

Debt Restructuring in Sri Lanka

Presentation to the Cabinet of Ministers

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Central Bank of Sri Lanka

Outline

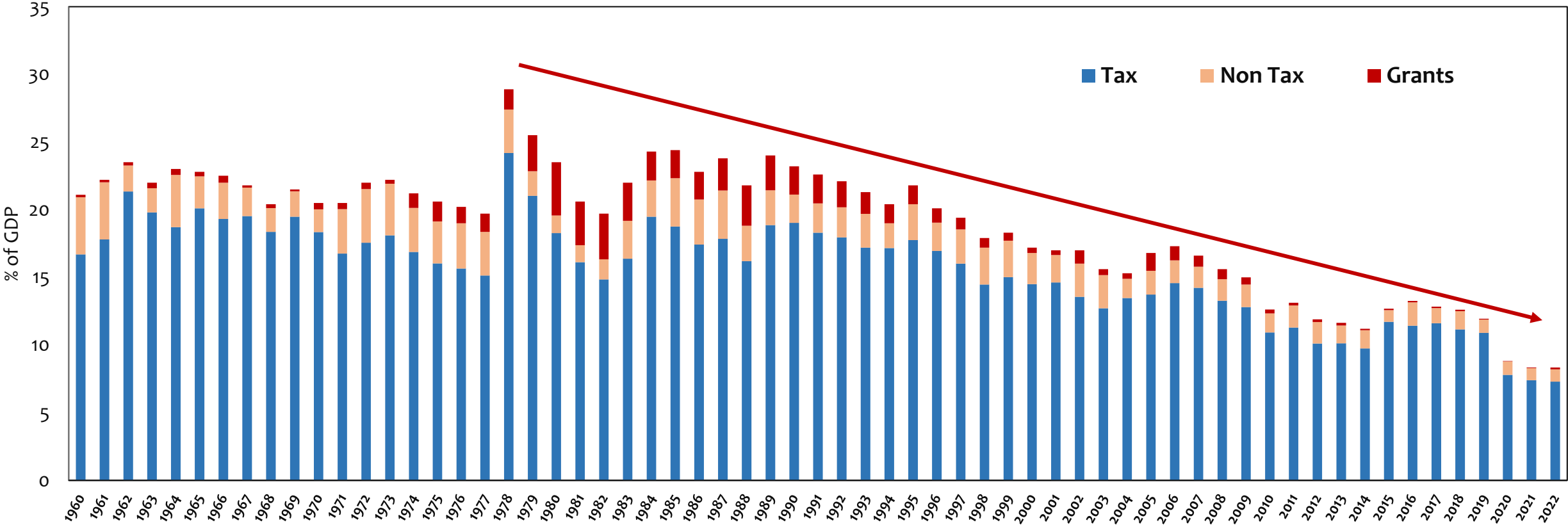
- Sri Lanka's Public Debt Sustainability - Background
- How to Restore Debt Sustainability?
- Why Domestic Debt Optimization (DDO) is essential?
- Who should (will) share the burden of DDO?
- Envisaged Terms of Sri Lanka's Domestic Debt Optimization...

Sri Lanka's Public Debt Sustainability- Background



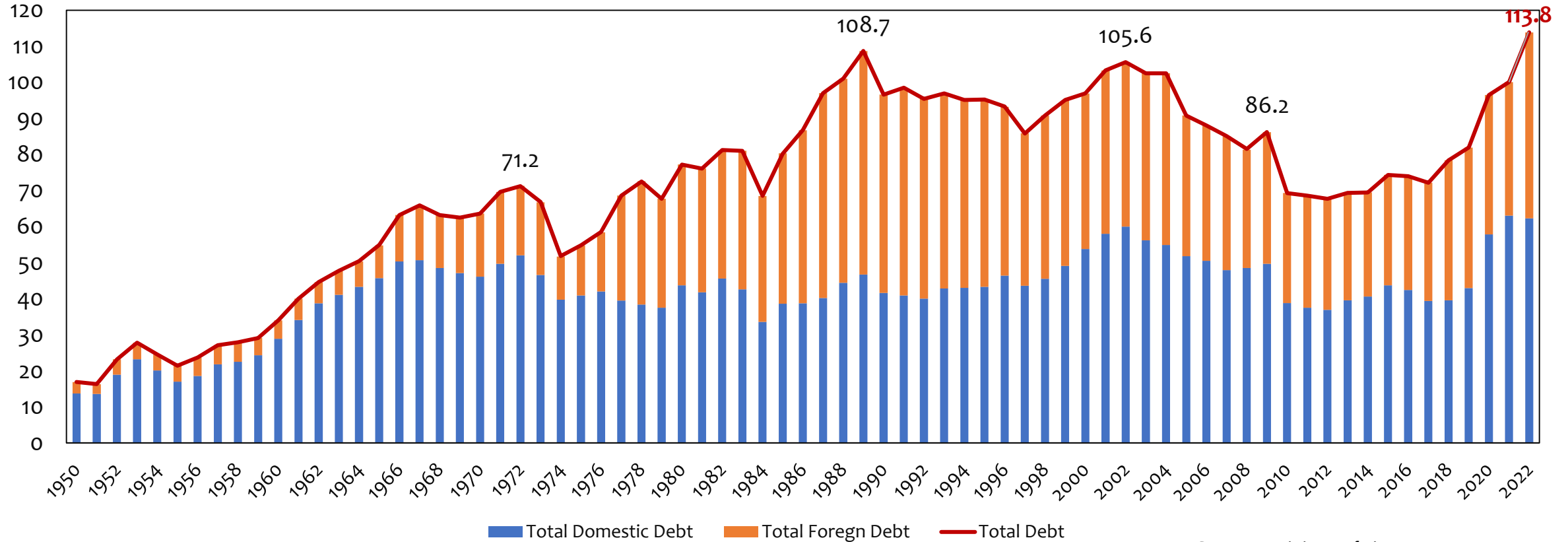
Sri Lanka has not been able to maintain a healthy level of government revenue despite the large public sector expenditure...

Government Revenue



Consequently, outstanding central government debt increased to an unsustainable level...

Outstanding Central Government Debt (as a % of GDP)*



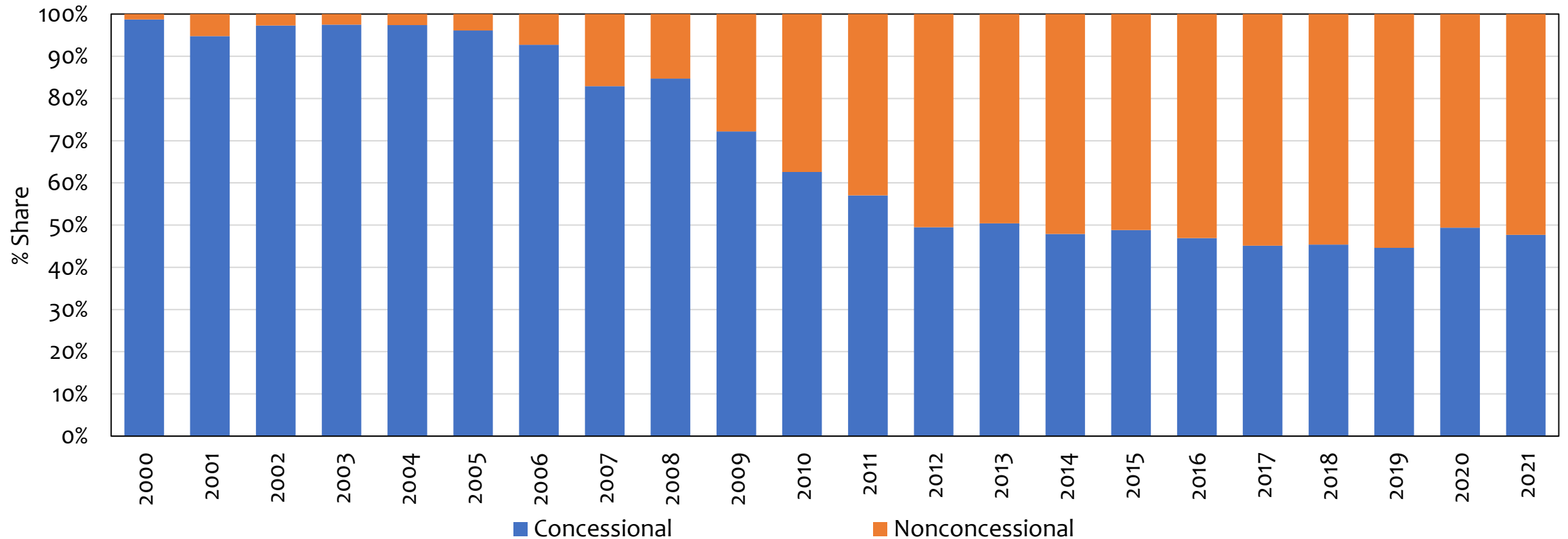
* Based on rebased GDP

Source: Ministry of Finance, Central Bank of Sri Lanka

Despite there have been periods with high debt to GDP ratios, outstanding government debt has reached an unsustainable level in the past two years, due to the debt servicing challenges amidst low revenue mobilisation and limited foreign inflows to the country

