WORKING PAPER

Debt4ESG Swap

A renewed and sustainable restructuring approach by SACE

SACE

EXECUTIVE SUMMARY

Global business insolvencies increased rapidly in the first half of 2023, although far from historically low levels. The global macroeconomic outlook remains exposed to several downside risks, especially due to the growing geopolitical tensions, primarily linked to the conflict between Russia and Ukraine but also to the China-Taiwan issue with repercussions on Sino-American relations.

In this context, SACE is promoting – with some new enhancements – the application of an already existing (yet poorly adopted) tool, the "**Debt-For-Environment-Swap**" ("Debt4ESG").

Debt4ESG has been historically defined as an instrument to be used in restructuring processes of sovereign exposure, which involves some facilitations allowed to debtor countries in exchange (i.e. "swap") of their commitment to perform environmental initiatives.

Bearing in mind SACE's purpose to "**contribute to the well-being and prosperity of the Community**", Debt4ESG has the potential to assume a central role in the restructuring of distressed debts, enabling significant positive externalities for the economy and, ultimately, for the planet itself.

This also considering a disruptive approach aimed at broadening the fi eld of application of the instrument both in terms of debt nature (including sub-sovereign and corporate exposure) and debtors' obligations, including all kinds of initiatives (not only environmental, but also social and governance-related) which could have a positive impact on the Community.

In this regard, we've introduced a new type of Debt4ESG: the "Debt-For-**ESG**-Swap".

The actual application of Debt4ESG should always be considered with a "case by case" approach, also taking into account potential threats related to *i)* the monitoring of the actual performance of the initiatives and *ii)* the implications of a possible breach by the debtor.

However, in the first year of application of the new Debt4ESG, we can mention one case among the others, the restructuring process of **U.C. Sampdoria S.p.A.**, which represented a win-win solution both for SACE and the debtor, allowing the going-concern of the company, the maximization of the recovery for SACE and, at the same time, the commitment of Sampdoria to perform specific social initiatives able to produce positive externalities for the ecosystem and for the territory in which the company operates (Genova). A preliminary estimate of the externalities directly linked to these social initiatives has been approx. quantified in €3.2mln over 10 years (the repayment period of the SACE loan).

In 2024 we have set ever more ambitious goals in line with the strategic plan "Together2025" and, more in general, with the role of SACE in the world economy since its establishment. In this context, we expect to expand the application of Debt4ESG, potentially representing a significant breakthrough in restructuring processes.

INTRODUCTION

A **Debt-For-Environment-Swap** is an instrument generally utilized in restructuring processes that involves the exchange of a sovereign debtor external obligation to support a specific environmental project[1].

A broader explanation of the tool is provided by the OECD which defined Debt4ESG as "*the* ***cancellation of*** *(part of the)* ***external debt*** *of a country in exchange for the debtor government's commitment* ***to mobilize domestic resources*** *(local currency or another asset, such as bonds, privatized public assets)* ***for an agreed purpose on agreed terms****. [...]. The main idea underlying a debt-for-environment swap is that instead of continuing to make external payments on outstanding loans in hard currency,* ***a debtor country makes payments in local currency to environmental projects in the country on terms agreed upon with creditors***"[2].

This tool has been created with the dual aim of improving "Sovereign debt" restructuring processes (especially for "Paris Club" credits) and reallocating financial resources for initiatives that could have a positive impact on the environment[3].

However, past experiences have shown some issues with the use of the tool, mainly because of the lack of an adequate monitoring structure able to verify the actual performance of the obligations by the borrower. Hence, Debt4ESG has been poorly adopted in practice.

Nowadays, the financial crisis related to Covid-19 pandemic (which further worsened the debt vulnerabilities of many low- and medium-income sovereigns), in connection with the general increase in interest rates and exchange rate fluctuations (when debt servicing payments are denominated in foreign currencies) pushed toward the needs to provide fiscal headroom in order to limit the impact of distressed situations, with potential systemic consequences on the economy and on the world population itself (especially for low-income countries)[4].

