

SRI LANKA'S BONDS INNOVATIONS

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1. Introduction

After defaulting due to a currency crisis in 2022, the Republic of Sri Lanka reached an agreement with the IMF designed to help the country to regain sustainability. According to the Extended Fund Facility (EFF) arrangement reached with the IMF, disbursements would be made available over the course of a four-year programme during which the Republic must implement far-reaching fiscal, monetary and governance reforms to raise tax revenue. Also, a comprehensive restructuring process must be achieved.

In order to conclude its debt restructuring process, Sri Lanka has announced the launch of an exchange of its outstanding international bonds to its private creditors, amounting to approximately \$12.55 billion. This invitation aims to support the country's fragile economic recovery, but most importantly, aligns with the parameters set out in the programme agreed upon with the IMF.

The proposal is a State Contingent Debt Instrument (SCDI), i.e. bonds that promise payouts if the country meets certain targets. Hence, holders of existing bonds are invited to exchange the old bonds for new ones over a three-week period, until 12 December 2024. The most salient innovations are: (1) the Macro-Linked Bonds, which are bound to Sri Lanka's economic performance during the IMF programme; and (2) the Governance-Linked Bonds, which are associated with the country's achievement of certain governance objectives. These two innovations are analysed below.

Moreover, the exchange proposal has also included a Most Favoured Creditor Clause (MFC), which protects equal treatment among bondholders as a way of encouraging creditors to participate assuring them that there will be no better offer (or if there is one, that terms will be matched).

2. The Macro-linked Bonds

The Macro-Linked Bonds are structured in a way that its payout is linked to the economic growth of the Republic, specifically the country's GDP. Within 30 days after the Macro-Linked Measurement Date (i.e., 15 November 2028), the Republic will determine if a Macro-Linked Adjustment Event has occurred meaning that the outstanding nominal amount of each series of Macro-Linked Bonds will be reduced or increased by an amount equal to the applicable Threshold Mark-Down Amount or Threshold Mark-Up Amount respectively. The notification of the trigger event to the Trustee and Bondholders will include technical details as the applicable GDP threshold, the satisfaction of the Control Variable¹, and other required information.

Basically, these instruments have two possible scenarios: if GDP rises the issuer will pay a higher coupon, if GDP falls, the market bond price will be reduced. Recent debt restructurings by Ukraine and Zambia have also linked bond repayments to GDP, the former issued two step-up bonds which will adjust if the economy outperforms IMF expectations, and the latter issued a zero-coupon convertible bond which will align with the economic performance as it can turn into a coupon-paying bond if the sovereign outperforms IMF forecast.

¹ The Control Variable means that Sri Lanka's Cumulative Real GDP Growth is greater than 11.50%.

A Macro-Linked Adjustment Event encompasses five possible degrees of an Adjustment Event:

- *A Lower Downside Threshold Adjustment Event, when the occurrence of (a) the Average USD Nominal GDP is lower than the Downside Threshold; and, (b) the Control Variable is not satisfied, triggers a reduction regarding any Macro-Linked Bond, of an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.21 (**Lower Downside Threshold Mark-Down Amount**).*
- *A Higher Downside Threshold Adjustment Event, when the occurrence of (a) the Average USD Nominal GDP is lower than the IMF Baseline but higher than or equal to the Downside Threshold; and, (b) the Control Variable is not satisfied, triggers a reduction regarding any Macro-Linked Bond, of an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.05 (**Higher Downside Threshold Mark-Down Amount**).*
- *A Lower Upside Threshold Adjustment Event, when the occurrence of (a) the Average USD Nominal GDP is higher than or equal to the Lower Upside Threshold, but lower than the Intermediate; and, (b) the satisfaction of the Control Variable, triggers an increase regarding any Macro-Linked Bond, of an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.13 (**Lower Upside Threshold Mark-Up Amount**).*
- *An Intermediate Upside Threshold Adjustment Event, when means the occurrence of (a) the Average USD Nominal GDP is higher than or equal to the Intermediate Upside Threshold, but less than the Higher, and (b) the satisfaction of the Control Variable, triggers an increase equal to the **Intermediate Upside Threshold Mark-Up Amount**:*
 - *For 2030 and 2033 Macro-Linked Bonds, an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.17.*
 - *For 2036 and 2038 Macro-Linked Bonds, an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.22.*
- *A Higher Upside Threshold Adjustment Event, when means the occurrence of (a) the Average USD Nominal GDP is higher than or equal to the Higher Upside Threshold; and, (b) the satisfaction of the Control Variable, triggers an increase equal to the **Higher Upside Threshold Mark-Up Amount**:*
 - *For 2030 and 2033 Macro-Linked Bonds, an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.17.*
 - *For 2036 and 2038 Macro-Linked Bonds, an amount in USD equal to the nominal amount outstanding of such Macro-Linked Bond multiplied by 0.22.*

3. The Governance-Linked Bonds

The Governance-Linked Bonds have two key performance indicators (KPIs) attached: (1) KPI 1, shall be satisfied if the Republic's total revenue to GDP for 2026 and 2027 calendar years each exceeded the IMF Baseline; and, (2) KPI 2, shall be satisfied if the Fiscal Strategy Statement has been prepared by Sri Lanka in accordance with the requirements of the Public Financial Management Act No. 44 of 2024 (the "PFM Act") and published on the Ministry Website for each of 2026 and 2027 calendar years. Thus, the delivery of an Officer's Certificate must verify that: (1) KPI 1 and 2 are satisfied; (2) the reports required to be published, were indeed published prior to KPI Measurement Date. Moreover, as indicated in the prospectus, investors' calls are required to be organized prior to the KPI Certification Date have taken place. Therefore, if these requirements are met, the interest rate shall be reduced 75 basis points.

4. Some final considerations

Overall, it is worth mentioning that the components of GDP are all influenced by government policies (fiscal and foreign being the main drivers for the data source affecting the outcomes).² Transparency and accountability need to be robust in order to avoid data manipulation and other opportunistic behaviour. Hence issuing governance-linked bonds may help credibility and attract more creditors to the exchange offer as they will have a relying parameter enhanced by transparency and greater accountability.

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² Governments can reweight and revise their calculations and methodologies of inflation, deflators and exchange rates therefore affecting the expected returns on GDP linked instruments. An example of this is the ongoing litigation against Argentina in London and New York for its GDP-linkers issued in 2005.