Access to concessional funding was constrained with the graduation to the middle-income country status in early 2000s...

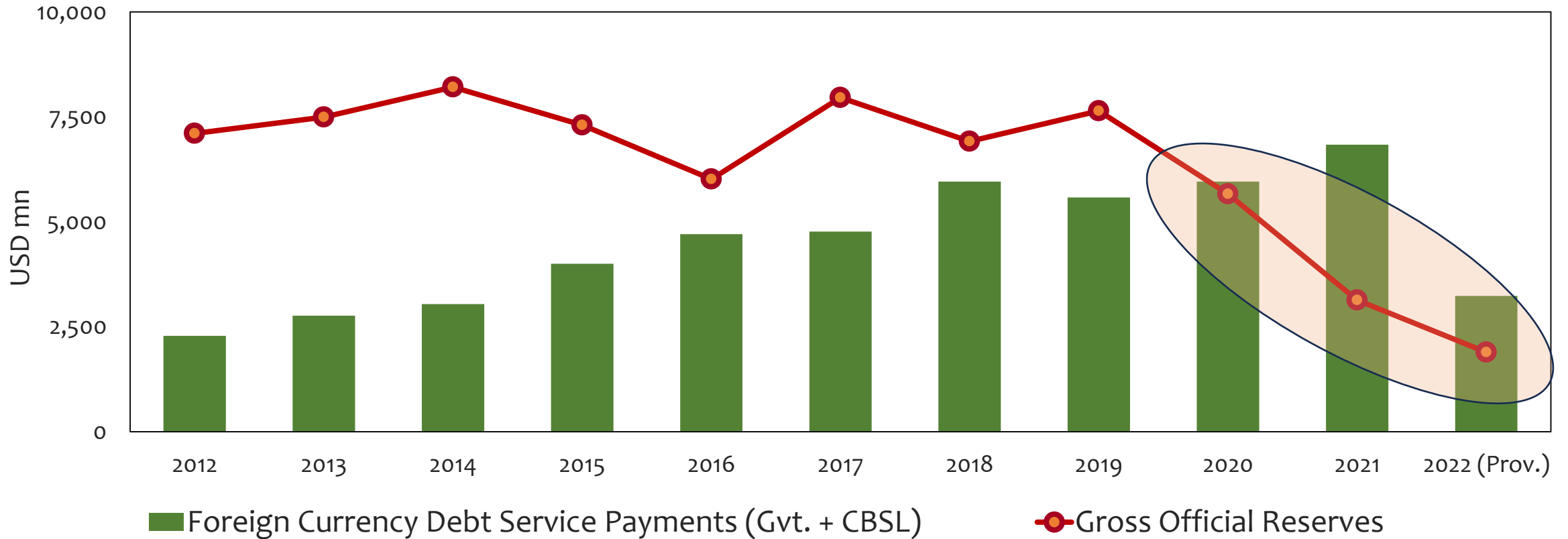
Concessional vs Non-Concessional Central Government Debt



Low cost government foreign borrowings were replaced with high cost borrowings due to the limited access to concessional funding in line with the country's transition towards the middle income status

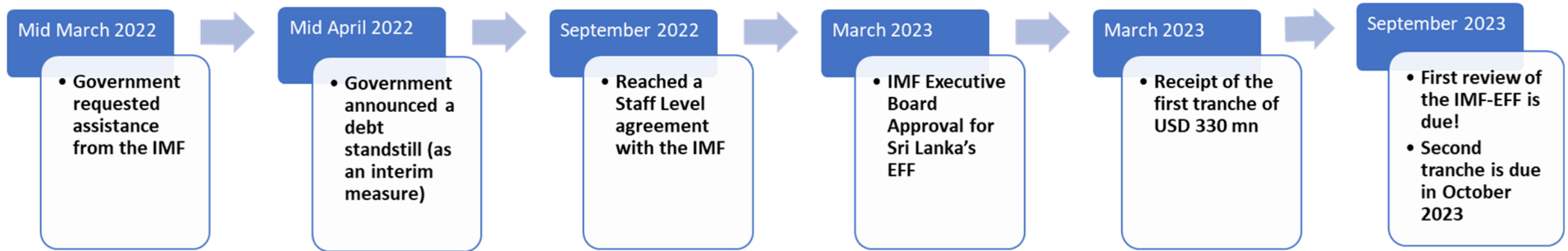
Rolling-over of maturing forex debt became infeasible with constrained access to financial markets from 2020...

Gross Official Reserves and Foreign Currency Debt Service Payments



Heightened external sector vulnerabilities amidst heavy external debt service payments have led to a significant depletion of gross official reserves...

The Government sought assistance from the IMF for an EFF arrangement, which required efforts to restore debt sustainability...

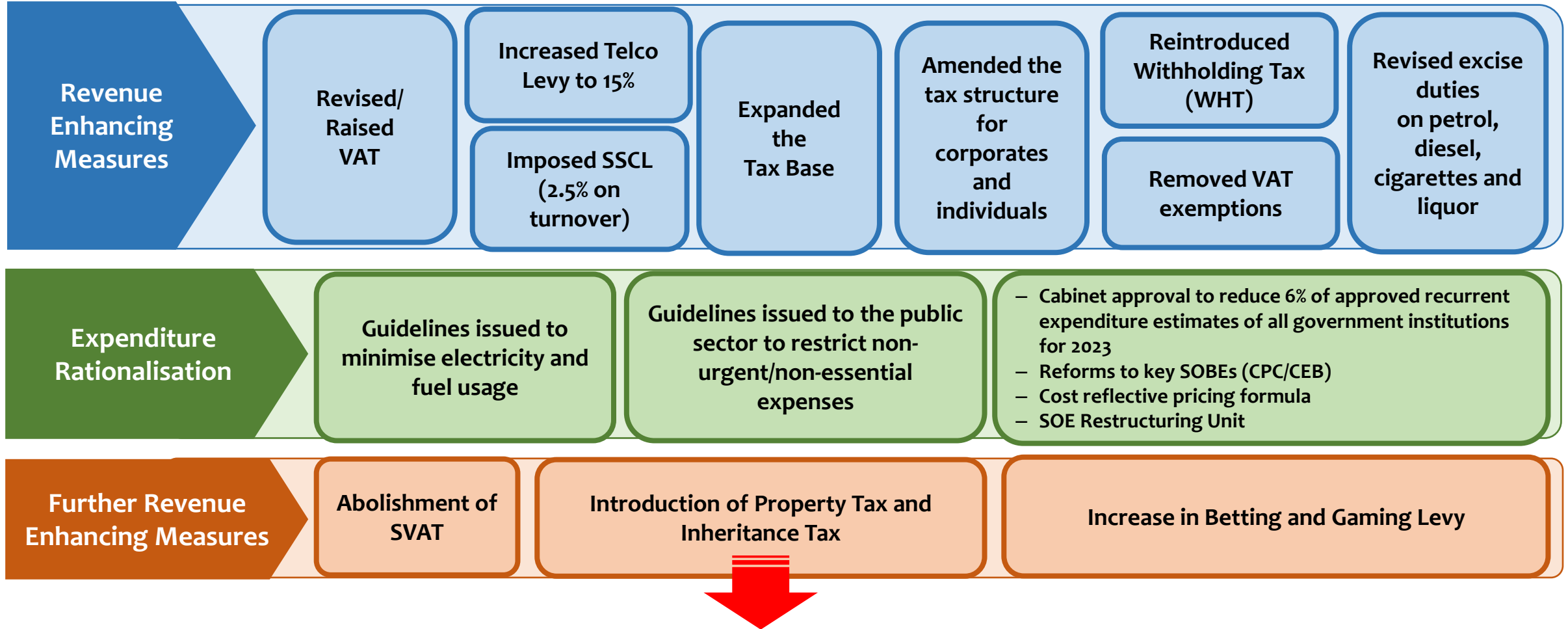


- The release of the second tranche of EFF would require a notable progress on debt restructuring...
- Lazard Frères SAS (financial advisor) and Clifford Chance LLP (legal advisor) are contracted to support the debt restructuring process

