial financial needs of FICs will require considerable mobilisation of external financial resources. To this end, an expedient approach towards accessing the climate finance commitments by developed countries and the funding sources under the United Nations Framework Convention on Climate Change (UNFCCC) and the Paris Agreement (e.g., GCF, AF and GEF), is needed. In addition, FICs need to increase their efforts towards innovative financing pathways including debt for climate swaps, green and blue bonds, carbon emissions pricing, micro-insurance, green fee, environment climate adaptation levy, national climate funds and philanthropic foundations.

## B. Background and new Plethora of Climate Funding Opportunities

5. At COP26 in Glasgow, developed countries assured developing countries through a Climate Finance Delivery Plan co-led by Germany and Canada that the US\$100 billion annual climate finance goal would be met by 2023. In addition, global discussions under the UNFCCC have started since Glasgow

<sup>1</sup> IMF. 2021. Unlocking Access to Climate Finance for Pacific Island Countries. <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/09/23/Unlocking-Access-to-Climate-Finance-for-Pacific-Islands-Countries464709>

<sup>2</sup> Consolidated figure from PIFS climate finance assessment reports completed in 11 PICs.

<sup>3</sup> [http://islands.irena.org/-/media/Files/IRENA/Sids/Publications/Strategy\\_2030.ashx?la=en&hash=BB706F032511A801A1FE010C333E32D77BD85522](http://islands.irena.org/-/media/Files/IRENA/Sids/Publications/Strategy_2030.ashx?la=en&hash=BB706F032511A801A1FE010C333E32D77BD85522).

<sup>4</sup> Regional Pacific NDC Hub. 2021. Strategy 2030: A Blueprint for NDC Implementation in Pacific Island Countries.

to determine a ‘new collective quantified climate finance goal’ that would succeed the \$100 billion commitment by developed countries, effective post-2025.

6. The UN Special Envoy Mark Carney also announced at COP26 that over 450 financial firms across 45 nations with total assets of US\$130 trillion private finance have collectively committed to aligning their businesses, lending, and investments with net-zero goals. This was through a consortium known as the Glasgow Financial Alliance for Net-Zero, which Carney chairs.

7. In addition, there was a financial commitment of US\$130 billion by the CEOs of Nordic and UK pension funds, to be invested in clean energy and climate investments by 2030. The asset owners from the UK, Sweden, Norway, Finland, Denmark, and Iceland made the commitment with an aim to contribute to increasing global climate ambition and spur the global uptake of climate investments for the green transition by 2030. The move builds on a 2019 commitment by Danish pension funds to invest US\$55 billion in the green transition by 2030.

8. Four Canadian pension funds - Caisse de dépôt et placement du Québec (US\$419.8 billion), Canada Pension Plan Investment Board (US\$539 billion), Ontario Municipal Employees’ Retirement System (US\$121 billion) and Ontario Teachers’ Pension Plan (US\$241.6 billion) - have recently made net-zero emissions commitments and some of them have set interim targets to govern shifts in their investment strategies.

9. In late 2021, New Zealand quadrupled its new climate finance commitment up to NZ\$1.3 billion until 2025, with NZ\$650 million earmarked for FICs. Australia has also increased its climate finance commitment up to A\$2 billion until 2025 with A\$700 million earmarked for the Pacific, including commitment towards investing in a Pacific Climate Infrastructure Financing Partnership. In May 2022, Norway also launched its Norway Climate Investment Fund to invest US\$1.97 billion per year in developing countries for the next 5 years.

10. Innovative financial instruments that can leverage the reservoir of finance in the global capital markets are emerging and are being adopted by developing countries. There is evidence that the global capital market is aligning itself with sustainable development outcomes including the SDGs as experienced in the 80% surge in the global value of sustainability themed investments in 2020 from the 2019 level of US\$3.2 trillion<sup>5</sup>. A critical component of this trend is the use of sustainability themed debt instruments such as green bonds. The current market value of green bonds is estimated to be US\$1 trillion, while the cumulative market value of the sustainability themed bond market (i.e., green, social, sustainability and blue bonds) is estimated to be US\$1.5 trillion<sup>6</sup>.

11. These emerging global developments offer new significant financing opportunities for the Pacific to tap into, compared to the scale available in the few vertical multilateral climate funds that most FICs have been pre-occupied with in the past decade. However, to be effective it will require expanding the landscape of available financing sources, the ability to mobilise private sector finance, robust public financial management (PFM) systems, prioritising capacity building and supplementation, and consolidating individual country efforts towards a regional programmatic approach.

12. Within the UNFCCC process, the role of the Pacific Political Climate Champions was instrumental at COP 26 in Glasgow and remains crucial leading up to COP 27 in Egypt in November 2022. Three Finance Ministers are part of the Political Climate Champions initiative endorsed by Leaders in 2021. They are Cook Islands Prime Minister who is also responsible for the Ministry of Finance, Fiji’s Minister

---

<sup>5</sup> UNTAD. 2021. Sustainable Finance surges despite volatile markets during COVID-19. <https://unctad.org/press-material/sustainable-finance-surges-despite-volatile-markets-during-covid-19-says-un-report>

<sup>6</sup> ibid

of Economy, and Tuvalu’s Minister of Finance. Cook Islands is the Champion on Climate Finance, but at COP 26 Fiji played a key role in pushing for Pacific climate finance priorities at Glasgow. Tuvalu’s role as the Champion on Loss and Damage is critical because of the emerging global discussions on dedicated financing for loss and damage through the ‘Glasgow Dialogue’ established at COP 26. Leading up to COP 27, a key priority is to consolidate the climate finance needs of Forum Island Countries building on existing national plans and NDC implementation roadmaps to inform the global deliberations on a new collective quantified goal on climate finance to be effective post-2025. This work will be concluded at COP 29 in 2024. Also, the role of the Champion on Finance is vital to provide guidance to further simplify access procedures to the GCF, Adaptation Fund and Global Environment Facility as well as ensure the US\$100 billion commitment by developed countries is met by 2023 and a clear roadmap on how the doubling of adaptation finance from 2019 levels would be met by 2025, as decided at COP 26.

