Sri Lanka's Debt Restructuring
A Win for Private Bondholders

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The Sri Lankan government announced that it has reached an agreement with its foreign private creditors to restructure the $12.5 billion of its external debt that they hold. The agreement incorporates a novel instrument: a macro-linked bond for which the payout is linked to the GDP performance of the debtor country. These bonds are to be issued in exchange for existing bonds, incorporating a suitable haircut aimed at restoring debt sustainability. However, the terms of those bonds may end up delivering significant gains for foreign creditors without any for Sri Lanka.

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Early in July, the Sri Lankan government announced that it had arrived at a debt restructuring agreement with international sovereign bondholders who hold about $12.5 billion of the remaining $34 billion of foreign exchange debt owed by Sri Lanka as of March 2024.[1] The agreement has attracted attention not just because it is potentially an early case of complete debt restructuring since the COVID-19 pandemic but because it incorporates a novel instrument to share the gains and losses resulting from default and restructuring between the creditors and debtor: a macro-linked bond. According to White and Case LLP, legal advisors to the ad hoc committee of bondholders, the

> new instrument … is designed to be liquid and index-eligible and whose payouts are linked to the evolution of Sri Lanka's gross domestic product. This design seeks to ensure both that the instrument is acceptable to bond market participants and that its cash flows will at all times comply with the Debt Sustainability Analysis targets embedded in Sri Lanka's IMF Programme in a range of future macroeconomic scenarios.[2]

The agreement has to be vetted and accepted by the country's bilateral creditors who would check whether the terms of the deal implied comparable treatment of private and bilateral creditors to Sri Lanka.

If the deal passes muster, it will mark the end of a saga that began in April 2022 when the government announced that it would be defaulting on payments due to external creditors. That long saga has had many phases, though the outcome was more or less predetermined when the Sri Lanka government obtained an International Monetary Fund (IMF) staff-level agreement and was provided board sanction in March 2023 for an extended finance facility (EFF) loan of about $3 billion to be disbursed in stages over 48 months.

Prerequisites for that sanction, *inter alia*, were evidence of prior action to establish that the government was willing to take the steps considered necessary by the IMF to restore debt sustainability, a letter of intent indicating the "reforms" that would be implemented following the sanction of the loan and the timeline for those reforms, and a debt sustainability analysis (DSA) authored by the IMF that besides setting targets for growth, the balance of payments indicators and fiscal consolidation identified the size of external debt reduction (or "relief") required to restore debt sustainability and the possible distribution of the burden of that reduction across different classes of creditors—nil for multilaterals and the possible shares for bilateral and private creditors.

Based on that agreement, the government began, in the second phase, negotiations with bilateral creditors, among which China, India and Japan were dominant. Sustaining the IMF programme over its four-year lifespan, with fund releases following periodic reviews of performance, required in the first instance financing assurances from bilateral creditors. The role of the DSA is crucial since it provides the basis on which the sovereign debtor will seek to obtain such assurances from bilateral creditors that they would consider restructuring the debt they hold in keeping with the "debt relief" targets set by the IMF. The IMF expects the "official bilateral creditors to provide an upfront credible assurance about delivering debt relief and/or financing"[3] that is in keeping with the IMF's assessment of requirements for restoration of debt sustainability.

Bilateral creditors prefer not to accept upfront "haircuts" or reductions in the nominal value of the debt owed to them. Debt relief is in the form of lower interest, deferred payments and extended maturities and the quantum of debt relief afforded is estimated based on the reduction of the net present value of the loans consequent to such concessions. Since the EFF loan is disbursed in instalments by the IMF, with reviews on progress in policy implementation and meeting targets, access to the subsequent instalments becomes dependent on bilateral creditors delivering on their commitments. Significantly, while sanction for the IMF loan was provided in March 2023, the Second Review of the IMF programme was completed on 12 June 2024,[4] and the agreement with the bilateral creditors, including India, Japan and France for restructuring of $5.8 billion of debt was announced on 26 June. A separate agreement with China's Export–Import Bank was being forged.

While discussions with bilateral creditors are underway, the debtor government has to begin negotiations with the private creditors, in whose case too the IMF provides a benchmark level of debt relief that is compatible with restoration of debt sustainability according to its DSA. In Sri Lanka's case, indications are that the IMF suggested that private creditors should offer a net haircut equal to around 30% of the nominal value of debt.[5] To recall, at the height of Sri Lanka's debt crisis, its international bonds were reportedly trading at less than 40 cents to the dollar, implying a market-determined haircut of as much as 60%.[6] But the IMF, for its own reasons, chose to restrict that to around 30%, making that the benchmark for the discussions that were to follow. It needs to be noted that this is not a negotiated benchmark, but one arbitrarily decided by the IMF for a "technical analysis," which many have argued is riddled with problematic assumptions and is based on questionable methodology. In principle, since private creditors decided to take the risk to lend and are known to build risk premia into the interest they charge, they must bear a significant share of the loss in the event of default. And that share needs to be negotiated. What is happening here is that the IMF is arbitrarily specifying the loss to be incurred by all creditors in return for a small amount of bridge finance provided to the debt-stressed government.

