



Nature Performance Bonds

FREQUENTLY ASKED QUESTIONS



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Nature performance bonds are an emerging set of debt performance-linked instruments that seek to better align the cost of sovereign debt with success in protecting or enhancing a country's valued, productive natural capital. The following document summarises answers to the most frequently asked questions about these instruments.

Q. By what mechanism does this sovereign debt instrument work?

A. Nature Performance Bonds (NPBs) are key performance indicator (KPI) debt instruments that link a set of nature performance outcomes (or perhaps climate or other sustainability outcomes) to debt terms. A central characteristic of these instruments is that where performance outcomes are achieved, there would be a reduction in either the interest payment and/or principal payment, depending on the structure of the deal.

In September 2020, F4B set out the core rationale for these instruments. A [technical paper](#) and [policy briefing](#) further set out the core rationale for these instruments.

Q. How do NPBs benefit an issuer in terms of reducing debt payments?

A. In the case of an NPB being structured to reduce interest payments - should performance goals be met - annual debt service would be reduced. This has the advantage of providing ongoing incentives to the issuer to meet performance goals to achieve more advantageous debt terms. In the case of a principal reduction, any savings on debt repayments from meeting the agreed performance would occur at maturity of the bond.

Q. How do nature performance bonds link to a country's natural capital and sovereign debt?

A. In some countries, nature does already count in sovereign risk analysis. For example, [droughts in agriculture-intensive export economies](#) (such as Argentina) showcase where nature already implicitly figures in sovereign risk pricing. In most circumstances, however, natural capital is not effectively incorporated into business-as-usual sovereign market risk pricing and trading. There is now burgeoning work on how nature fits into sovereign credit rating models, as well as work to determine where nature and climate fit into

debt sustainability criteria set by the International Monetary Fund (IMF). For instance, F4B is currently working with leading researchers in both the climate/nature and debt fields to quickly build this evidence base. These pieces of work represent longer term efforts to incorporate natural capital into sovereign debt markets in a more systematic and comprehensive manner. Nature performance bonds fit into a set of short-term solutions to effectively move towards pricing nature into sovereign debt markets.

Q.

How do these instruments differ from green bonds? What additional benefits do they bring?

A.

Green bonds are use-of-proceeds bonds, where all funds raised must be spent on delivering climate and/or nature outcomes. In contrast, nature performance bonds only incentivise issuers to meet nature performance outcomes, without specifying how the funds must be used. The issuer therefore keeps policy autonomy to achieve the nature performance objective, as well as other goals. This has the advantage of creating more fiscal space - particularly in the context of the current crisis that many emerging markets are facing - to also fund other policy aims, such as health and social care. Therefore, this is not hypothecated funding, but funding based on agreed performance outcomes.

Q.

To what extent are NPBs different from the better-known debt for nature swaps?

A.

Debt for nature swaps have a long and noble history. But they suffer from being small, ad hoc and not scalable. They are an exotic set of activities on the margins of sovereign debt markets. For these reasons, they have no future in the way in which they are currently run.

Similarly, experience in green bond markets shows that to build a larger, scalable flow of funds linked to policy outcomes, as well as developing a market for pricing outcomes, one needs rapidly to standardise the offer. The key challenge is to design an approach that can work at scale in all debt markets, including sovereign debt markets. A move, therefore, from debt for nature swaps to performance bonds provides an opportunity to link nature and climate in a way that can be standardised, and therefore scaled, to fit the way debt markets fundamentally operate.

By linking nature performance outcomes directly to debt service or principal repayment structures and volumes, one is also reducing the gaming that we have observed in the case of debt for nature swaps, where, in effect, the cancellation of a debt is triggered by the promise of future nature performance returns. This is not the best incentive architecture to ensure that the job gets done. In the case of NPBs, it is a 'pay for performance' model which is more attractive to the creditor, although perhaps a little less attractive to the debtor, because it is not an instant payment in advance of the nature performance being delivered.

According to the United Nations Development Programme, since their inception in 1987, debt for nature swaps been tried out in over 30 countries and have restructured US\$2.5 billion of debt and released US\$1.2 billion into conservation projects.