13. At COP 27, there will be a dedicated Ministerial Roundtable on Finance, a key meeting for the Pacific to actively participate in. Close collaboration between the Ministers of Finance from Cook Islands, Fiji and Tuvalu – as Political Climate Champions – would be critical to effectively engage at COP 27 recognising that there will be around 14 climate finance-related agenda items to be discussed, including strong push from the Pacific to have a dedicated agenda on ‘Funding arrangements for Loss and Damage’ at COP 27. In a letter from the UNFCCC Executive Secretary on 27<sup>th</sup> June, she has advised that this has been included in the ‘provisional agenda of COP 27’, subject to country Party views at the opening plenary of COP 27. Therefore, Forum Economic Ministers’ support for this proposal to have a COP 27 agenda on ‘Funding arrangements for Loss and Damage’ will add more weight to the region’s position in the lead up to COP 27.

### **C. Review of the Status of Access for the Pacific**

14. The Pacific’s effort in the past 10 years had been focused on meeting the access and reporting requirements of the GCF, Adaptation Fund, GEF and Climate Investment Fund. That was in addition to key bilateral sources including Australia, EU, New Zealand, Japan, China, U.S and MDBs such as the ADB and World Bank.

15. Based on completed national climate finance assessments, the Forum Secretariat estimated that around 41% of climate finance flows to the Pacific was from bilateral channels. A total of US\$2.2 billion has been analysed to be approved for the region in the past 10 years, largely delivered through multilateral implementing entities. To-date around US\$497.9 million of ‘project funding’ has been approved by the GCF for the Pacific (Figure 2). Approximately US\$29.71 million has been approved as ‘readiness grants’ (Figure 3).

*Figure 2. Amount of GCF approved project funding for FICs and number of approved projects*

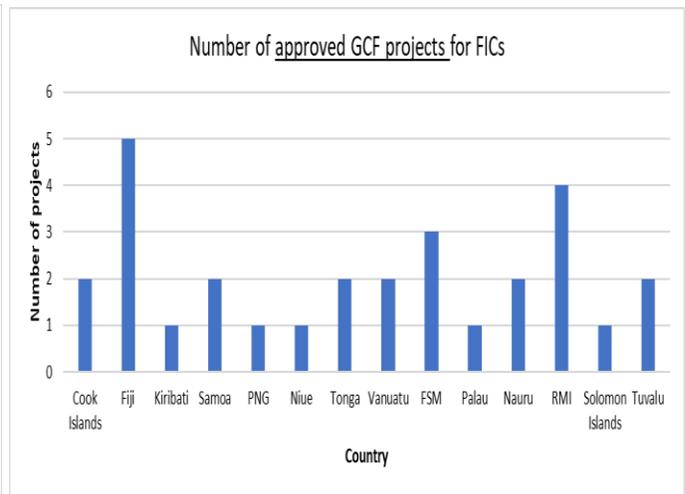
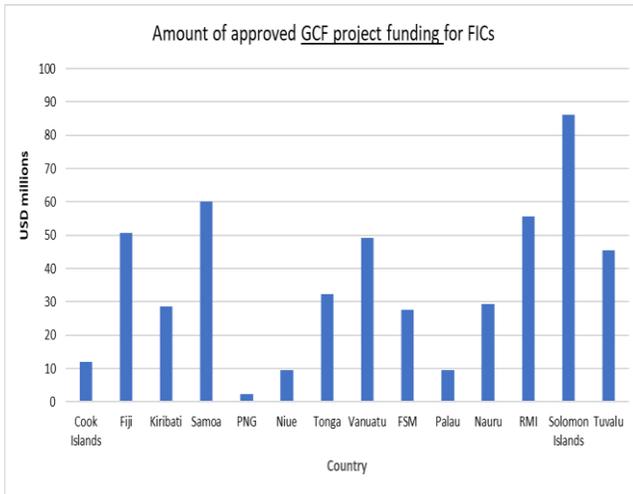
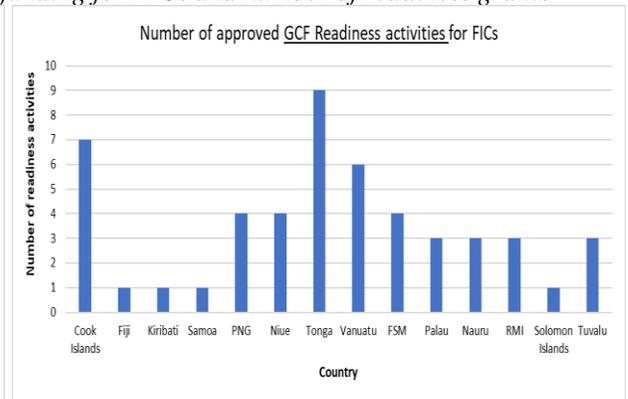
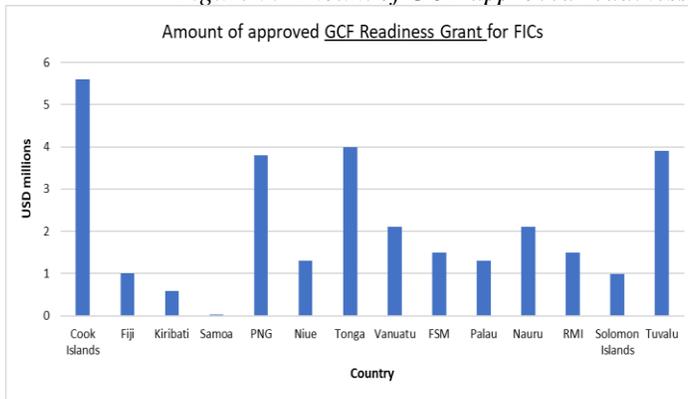
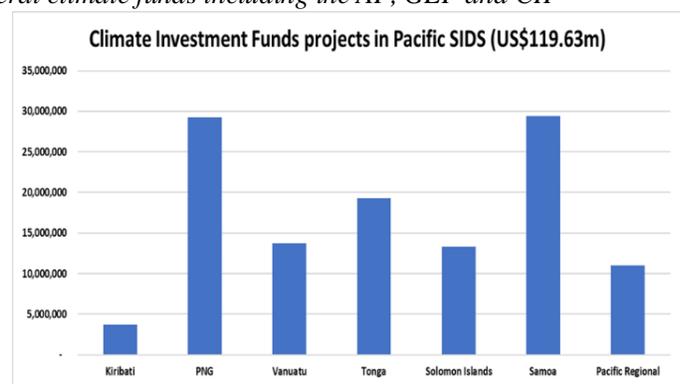
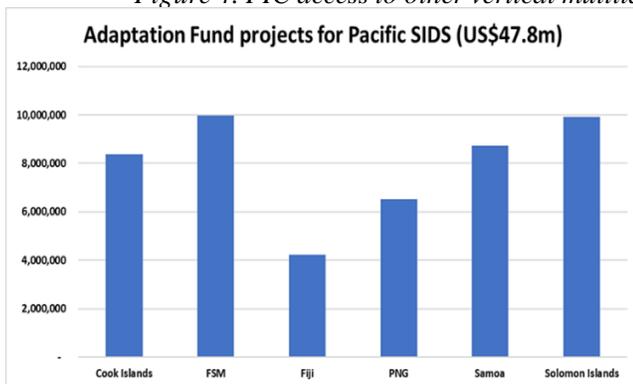