Since the negotiations begin after the IMF's DSA is published, for the private creditors seeking to drive a hard bargain, the favourable deal offered by the IMF is only the floor. However, since the DSA is in the public domain and provides the basis for the financing assurances provided by the bilateral creditors, there is some pressure on them to align their demands with those incorporated in the sustainability analysis. Recent restructuring exercises illustrate how private creditors are addressing this problem.

Unlike bilateral creditors, private creditors prefer an upfront haircut and a short restructuring timetable with high market-related interest rates. Given that, one element of the restructuring strategy proposed by bondholders was to define a deal incorporating these elements so that the real haircut is smaller than made out to be. The other element was to provide for alternative levels of the haircut by linking it to some value recovery instrument. A common one was to link enhanced repayments to the potential for generating foreign exchange revenues from a likely export source, like oil. The link would, for example, specify that if that potential is realised yielding foreign exchange in excess of some base value, then the foreign creditor should be provided a part of it to cover some of the loss it has incurred from the original haircut.

This kind of link has taken an altogether new form in the Sri Lanka restructuring deal with so-called "macro-linked bonds." These bonds specify that if Sri Lanka's economic performance, according to some chosen indicator/s, betters than that projected in the IMF's DSA, then an adjustment of debt service payments would reduce the size of the haircut. So, there is a base-level haircut that the creditors agree too, there is a trigger defined in terms of change in a specified variable that sets off an adjustment of the haircut, and the exact nature of that adjustment is specified from the start. To be "fair," this adjustment should take either direction: if Sri Lanka performs better than projected, the creditor gets a better deal and if it performs worse, Sri Lanka should get a better deal. The trigger specified in the Sri Lankan restructuring deal is the average nominal gross domestic product (GDP) in dollar terms over 2025–27. If that exceeds a specified level linked to projections in the IMF's DSA, then payments are adjusted starting from 2028.

The obvious problem with that specification is that if the Sri Lankan currency, which collapsed during the crisis, appreciates significantly vis-à-vis the dollar following the partial restoration of reserves despite real growth, the benchmark nominal GDP in US dollars can be exceeded and the haircut for the private creditors would be reduced. The Sri Lankan negotiators could not agree to that. Neither could the IMF or bilateral creditors.

In addition, the original proposal from the bondholders' group, according to one estimate, offered a 20% haircut,[7] there was asymmetry in the gains and losses to be registered if GDP deviates from the benchmark. There were more thresholds defined for a calibrated increase in gains for creditors when GDP went beyond that level, and small benefits of reduced payments by Sri Lanka if it fell below that benchmark. Finally, the original bondholder proposal was not based on the IMF GDP benchmark but a more optimistic alternative benchmark, which would have reduced the base haircut the creditors would take. The proposal also included provisions for the issue of "governance bonds" linking the haircut to Sri Lanka adopting measures to improve governance, beyond what is embedded in the IMF's conditionality. But this clearly was just a cover, with the instrument basically holding poor governance as the prime reason for excess debt and default, ignoring the lack of due diligence on the part of the creditors.

It is clear that this proposal was an initial negotiating stance, which when bettered as a concession during negotiations would still leave the bondholders well compensated. The final deal involves the exchange of existing bonds in default with four sets of macro-linked bonds and one set of plain vanilla bonds with interest payments starting in September 2024 and amortisation payments from March 2029 and running through to 2038. The interest rates on the bond would be between 3.5% and 4% till 2027, then rise to 3.75% to 5.5% during 2028–32, and then spike to 8.75% to 9.75% over 2033–38. In addition, a separate set of bonds would be issued to cover past due interest (PDI) with interest of 4% and repayment over 2024–28. Finally, the bondholders are to be paid a "consent fee" of 1.8% upfront.

According to the official estimates, excluding PDI bonds, the total value of the new bonds of $9.036 billion reflects a 28% haircut relative to the value of existing bonds. The value of the bonds being restructured is placed at $12.5 billion. But if we add the bonds issued to cover PDI as well as the consent fee, the amount being repaid in cash or through new bonds amounts to $10.94 billion (excluding interest). The relief that Sri Lanka gets is less than 13%. That relief is unlikely to be adequate to achieve debt sustainability, even with optimistic projections of economic performance.

