CASE STUDY

SEYCHELLES DEBT CONVERSION FOR MARINE CONSERVATION AND CLIMATE ADAPTATION

MARCH 2017

EXECUTIVE SUMMARY

NatureVest, the conservation investing unit of The Nature Conservancy (TNC), structured a groundbreaking debt conversion for marine conservation and climate adaptation with the Seychelles government. TNC created the Seychelles Conservation and Climate Adaptation Trust to raise grant and loan capital for the debt conversion and, in exchange, the Seychelles government committed to improved policies and increased investment around marine conservation and climate adaptation. The trust extended a specific-purpose loan to the Seychelles government to purchase USD 21.6M of its sovereign debt at a discount. The debt conversion effectively redirects the Seychelles' debt payments from official creditors to the newly created local trust, and restructures debt payments to more favourable terms (i.e., longer term and partial conversion to local currency). The trust will use the Seychelles' debt payments to (1) repay the initial capital raised, and (2) fund ongoing marine conservation and climate adaptation programming. The debt conversion is expected to contribute to the creation of the Indian Ocean's second largest marine reserve.

While debt conversion instruments are complex and context-specific, debt conversion does represent a potentially high-impact model for small island and coastal nations that face high levels of sovereign debt and lack funding for important environmental and development priorities. NatureVest aims to work with other countries facing similar challenges to structure debt conversions that will support ecosystem-based adaptation strategies and improve fisheries and marine management.

SYNOPSIS

Lead intermediary	NatureVest, the conservation investing unit of The Nature Conservancy
Transaction overview	• Grant and loan capital raised for Seychelles Conservation and Climate Adaptation Trust • Trust extends loan to the Seychelles gov't to purchase sovereign debt at a discount • Seychelles gov't repays the trust on more favourable terms compared with official creditors • Trust (1) repays loan capital and (2) uses remaining funding (grant capital, discount on debt) to fund marine conservation and climate adaptation activities
Transaction size	USD 21.6M total, comprising: • USD 5M grant funding • USD 15.2M loan capital • USD 1.4M discount on USD 21.6M sovereign debt
Key stakeholders	• Government debtor: Seychelles • Official creditors: Belgium, France, Italy, the United Kingdom (under the Paris Club) • Grant providers: Several philanthropic foundations and individuals • Loan capital: TNC
Close date	• 2015
Trust activity	• Repay USD 15.2M loan from TNC at 3% over 10 years • Disburse USD 280K/year over 20 years in local currency for marine conservation and climate adaptation activities • Invest USD 150K/year over 20 years in endowment to fund future programing
Target impact	Increase protection for Seychelles waters from less than 1% to more than 30% of the country's Exclusive Economic Zone; support the creation of the second largest Marine Protected Area in the West Indian Ocean; provide a permanent funding stream for ongoing climate adaptation and marine conservation activities

INTRODUCTION

The Nature Conservancy (TNC) is a conservation organization working around the world to protect ecologically important lands and waters for nature and people. NatureVest is the conservation investment unit of TNC, and its mission is to create and execute investable deals that deliver conservation results and financial returns for investors. To mitigate the effects of climate change on the Seychelles, NatureVest worked with the Seychelles government on a groundbreaking debt conversion for marine conservation and climate adaptation.

The Seychelles is a developing nation of 115 small islands off the coast of East Africa. The country is 99% ocean, and tourism and fishing are major parts of the economy. As a result, the people and economy of the Seychelles are vulnerable to the threats of climate change. Already, more severe storms and rising sea levels are battering coastal areas that attract tourists, warmer ocean temperatures are diminishing fish stocks, and increasing ocean acidity from rising carbon levels is destroying coral reefs that buffer the force of storms and provide vital habitat for numerous marine species.

TRANSACTION DESIGN AND FUNDRAISING

The Seychelles debt conversion came about through TNC's expertise and work structuring debt conversions for conservation. In a typical debt conversion, TNC raises a mixture of grants and repayable loans for a new non-profit trust. The trust uses its capital to extend a loan to a government that has a high debt burden and faces the imminent threat of climate change. The government purchases its debt from creditors. The government repays the trust on more favourable terms (e.g., over a longer period). The trust uses the debt payments from the government to (1) repay the initial capital raised, and (2) fund ongoing conservation programming. In exchange for restructuring its debt obligation on more favourable terms, the government commits to improved policy and increased investment in conservation (e.g., creating marine protected areas and no-take zones).