Will these bonds be linked to new policies or linked to their existing policies?



NPBs could support both existing and new policies. The critical point is that this instrument delinks the mobilisation of funds from the delivery of the performance. In some cases, the debtor may choose to relink the two, for example if the performance outcomes are their fiscal priority; or they may find much lower cost ways to deliver nature performance outcomes that the market - whether a sovereign creditor or a private creditor - is willing to reward them for.



What impact would the issuance of these bonds have on country's credit worthiness?



Credit ratings reflect the estimated ability of an issuer to repay debt. This is partly based on an assessment of macroeconomic fundamentals, and partly on the perceived trust in the institutions who will repay. The issuance of these bonds would not directly impact credit worthiness but, through the achievement of performance outcomes, could well demonstrate over time that countries are improving natural capital at scale and are doing so in a credible manner. Given the increasingly apparent links between natural capital and macroeconomic performance, the achievement of nature-related targets could signal to the market that capital assets central to sustained economic growth are being properly looked after. Therefore, in the medium term, the market may well decide that these performance outcomes are indicators of macroeconomic performance and good governance.

Take, as an example, two countries that are identical apart from the state of nature in each. Both private and public creditors will increasingly consider how nature fits into the pricing of sovereign risk. Depending on all the usual issues to do with scale, data and so on, we would expect to move towards a situation that a country with an improved state of nature could see its debt increasing in relative value for the investors, therefore costing less to the issuing country. That is the outcome that Nature Performance Bonds aim to secure. As with the initial development of the green bond market, it does need to be 'pump primed' (stimulated by initial investment) at the beginning to kick-start the process and get things rolling.

Q.

Is the target group of this new bond only sovereign creditors and not private creditors?

A.

As with the way the market for green bonds has evolved, there should be more and more interest on the part of private creditors, and this interest is already evident. For instance, new data about the degradation of soil in Argentina will certainly interest private sovereign bond traders because agriculture is a primary export of Argentina, and an earner of foreign exchange.

To scale this new market much more rapidly, Nature Performance Bonds would benefit at a catalytic stage from sovereign creditors that recognise the importance of factoring in natural capital as a standard pricing issue in debt markets over the long-term but who, in the short-term, are also willing to 'pump prime' that market by buying down public goods. Thus, positive nature and climate - and indeed development - outcomes, are a direct result of this bond instrument.

The long game is therefore a healthy mix of sovereign creditors and private sector issuers including the hybrids such as Development Finance Institutions (DFIs). In the short-term, just as we saw with the green bond market from 2008 to 2011, initial segments of the market could usefully be 'pump primed' using support from sovereign creditors with an interest in advancing this area, while simultaneously buying down public goods.

The first green bond was issued by the European Investment Bank in 2007 and was used to fund renewable energy and energy efficiency projects. According to the Climate Bonds Initiative, in 2020 a milestone was reached with the issuance of green bonds globally reaching over US\$1 trillion.

Q

What is the role of donors at this stage?

A

For many donors who have Official Development Assistance (ODA) commitments linked to climate and nature, often connecting across different departments, the challenge is to join up those different parts of government where pockets of money are sitting in different places.

The first role of donors is therefore taking up the opportunities to allocate climate- and nature-linked ODA - or ODA more broadly - into specific nature performance bond pilots. This is an area that is low cost and a modest amount of money can support an experiment. There is also the potential to use a modest amount of trust funds to undertake some pilots. The aim should be to launch not just a handful but to see if, in the next six to eighteen months, twenty, thirty or forty pilots can be launched, and rapidly learn what is working and what is not.

Secondly, there is the classic capacity building challenge, which spills across to performance assessment. In a perfect market, an investment bank would negotiate the performance models and would have access to the right capabilities to ensure that nature and climate fit into sovereign debt markets. This would not require special action by sovereign actors or their representatives, and that is the stage we are trying to reach. But today those market intermediaries do not have these capabilities to hand. What we want to avoid is that every single transaction creates a unique performance model that does not really build across and feed into a larger architecture.