But therein lies the catch. If performance measured in nominal dollar GDP exceeds the IMF's baseline of an average of $88.6 billion over 2025–27 to an extent where it crosses one of three thresholds, the haircut falls steeply. At $92, the haircut reduces to 20.3% and at $96 to 85%. In addition, the weighted average interest rate on the bonds post–2028 rises from 6.3% to 6.6% when the average nominal GDP rises from $88.6 to $92, to 7.2% if the average 2025–27 touches $96 and 8.2% if it touches $100. The Sri Lankan government has expressed satisfaction that on the downside, Sri Lanka would be compensated at two levels if the average GDP falls short of the IMF baseline estimate. The haircut rises to 34.5% if nominal GDP averages $86.7 and 40.4% if it falls to $84.7. But, with some appreciation of the Sri Lankan currency inevitable after the restructuring deal and recovery of foreign exchange earnings and growth likely to be positive given the trough into which the economy had fallen, a fall in nominal GDP in US dollars is unlikely to fall short of the benchmark. Creditors must be pretty sure that the downside risk for them is negligible. The concession is merely an attempt at whitewashing a bad deal.

On the other hand, the probability of GDP exceeding the benchmark is high.[8] When the crisis struck, the Sri Lankan rupee depreciated by 79.7% between February and May 2022. It then began a process of recovery, but the May 2023 exchange rate still reflected a 46.6% depreciation relative to February 2022, and the June 2024 figure reflected a 52% depreciation. So, there is much distance to cover and even if appreciation does not restore the February 2022 exchange rate, a double-digit appreciation is a real possibility. But for nominal GDP in dollars to cross the first threshold, only a 3.8% appreciation is needed and an 8.4% appreciation if threshold 2 is to be touched. What is more, this does not take into account the effect of inflation which would raise the nominal GDP in Sri Lankan rupees, adding to the nominal increase in dollar terms due to currency appreciation. Year-on-year inflation averaged 3.68% in the first five months of 2024.

The Sri Lankan government, realising the absurdity of this metric, had argued for a dual trigger, with one being a target for real GDP growth. But all that the creditors conceded was the use of a control variable in which, when any threshold is crossed, the adjustment in the haircut would be activated only if cumulative real GDP growth over 2024–27 amounts to 11.1%. Though it is not clear what this means, if the definition of "cumulative" is the growth in real GDP between 2024 and 2027, this can be placed in context by noting that, in the years before 2019, during 2011–14, the cumulative real GDP growth in Sri Lanka was 20.2% and during 2015–18 it stood at 14.4%. Private creditors appear to have managed to ensure that there is a strong likelihood that their haircut would be just 15% as opposed to the modest 28% if Sri Lanka's dollar-GDP performance aligns with the IMF projection.

NOTES

1 Ministry of Finance, Economic Stabilization and National Policies, Government of Sri Lanka, *Press Release: Sri Lanka's International Sovereign Bond Restructuring*, Colombo, 4 July 2024.

2 See *Ad Hoc Group of Sri Lanka Bondholders Submits Restructuring Proposal*, https://www.prnewswire.com/news-releases/ad-hoc-group-of-sri-lanka-bondholders-submits-restructuring-proposal-301956251.html.

3 https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/03/17/Changes-to-the-Funds-Financing-Assurances-Policy-in-the-Context-Of-Fund-Upper-Credit-531091.

4 https://www.imf.org/en/News/Articles/2024/06/12/pr-24214-sri-lanka-imf-concludes-2024-article-iv-consultation-completes-2nd-review-under-eff.

5 The IMF's debt sustainability analysis only noted that: "For external private debt, a principal reduction is assumed, with amortization beyond the program period, implying a large NPV reduction. For official bilateral debt, similar debt relief in NPV terms is assumed, implemented through a long maturity extension – with amortization payments starting in 2033." See IMF (2023), *Sri Lanka: Request for an Extended Arrangement Under the Extended Fund Facility—Press Release*, IMF Country Report No. 23/116. However, in June 2023, then central bank governor Nandalal Weerasinghe publicly stated that Sri Lanka was asking international bondholders to take a 30% haircut. This must have been based on figures factored into the IMF's debt sustainability analysis. See Uditha Jaysinghe, "Sri Lanka Targets 30% Haircut for International, Domestic Dollar Bonds," *Reuters*, 29 June 2023, https://www.reuters.com/world/asia-pacific/sri-lanka-asks-dollar-debt-holders-30-haircut-2023-06-29/.

6 Tradeweb data quoted in "Sri Lanka International Bondholders May See 20% Principal Haircut-analysts," *Reuters*, 23 March 2023, https://finance.yahoo.com/news/sri-lanka-international-bondholders-may-122543260.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAHYktn745XgNbj-mZe9geqbqwstolF3pI5lqGEnw5SKrvKq40bN-vZSYX3lYrBLooVRZwtrtoOSg3p1uPelbbZ4yXs-abfmu6Rm7c1XBE4ORs7O_U9utiH7uh3Xl3c-ZYookxfdXs3cfjf9Og8dvPNskuBtXcIn-QnEBB3bJyzcuBkVO.

7 *Reuters* (2023).

8 Thilina Panduwawala and Chayu Damsinghe, "The Sri Lanka-linked Future of Macro-linked Bonds," *Financial Times*, 22 May 2024, https://www.ft.com/content/d6c764e1-3676-4179-af18-7b8a3a0400f5.