

VERITÉ RESEARCH DEBT UPDATE

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The Verité Research Debt Update provides a regular update for investors, policy makers and analysts, on the latest developments in this space together with commentary and analysis on Sri Lanka's path to resolving its economic crisis since suspending debt repayment in April 2022.



Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, politics, and media.

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KEY DEVELOPMENTS AND INSIGHTS

- Sri Lanka announced a renewed agreement with international bondholders in September 2024. An economic path framed as the "IMF DSA baseline" was used to estimate the debt relief expected for Sri Lanka from the agreement. However, analysis by Verité Research shows that this baseline scenario does not align with the official economic data and projections for Sri Lanka.
- The agreement includes a Macro-Linked Bond (MLB) that adjusts the level of debt relief based on future economic growth. It sets out **six** debt relief scenarios. The agreement presents Sri Lanka as expecting to be in the **third** highest debt relief scenario, which is described as the baseline scenario. However, Verité Research's calculations, based on the current official data, puts Sri Lanka in the **fifth** highest (second to lowest) debt relief scenario.
- Therefore, Sri Lanka's expected debt relief from the agreement will be less than 20% (specifically, 19.8%) in Net Present Value (NPV) terms at a 5% discount rate, rather than the 30% NPV debt reduction anticipated in the baseline scenario.
- The debt relief terms with official creditors have not been disclosed. Based on the agreement with international bondholders, the comparability of treatment criteria could have Sri Lanka receiving less than 20% in NPV reduction from official creditors as well.
- The agreement includes a Governance-Linked Bond (GLB), which enhances debt relief by structuring a portion of the USD 1,722 million in Plain Vanilla Bonds as a GLB with a future coupon step-down.

1. BACKGROUND AND STRUCTURE OF SEPTEMBER AGREEMENT

On 21 September 2024, Sri Lanka held a presidential election where the incumbent over the last two years, President Ranil Wickremesinghe, secured only 17.3% of the valid votes polled and came a distant third. See Box 1 for more on the election.

Two days before the election, on 19 September 2024, the Government of Sri Lanka (GOSL) announced its latest agreement in principle with the Ad Hoc Group of Bondholders (the Group) to restructure approximately USD 14.2 billion of its international sovereign bonds. However, there has been no news of the new government requesting any adjustments to the agreement.

The September Agreement has a similar structure to the previous July Agreement. It structures nominal repayments in 3 forms, as set out in Exhibit 1.

Exhibit 1: Distribution of Nominal Repayments in the September Agreement

Instrument	Nominal Payments (In USD MN)	Nominal Payments (In Percentages)	Payment Time Frame
Macro-Linked Bonds	7,437	68.5%	2024 - 2038
Plain Vanilla Bond to be partly structured as Governance-Linked Bond*	1,722	15.9%	2024 - 2035
Plain Vanilla Bond to repay past due interest	1,678	15.5%	2024 - 2028

* First announced in the April proposal and included in the July Agreement as well.

The full set of terms of the September Agreement can be found in a document posted on the Singapore Stock Exchange.¹ It introduces significant changes compared to the previous proposals and agreements that were announced on 16 April 2024² and 3 July 2024.³

Box 1: Presidential Election: Context and Results

The presidential election on 21 September 2024 was Sri Lanka's first national-level election since the 2020 parliamentary elections, where the SLPP (Sri Lanka Podujana Peramuna), led by the Rajapaksa family, won nearly two-thirds of parliamentary seats.

Gotabhaya Rajapaksa, elected president in 2019, resigned in July 2022 following the largest democratic protests in Sri Lanka's history. His successor, Ranil Wickremesinghe, was voted in by the SLPP-dominated Parliament.

In the presidential election held in September 2024, Anura Kumara Dissanayake was elected president in a race among 38 candidates,⁴ polling 42.3% of the vote in the final count. Sajith Premadasa came in second with 32.8% of the vote.⁵

1 Singapore Exchange (SGX). "Sri Lanka: Announcement of Agreement in Principle" at <https://bit.ly/3Ykmt4> [last accessed 14 October 2024].

