Sri Lanka restructures local debt: who gets hit the most?

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Introduction

In early July 2023, the Sri Lankan government, in collaboration with the Central Bank of Sri Lanka, presented a vital proposal to Parliament aimed at restructuring its domestic debt. This initiative, known as the Domestic Debt Optimization (DDO) program, comes in the wake of a default on foreign debt payments in April 2022. As the country grapples with the challenge of achieving a sustainable and manageable level of overall debt repayments in the short and medium term, the proposal highlights a critical point: the Employee Provident Fund (EPF), a significant superannuation fund, might need to absorb some of the impact. This paper delves into the potential repercussions of such a move for the fund itself and evaluates its broader implications on the country's economy. Understanding the dynamics of this proposal and its interactions within the national financial landscape is essential to gauge the potential outcomes for both the fund and the nation as a whole.

Sri Lanka's debt history and the rise of ISBs

Sri Lanka has a history of borrowing to finance its development and growth activities. As per Macrotrends, the country's external debt by 1970 was recorded as USD 435 million. Since then, it has steadily risen, and by 2021, the country's total external debt stood at USD 56.6 billion (Macrotrends, 2023). Four months later, on 12th April 2022, Sri Lanka declared halting of foreign debt payments for the first time in its history (Economynext, 2022). The country subsequently entered a process of debt restructuring in talks with the IMF (Hoskins, 2022).

However, a major contributor towards the country's debt trap and push towards default is its investment in high-interest ISBs, or International Sovereign Bonds (Nicholas & Illanperuma, 2023). Post-2009, the country had emerged from a 30-year civil war and embarked on a rapid development drive. According to Nicholas & Illanperuma, Sri Lanka issued USD 17 billion worth of ISBs between 2007 and 2019, at high coupon rates, typically ranging from 5% to 8%. This pushed the country's ratio of public external debt stock to GDP from 29% in 2010, to 44% by 2021. It has been noted by the same authors that countries such as Zambia, Ghana, Ecuador, Argentina, and Lebanon who defaulted post-2019 bore similarly high ISB rates.

Domestic Debt Optimization

In 2022 as Sri Lanka entered IMF negotiations, one of the main stipulations was that it restructure its debt to a sustainable level. To do achieve this, one the government would have to ensure strong fiscal consolidation through the increasing of revenue, two rationalize expenditure and three reduce its public debt to GDP ratio (IMF Executive Board Approves US$3 Billion Under the Extended Fund Facility (EFF)

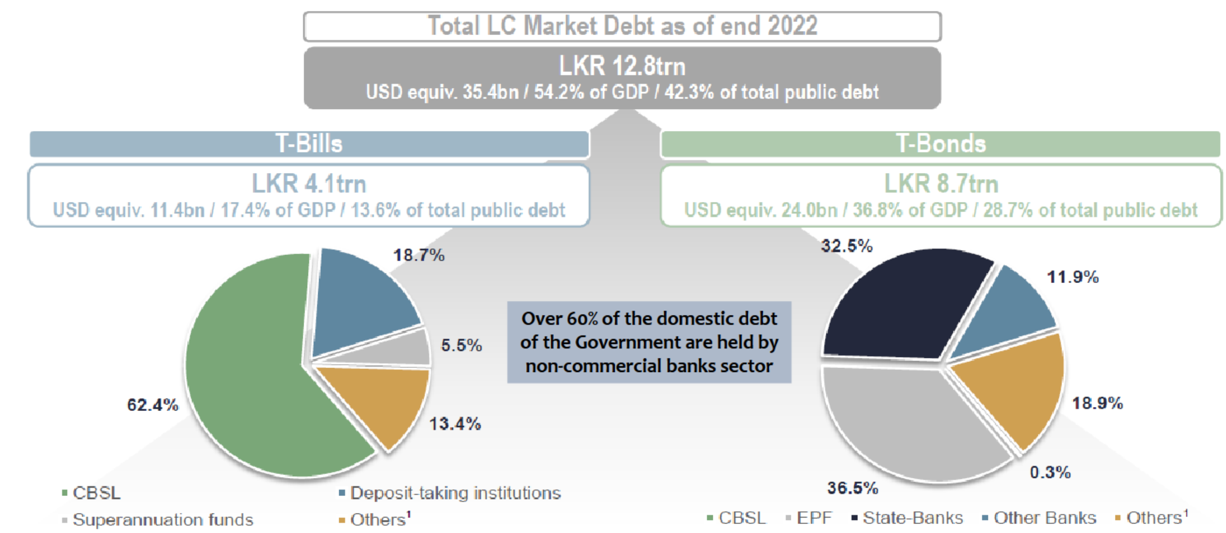
Arrangement for Sri Lanka , 2023). For the first, the government introduced increases in taxes which had been reduced in 2020 and expanded its tax base (Andrew, 2023).