How to Restore Debt Sustainability?

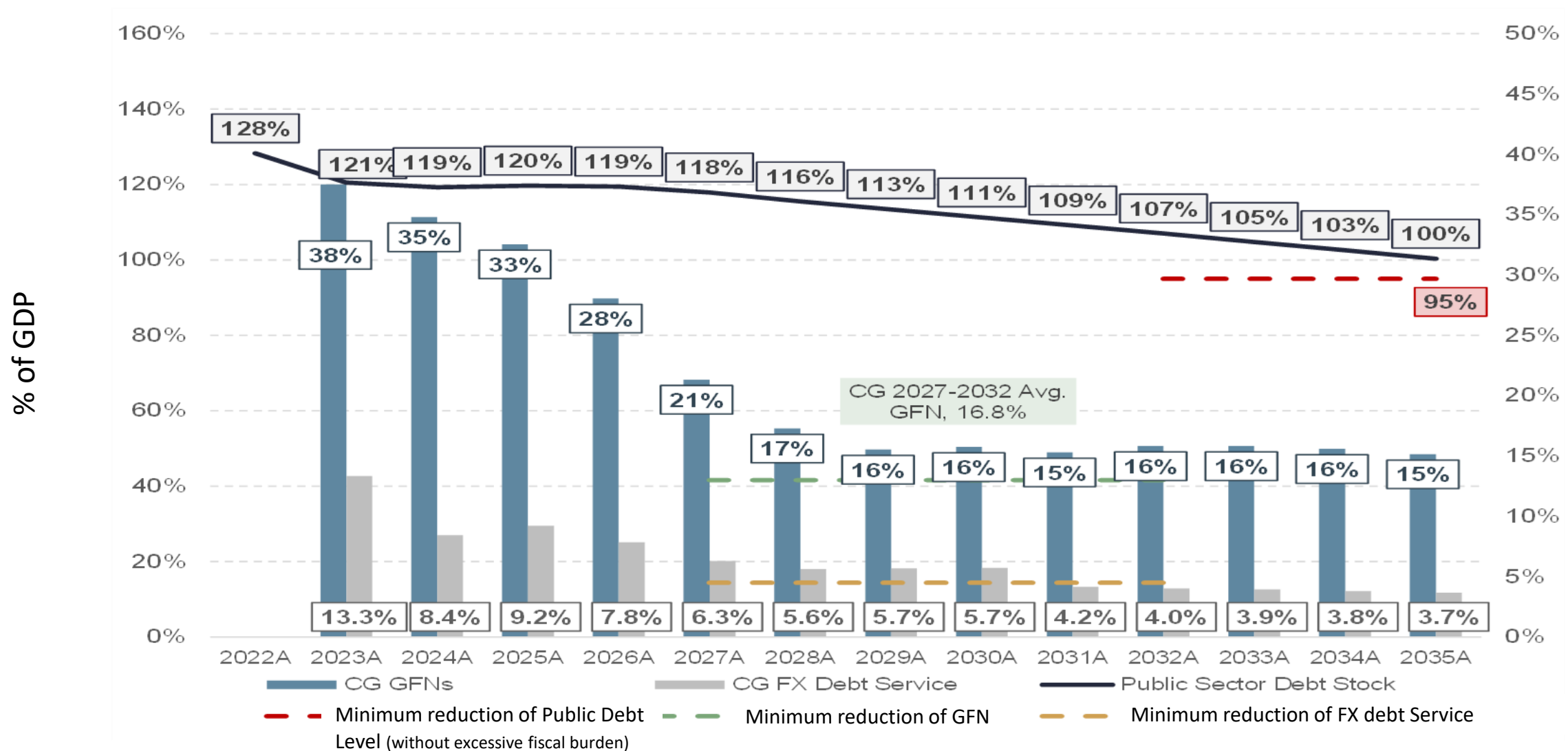


Government has already embarked on a strong fiscal consolidation path, aiming at a sustainable surplus in primary balance...

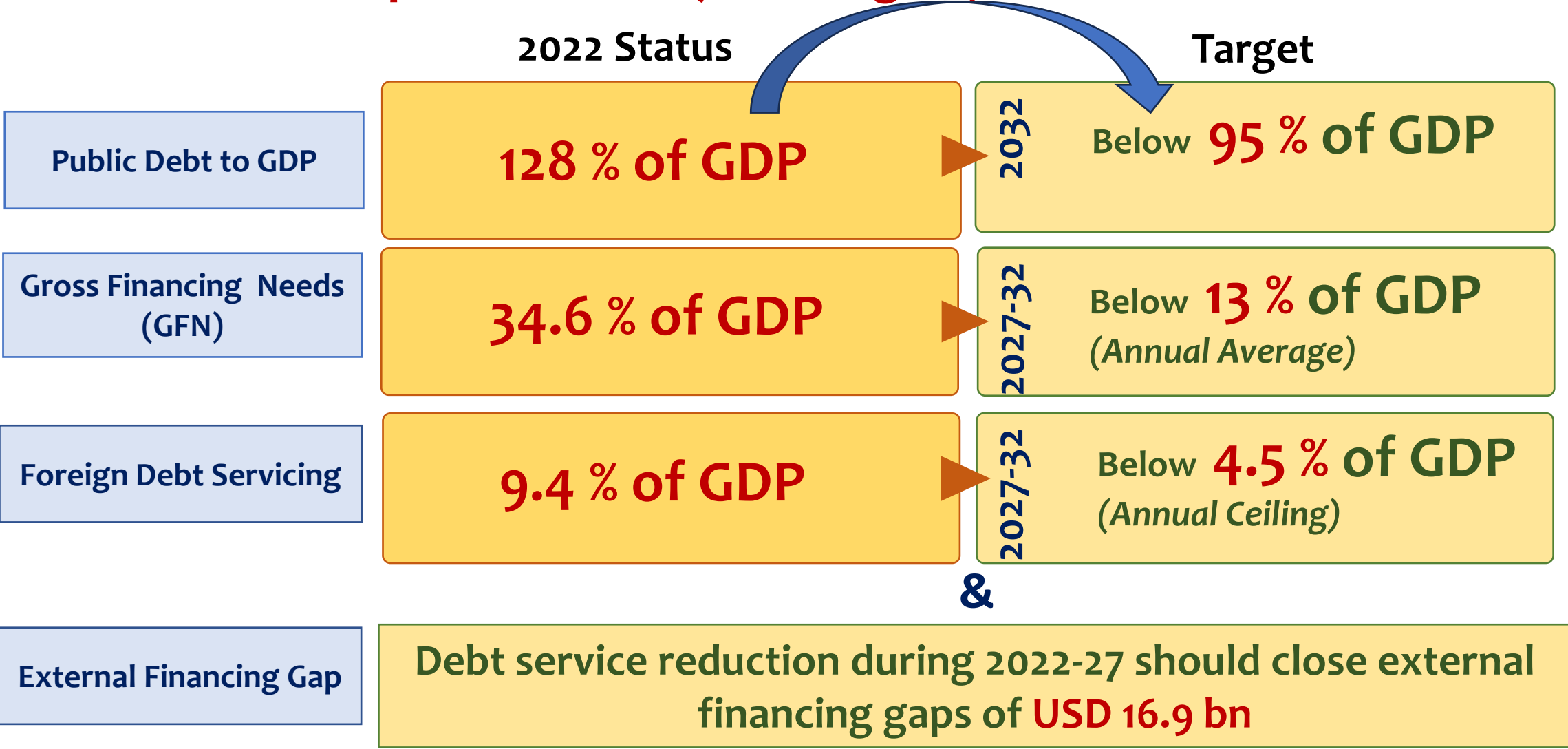


- Significant burden on businesses and households, resulting in a heavy toll on economic activity
- Therefore, further tightening of fiscal stance could be economically and socially costly...