The Seychelles government became interested in the idea of a debt conversion after hearing about a TNC-led debt conversion for Belize focused on marine conservation and climate adaptation that ultimately did not come to fruition. In early 2011, NatureVest and the Seychelles government began working together on designing the transaction. This was the first step in the structuring process: identifying a debtor country (the Seychelles) that would agree to participate in a debt conversion in exchange for commitments to improve policies and increase investment focused on marine conservation, ocean protection, and climate change adaptation.

The second step in the structuring process was to identify a willing creditor to whom the Seychelles had an outstanding debt obligation. At the time, a large part of the Seychelles external public debt was to creditors subject to a Paris Club restructuring. The Paris Club is an informal group of official creditor countries whose role is to find coordinated and sustainable solutions to payment difficulties experienced by debtor countries.

The Seychelles had encountered debt payment difficulties because of the 2008 financial crisis. In 2008, total public debt of the Seychelles stood at over 150% of GDP, with external public debt representing 95% of GDP. A large part of this external public debt was to Belgium, France, Germany, Italy, Japan, and the United Kingdom, and a large proportion was in arrears. In 2009, this debt was restructured under the umbrella of the Paris Club and the Seychelles embarked on a five-year, International Monetary Fund (IMF)-backed economic reform programme to reduce external public debt.

Official creditors within the Paris Club were identified as potentially willing sellers, and negotiations began to convert up to USD 80M of Seychelles debt with an average tenor of 8 years. Approximately half of the USD 80M target was concessional debt owed to France that had already been reduced in value through the first Paris Club restructuring, and the remainder was non-concessional debt owed to a combination of Belgium, France, Germany Italy, Japan, and the United Kingdom. Due to several factors, the target debt conversion amount of USD 80M was not realized. Germany and Japan opted not to participate, and France chose not to include the already-restructured concessional debt in the conversion.

After a lengthy negotiation process, debt totalling USD 21.6M was agreed with Belgium, France, Italy, and the United Kingdom. This amount was then discounted to USD 20.2M a rate of 93.5 cents on the dollar. Initial expectations of a larger discount – around 75 cents on the dollar – were not possible, as the Seychelles became a model for reforms after the 2009 restructuring; the Seychelles had reduced its debt burden, was running budget surpluses, and was achieving strong economic growth.

The transaction is notable for several reasons. It marks the first time Paris Club creditors have supported a debt buyback designed to benefit the environment, and creditor participation in the agreement is the highest ever achieved in a buyback reached through the Paris Club's market-based window.

The third step in the structuring process was to raise USD 20.2M to purchase the sovereign debt. NatureVest raised the funds from two sources: (1) USD 5M in grants was raised primarily from philanthropic foundations, including the Leonardo DiCaprio Foundation, Waitt Foundation, Oak Foundation, China Global Conservation Fund, Jeremy and Hannelore Grantham Environmental Trust, and the Turnbull Burnstein Family Charitable Fund as well as Lyda Hill and (2) TNC provided a USD 15.2M loan repayable at 3% over 10 years.

Grant providers played an important role in pushing the transaction forward; an early USD 1M commitment from one foundation was a catalyst for securing participation from the Seychelles government in the transaction. One grant provider commented that while the structure may have been complex, their relatively small commitment would flow through to funding for NGOs and other entities undertaking conservation efforts on the ground in the Seychelles, as well as result in a much larger commitment from the Seychelles government around marine conservation and climate adaptation policy and investment.

The final step in the structuring process was to establish the local entity, the "Seychelles Conservation and Climate Adaptation Trust," to do the following:

- Hold USD 5M grants and USD 15.2M loan from TNC
- Lend USD 20.2M to the Seychelles government to purchase USD 21.6M in debt from official creditors at a discount to face value
- Hold two promissory notes issued by the Seychelles government on more favourable terms relative to original debt (average tenor of 13 years versus 8 years originally; repayments partially in local currency)
  - Note 1: USD 15.2M at 3% over 10 years
  - Note 2: USD 6.4M at 3% over 20 years, with annual payments of USD 430K totalling USD 8.6M. The government may pay up to 68.5% of this note in local currency at the spot rate on the day payment is due. While the government takes currency risk, it is beneficial for payments to be in local currency rather than USD.
- Use the proceeds from the new notes to:
  - From note 1: Repay the USD 15.2M TNC loan at 3% over 10 years for a total of USD 17.7M
  - Partially from note 2: Fund marine conservation and climate adaptation programming, disbursing USD 280K per year in local currency equivalent over 20 years for a total of USD 5.6M
  - Partially from note 2: Capitalize an endowment for future programming, investing USD 150K per year at 7% compounding interest over 20 years for a total of USD 3M; the endowment has an expected value of USD 6.6M

NatureVest undertook all structuring and fundraising internally, with pro-bono legal support from Ropes & Gray and advisory support from White Oak Advisory. While the process of bringing the debt conversion to close was not linear, the figure below illustrates the high-level steps in the process.

STRUCTURING PROCESS

1. Identify and work with debtor country to purchase sovereign debt; secure commitments from debtor country to improve policy and increase investment in specific development area
2. Identify and reach agreement with creditors willing to sell debt owed by debtor country
3. Fundraise for repayable loan and non-repayable grant capital for debt buyback
4. Establish a local trust fund or non-profit entity to lend debtor country funds to purchase sovereign debt, receive debt payments, and fund programming

Figure 1: High-level steps in process of structuring transaction

The structuring process began in early 2011 and reached a close in early 2015, approximately four years later.

TRANSACTION STRUCTURE

The figure on the following page illustrates the transaction structure, including the sequence of funding flows between different stakeholders.

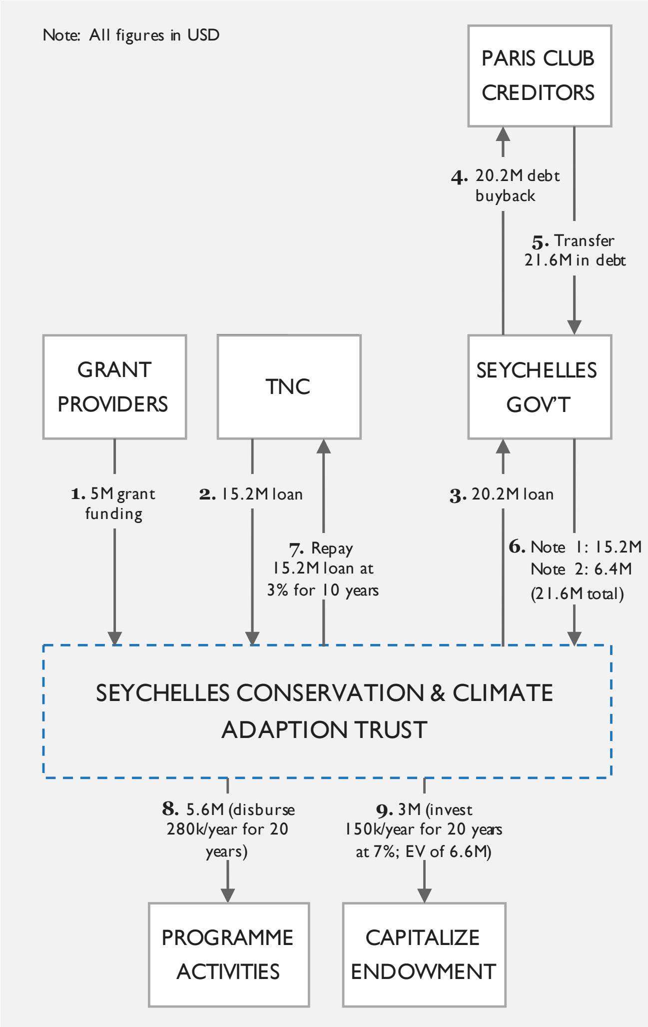

Figure 2: Transaction structure

TRUST FUND STRUCTURE AND OPERATIONS

LEGAL AND GOVERNANCE STRUCTURE

The Seychelles government established the Seychelles Conservation & Climate Adaptation Trust as an independent, nationally based, public-private trust fund through the Conservation and Climate Adaptation Trust of Seychelles Act of 2015.