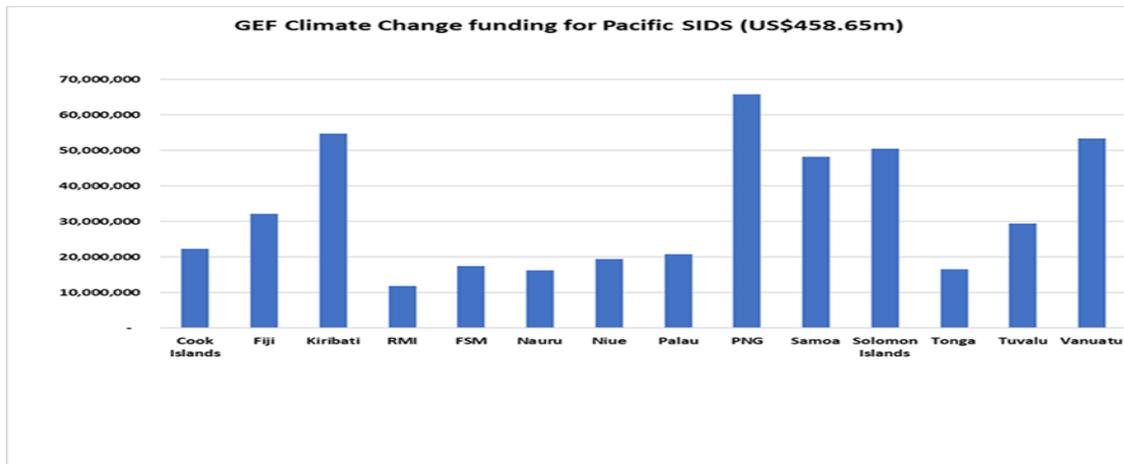
Figure 3. Amount of GCF approved readiness funding for FICs and number of readiness grants



16. A total of US\$47.8 million was approved by the Adaptation Fund for six FICs, US\$119.63 million from the Climate Investment Funds, and US\$458.65 million from the GEF (Figure 4).

Figure 4. FIC access to other vertical multilateral climate funds including the AF, GEF and CIF

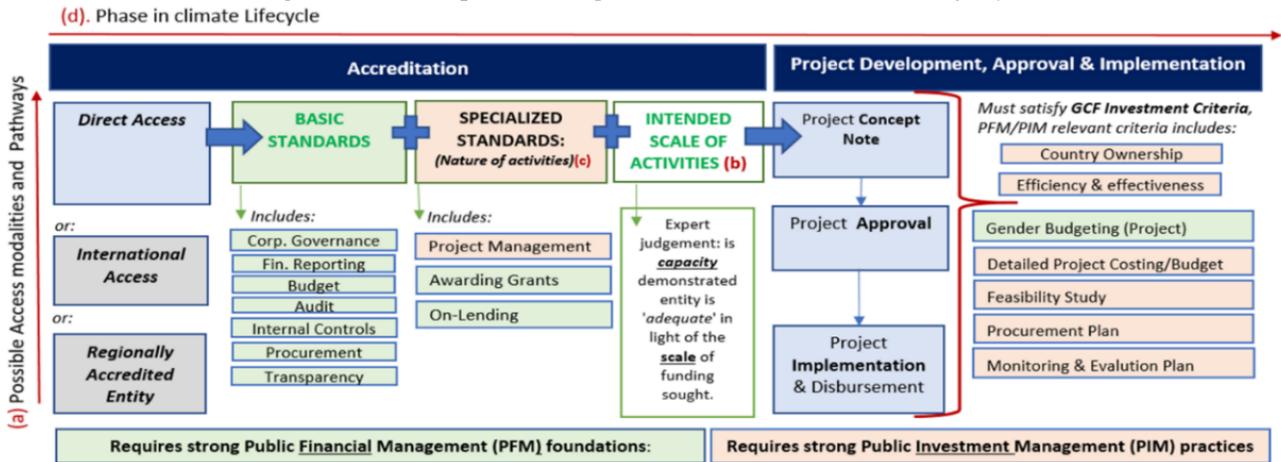




### Lessons Learnt

17. The role of a robust PFM system is critical in accessing and managing climate finance (Figure 5). Striking the balance between responsiveness and accountability is an ongoing challenge. Within the region, the same narrative resonates as there are varying levels of progress due to the strength of national systems and capacity constraints. Weaknesses in areas of procurement and project management have constrained FICs efforts to mobilise finance at scale, directly access funding from existing and new innovative sources, and ensuring the effectiveness of the finance accessed.