However, a fiscal adjustment alone would not achieve Sri Lanka's public debt sustainability, in the absence of an upfront comprehensive debt treatment...



What is the minimum level of adjustment needed to make Sri Lanka's debt sustainable in the period ahead (DSA targets)?



Discussions are underway for foreign debt restructuring...

Common Platform

- A **Common platform** has been established with the support of Japan, France and India for coordinated negotiation to expedite debt restructuring of Sri Lanka's official debt

Perimeter

- Discussions are ongoing in relation to the **perimeter and parameters for debt restructuring** with regard to bilateral and commercial foreign debt to reach an agreement before the first review of the IMF-EFF

Burden Sharing

- The need for sharing the burden of the envisaged debt treatment between **both the foreign and domestic creditors** has been highlighted by the creditors...

Why Domestic Debt Optimization is essential?

Strategies to achieve debt restructuring targets...

Fiscal adjustment and external debt restructuring alone are inadequate to meet DSA targets?

Restructuring
foreign debt only

- Would not be enough to bring down the GFN to 13%



Large fiscal adjustments
to achieve sizable
surpluses
in the primary balance

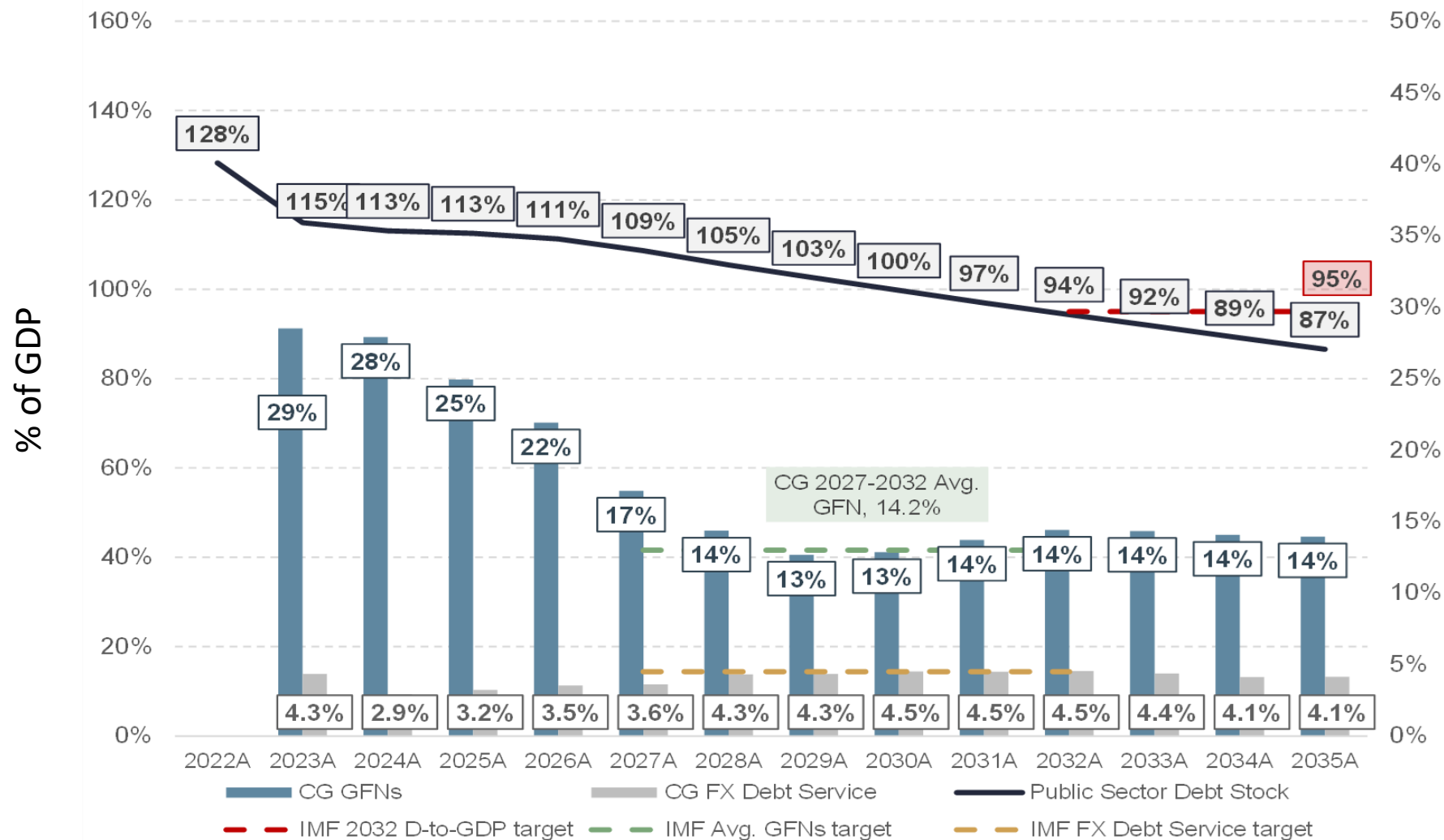
- Will result in extra burden on the people and businesses



Some amount of
Domestic debt
optimisation

- Will be possible with no impact on the banking sector

Envisaged relief from External Debt (EDR) Restructuring to achieve the DSA targets*...