2 London Stock Exchange. "Conclusion of Initial Restricted Discussions" at <https://www.londonstockexchange.com/news-article/70ZL/conclusion-of-initial-restricted-discussions/16425024> [last accessed 14 October 2024].

3 London Stock Exchange. "Conclusion of Second Round Restricted Discussions" at <https://www.londonstockexchange.com/news-article/70ZL/conclusion-of-second-round-restricted-discussions/16551586> [last accessed 14 October 2024].

4 Department of Elections, Sri Lanka. "Election Results Portal" at <https://results.elections.gov.lk/> [last accessed 14 October 2024].

5 Manthri.lk. "Presidential Election Result 2024" at <https://manthri.lk/en/presidential-election-result-2024> [last accessed 14 October 2024].

2. STRUCTURE AND SCOPE OF GOVERNANCE-LINKED BONDS

A Governance-Linked Bond (GLB) option was first introduced in the April Proposal, based on submissions to GOSL and the Group by Verité Research.⁶

The proposed GLB offers an upside for Sri Lanka, featuring a coupon step-down linked to specified governance actions. With only the option of a coupon step-down and no coupon step-up, it offers a greater debt reduction than the alternative Plain Vanilla Bond.

The GLB is an attractive instrument by which the GOSL achieves a reduction in debt service costs while taking actions that would improve governance and foster greater confidence in its future path of debt management.

The April Proposal offered to structure USD 0.5 to 1 billion of the Plain Vanilla Bonds as a GLB. It proposed a coupon step-down of 50 basis points in 2028 and three governance actions that could function as the trigger for the coupon step-down, while allowing the GOSL flexibility to refine or reformulate these actions.

The September Agreement has made the specifications even more open – with greater flexibility for the GOSL to increase the quantum of Plain Vanilla Bonds that would be structured as a GLB, as well as the extent of the coupon step-down on the GLB.

The political space for adopting the GLB has increased following the recent presidential election, which was won on a platform of anti-corruption and improving governance.

3. STRUCTURE AND SCOPE OF MACRO-LINKED BONDS

The September Agreement also includes Macro-Linked Bonds (MLBs), which change the debt reduction outcome for Sri Lanka based on criteria connected to its GDP trajectory. The MLB is calibrated on two criteria: (1) the cumulative real GDP growth between 2024-2027 and (2) the average USD value of Sri Lanka's nominal GDP between 2025-2027.

Exhibit 2: Debt Reduction Scenarios in the September Agreement

Scenario	Nominal GDP (Average, 2025- 2027, USD billion)	Cumulative Real GDP Growth Rate (2024 – 2027)	Coupon Change from S3 ^a (2028 - 2032) ^b	Capital Change from S3 ^a (2028 onwards)	NPV Reduction ^c
S1	84.7 or below	Lower than 11.5%	None	-17.1%	38.7%
S2	86.7 or below	Lower than 11.5%	None	-4.1%	32.1%
S3 (Baseline)	86.7 to 94.0	Any	3.9%	9,158	30.0%
S4	94.0 or above	Higher than 11.5%	+0.5%	+10.6%	23.5%
S5	99.0 or above	Higher than 11.5%	+0.9%	+15.8%	19.8%
S6	107.0 or above	Higher than 11.5%	+1.4%	+15.8%	18.6%

a) The average coupon rate and nominal capital paid in billions are shown in row S3. The other rows indicate the increase in the coupon rate and the percentage of capital repaid from S3. A minus (-) sign indicates a reduction from S3, while a plus (+) sign signifies an increase from S3.

b) Coupon adjustments are applied over 2028-2032. For MLBs maturing between 2033 and 2038, the coupons will revert to their original level from 2033 onwards.

c) The NPV reduction is calculated using the standard 5% discount rate. The stream of payments include past due interest and the upfront consent fee of USD 255 million.