Figure 5. PFM requirements span the GCF Climate Finance life cycle



Source: IMF 2021

18. Other key lessons<sup>7</sup> include:

- A mix of access modalities is needed, which should be strategically deployed by FICs;
- FICs should continue to build PFM capacity and incorporate GCF and other climate funding requirements into PFM reform plans;
- GCF direct access requirements are complex while building capacity takes time;
- Grant-based instruments are needed to meet adaptation costs in FICs, given limited fiscal space;
- Direct access has been the FICs preferred pathway, but progress has been too slow despite efforts by the GCF to support countries;

<sup>7</sup> IMF PFTAC presentation 2021

- International access pathway has been the most successful so far, but some countries can be left behind; and
- Many approved GCF projects are country-specific, but finance can be mobilised at scale and achieve transformational outcomes if FICs pool their efforts towards regional programmes or multi-country approaches.

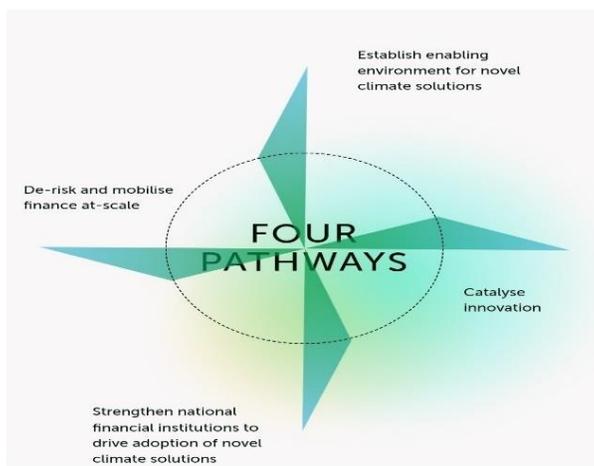
19. In response to the decision of Forum Economic Ministers in 2021, the regional Technical Working Group on PFM and Climate Finance has met and established a sub-committee that is currently developing the Working Group’s plan of action for 2022 – 2023 to support its role as an advisory body to the FEMM on PFM-Climate Finance issues.

20. To mobilise private sector engagement, the Forum Secretariat through the EU funded PACRES and DFAT-GIZ Climate Finance Readiness in the Pacific projects have supported national private sector mapping on climate finance in Tuvalu, Kiribati, Fiji, Tonga, Solomon Islands, Cook Islands, Samoa and Vanuatu with Palau and FSM in the pipeline. Three sub-regional private sector workshops on climate finance have been conducted for Melanesia, Polynesia, and Micronesia; with follow up meetings for Polynesia in Samoa and Micronesia in Palau scheduled later this year. Technical support has been provided directly to National Private Sector Organisations and will continue, to strengthen private sector engagement with the government and other stakeholders through capacity building initiatives.

**D. Proposed approach to accelerate investment and innovation for climate action**

21. Considering the emerging global financing opportunities and the need to strengthen robust country systems to facilitate direct access and effective absorptive capacity, it is timely to consider a shift in the approach to accessing and managing climate finance, shaped by the four pathways presented in Figure 6.

*Figure 6. Revised approach to accelerate investment and innovation for climate action*



Source: GCF

22. To promote transformational outcomes, there are four key pathways:
- Establish enabling environment for novel climate solutions – having the necessary climate policy and legislative frameworks, climate finance strategies/roadmaps, NDC implementation roadmaps, clarity on institutional roles and responsibilities etc.
  - Catalyse innovation – pursue innovative financing pathways, instruments, and new climate sensitive technologies.

- (iii) Strengthen national financial institutions to drive adoption of novel climate solutions – continue to undertake PFM reforms and institutional strengthening to improve direct access (NIE accreditation), absorptive capacity, M&E capability, mainstream climate change and resilience functions into ministry of finance, sustainability of novel climate solutions, and ensuring the effectiveness of finance accessed.
- (iv) De-risk and mobilise finance at scale – de-risk (i.e., guarantees, equity) and incentivise (i.e., tax rebates, subsidy) private sector investments in climate friendly projects in areas such as the renewables and blue economy to mobilise finance at scale. Also consider regional/multi-country programmatic approaches in addition to bilateral/individual country approaches.

23. To be able to monitor and report on progress as well as engage with our development partners in a more strategic and coordinated manner, in response to the lessons learnt discussed above, it is worthwhile to consolidate national reforms and efforts in a Regional Climate Finance Strategy that builds on existing national climate policies and priorities, GCF country programs, and NDC investment roadmaps. This will also align and elevate the region’s climate finance priorities closer to the emerging global financing opportunities. In addition, this is a strategy that is best overseen by ministries of finance, in collaboration with climate change ministries and other sector agencies, to link closely with national development plans and budget planning processes. Through this approach, Ministers of Finance will have an improved oversight and direction on how climate finance flows to each country, with increased emphasis on channelling funds through country systems. Furthermore, there will be opportunities for peer-to-peer exchanges. In June, the Forum Secretariat had discussions with the UNFCCC Secretariat Climate Finance Team in Bonn, Germany, and they are keen to support the Pacific on this initiative if supported by Economic Ministers.

## **E. Examples of innovative climate-related financing instruments**

24. There is global momentum and appetite to support innovative financing mechanisms recognising the ongoing challenges with timely access to global climate funds. The impetus is on FICs to increase their engagement in line with the latest global trends, so we are not left behind. Some examples of innovative financing instruments recently explored in the region are discussed below.

### *Debt for Climate Swaps*

25. Debt for climate swaps provide a channel for developed countries to fulfil their climate finance commitments under the Paris Agreement. They can do this in various ways. As creditors, they can engage in a debt for climate swap deal directly with developing country debtors. As donors, they can partially pay off a debt of a developing country with a multilateral development bank or a bilateral donor. In either case, the debtor will fulfil a commitment to invest the savings in climate projects.

26. In 2021, the Forum Secretariat together with UNESCAP undertook a study on Debt for Climate Swaps in the Pacific. The findings of the study were presented at a Pacific Regional Workshop in March 2022<sup>8</sup> and summarised in [Annex 1](#).

