Overview of Debt for Nature Swaps and Description of the Structure of Debt for Nature Swaps Executed Pursuant to the US Tropical Forest Conservation Act

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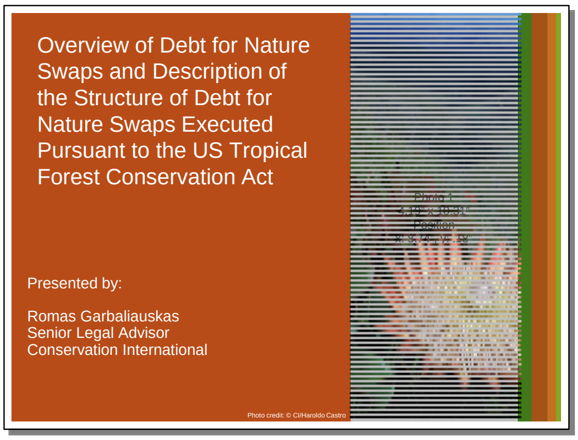
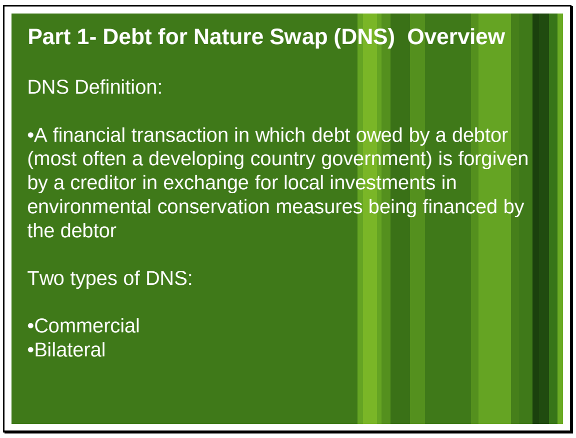


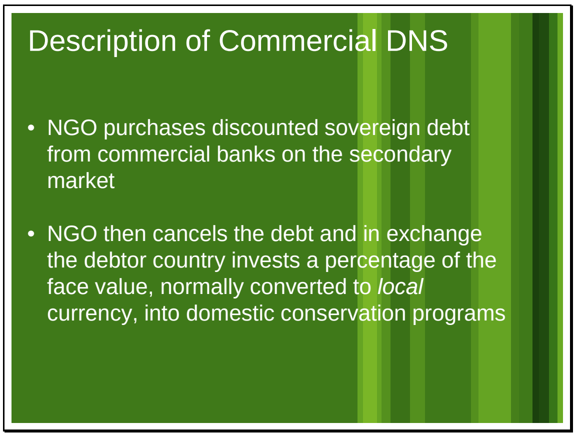
I think the one disadvantage of speaking last in the session is that I expect that I will probably get all the hard questions, but please ask many hard questions. I am ready.

Why am I speaking about debt for nature swaps? Debt for nature swaps are a tool to provide financing for nature conservation including REDD+ activities. This session will have two parts. One is just a general overview of debt for nature swaps just to explain what they are. Many people in the audience probably already have a pretty good understanding but it should be helpful to generally to give a quick overview of what they are and then to speak about debt for nature swaps done under the US Tropical Forest Conservation Act which, I believe, has been the largest bilateral debt for nature swap program. I will also speak about three debts for nature swaps that have benefited Indonesia.

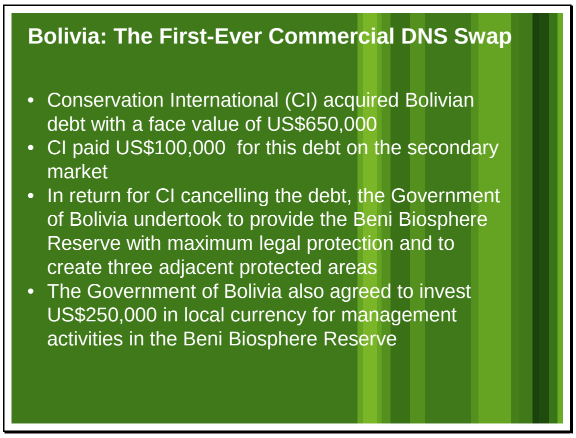
1. Debt for Nature Swap (DNS) Overview



Part one is just the overview of the debt for nature swap. A debt for nature swap is a financial transaction in which debt owed by a debtor (most often a developing country) is forgiven by a creditor. In exchange local investments in environmental conservation measures are financed by the debtor. There are two types of debt for nature swaps. The earlier ones were commercial debt for nature swaps. Subsequently, in the last 15 years or so there have been a lot of bilateral debt for nature swaps.