The attraction of the work the World Bank and other partners are now taking forward in building a nature and climate sovereign debt facility, is that one can build not just the ability for people to do deals, but also create a more systematic approach that is replicable across multiple deals to measure nature performance outcomes. This is both in the construction of the deal and in the model to oversee the measurement, reporting and verification of performance outcomes, subsequent to deals being agreed. Thus, the donor community can support pilots and infrastructure, and even at this early stage, there is the opportunity to engage actors in a way that builds the longer-term infrastructure of data, performance models and oversight that can eventually transition away from public intermediaries and be taken up by the market.

In February 2021, F4B set out the rationale for a facility to provide the functions needed to rapidly catalyse the issuance of nature, climate and other sustainability bonds.

Following this, the World Bank and its partners the IMF, OECD and UN are working with sovereigns and international stakeholders to establish a new international platform to provide these services.

Q.

Why would private investors be interested?

A.

There are many examples of where the private trading of sovereign debt is already taking into account some aspects of nature. But nature performance bonds really act as a bridge because this is not systematic and widespread yet. There is an urgent need to think about the role of natural capital in underpinning economic performance. The long game is not a continued model of subsidy and buying down public goods but one where natural capital becomes a keystone aspect for the way that many countries manage nature.

Over time, there will be a much bigger role for private investors. They will be able to take this debt on from the beginning, and see how the costs can be reduced and shared. There will be innovation and developments in instrument design that will facilitate this. For instance, Kingfisher recently launched a credit facility worth £550 million dollars to support its targeting of sustainability outcomes. The fixed income market is where Environmental, Social and Governance (ESG) was ten or fifteen years ago in equities, where some asset management firms launched small funds that grew over time. As these funds grow over time, so will the demand for instruments that integrate nature into debt markets.

A good example of how a market has evolved away from public support is seen in the renewable energy market. Ten to fifteen years ago the prevalent assumption was that feed-in tariffs would always be needed to attract private investors. That assumption generated scepticism in private markets, since it is hard to envisage large-scale market development for renewables given their dependency on public support. Today, however, the cost of energy, technological innovation and new business models have enabled the sector to grow as a private market with public support. This demonstrates that, although we expect sovereigns, multilateral actors, and the public sector initially to play a central catalytic role in the development of these new instruments, the private sector looks inclined to respond positively in a range of ways.

Q.

How can NPBs be designed to attract private sector investors?

A.

There are several reasons why private investors would be increasingly interested in these bonds based on how capital markets have responded to the flow of ESG funds. One is that companies with good ESG credentials are trading at higher premiums and getting better traction. Additionally, there is now a track record in corporate fixed income markets of companies issuing bonds based on sustainability outcomes, broadly known as 'sustainability-linked' bonds.

An acceptance of NPBs by investment banks, in terms of issuing and trading, would also help lower the cost of issuing these instruments, enticing in more investors. As more of these bonds are issued over time, and, depending on the nature or climate outcomes, you will see the emergence of new business models that support more private involvement. A key development has been from the European Central Bank, which announced in September 2020 that it would accept bonds with variable payment structures, such as NPBs, as collateral. That is of considerable importance for banks because, if they issue these bonds, they can be used in support of their meeting their capital requirements.

A recent survey by Environmental Finance shows that since 2019, 49 'sustainability-linked bonds' have been issued, worth US\$27 billion. These feature a range of green, sustainability and social outcomes, and payment structures, should performance outcomes be achieved. Notable examples include:

- *In 2019, the Italian energy group Enel issued a US\$1.5 billion five-year, sustainability-linked bond. The bond rate is subject to it having achieved a target of at least 55% of its installed capacity in renewable energy by 2021. If the 55% goal is not reached by end 2021, the coupon will be increased by 25bps until the bond matures.*

- *This initial activity has been followed by other firms issuing these bonds, including LafargeHolcim (November 2020), Suzano (September 2020) and Novartis (September 2020). In January 2021, Hong Kong property developer New World Development Co issued the first sustainability-linked bond in Asia, worth US\$200 million over 10 years.*

Q.**Are there accepted market standards available to undertake NPBs?****A.**

There are already a set of emerging initiatives, and these will continue to develop and become more refined. Most notably, the International Capital Markets Association (ICMA) has developed a set of Sustainability-Linked Bond Principles, which lay out approaches to the design of these instruments, such as structuring, disclosure and reporting. They are intended for use by market participants and are designed to drive the provision of information needed to increase capital allocation to such financial products.