### *Green and Blue Bonds*

---

<sup>8</sup> [https://www.unescap.org/sites/default/d8files/event-documents/Alberto%20Isgut\\_Debt%20for%20climate%20swaps%20workshop\\_rev.pdf](https://www.unescap.org/sites/default/d8files/event-documents/Alberto%20Isgut_Debt%20for%20climate%20swaps%20workshop_rev.pdf)

27. The sustainable bond market comprises several thematic bond types. These include green bonds, transition bonds, SDG-linked bonds, social bonds, and blue bonds. These bonds all contribute to the broader goal of advancing the SDG in the global market, but they differ slightly in terms of structure and design. In the region, the conversation on green and blue finance as additional tools to address climate change impacts is not a new issue. Fiji became the first SIDS globally to launch its green bond in 2017 for US\$50 million. Fiji also plans to launch its first blue bond later this year to fund ocean-centric projects, building on Seychelles' experience with their blue bond launched in 2018. Green and blue bonds are key instruments to mobilise private sector finance.

28. The Forum Secretariat together with UNDP have spearheaded a study to demystify how green and blue financing instruments that are being adopted by other developing countries could be of relevance and practical use for FICs. A summary of the findings is in [Annex 2](#).

#### Carbon Emissions Pricing

29. In response to the Forum Economic Ministers decision in 2021 to undertake further analytical work and consultations on the pros and cons of a carbon emissions pricing, the Forum Secretariat with input from the Micronesian Centre for Sustainable Transport engaged a team of consultants to undertake a rapid analytical study.

30. The study found that the two most common methods of carbon pricing are carbon taxes/levy and emission trading schemes (ETS)/carbon markets. Carbon taxes/levies are argued to be the most relevant if carbon pricing is to be implemented by finance ministries and covering sectors such as shipping, land and air transport. Emissions Trading Schemes are more relevant if implemented by national climate change divisions and covering sectors such as forestry/green carbon and ocean/blue carbon. New Zealand has an ETS, and Australia uses an Emissions Reductions Fund (ERF). The key findings of the study and the pros and cons of both the carbon taxes/levies and ETS/carbon market are summarised in [Annex 3](#).

#### Micro-insurance

31. The Pacific Insurance and Climate Adaptation Programme (PICAP) jointly implemented by UNCDF, the United Nations Institute for Environment and Human Security (UNU-EHS) and UNDP launched a pilot in Fiji in August 2021 as the Pacific's first parametric micro-insurance product for extreme weather events (heavy rain/high windspeed). Since launching, the parametric microinsurance cover has been extended to over 1,388 individuals in Fiji; 32% of the beneficiaries are women. It is a multi-year (2021-2025) initiative poised to expand regionally to other Pacific countries later in 2022 and beyond, establishing new partnerships and leveraging, unlocking private and public sector potential for developing sustainable climate disaster risk insurance for beneficiaries at micro and household levels.

32. In addition, Fiji has established the 'Drua Incubator' in 2017 as a tool to leverage financial innovation and private sector engagement to address climate challenges. This was supported with a €1 million from the Government of Luxembourg.

#### National Climate (Trust) Funds

33. National climate (trust) funds promote more flexibility for governments to support adaptation, mitigation, or relocation interventions in a timely manner. Key examples include the Tuvalu Climate Change and Disaster Survival Fund, Tonga Climate Change Trust Fund, Fiji Climate Relocation Trust Fund, Vanuatu Green Energy Fund, and the Palau Protected Area Network Fund. While FICs have shown leadership to establish dedicated national funds, it has been challenging to attract scalable donor contribution to these national climate funds. Some sustainable financing options include the green fee in Palau charged to non-Palauans departing Palau air/seaports, and the environmental and climate adaptation

levy charged on plastic bags and the tourism sector in Fiji. At the regional level, the role of the Pacific Resilience Facility as a sustainable small grants financing mechanism for building resilience in the Pacific is extremely critical.

34. The Government of Niue, in collaboration with Tofia Niue through the Niue Ocean Wide (NOW) public-private partnership, recently made progress in setting up a Trust Fund to mobilise sustainable financing including through ‘Ocean Conservation Credits’, building on their recent commitment to safeguard 100% of the nation’s EEZ through the ‘Niue Nukutukulea Multiple-Use Marine Park’. These are a suite of potential sustainable financing options that FICs could further pursue and learn from each other’s experience.

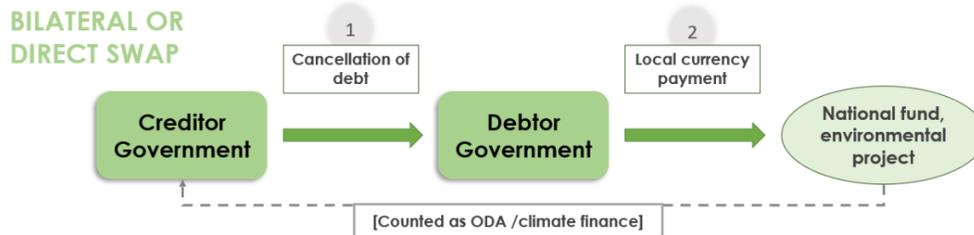
Pacific Islands Forum Secretariat  
20 July 2022

## Annex 1. Feasibility of Debt for Climate Swaps in the Pacific: Key Findings

### What is it? What potential Swap arrangements could be considered for the Pacific?

Debt for climate swaps can either be arranged directly between a debtor and one or more creditor governments (bilateral or multilateral swaps) or facilitated by a third party (third-party swaps).

#### *Bilateral or Direct Swap*

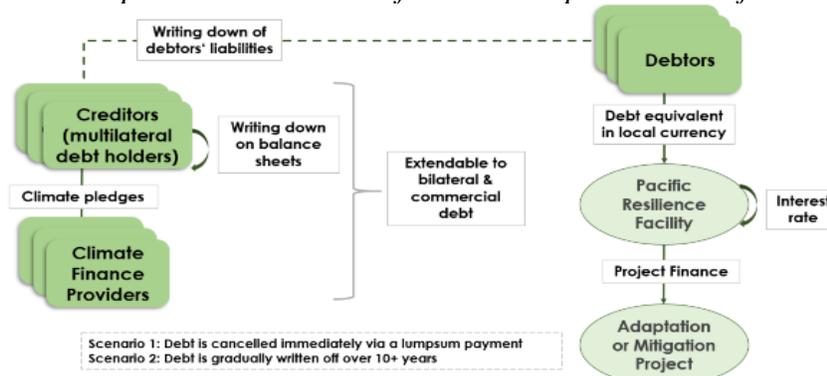


#### *Third Party Swap*



In both kinds of debt for climate swaps, two potential concerns for both creditors and third parties, in the case of a third-party debt swap, are the use of the funds saved and the effectiveness of the climate mitigation or adaptation projects to be implemented. A solution to both concerns is to set up an independent entity such as a trust fund or facility with responsibility for managing the saved funds, allocating them to appropriate projects, and monitoring, reporting, and verifying the execution of these projects. In the case of the Pacific, a suitable independent facility for the implementation of debt for climate swaps could be the Pacific Resilience Facility (PRF). The PRF is a multi-donor funded facility that aims to provide predictable, sustainable, accessible, and accountable grant funding, with technical assistance if required, for community-level projects across the Pacific. The projects to be funded by the PRF will aim to increase community resilience to climate-induced disasters. The PRF will have the capacity to both manage funds and provide technical support in areas such as monitoring, reporting and verification.