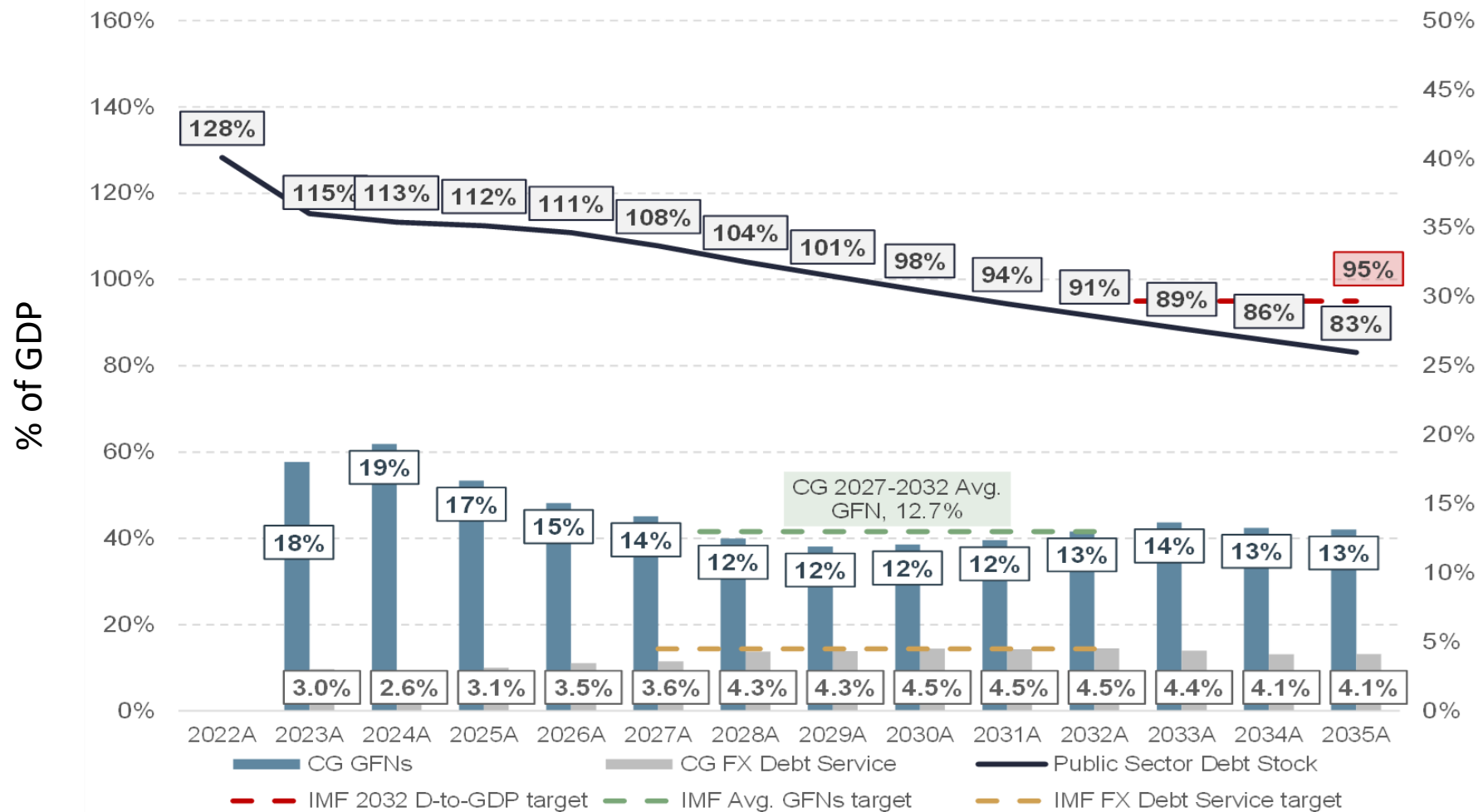
1 ✓ **Debt stock target: 95% of GDP by 2032**

2 ✗ **GFN target: avg. 13% of GDP in 2027-2032**

3 ✓ **FX debt service target: max 4.5% of GDP in 2027-2032**

* Assuming the implementation of the indicative debt restructuring strategy shared with external creditors

Envisaged relief from Domestic Debt Optimization (DDO) to meet the DSA targets*...



1 ✓ **Debt stock target: 95% of GDP by 2032**

2 ✓ **GFN target: avg. 13% of GDP in 2027-2032**

3 ✓ **FX debt service target: max 4.5% of GDP in 2027-2032**

* This assumes that the minimum participation is met, while keeping a buffer to account for any implementation contingencies.

The successful implementation of DDO treatment enables Sri Lanka to achieve the GFNs Target...

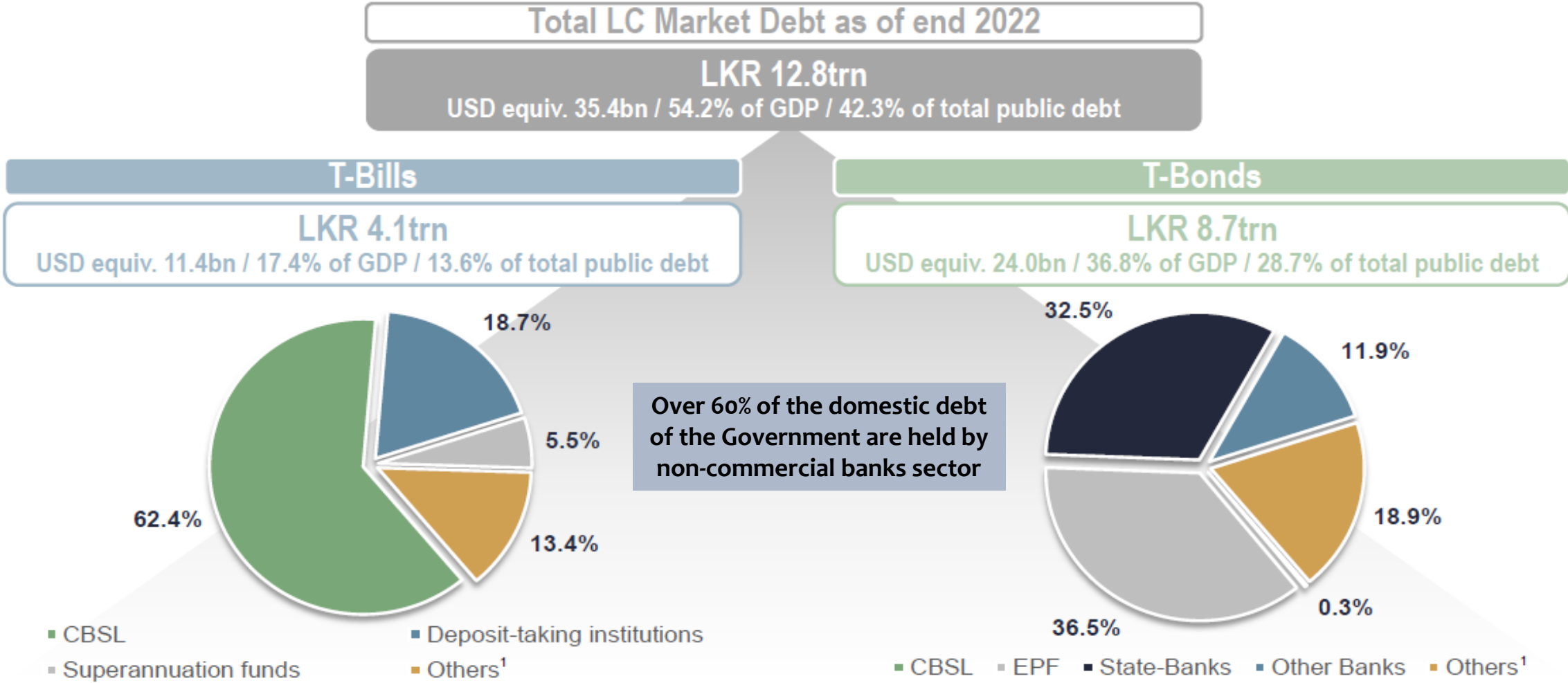
	GFNs (avg. between 2027-32)	Is the GFNs target met? (avg. 13% between 2027-2032)
Absence of debt treatment	16.8%	✘
External debt restructuring ¹ (no DDO)	14.2%	✘
External debt restructuring and domestic debt optimization	12.7%	✔
DDO Impact on GFN	1.5 percentage points	n.a.
<i>Comments</i>	<i>Although it impacts positively the Public Debt Stock, the DDO is mostly aimed at bringing GFNs downwards (as GFNs incorporate both local and external components)</i>	

Note: (1) As per the illustrative debt scenario shared with Sri Lanka's external creditors

Who should (will) share the burden of DDO?



Sri Lanka's local currency market debt represents a significant share of the country's public debt at 42% of total public debt, and more than 50% of the country's GDP...