As the market for these instruments continues to grow, we are then likely to see the emergence of standards and clear examples of best practice, which will drive down issuance costs and allow market participants to align performance targets with science-based nature and climate indicators.

Q.**How much money is needed to ‘pump prime’ this market?****A.**

There is no exact figure, but several factors need to be considered. The ‘pump priming’ aspect might be less painful and more attractive in a situation where sovereign creditors are considering debt relief. There are also ongoing discussions about the redistribution of the new, USD\$650 billion Special Drawing Rights (SDRs) allocation supported by key IMF member countries – for example, whether there are any ways SDRs could be linked to green performance outcomes for climate and/or nature. The main issue is to show early ambition in the size and scale of NPBs. If issuance is limited to \$500 million or \$5 billion, that is a good start in capital market terms. But in terms of a fixed income markets, it is a small amount. On the low end, \$50 billion worth of issuance in a year would be a good start. But there is the potential to be much more ambitious and achieve a situation where half a trillion of issuance is possible each year.

Q.**Is using public funds to support nature performance outcomes an effective way of improving nature outcomes?****A.**

In the case of a one-off deal, supporting nature outcomes through sovereign debt markets would probably be an inefficient way of using public funds. When seen as a way to ‘pump prime’ a market, however, the value for money increases. This is a classic infant industry argument applied to a piece of financial system as opposed to the long-term subsidy model.

There are further considerations. There is a difference between thinking about NPBs as a concessionary blended finance model to reduce the cost of capital on the one hand, and the need to build a more systematic way for NPBs to move more rapidly into capital markets without concessionary finance, on the other. It follows that public investment in building nature performance finance and governance models, and building the technical assistance capacity needed to oversee these, enables us to go beyond a direct subsidy to one deal but instead eases the capacity to do many deals.

Q.

Could NPBs be linked to broader efforts to develop nature and climate markets?

A.

There are several parallel discussions on whether one can link nature performance bonds into voluntary carbon markets, which are rapidly emerging as a potential way to fund urgent nature-based solutions. There is also a broader ecosystem of initiatives beginning to emerge where nature performance bonds could potentially be linked to revenue generating models. That could be in the carbon market space or it could be elsewhere. The direction of these initiatives is not only to focus on public good outcomes or long-term enhancements of the economy as the sole objective. Instead, there is an emphasis on the opportunities to link with specific private revenue models as well. This would reduce the need for public support. There are a range of different ways in which this could happen. What is really needed at this stage is trying several things out. In the green bonds space, as market participants began to try out different business models between 2008 and 2011, the market did pick up and began dynamically to develop its own approaches. The same is likely to happen with NPBs.

A leading example of this approach is the Natural Capital Investment Alliance founded by Lombard Odier, Mirova, HSBC and Pollination, which seeks to raise \$10 billion by 2022. The initiative will look to source new revenue streams from nature, including from forests and oceans, and from large-scale habitat restoration schemes.

Q.

How would these instruments work in the context of international discussions about debt restructuring? Would nature performance bonds offer an opportunity to scale investments in nature in this context?

A.

Advancing the place of nature and climate in sovereign debt is a particular opportunity in the context of the emerging market sovereign debt crisis. Debt relief in effect places sovereign creditors - and potentially private creditors - in a position where they could make some reductions in capital repayment demands. The context for building nature and climate into sovereign debt is more relevant due to the awful situation that we are in. There are a number of initiatives out there that are notable, for instance, the UNECA Africa Debt Liquidity Facility, that could be connected directly and indirectly to green, inclusive debt relief; that conversation isn't yet concluded. Despite this, it seems that integrating nature and climate KPI-linked sovereign debt instruments into a consolidated Paris Club or G20 deal is not very likely at scale because it is too complicated. It seems more likely that these instruments would be used primarily in the new issuing space, which can happen alongside the debt relief process, as well as into the longer term.