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[1] M. Ochiolini, March 1990, International Economics Department of The World Bank, "*Debt-for-Nature Swaps*".

[2] OEDC, 2007, Environmental Finance, "*Lessons Learnt from Experience with Debt-for-Environment Swaps in Economies in Transition*".

[3] "The first swap was in Bolivia where the Beni biosphere reserve was protected in 1987 when Conservation International bought $650,000 worth of Bolivian debt owed to Citicorp for $100,000. The Bolivian government set aside 330,000 acres that were home to a group of nomadic Indians as well as habitat for 13 endangered species. The government also established three additional reserves totaling 3. 7 million acres. Then, the United States Agency for International Development (USAID) provided $150,000 and the Bolivian government the equivalent of $100,000 for personnel to manage and protect the reserve. All of that not only protected the forest, watershe*d, and native inhabitants, but it permitted some grazing, some logging, and the expansion of settlements as necessary*". WORLD BANK INFORMATION BRIEFS #C.05.4-93.

[4] D. Singh, V. Widge, May 2021, "*Debt for Climate Swaps Supporting a sustainable recovery*".

The environment both for sovereign and non-sovereign entities (i.e. companies) is still very challenging as the global macroeconomic outlook remains exposed to several downside risks, especially due to the growing geopolitical tensions, primarily those linked to the conflict between Russia and Ukraine but also to the China-Taiwan issue with repercussions on Sino-American relations; last but not least, the recent attack conducted by Hamas against Israel, which could lead to a long conflict, aggravating further the risk picture.

The Global Economic Policy Uncertainty index, which measures the level of uncertainty in the world economy, has recently started to grow again (although remaining below the peaks reached in the most acute phase of the pandemic emergency). The weak economic cycle and the lesser confidence that the stressing factors will cease in the short term will lead to an uptick in corporate insolvencies in 2024[5].

The aforementioned factors lead to a scenario in which Debt4ESG represents a good fit[6].

The purpose of such tool is virtuous for all the parties involved in a negotiation[7]:

- for **creditors**, it allows *i)* to **restructure the exposure** (especially when negotiation results are complicated), *ii) to* create **positive externalities,** and *iii)* **to improve the reputation**.
- for **debtors**, it allows *i)* to **reduce the debt** and better manage the cash flow position, and *ii)* to **invest in sustainability**, creating added value for the country in which it operates.
- for **planet Earth**, it increases **the level of sustainability and wellness of the society**.

[5] C. Guerrieri, V. Ranciaro, December 2023, "*Claims and restructuring: What to expect for 2024*", 2023 Berne Union Yearbook

[6] For instance, "*In 2021, Belize needed to restructure a US$553m so-called 'superbond' it had issued because it did not have the resources to pay the debt service on the bond. But with the help of The Nature Conservancy (TNC), a non-governmental organization, Belize was able to enter into a restructuring transaction whereby it achieved a huge reduction in its outstanding debt burden* ***in exchange for Belize making a series of commitments to protect and conserve the enormous but delicate barrier reef that lies off the Caribbean coast of Belize.*** *[…] This was a classic win-win situation.*
Belize achieved huge debt reduction (equivalent to 10% of its annual GDP) and the global community achieved commitments for additional conservation and protection of an ecologically vital barrier reef". by Steven T. Kargman, Kargman Associates, International Insolvency & Restructuring Report 2022/23.

[7] SACE ESG Strategy in collaboration with Bain Capital, December 2023, "*ESG in Restructuring processes*".

HOW DEBT4ESG COULD BE APPLIED

As reported above, the instrument is applied in distressed situations where the debtor cannot meet its financial obligations, and it can be considered an "add-on" to the traditional restructuring approach.

In these contexts, negotiations are conducted between the lenders and the debtor to define a restructuring plan and find a solution to maximize the recovery in line with the expected debtor's cash flow projections.