Note: (1) The category "Others" includes: for (i) T-Bills: insurance companies, corporations, Local Individual, foreign investors and Treasury securities used for repurchase transaction allocations, and for (ii) T-Bonds: ETF, Insurance companies, corporations, Individual, Gov't Institutions and SOEs, Treasury securities used for repurchase transaction allocations

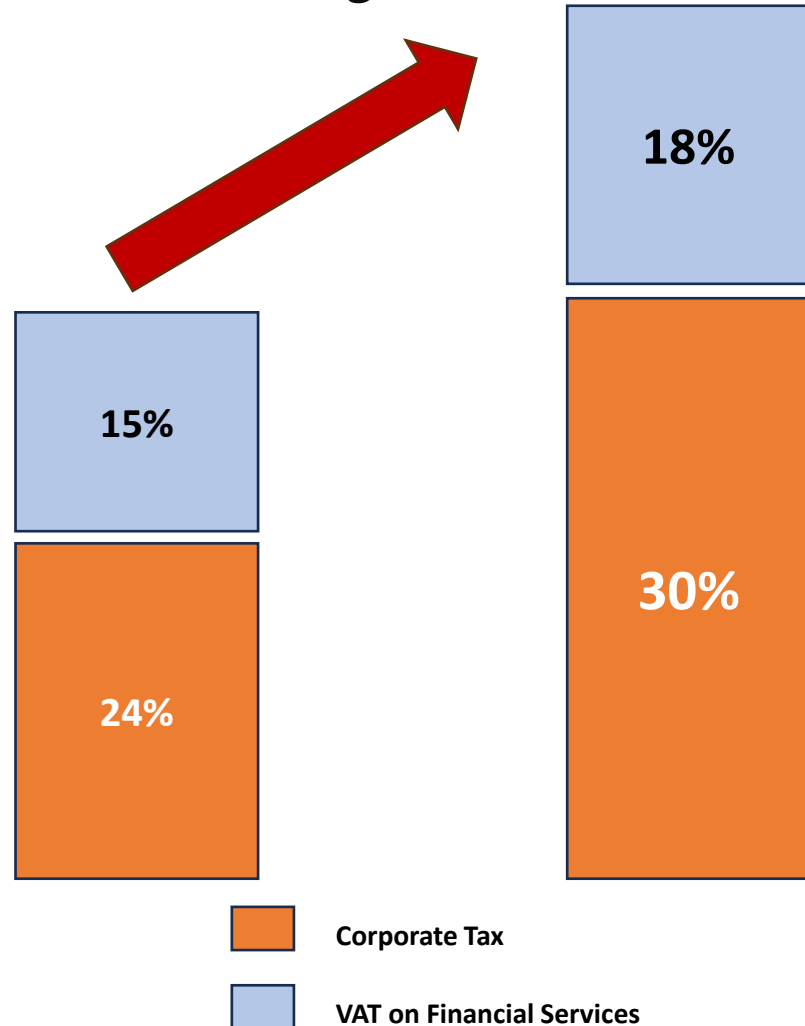
Central Bank Treasury bill holdings will be considered for debt optimization*...

- Central Bank holdings of Treasury bill will be converted to Treasury bonds
 - This will help to reduce gross financing needs
- The impact of this adjustment will reflect in the balance sheet with depleted and negative capital of the Central Bank
- **Recapitalization may be needed to mitigate negative equity's adverse impact on CBSL's credibility and independence**

* This is subject to the enactment of the necessary legislation

Banking sector has already borne a significant burden of the fiscal adjustment and the economic crisis in several ways...

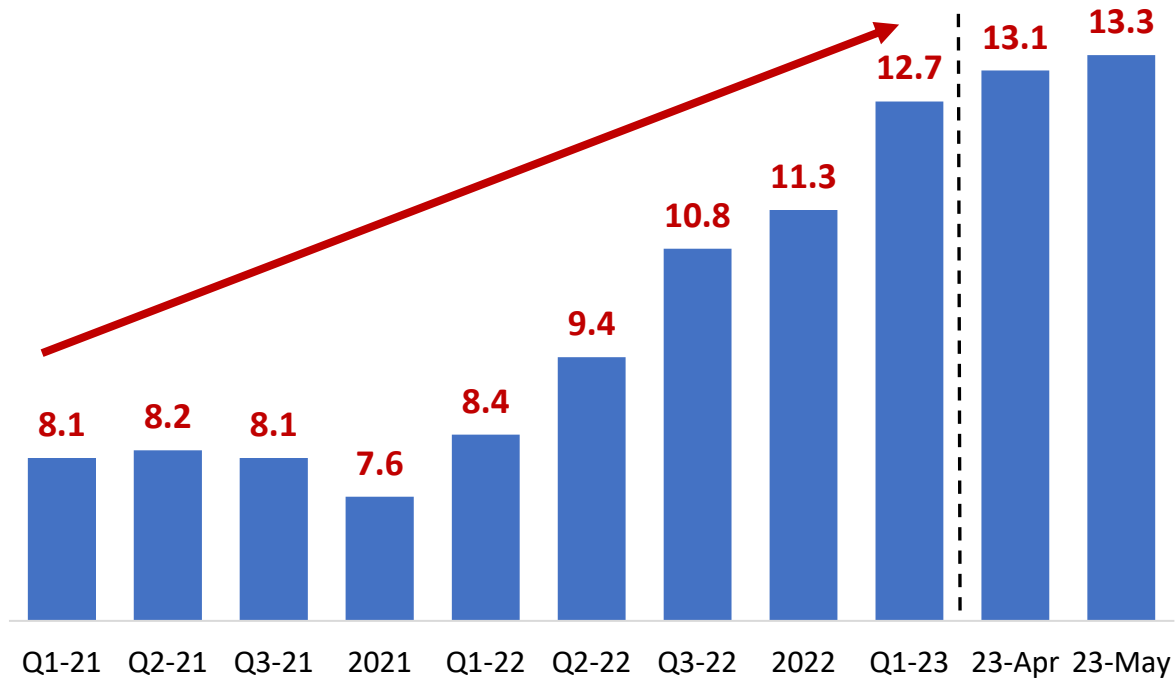
Taxes on Banking Sector %



- The banking sector has been paying higher tax rates than other corporates
- Total tax burden to the banking sector has been increased from **39%** to **48%**.
- Through high tax payment banking sector is helping the Government's fiscal consolidation efforts.
- Burden on the banking sector is being borne by not only the shareholders, but mainly the depositors through lower return on the savings...

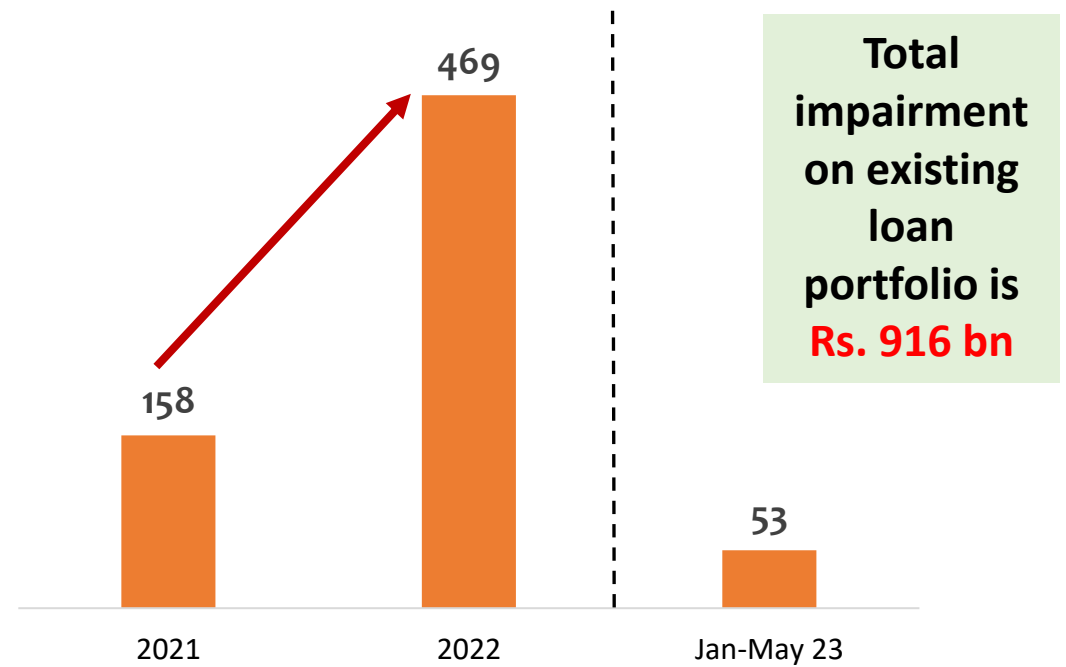
Banking sector is already facing significant stress amidst the economic crisis...