6 Verité Research. "Proposal for a Governance-Linked Bond in Restructuring Sri Lanka's Debt" at <https://www.veriteresearch.org/publication/governance-linked-bond/> [last accessed 14 October 2024].

These two criteria interact to create six possible scenarios (S1-S6) for the level of debt reduction, as outlined in Exhibit 2, arranged in order of the extent of debt reduction. Scenario S1 has the highest level of debt reduction, while scenario S6 has the lowest.

4. THE EXPECTED DEBT REDUCTION IS LESS THAN BASELINE SCENARIO

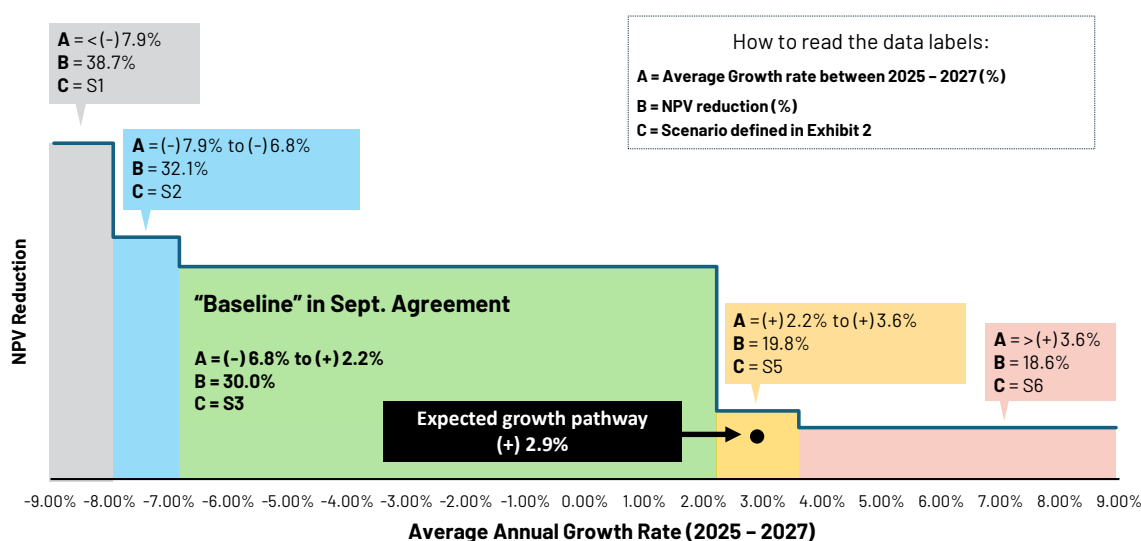
Sri Lanka's debt reduction expectations from the September Agreement are specified in the official public communique of the GOSL.⁷ The communique refers to S3 as the "baseline" (or the "IMF baseline") outcome and frames it as the "expected" outcome for Sri Lanka.

The alternative scenarios are framed as deviating from this "expected" baseline outcome. Scenarios S1-S2 are framed as cases of an "economic downturn" while scenarios S4-S6 are framed as "exceeding [economic growth] expectations".

But those expectations are incorrect. Because our calculations show that S3 (the baseline scenario in the September Agreement) could only occur if Sri Lanka's average growth rate between 2025-27 falls below c. 2.2%. The data and sources for the calculation are set out in the Annex.⁸

The data and projections from the GOSL and the IMF currently indicate an average growth rate of c. 2.9% for Sri Lanka between 2025-27. **This means that S5, not S3, is the expected outcome scenario for Sri Lanka.** This is shown graphically in Exhibit 3. The S5 scenario is the second lowest debt reduction scenario, with a NPV reduction of 19.8% on a discount rate of 5%. This is also enumerated in Exhibit 4.

Exhibit 3: Debt Reduction Scenarios Based on 2025-2027 Growth Rates



Note: Data sources for this calculation are set out and explained in the Annex

7 Ministry of Finance, Sri Lanka. "Sri Lanka reaches debt restructuring agreement in principle with external creditors on approximately US\$17.5 BN of sovereign debt" at <https://www.treasury.gov.lk/api/file/16dc614c-d9a9-47ff-94d6-aab0811e62ba> [last accessed 14 October 2024].