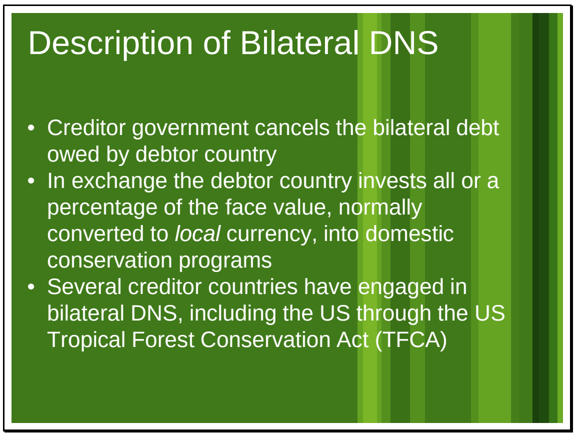
In a commercial debt for nature swap, an NGO purchases discounted sovereign debt from commercial banks on the secondary market. The NGO then cancels the debt in exchange for the debtor country investing a percentage of the face value, normally converted to local currency into domestic conservation programs.



It is good to illustrate this by way of examples. I have the honor of working for the organization that actually initiated and did the first ever commercial debt for nature swap well before I joined the organization. It was a very exciting moment for CI early in its history. This happened back in the 1980s. Conservation International acquired Bolivian debt with a face value of $650,000. This was during the Latin American debt crisis. A lot of the Latin American debt was being sold at discount because it was in default at the time.

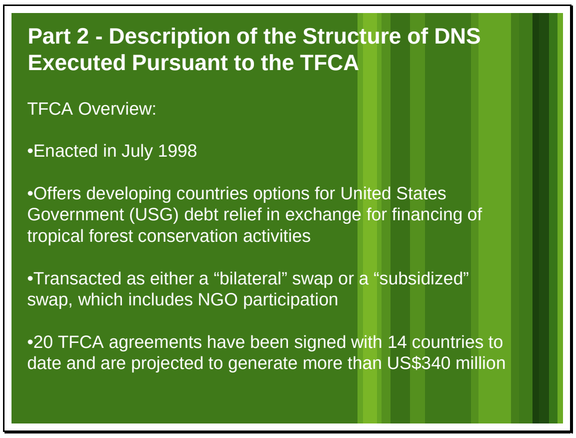
CI was able to purchase $650,000 face value debt for $100,000 because the secondary market was only valuing that $650,000 debt as being $100,000 because of the inability to seek repayment of the face amount. CI then canceled the debt, and in exchange, the Government of Bolivia did two things. It undertook to provide the Beni Biosphere Reserve with maximum legal protection and create three adjacent protected areas. The Government also agreed to invest $250,000 US in local currency for management activities.

The government basically was able to get rid of $650,000 face value debt off their books in exchange for only a $250,000 investment, an investment, in their own conservation priorities. CI as a conservation organization was able to leverage $100,000 to $250,000 to be used in a country where it was already very interested in doing conservation work.



Bilateral debt for nature swaps: these are country to country debt for nature swaps. A creditor government cancels a bilateral debt owed by a debtor country. In exchange, a debtor country invests all or a percentage of the face value. Sometimes, it has a haircut. There could be a cancellation of $20 million, but only a requirement to invest $15 million. Normally, it is converted into local currency and it is invested in domestic conservation programs. Several creditor countries have engaged in bilateral debt for nature swaps, including the US through the US Tropical Forest Conservation Act.