#### *A possible architecture for Debt Swaps in the Pacific*



Using the PRF could be advantageous to both Pacific debtors interested in a debt for climate swap deal and to the PRF itself. For the debtor, the PRF will remove the need to set up a specialised national entity to manage the funds and oversee the implementation of projects. This possibility is appealing to small economies with limited human resources to undertake specialised financial and technical functions. For the PRF, supporting debt for climate swaps will provide it with additional experience and expertise in both fund management and in the technical management of climate projects that will be transferable to projects funded by the fund itself. In addition, having a single entity managing debt for climate swaps in several countries will allow it to reach an economically efficient scale and reduce overhead costs. However, in the interim, debtors seeking a debt for climate swap deal could make alternative institutional arrangements with a development partner, international NGO or private entity with the appropriate capacity and technical and financial expertise.

### Recommendations/Way Forward

Based on the description of debt swaps and the opportunities and challenges, the debtor country designing and negotiating a financial structure of a swap mechanism to maximize the financial values of such schemes should consider the following essential features:

- Seek to achieve a positive difference between the original face value of the debt and the redemption price so that fiscal space is created. This can be done either by purchasing the debt title on the secondary market in the case of commercial debt or by bilaterally agreeing on applying a write-off rate greater than zero with an official creditor.
- Negotiate a full or partial cancellation of the outstanding debt service payments before making counterpart payments to a trust fund in order to provide extra-budgetary room. This could be achieved either by bilateral negotiation with the creditors or, more likely, through a third party that can raise finance to pay back the debt to the creditors and refinance it at more favorable terms, including a grant element and concessionality in the interest rate.
- Ensure that savings in debt service payments are channeled in local currency into a trust fund that will invest in climate adaptation and mitigation projects, so that hard currency reserves can be preserved.
- Schedule payments according to the original repayment schedule so that a constant and predictable stream of finance is provided to invest in climate adaptation and mitigation.
- Allocate part of the funding in the trust fund to financial assets and re-invest the return on those assets to provide additional capitalization for the trust fund.
- Only conduct debt swaps if the savings in debt services payments are large enough to justify the lengthy negotiation process and high transaction costs associated with debt restructuring and implementation.

The additionality of the funding should be ensured in three ways. First, debt swaps and their corresponding debt relief should be additional to existing ODA commitments and not crowd out other ongoing investments in climate mitigation and adaptation. Second, climate-related projects funded by debt swaps should be additional to those both climate and non-climate projects already funded in debtor countries. In particular, payments originating from swap deals should not be used to legitimize cutting back governmental spending in other areas. Finally, it is essential to ensure financial additionality for the debtor country through debt relief.

The design of the climate swap mechanism should also be aligned with national climate commitments. In particular, the activities funded by the swap should be fully anchored in and aligned with national climate

change priorities and the objectives communicated in the NDCs.

To ensure the achievement of climate and other environmental and social benefits through a climate swap scheme, it is important to establish a baseline scenario against which progress, and final outcomes are measured. This entails developing clear performance indicators and defining specific targets for the various steps throughout the implementation phase. Monitoring plans and methodologies also need to be developed to enable regular progress tracking, reporting and communication to all stakeholders and the wider community to ensure transparency.

The involvement of independent actors, such as environmental NGOs, has also proven helpful to facilitate trust between a debtor and creditor government and has been crucial for encouraging civil society participation. While international NGOs such as Conservation International and WWF have gathered extensive experience in facilitating debt for nature swaps, the contribution of a local or regional organization like the new Pacific Resilience Facility is similarly important to provide insights about local conditions. Moreover, studying the effectiveness of implemented projects will help guide policymakers in designing future swaps according to best practices.

Effective implementation and governance structures are essential for the success of the swap mechanism. The priority is the establishment of an operator of the scheme, which can be selected among existing organizations. This should be a financial institution with solid funds management expertise and technical capacities to implement climate projects. The combination of financial and climate expertise rarely exists in developing countries and often must be built from scratch with additional technical assistance from international organizations such as the Global Environmental Facility or the Green Climate Fund as was the case in Seychelles. A good practice is to establish a supervisory committee that is comprised of representatives of both the debtor government and the creditors, as well as international and national NGOs, to provide oversight and strategic guidance.

The debtor government's leading role and close involvement in designing and implementing a swap deal is crucial to ensure national ownership and the longevity of the program. At the negotiation stage, political support of the climate swap proposal at the highest level has proven decisive to make the deal happen. Crucially, the climate-related projects funded must be anchored in national climate policies and the debt swap must be embedded in a broader debt reduction strategy.

Pacific SIDS interested in accessing this novel form of financing should have a suitable pipeline of climate projects that contribute to the implementation of their NDCs and could be started as soon as financing becomes available. Building such project pipelines may require technical assistance, but this is a worthy undertaking, as the projects in the pipeline could be financed through other available sources.

To acquire appropriate technical and financial capacities to negotiate debt for climate swaps, a useful source of funding is the GCF Readiness and Preparatory Support Program. Finally, it is important to note that countries that have higher transparency in debt reporting and monitoring and pledge increased climate commitments in their NDCs under the Paris Agreement may receive more favorable consideration by creditors and development partners for the implementation of a debt for climate swap.