8 The expected economic outcomes of the GOSL are published regularly and updated in its budgets and related documents. The IMF also updates its projections on economic variables in each review. The latest IMF review was published in June 2024

Exhibit 4: “Baseline”, Currently Expected, and Least Debt Reduction Scenarios for Sri Lanka

	“Baseline” Outcome (Scenario 3)	Currently Expected Outcome (Scenario 5)	Least Debt Reduction Outcome (Scenario 6)
Average growth rate in 2025 – 2027 that triggers the scenario	(-) 6.8% to (+) 2.2%	(+) 2.2% to (+) 3.6%	> (+) 3.6%
Present value concession at 5% discount rate	30.0%	19.8%	18.6%
Upfront reduction in debt stock	USD 3.2 Bn	USD 2.0 Bn	USD 2.0 Bn
Weighted average coupon rate (2024 – 2038)	4.4%	4.8%	4.9%
Nominal Reduction / (Increase) in debt service payments (2024 – 2038)	USD 1.0 Bn	(USD 1.5 Bn)	(USD 1.7 Bn)
o/w Nominal Reduction in debt service payments (2024 – 2027)	USD 9.5 Bn	USD 9.5 Bn	USD 9.5 Bn
o/w Nominal Increase in debt service payments (2028 – 2038)	USD 8.6 Bn	USD 11.1 Bn	USD 11.3 Bn

Note: Data sources for this calculation are set out and explained in the Annex, PDI = Past Due Interest

ANNEX: DATA AND SOURCES FOR THE CALCULATIONS

The data is sourced from three institutions: the World Bank,⁹ the IMF,¹⁰ and the GOSL. We selected the data source for the calculations as follows. For 2024, we used the most recent real GDP growth estimate published by the World Bank on 10 October, and the monthly exchange rates published by the GOSL. For the balance data we selected the data source that would give a result closest to what had been calculated as the baseline scenario in the September Agreement.

Therefore, the GDP deflator estimate for 2024 was as published by Verité Research,¹¹ and the 2025–2027 deflator was the inflation target of the GOSL, and the growth rates and depreciation rates were drawn from the latest IMF review of Sri Lanka published in June.

Exhibit 5: Data and Sources for the Calculations

Scenario	Source	2024	2025	2026	2027
Real GDP (%)	Second IMF Review Projections – June 2024	2.0%	2.7%	3.0%	3.1%
	Sri Lanka Development Update – World Bank – October 2024	4.4%	3.5%	3.1%	N/A
	Used by Verité Research	4.4%	2.7%	3.0%	3.1%
Deflator (%)	Second IMF Review Projections – June 2024	9.8%	6.9%	5.4%	5.2%
	GOSL – Inflation Target		5.0%	5.0%	5.0%
	Used by Verité Research	7.3%	5.0%	5.0%	5.0%
Exchange rate (USD to LKR)	Second IMF Review Projections – June 2024 Implied Average Depreciation Rate (2023 – 2029)		5.9%		
LKR 305 per USD (Jan – Oct 2024 average – reported by GOSL)	Used by Verité Research Average Depreciation Rate (2023 – 2029)	Actual (–) 6.9%		5.9%	

9 World Bank. "Sri Lanka Development Update 2024" at <https://www.worldbank.org/en/country/srilanka/publication/sri-lanka-development-update-2024> [last accessed 14 October 2024].

10 International Monetary Fund. "Sri Lanka: 2024 Article IV Consultation and Second Review Under the Extended Fund Facility" at <https://www.imf.org/en/Publications/CR/Issues/2024/06/13/Sri-Lanka-2024-Article-IV-Consultation-and-Second-Review-Under-the-Extended-Fund-Facility-550261> [last accessed 14 October 2024].

11 Verité Research. "State of the Budget 2024" at <https://www.veriteresearch.org/publication/state-of-the-budget-2024/> [last accessed 14 October 2024].

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