2. Description of the Structure of DNS Executed Pursuant to the TFCA

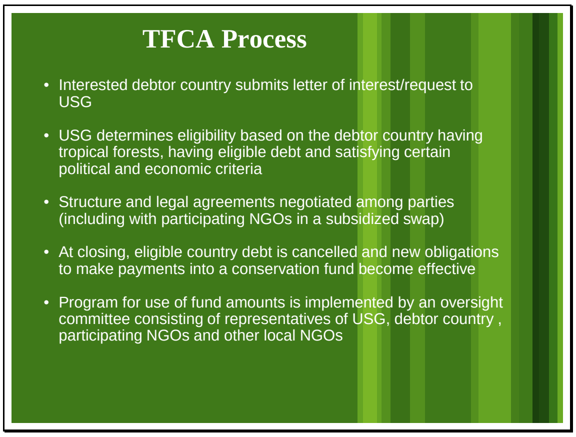


Part two of this presentation is to describe the structure of a debt for nature swap pursuant to the US Tropical Forest Conservation Act. That is really the area that I am most familiar with. I have worked on four debt for nature swaps under the US Tropical Forest Conservation Act. My organization CI has been involved in, I believe, five or six to date. I believe, as I said, that it is the largest bilateral program.

TFCA[1] overview: it was enacted in 1998. It offers countries options for the US debt relief in exchange for financing of tropical forest conservation activities. The deals are transacted either as a bilateral swap or a subsidized swap. The difference is, in a bilateral swap, the only financial contributor to the swap is

[1] Tropical Forest Conservation Act: http://www.usaid.gov/biodiversity/TFCA

the US government. In a subsidized swap, NGOs also contribute some of the money towards the debt reduction. Also, in a bilateral swap, the negotiation is purely between the two governments. In a subsidized swap, the NGOs also get to participate in the negotiations of the transaction. To date, there have been 20 TFCA agreements with 14 countries, and they are projected to generate more than $340 million. Most of them have been subsidized debt swaps. I believe only five or six have been truly bilateral debt swaps.



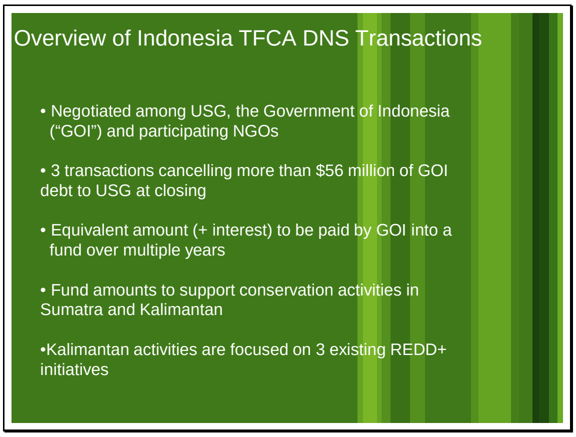
The TFCA process: an interested debtor country submits a letter of interest/request to the US government. The US government then determines eligibility based on the debtor country having tropical forests, having eligible debt, and satisfying certain political and economic criteria. Even if there is an interest and the country satisfies the various criteria, not every interest will be accommodated. There is only a limited amount of money appropriated by US Congress to this program. The treasury department administers the program. In certain years, they may only have a certain amount of funds available for the program and many countries are asking for a debt swap. The US government does have to go through a process of deciding which interest to accommodate.

Once the US Government and the country actually agree to enter into a debt for nature swap, then the participants (and the participants in a subsidized debt for nature swap include NGOs) work to structure the legal agreements. They negotiate how the whole program will work. Most of the emphasis of negotiations is really on how the money is going to be spent. There are also a lot of technical details; how the swap is going to be governed; how it is going to be administered. That is all very important, but really where most negotiations happen is which geographies will the money be invested in and for what priorities?

At closing, the eligible country debt is cancelled and new obligations to make payments into conservation fund become effective. When the eligible country debt is canceled, the debtor government then has an obligation to pay an equivalent amount or a discounted amount somewhere. It does not stay with the government. It gets paid into a third party fund. It actually goes into a non-governmental fund. Then the program for the use of funds is implemented by an oversight committee. The agreements may actually specify geography. They may specify a priority. There will be an example in this presentation of a debt for nature swap done a few years ago which had a REDD+ focus in Kalimantan. Nonetheless, it is a dynamic process. You cannot just decide upfront exactly where every dollar will be spent. It still needs to be governed and administered over time. It is a very interesting governance arrangement where you have this oversight committee which has members appointed by each of the governments.

In the Indonesian example, there is a member of the oversight committees appointed by the Government of Indonesia, one appointed by the government of the United States and then the other members are appointed by NGOs. I think that one of the strengths that has evolved out of the US debt for nature swap program, is these governance arrangements where there is a real collaborative effort among different governments and NGOs which really brings together very different perspectives and very different expertise to provide some very robust and well thought out governance for how the money is spent.