Non Performing Loans Ratio*(%)



*Share of stage 3 loans to total loans

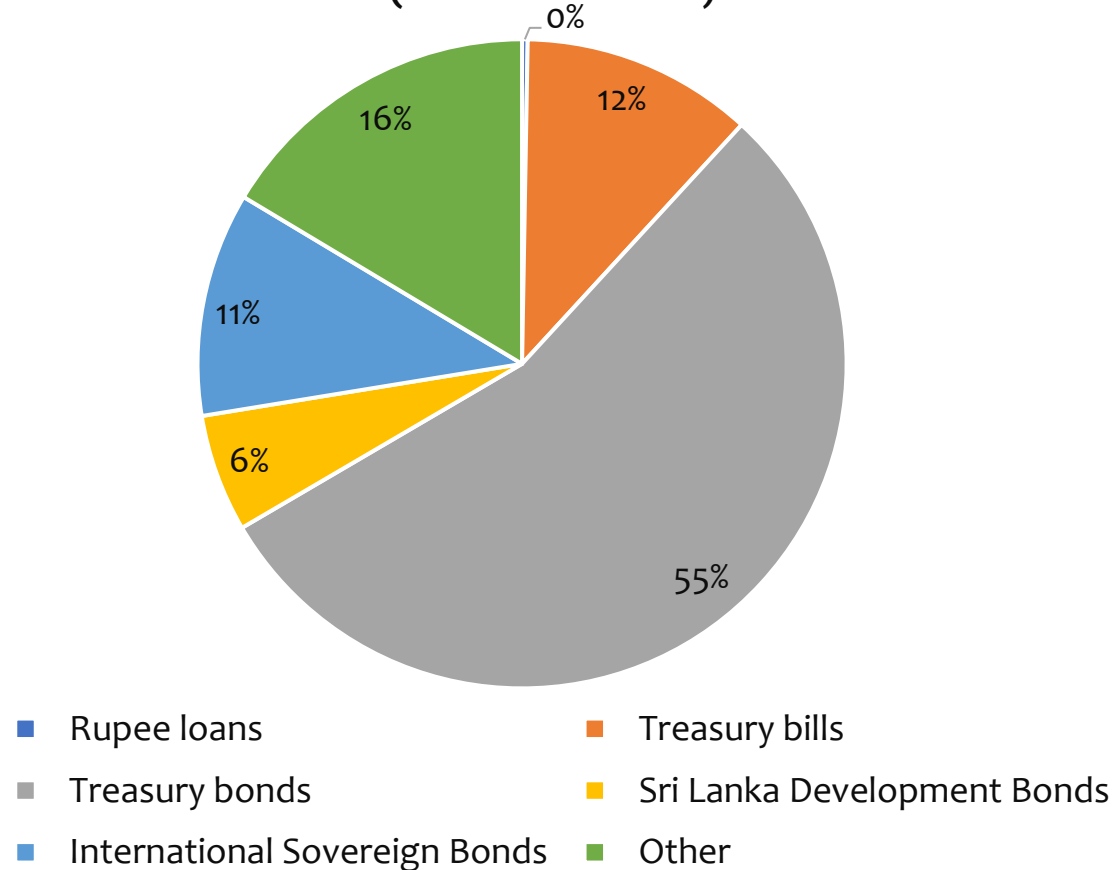
Impairment for Loans and Other Losses (Rs. Bn)



- Banking sector nonperforming loans have increased substantially...
- There is already a need for high provisioning and capital enhancement...
- These would affect the banking sector performance and profitability

Foreign currency debt restructuring will result in a notable impact on the banking sector...

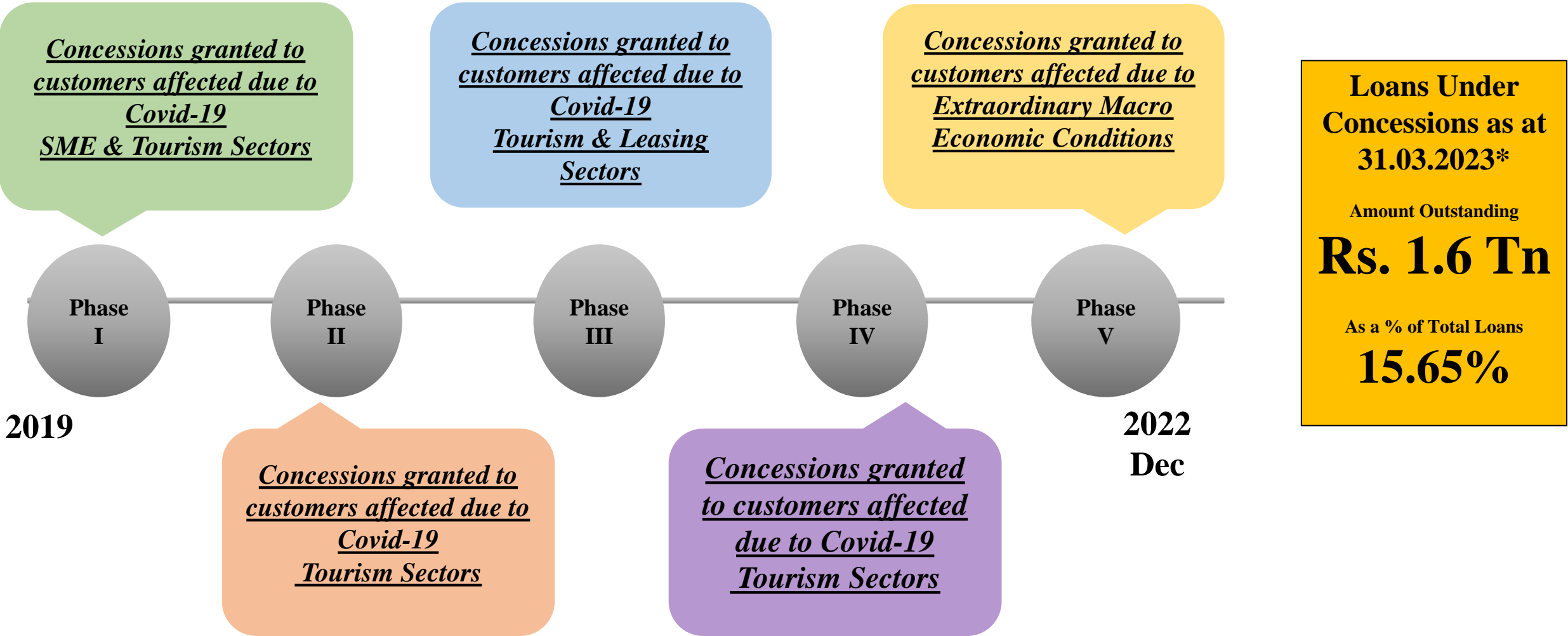
Commercial Banks' Holdings of Government Securities
(Instrument wise)



Source: Central Bank of Sri Lanka

- Some domestic banks are expected to contribute to debt restructuring through the ad hoc bondholder committee comparable with the ISB holders
- ISBs and SLDBs contribute to 17% of the government securities holdings of the banking sector
- Restructuring of foreign currency debt of the government is expected create a significant loss to the banking sector
- Further burden on domestic banking system could jeopardize financial system stability

Further, Banking Sector shared some burden of the crisis through the provision of debt moratoria and helped the businesses and the public...



On the other hand, any disturbance to Financial System Stability could be costly...

- **Cost of financial instability:**

- Fiscal cost to the Government to restore financial stability
- Indirect costs including depositors distress, business closures, interruptions to economic activity, reduced investor confidence and reduced credit availability..

No of depositors of the banking system is 57.2 million*

- **Disruptions to the banking system will impact the effective transmission of monetary policy**
- **Financial instability could trigger multiple crises...**

* Number of insured depositors of the banking sector as at end 2022, which includes multiple individual and institutional accounts

Envisaged terms of DDO...

Indicative terms of Sri Lanka's Domestic Debt Optimization...