There is also a broader issue of debt sustainability, particularly in differentiating debt restructuring to fix short-term liquidity problems compared with longer term debt issues. Debt instruments that promote the role of nature are clearly more important in the latter case, given the underlying green drivers of nature, productivity and prosperity. In the context of countries with a serious debt sustainability problem, NPBs aim to support countries on the progressive side of the story while not undermining the discipline that is needed in their core mandate around debt sustainability. There is precedent from five or six years ago when Financial Sector Assessment Programs (FSAPs) conducted by the IMF could not take account of climate issues. F4B is now encouraging new ways for debt sustainability criteria to account for climate and nature, which are clearly part of country resilience and productivity drivers. This is part of the drive to develop ways in which relevant nature and climate aspects can be part of the way we think about debt sustainability going forward.

About Finance for Biodiversity

Finance for Biodiversity (F4B) aims to increase the materiality of biodiversity in financial decision-making, and so better align global finance with nature conservation and restoration. F4B is advancing five workstreams that create and amplify the feedback signals that increase the value of biodiversity in private and public financing decisions:

Market efficiency and innovation: including a leadership role in the Taskforce on Nature-related Financial Disclosures (TNFD), and support to a number of data and fintech-linked initiatives.

Biodiversity-related liability: with a particular focus on the place of extended environmental legal liabilities for financial institutions, as well as financial policy and regulatory initiatives.

Citizen engagement and public campaigns: advancing data and fintech-led instruments to catalyse shifts in citizen behaviour as consumers, savers, pension holders, insurers and capital owners.

Responses to the COVID-19 crisis: advancing measures and advocacy linked to stimulus and recovery spending, and the place of nature in sovereign debt markets.

Nature markets: catalysing nature markets by developing new revenue streams and robust governance innovations.

F4B has been established with support from the MAVA Foundation, which has a mission to conserve biodiversity for the benefit of people and nature. Its work is also supported by the Gordon and Betty Moore Foundation through The Finance Hub.



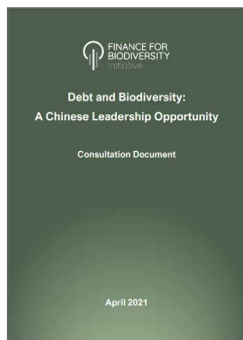
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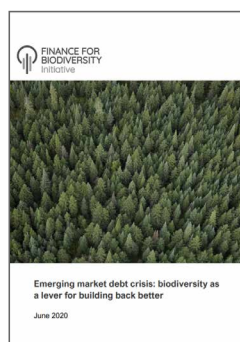
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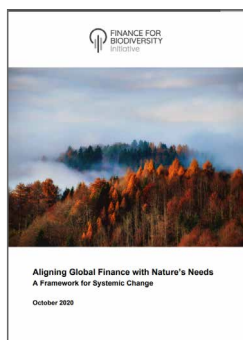
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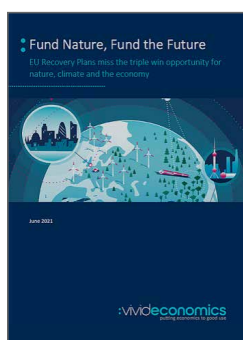


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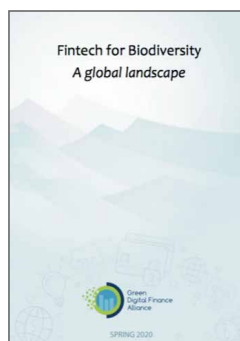
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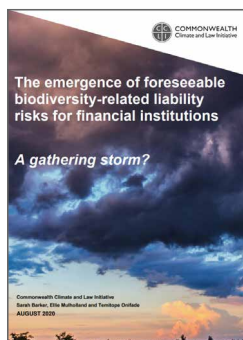
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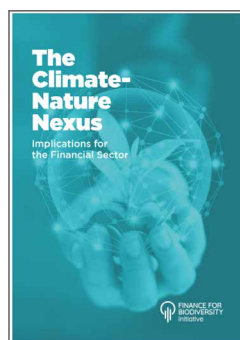
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