3. Overview of Indonesia TFCA DNS Transactions



I am going to do a quick overview of the Indonesia debt for nature swap transactions. These transactions, were subsidized debt for nature swap transactions, so they included the US government, the Government of Indonesia, and participating NGOs.

There have been three of them. In two of them, the participating NGOs were Conservation International and an Indonesian NGO by the name of KEHATI[2]. In the other, the two NGOs were The Nature Conservancy[3] and WWF. These three transactions in total canceled more than $56 million of Government of Indonesia debt to the US at closing with an equivalent amount committed for conservation. There was no reduction of the amount of the Government of Indonesia's financial commitment. The Government of Indonesia was assessed to have sufficient foreign currency reserves, have sufficient ability to repay the original debt and so on, so it was negotiated that there was not going to be a haircut to what was canceled. An equivalent amount was going to be obligated by the Government of Indonesia to finance the program. This equivalent amount was to be paid by the Government of Indonesia into a fund over multiple years. For various reasons, the fund was structured offshore. It was set up as a trust in Singapore where the capital of the fund is held and annually money from the fund gets transferred and disbursed into Indonesia for use for the program.

The fund amounts are used to support conservation activities in Sumatra for two of the debt swaps and in Kalimantan for the other. The Kalimantan activities are focused on two existing REDD+ initiatives, but there are three different geographies: the Barao project and the heart of Borneo. The REDD+ project is

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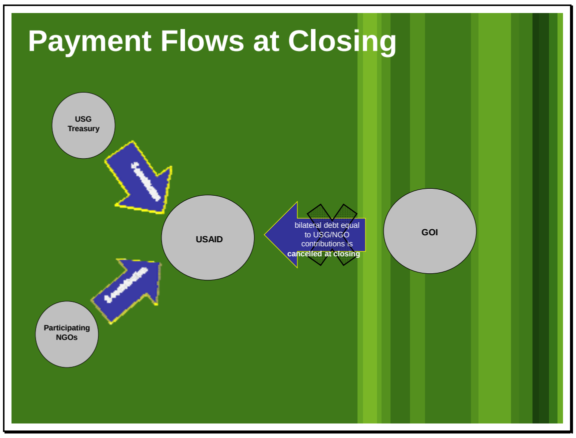
[2] Indonesian Biodiversity Foundation: http://www.kehati.or.id/
[3] http://www.nature.org/

the one with the Nature Conservancy and WWF as the NGO participants. I have some knowledge of it but not the deepest knowledge of that particular project. The ones that I was involved in are those that are supporting Sumatra.

In a lot of the US debt for nature swap transactions, the way that the money is spent is through an open grants program. There are eligible geographies and priorities for the use of funds, but funds are disbursed based on an open grants program which will involves an annual request for proposals to local NGOs. Local NGOs submit proposals for grants in accordance with the program priorities, geographies and a strategic plan.

Just another thing to point out: the NGOs that participate in negotiating these debts for nature swaps are not eligible to actually receive funds. There is a real division between their participation and the ngos receiving grants. They participate by negotiating the deals and helping create the vision for the debt for nature swap, but they themselves are not eligible to receive money for their own conservation activities in country.

4. Payment Flows



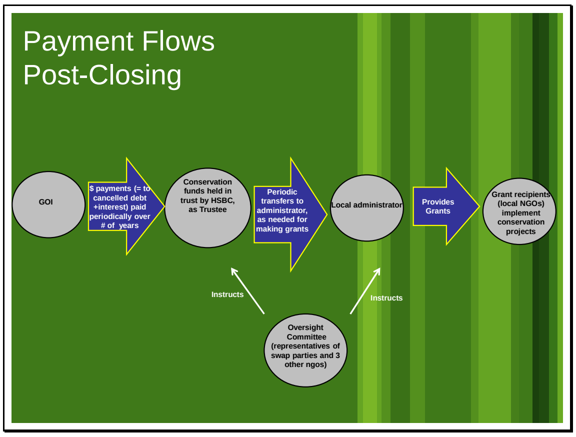
These are two schematics as to how it works. This first schematic basically shows what happens at closing and explains how the various payment mechanics work. Right before a deal closes, what you have are all of the participants. You have the Government of Indonesia, two parts of the US government, the US treasury and USAID, and the participating NGOs.