CBSL's T-Bills and Provisional Advances to Government

To be implemented in Phase 2 of the DDO

• Converted into T-Bonds

- **A basket of 10 instruments maturing from 2029 to 2038 for a total equivalent to the tendered instruments' nominal value (no haircut)**
 - Composition of the basket of instruments:
 - 4 instruments maturing between 2029-2032, each equal to 4% of tendered amount
 - 6 instruments maturing between 2033-2038, each equal to 14% of tendered amount
 - Bullet repayment
 - Step down coupon profile:
 - 12.4% up until 2024 (incl.)
 - 7.5% up until 2026 (incl.)
 - 5.0% until maturity

Superannuation Funds' T-Bonds

• Exchanged against longer term maturity T-Bonds

- **A basket of 12 instruments of equal amount maturing from 2027 to 2038, for a total equivalent to the tendered instruments' nominal value (no haircut)**
 - Bullet repayment
 - Step down coupon profile:
 - 12.0% up until 2025 (incl.)
 - 9.0% until maturity
- **Authorities may consider increasing income tax to 30% from the current special treatment at 14% for Superannuation Funds that do not meet the minimum participation requirement, set at 50% for outstanding bonds maturing in 2023 and 100% of bonds maturing between 2024 and 2032 (incl.)**
- **Coupon payments accrued up to the settlement date will be settled in LKR (cash)**

Indicative terms of Sri Lanka's Domestic Debt Optimization...

SLDBs and FCBU	USD Option 1 <i>("ISBs-like")</i>	Exchange of outstanding SLDBs/FCBUs against new USD-instruments	<ul style="list-style-type: none"> Nominal haircut: 30% 6-year final maturity (2029), no grace-period (first amortization: 2024) Amortization profile: linear Interest rate: 4.0% (fixed) Past due interest and interest accrued up to the settlement date will be settled in LKR (cash) 	✓ Treatment comparable to external creditors
	USD Option 2 <i>("Official creditors-like")</i>		<ul style="list-style-type: none"> No nominal haircut 15-year final maturity (2038), 9-yr grace-period (first amortization: 2033) Amortization profile: linear Interest rate: 1.5% (fixed) Past due interest and interest accrued up to the settlement date will be settled in LKR (cash) 	✓ Treatment comparable to external creditors
	LKR Option	Exchange of outstanding SLDBs/FCBUs against new LKR-instruments	<ul style="list-style-type: none"> No nominal haircut 10-year final maturity (2033), no grace period (first amortization: 2024) Amortization profile: linear Floating interest rate: SLFR (policy rate) + 1.0% Past due interest and interest accrued up to the settlement date will be settled in LKR (cash) 	• No CoT constraint

Every holder of SLDBs and FCBU would be entitled to choose between one of the three options listed above...

Each component of the DDO contributes to the reduction of GFNs, allowing to successfully meet the IMF DSA Target...

<i>In % of GDP</i>	GFNs <i>(avg. between 2027-32)</i>	<i>o.w. Primary Balance</i> <i>(surplus if negative)</i>	<i>o.w. Interest Payments</i> <i>(on CG+debt)</i>	<i>o.w. Principal Payments</i> <i>(on CG+debt)</i>
Absence of debt treatment	16.8%	(2.3%)	7.9%	11.2%
External debt restructuring ¹ (no DDO)	14.2%	(2.3%)	6.4%	10.1%
External debt restructuring and domestic debt optimization	12.7%	(2.3%)	5.9%	9.1%
DDO Impact on GFN	1.5 percentage points	-	0.5 pp	1.0 pp
1 <i>o.w. CBSL's T-Bills and Gov. Advances</i>	1.0 pp	-	0.3 pp	0.6 pp
2 <i>o.w. Superannuation Funds' T-Bonds</i>	0.5 pp	-	0.1 pp	0.4 pp
3 <i>o.w. SLDBs/FCBUs</i>	0.1 pp	-	0.1 pp	0.0 pp

Note: (1) As per the illustrative debt scenario shared with Sri Lanka's external creditors

Impact of the Domestic Debt Optimization: Major Takeaways

Treatment of the CBSL's T-Bills and advances to the Government

- The avg. GFNs target is very sensitive to the envisaged treatment of (i) the CBSL's T-Bills and (ii) the CBSL's advances to the Government
- This leads to 13.2% average GFNs across the IMF program period (instead of 14.2%)

Treatment of the Superannuation Funds' T-Bonds

- The avg. GFNs target is relatively sensitive to the envisaged treatment of the Superannuation Funds' T-bonds
- This leads to 13.7% average GFNs across the IMF program period (instead of 14.2%), a 0.5 percentage point decrease

Treatment of SLDBs and FCBU's

- The avg. GFNs target is less sensitive to the envisaged treatment of SLDBs and FCBU's
- This leads to 14.1% average GFNs across the IMF program period (instead of 14.2%)

Focus on Superannuation Funds - Which Incentives to Participate to the Exchange?

Superannuation funds would be encouraged to participate to the envisaged operation, on the back of higher income taxation to be applied to non-participating funds...

1
Scenario 1:
Participation to the DDO as per the DDO terms

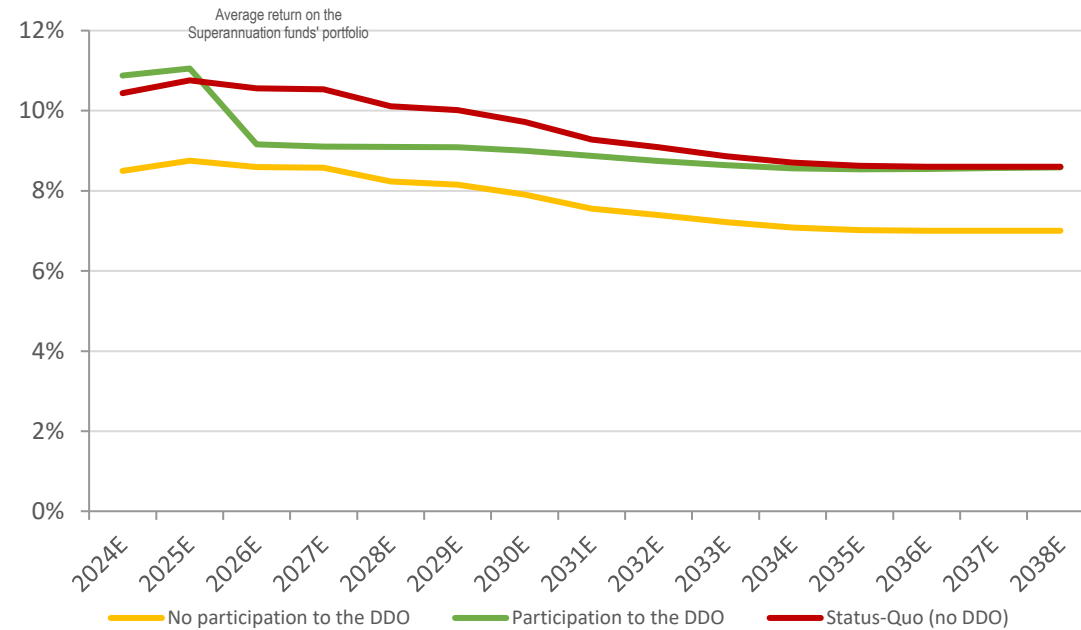
2
Scenario 2:
No participation to the DDO, application of higher annual income tax of 30% (16 pp higher than current tax)

3
Current status-quo, no DDO and annual income tax at current rate of 14%

Participation of Superannuation Funds	Avg. return on portfolio over 2023-2038
Scenario 1	9.1%
Scenario 2	7.7%
Status Quo	9.4%

Projected returns (net of taxes) of Superannuation Funds over 2023-2038 under three scenarios¹

In % of average return on the Superannuation Funds' Portfolio



Takeaways

- Projected net returns (after tax) on the T-bonds portfolio of superannuation funds are higher by an avg. 1.4pp under the envisaged DDO terms, relative to a scenario in which Funds do not participate to the DDO but are subject to an increased income taxation of 30%

As observed on the graph, average net return on superannuation funds' portfolio will be slightly lower than in the Status Quo situation after 2026 but will start converging in the outer years

Note: (1) The analysis is based on the conservative assumption that only net interest incomes are reinvested in bonds. In reality, the Funds would be expected to grow by more than that given the new contributions coming in (which would only reinforce current conclusions). Note that the analysis does not envisage large refunds

End