Potential alternatives (that could be further extended) could be represented by:

- an extension of the debt duration (i.e. extension of the reimbursement plan).
- lower applicable interest rates.
- partial haircut in principal repayment.
- partial conversion of the debt into equity or other fi nancial instruments.
- a combination of the above.

The involvement of Debt4ESG in these situations could result in granting additional incentives to the debtor in exchange for the implementation of ESG initiatives ("swap" of financial with ESG terms) as reported in the following table[8].

	Partial credit haircut	**Duration extension**	**Interest payment moratorium**	**Conversion into Equity / other financial instruments**
Without Debt4ESG	Partial haircut → €60k	Duration → 10y	Interest payment → €5k	Conversion into Equity → €100k to be converted
With Debt4ESG	Partial haircut → €70k with obligation for debtor to invest up to €10k in ESG initiatives	Duration → 20y, subordinated to the implementation of ESG projects	Interest payment → €0, subordinated to the implementation of ESG projects	Conversion into Equity → 70k€ converted, up to €30k to be invested in ESG projects

Table 1. Traditional restructuring tools vs Debt-for-ESG-Swap (Example for a 100k€ credit deemed eligible for Debt4ESG – focus Corporate)

[8]SACE ESG Strategy in collaboration with Bain Capital, December 2023, "*ESG in Restructuring processes*".

In all cases, if Debt4ESG covenants are not met (i.e. the debtor is not able to perform its ESG obligations as defined with the creditor), some remedies should be defined between the counterparties, including the application of additional costs/penalties (**clawback condition**) such as a higher interest rate, a lower duration in debt reimbursement and others.

THE SACE APPROACH

SACE supported the growth of Italian companies for almost 50 years, providing – *inter alia* – guarantees on loans granted to support the economy in the context of the coronavirus outbreak (under the "The State Aid Temporary Framework") fi rst, and of the negative economic effects resulting from the Russian-Ukrainian crisis subsequently.

Bearing in mind SACE's purpose to "***contribute to the well-being and prosperity of the community***" and the strategic guidelines of the industrial plan "Together2025", Debt4ESG has the potential to assume a central role in SACE's workflow.

In detail, considering the potential externalities of Debt4ESG, SACE is setting its goals and ambitions by gradually adapting its internal policy to embrace the utilization of the tool at its full potential, expanding the fi eld of application of the instrument both in terms of debt nature (including **sub sovereign** and **corporate** exposure) and in terms of swap obligations for the debtor (also including initiatives that could have **a social impact** and, in general, all kind of initiatives that could have a positive effect on the ecosystem).

We introduced a new type of Debt4ESG, the Debt-For-**ESG**-Swap, in line with our purpose to create wellness for the Community. Hence, we also extended the concept of Debt-For-Environment-Swap to Social and Governance.

This approach, in connection with the analysis of SACE's credit portfolio, has allowed to defi ne some "eligibility criteria" (differentiated by type of credit) utilized as guidance in terms of "opportunity prioritization".

Nevertheless, due to Debt4ESG nature, every position should be constantly evaluated on a "case by case" approach considering at least:

- the status of the negotiation.

SACE exposure vs total exposure (to understand potential leverage in negotiations process).

- willingness and possibility of the debtor to perform such ESG initiatives.
- reasonable cash flow projections and SACE debt size (to understand the potential budget to allocate to these initiatives).
- potential externalities of ESG initiatives to be performed.
- proper monitoring and reporting structures to verify the effective implementation of the initiatives by the debtor and related remedies/penalties in case of breach by the latter.

It is an instrument characterized by a virtuous purpose. Still, there are also potential threats in its application related to the subsequent **monitoring process** of the initiatives and the **implications of any breach** by the debtor.

Considering the numerous variables that could affect a restructuring process, the effective application of Debt4ESG could be associated more with an "art" than a "science".

However, already in the first year of application there is one case, among the others, which represents a win-win solution both for the debtor and for SACE: the restructuring process of **U.C. Sampdoria S.p.A.** ("Sampdoria"), an Italian football club with headquarters in Genoa.