## Annex 2. Demystifying Green Bonds and Blue Bonds for the Pacific: Key Findings

### Green Bonds and Blue Bonds: A Brief Overview

Green bonds and blue bonds refer to sustainability themed debt instruments that are being adopted by countries and corporations to attract and mobilize private capital towards financing sustainable and low carbon initiatives. The main difference between sustainable themed bonds and regular bonds is the use of proceeds. Capital raised from green or blue bonds are invested in predetermined climate and environmental related projects, while for regular bonds the use of proceeds is not specified in terms. Similarly, the difference between green bonds and blue bonds is also in the use of proceeds. Green bond proceeds are primarily invested in environmentally friendly projects mainly renewable energy and low carbon initiatives etc. Blue bonds on the other hand are a subset of green bonds where the proceeds are channelled to finance projects related to ocean conservation and water-related projects.

### Rationale for Green Bonds and Blue Bonds adoption for FICs

The frequency and the magnitude of disasters in recent years have left many PICs with short recovery time frames and huge financial gaps to meet increasing development costs let alone recover the development gain lost. It has been estimated that the climate finance gap alone for the region to be USD 1 billion<sup>9</sup>. There is also a high probability that the Pacific will face a ‘decade of loss’ if a substantial economic recovery package for COVID-19 is not urgently forthcoming<sup>10</sup>. The cost of pursuing viable resilient pathway for PICs is increasing and the availability of donors to provide critical support is unfortunately, short in supply.

To fill these funding gaps, mobilizing funding from sources other than public sources is critical. Given that the political appetite amongst donors for grant-based financing is also limited, it is imperative that FICs be open to exploring the potentials for emerging financing instruments such as thematic bonds including green bonds and blue bonds. Adopting these instruments is critical as it is designed to tap into and mobilize the much-needed private sector capital that is critical in catalysing and scaling up the impacts of public finance.

The global sustainable bond market is rapidly expanding, and its market value has exceeded USD 1 trillion to-date as companies, national and sub national governments globally, seek new funding to deliver on their climate goals and overhaul their operations and processes to pivot away from high-carbon assets and activities<sup>11</sup> in line with the global goal of a net-zero development pathway. The COVID-19 pandemic has also prompted investors and governments to explore alternative financing markets such as the sustainable debt market to not only boost their internal sustainability goals, but to also bolster a ‘green’ recovery pathway from the pandemic. This is the area that the sustainable debt market is currently filling, resulting in increased demand for such related sustainability debt instruments.

### Lessons Learnt for Green Bonds and Blue Bonds

- ***Bonds will not deliver all the necessary funding required by Forum Island Countries (FICs) to enable them to build resilience to climate and disaster risk.*** Bonds provide another option in the range of funding sources that countries can be used but will not provide enough funds. A combination of

---

<sup>9</sup> Fouad, M, Novta, N, Preston, G, Schneider, T, Weerathunga, S. (2021) Unlocking Access to Climate Finance for Pacific island Countries, pp 1-103.

<sup>10</sup> Rajah, R & Dayat, A. (2020) Avoiding the Pacific Lost Decade: Financing the Pacific’s COVID-19 Recovery. Lowy Institute.

<sup>11</sup> Keating, C. (2021) Why 2021 could be the landmark year for sustainable debt. Available: <<https://www.greenbiz.com/article/why-2021-could-be-landmark-year-sustainable-debt>>

instruments is required to meet the goals and achieve the transition to low carbon and climate-resilient economies.

- ***Debt financing can fill gaps in grant-based finance.*** Debt financing instruments are a critical source of sustainable development finance. Grants based financing is highly desirable for FICs however, it is highly unlikely that this modality will be available in the required scale due to limited donor appetite.
- ***Thematic bonds are an appropriate debt financing instrument.*** Appropriate structured loans including thematic bonds can be a feasible option for FICs to finance their recovery as well as resilient and low carbon development pathway. Sovereign green and blue bonds are part of a set of financing tools that have the potential to provide the additional capital to cushion the widening sustainability financing gaps in FICs, protect their development gains as well as the productivity of their natural ecosystems from disasters and climate change.
- ***The potential benefits of thematic bonds extend beyond just accessing additional capital.*** Adoption of green and blue bonds can also bring new source of expertise and private sector innovations into the region. Their adoption can also challenge policy makers to develop consistent and well-governed approach to comprehensive sustainable and environmental solutions.
- ***Use of bond proceeds must be effective as they create long term debt liabilities.*** Sovereign green and blue bonds are debt instruments that create long term financial liabilities that will need to be repaid. It is vital that they are used in an effective and strategic manner.
- ***Enhanced PFM and broad inclusion will be required to meet transparent material bond information demanded by investors.*** Sovereign green and blue bonds also offer opportunities to improve the PFM systems of FICs. The required transparency of material information associated with thematic bonds necessitates that FICs strengthen their budget and planning process. This will include M&E capability as there is increasing demand from investors for robust results-based reporting and accountability of bond investments. Increasing the scope of material information will require expansion of the bond constituency, necessitating inclusion of NGOs, CSOs and citizens in determining local outcomes, assessing investment impact and the identifying further investment priorities. This could potentially result in an increase in the cost of bond issuances potentially rendering them uncompetitive in some FICs as a funding source.
- ***Embedding environmental and social dimensions directly into national economic planning will be required.*** Having a clear national sustainable financing strategy including a robust costed project pipelines which provides clarity on how and where green or blue bonds issuance will play a role in delivering that strategy is critical. This means that FICs must strengthen their resilience integration and mainstreaming approach and adopt a culture of incorporating environmental and social aspects in their economic and financial planning processes. The adoption of sustainability bonds will be a natural step for financing if this is the case.
- ***Regional thematic bond issuance has scale and benefits.*** Considering the need for issuers to make bond size attractive to investors and the need to increase regional resilience to climate change and disasters, there is potential to for FICs to seriously consider regional bond offerings. FICs may need to consider exploring the potentials and the viability of setting up the regional ‘enabling environment’ which include relevant institutions, frameworks and protocols that can support a regional thematic sustainable bond offering on common investment areas such as ocean and fisheries.
- ***Mobilization of investments from a wide range of investors including FIC institutional investors as well as community is important.*** There is potential for FICs to leverage institutional investors and key

private sector players in their respective countries particularly their national superannuation funds, insurance companies and sovereign wealth funds which tend to hold significant pool of private capitals to invest in sovereign/regional green and blue bonds. Additionally, FICs need to explore tapping into mobilizing the finance from community groups such as church institutions and diasporas to support a range of local issues.