Before closing, all you really have is bilateral debt. Most of this debt is either old USAID[4] debt or old US Department of Agriculture debt. The Government of Indonesia owes several million dollars to USAID. At closing, the US treasury, which has a certain amount of money sitting in its accounts from a congressional appropriation, makes a payment to USAID and so do the participating NGOs. Normally, if the outstanding face value of the debt (for example in the first Indonesia debt swap) was $22 million, the US Treasury would pay 80% of that $22 million to USAID and the participating NGOs would pay 20%.

Collectively, the US Treasury and participating NGOs pay the equivalent of what is the principal outstanding amount at the time of closing. They basically prepay the debt on behalf of the Government of

[4] United States Agency for International Development: http://www.usaid.gov/

Indonesia. At that point, the bilateral debt is canceled. In exchange for that the Government of Indonesia agrees to make the exact same amount of payments with the exact same payment dates into a fund for the program.



This is how it works after the deal is closed. The government of Indonesia now has an obligation to make $22 million in principle payments plus interest over a number of years. Where are they making these payments? Every deal is structured differently. In this one, it was the parties agreed that the fund would be held in trust in Singapore. A Singapore trustee was identified and HSBC[5] acted as a trustee. Over the course of eight or nine years after the transaction closed, the Government of Indonesia had the obligation to make periodic payments to the trustee, which will equal with $22 million in principal plus interest.

The money gets paid over eight or nine years. It starts getting built up with the trustee. Then, shortly after the transaction closes, the oversight committee and, very importantly, also a local administrator start managing the debt swap funds. The oversight committee is really a committee of a number of individuals who are appointed by the governments and the NGOs. This is like a voluntary board position. They meet periodically every few months. They make the big decisions; how to spend the money and set the strategic focus for the program. However, they are not the ones who are actually interacting with the grantees, so they need somebody to do that from a day to day perspective. Therefore, there is always a local administrator that is hired. In this situation, it was the same organization, the same NGO that participated as a debt swap participant, KEHATI. KEHATI is the leading Indonesian organization when it comes to conservation finance. They have a lot of experience in managing money for conservation. KEHATI was hired on a contract to basically provide administrative services for the program.

What happens is that, after closing, the oversight committee gets to work with the administrator. They develop a strategic plan. They develop a whole grant making procedure. They go out and they do their first request for grant proposals and so on. That may not happen for a year or so until they have developed what they believe is a robust program.

Very often, the very first grant cycle will be a learning experience. They will get to know who the grantees are and there is sometimes a need for capacity building and so on. After a year or so, they are ready

[5] Hongkong and Shanghai Banking Corporation: http://www.hsbc.com/

to start distributing their first grants. What happens is that the oversight committee makes the final decision regarding what grants are going to be given for that year's allocation of grants. The oversight committee instructs the trustee. For example, the oversight committee may have approved in that particular year $2 million worth of grants to local NGOs. They instruct HSBC to wire $2 million to KEHATI. Then KEHATI does the day to day administration. They receive that $2 million and then they grant that money to the local NGOs pursuant to grant agreements.

5. Benefits to Participating NGOs

Why do NGOs like Conservation International, the Nature Conservancy, KEHATI, and WWF participate? There is a cost here. We pay 20% of the debt forgiveness. One is that, invariably, we always work in the countries where we participate in these debts for nature swaps. I believe that has always been the case. It would be hard to understand why an NGO would participate in a debt swap for a country where they are not working. We get to basically help establish conservation priorities. Nowadays, there is an incredible amount of respect to the host countries' conservation priorities. However, I think it is helpful for the NGOs and the US government to also share their perspectives on what the priorities should be.

NGO contribution is leveraged. We only contribute 20%, so our contribution is highly leveraged by the US contributions. The new financing sustains past NGO conservation investments. We have a fund at Conservation International called the Critical Ecosystem Partners Fund[6], which had already invested heavily in three areas in Sumatra. The debt swap really helped consolidate our previous investments. Our investments were basically in local conservation organizations to help build their capacity of conservation.

It helps further strengthen NGO relationships with local governments. It strengthens our local NGO partners and it is good messaging for us. It has a high communications value. These deals do attract a fair amount of attention.

[6] http://www.cepf.net/Pages/default.aspx