The trust is governed by a Board of Directors representing a diverse group of stakeholders, including:

- TNC
- Two local conservation NGOs in the Seychelles
- Seychelles Hospitality and Tourism Association
- Seychelles Chamber of Commerce & Industry
- Seychelles Minister of Finance
- Seychelles Minister of Natural Resources
- Seychelles Minister of Environment
- CEO of the Seychelles Island Development Corporation

PROGRESS TO-DATE

The trust is currently in the process of hiring a CEO (who will start at the end of March 2017) and finalizing the programming strategy (e.g., finalizing programming priorities, creating a grants committee). The trust expects to begin programming and put forward a call for proposals in mid-2017, and would disburse funds soon after. The Seychelles government made the first payment to the trust in September 2016. The Marine Spatial Plan will be finalized and formally adopted as policy by mid-2017.

EXPECTED PROGRAMMING

Trust programming is expected to take place in the following areas:

- Marine management of the new marine protected areas
- Coral reef and mangrove restoration
- Economic diversification
- Sustainable tourism and fisheries
- Improved related policies

EXPECTED IMPACT

Because of the Seychelles policy and investment commitments, as well as the trust programming activity, the following conservation impact is expected:

- Marine Protected Areas: The Seychelles will increase its marine protected areas from 1% to 30% of its territorial waters – this area amounts to roughly 400,000 square kilometers, or an area the size of Germany. The increase is expected to be complete by the end of 2020, with the first phase increase to 15% complete by the end of 2017.

- No-take fishing areas: Half of this new marine protected area – approximately 200,000 square kilometers – will be classified as "no-take" zone to help protect important tuna feeding grounds, which will increase fish stocks and improve the Seychelles' tuna industry.

- Coastal protection: The Seychelles will restore coral reefs and mangroves, which will buffer sea level rise and the force of increasing, severe storms. It will also develop and reform coastal zone management, fisheries, and marine policy and regulatory protection to cope with climate change.

- Permanent trust fund: The trust fund will manage the perpetual endowment to fund marine conservation and climate adaptation activities in addition to enforcing the terms of the debt restructuring agreement. The trust will also be responsible for distributing the proceeds of the debt conversion annually, through a transparent process, to government and other NGOs.

REPLICATION AND SCALE

The Seychelles is one example of the many small island and coastal nations that are highly threatened by the effects of climate change but lack the funding to adequately manage their marine resources. NatureVest aims to work with other small island and coastal nations facing similar challenges to structure debt conversions that will support ecosystem-based adaptation strategies and to improve fisheries and marine management. With the support of Convergence grant funding, NatureVest is also exploring the potential of issuing a blue bond to aggregate the raising of loan capital to support multiple debt conversions. Following this case study, Convergence anticipates it will publish a case study on the structuring process for the Blue Bond as well.

CONSIDERATIONS FOR FUTURE DEBT CONVERSIONS

The Seychelles debt conversion for marine conservation and climate adaptation represents one model for small island and coastal nations to restructure sovereign debt while supporting conservation and climate adaptation goals. Similar debt conversions in the future should incorporate the following considerations:

- Debt conversions are complex and require several pre-conditions for success: The complex process of structuring the Seychelles debt conversion took approximately four years and required extensive negotiations with multiple stakeholders. Further, the Seychelles presented the ideal pre-conditions for a debt conversion – a government interested in promoting marine conservation and climate, and official creditors willing to sell debt owed by the Seychelles.

- The complexity and high transaction costs of the structure can be justified by the outsized investment and policy commitments from the participating government: While funding for programming as a direct result of the debt conversion – USD 6.4M – may be relatively small, the investment and policy commitments from the Seychelles government in exchange for the debt conversion will result in significant additional funding flows for marine conservation and climate adaptation activities.

- Early funding commitments can have a large impact on pushing a debt conversion forward: An early commitment from one foundation of USD 1M played an important role in demonstrating to the Seychelles government that there was real funder interest behind the debt conversion.

- Expectations around total transaction size should be carefully managed: The initial debt conversion target of USD 80M was announced early in the structuring process, before official creditors made firm commitments. This estimate set expectations of a larger transaction than the USD 21.6M transaction that was ultimately agreed upon.

- Debt conversions could be explored for other development areas. Although the Seychelles debt conversion focused on marine conservation and climate adaptation, practitioners could explore the approach for other development areas.

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