- ***Integrity of thematic bond framework is critical.*** Pressure is increasing from institutional investors community of the integrity of thematic bond frameworks. The decision to issue a thematic bond must be supported by a genuine desire to implement robust project selection and impact reporting processes. Whilst thematic bond framework allows a degree of allocation of funds already in progress, ensuring that clear additionality of impact will be created with bond proceeds is critical to support an effective bond issuance.
- ***Partnership with competent development institutions for bond issuance may be necessary.*** Multilateral Development Banks and partners offers a rich pool of technical resources that can support the region in thinking through and piloting either a sovereign or regional sustainability bond. The ADB is an active party in this space having issued its first blue bond denominated in AUD and NZD to finance ocean-related projects in Asia and the Pacific. Additionally, it has launched a Blue Bond Incubator to boost ocean investments which could benefit FICs.

**Annex 3. Exploring the potential and limitations of Carbon Pricing in the Pacific: Key Findings**

- **Carbon pricing is argued as an effective tool to assist countries achieve their Nationally Determined Contributions (NDC).** This is because carbon pricing puts a price on carbon emissions and can create a financial cost to emitting carbon and potentially a financial reward for reducing carbon emissions.
- **Carbon prices can range from less than \$US 1 to \$US137 per ton of carbon.** Scandinavian countries such as Sweden have the highest carbon prices in the world. The global average for carbon prices is \$US 3 per ton. The IMF argue that a carbon price of \$75 a ton is needed to reduce emissions enough to keep global warming below 2°C.
- **Carbon pricing is happening everywhere except in the majority of SIDS.** This is primarily because of the costs of implementing carbon pricing and the low carbon footprint of SIDS. Carbon prices should be consistent with a country’s carbon footprint. That is, high polluting countries should have high carbon prices. The IMF suggest the following price floors:

Development status	Carbon price floor
High-income	\$US 75
Middle-income	\$US 50
Low-income	\$US 25

The only SID to implement a carbon pricing is Singapore who have set an initial carbon price of \$5.

- **The two most common methods of carbon pricing are carbon taxes and emission trading schemes.** Carbon taxes are argued to be the most relevant if carbon pricing is to be implemented by finance ministries. Emissions Trading Schemes are more relevant if implemented by national climate change divisions. New Zealand has an ETS, and Australia uses an Emissions Reductions Fund (ERF).
- **Regional carbon offset schemes present opportunities for PICs but require the development of institutional frameworks.** The Australian Indo-Pacific Carbon Offset Scheme was launched at the end of 2021 and Fiji and PNG were the first two official partners. The scheme is part of Australia’s broader climate mitigation strategy in the region and the scheme can support the Pacific’s Blue economy initiatives. The development of institutional and human resource capacity remains an issue and the Australian government, and other development partners have offered to provide financial and technical support in these areas.
- **Carbon pricing, if implemented at a national level will likely increase the cost of living, but COVID and the Ukraine-Russia war have shown that costs will rise, and governments respond accordingly to price increases from exogenous events.** A potential solution to mitigating inflationary pressure caused by carbon pricing is to use the proceeds from carbon taxes to reduce other taxes or pay dividends to citizens. The decision to implement carbon pricing must be based on sound and reliable data, rigorous modelling and the consideration of the specific circumstances, resources, and capabilities of each country.
- **Pacific leaders could advocate for higher carbon prices for high polluting countries.** There is no urgent need for PICs to implement carbon pricing at a national level but there is an urgent need for the biggest emitting countries to implement more effective carbon pricing mechanisms and higher prices in order to keep global temperatures below the 1.5°C agreed in the 2015 Paris Agreement. The Pacific could use their status as the climate most vulnerable region to advocate for the biggest polluters to adopt higher carbon prices. And the majority of the revenues from these initiatives be channelled to either vulnerable developing country such as SIDS or dedicated climate funds.

*Pros and cons of Carbon Taxes/Levies*

#	Pros +	#	Cons -
1.	More relevant for finance ministries.	1.	May not be ambitious enough.
2.	Simpler to implement as compared to emissions trading schemes.	2.	A punitive measure as compared to ETS that provides greater incentives.
3.	Provides certainty for business in terms of prices – helps companies plan.	3.	Targeted compensation from carbon tax revenues for low-income households in developing countries may be challenging as many citizens may not be formally registered taxpayers or benefit recipients.
4.	Generates revenue for governments.	4.	A carbon tax may not be palatable for PICs during the current record-high prices of fuel following the war on Ukraine.
5.	Carbon taxes allow revenue recycling where tax revenue could be redirected to citizens (especially in the form of dividends) to reduce the impact of carbon taxes on their cost of living.	5.	Due to the high fuel prices, most PICs have reduced or removed fuel excise taxes and as such a carbon tax would be inconsistent with these policies.
6.	Carbon taxes may be more suitable than an ETS due to their higher effectiveness in raising revenue and encouraging research, development, and technology adoption.		

*Pros and cons of an Emissions Trading Scheme/Carbon Market*

#	Pros +	#	Cons -
1.	Provides more incentives to companies to reduce emissions and invest in “greener” technologies (carrot approach).	1.	More suited for Ministries of Climate Change.
2.	Opportunities for PICs to sell carbon credits to countries (such as Australia) or to voluntary carbon markets.	2.	ETS does nothing to improve distributional outcomes across households as it forgoes large economic efficiency gains from revenue recycling.
3.	Provides financial incentives to resource owners to conserve their resources instead of leasing/selling to developers.	3.	More complex in nature as compared to carbon taxes.
4.	Argued as having a greater potential to develop a vibrant green/blue economy in the Pacific.	4.	Requires greater resources and administrative support.
		5.	Carbon prices are volatile and make planning difficult for businesses.
		6.	Costs of accreditation for carbon abatement/sequestration projects are extremely high.