CASE STUDY

RESTRUCTURING OF U.C. SAMPDORIA S.P.A.

In the last years Sampdoria highlighted weak economic/financial performance, resulting in the impossibility to face its financial obligation, with the consequent need to renegotiate with the creditor banks a rescheduling of debt.

The financial exposure of the football club was represented (approx. € 50mln) by bank loans insured by SACE.

The expected cash flow projections of the Company didn't allow neither to repay the loans, nor to repay players, staff, "Series A" fees, and other operating costs, resulting in the risk to lose the F.I.G.C. Sport title with the subsequent potential opening of a bankruptcy procedure.

In detail, two potential scenarios were defined:

1. bankruptcy and downgrade to "Serie D" league for the football club → **almost zero credit recovery**.
2. restructuring and capital injection by new investors → **partial (or, based on specific conditions, potentially also total) credit recovery** in the long period.

After several months of negotiations, an agreement was defined between Sampdoria and SACE based on the second scenario, allowing the going concern of the Company (and related workforce) and avoiding a possible detrimental recovery for SACE and a significant reaction from the fan club.

At the same time, to maximize the result of the restructuring process, some additional conditions were added to the agreement regarding the commitment of Sampdoria to perform specific ESG initiatives, with different impacts on interest rates applied to the SACE loans.

In detail, the initiatives are the following:

1. free access to sport facilities and soccer schools for all children from family households with an equivalent economic status index lower than €15k.

2. free admission tickets for UCS "in-house" matches to all people with disabilities or with an equivalent economic status index ("ISEE") lower than €15k.
3. organization of charity events (at least twice per year), devolving profits to *i)* non-profit organizations (ONLUS), *ii)* charitable organizations and *iii)* local startups with ESG purposes.
4. organization of charity auctions for original t-shirts worn by the top 3 players during "in-house" matches (or "commemorative" matches) and devolving profits to *i)* local non-profit organizations (ONLUS), *ii)* local charitable organizations, and *iii)* local startups with ESG goals.
5. organization of educational visits (twice a month) to secondary schools and youth centers in Genoa with the aim to *i)* promote ethical and moral values linked to sport and *ii) a*ddress social issues (e.g., bullying, youth crime, etc.).

Consequently, a monitoring and reporting structure has been defined between the parties to assess the completion rate of the initiatives yearly.

Monitoring of the implementation of the initiatives will be carried out both on a declarative base by the company itself and by sample checks from SACE.

At the end of every year, a scoring will be assigned to every initiative and a weighted average final scoring will be calculated (determined by the 5 initiatives considered), which will result in different interest rates applied on the SACE loans (based on a grid negotiated with the football club).

A preliminary estimate of the externalities directly linked to these social initiatives has been approx. quantified in €3.2mln over 10 years (repayment period of the SACE loan). There are also indirectly linked externalities, in the sense of incremental value added by the ESG initiatives on the relevant areas of Genova's public spending (to be verified with a counterfactual approach).

This was just an example in which the Debt4ESG represents a win-win solution between SACE and the Company.

The agreed solution has allowed a higher credit recovery compared to the alternative scenario while preserving the company's going-concern and related workforce and enabling potential positive externalities for the territory in which the company operates (Genoa) and for the planet itself.

CONCLUSIONS

At SACE, we believe that Debt4ESG is a promising financial instrument that can help countries and corporations tackle their environmental challenges while better managing (or reducing) their debt burden. One of the key advantages of Debt4ESG is that they can help borrowers address their environmental challenges without sacrificing spending on other development priorities (in the case of sovereign debtors) or the very going concern of a company.

Despite the potential benefits of debt-for-environment swaps, their adoption has been limited. One reason for this is that they can be complex to structure and implement. However, with the right policies and monitoring in place, Debt4ESG can be an effective tool for promoting sustainable development and environmental protection. It is our hope that more lenders will adopt this innovative mechanism in the future.

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