In terms of expenditure cuts, guidelines were issued to the public sector to restrict non-urgent/ non-essential expenses. Cabinet approval was also granted to reduce 6% of approved recurrent expenditure estimates of all government institutions for 2023. The government has also brought back a cost reflective pricing formula for fuel and state operated enterprises are to be restructured.

The more challenging task however has been to bring down the debt to GDP ratio from 128% to 95%. Sri Lanka also has 9.4% of its GDP which needs to go towards foreign debt servicing.

Sri Lanka is in the process of restructuring its foreign debt, but foreign creditors have stated that the debt burden should also be shared by domestic creditors (Mushtaq, 2023). It must be noted that as of 2020, close to 40% of Sri Lanka's debt is held by foreign creditors in the form of bilateral debt, multilateral debt and financial markets (Ownership of Sri Lanka's Outstanding Foreign Debt in 2020, 2023).

This has prompted the Central Bank to propose the DDO to restructure local debt. Sri Lanka's local currency market debt represents a significant share of the country's public debt at 42% of total public debt (USD 35.4 billion) - and over 5% of the country's GDP. Over 60% of this domestic debt of the government are held by the non-commercial banks sector (Central Bank of Sri Lanka) (See figure 1).



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

Figure 1. The charts indicate the percentage of debt held by each entity in the local currency market (Source: Central Bank of Sri Lanka presentation on DOD).

The local currency market is divided into Treasury bills (T-bills), Treasury Bonds (T-Bonds), ISBs and Sri Lanka Development Bonds (SLDB) (Wijayasekera, 2023). The Central Bank has proposed that T-Bills held by them (60%) would be converted to T-Bonds, helping to reduce gross financing needs and giving the government some breathing space for repayments. The banking sector which holds 18.7% of T-Bills and 44.4% (both state and commercial banks) of T-Bonds have been spared restructuring. The argument put forward by the Central Bank (Derana, 2023) is that Banks have already been burdened by higher taxation, debt moratoriums given during the pandemic and higher rates of non-performing loans due to the economic crisis. Adding to further financial pressure, the Central Bank fears would lead to financial instability and further economic crisis.

For the purposes of our paper, we would look at the DDO's impact on the EPF, the largest, mandatory single fund, holding close to Rs. 3 trillion (approx. USD 9 billion) worth of funds (Ranasinghe, 2023).

The EPF holds close to 36.5% of all T-Bonds. According to the DDO, the Central Bank has proposed that the EPF exchange short term maturity bonds to longer term ones. They state that the EPF has around 12 instruments of equal value maturing from 2027 to 2038. For this, no haircut would need be taken, instead they can offer a step down in coupon profile to 12% up until 2025 and a 9% interest rate until maturity. Failing to take this option would result in a higher taxation rate of 30% on the gross profit, instead of the current concessional 14%.

Why is the EPF special?

The EPF was initiated in 1958, and has continued ever since then (Verite Research, 2023). By 1960, the EPF's official declared rate of return was 2.5% per annum, where it remained until 1967. By 1970, it had reached 4%, and had more than doubled to 8.5% by 1980. It reached a high of 13% by 1988 before falling to a low of 11% for the following year. It once again peaked at 13.5% for 1993, before rising and falling until 2002 which is the period covered by this source (Rannan-Eliya & Eriyagama, 2003). More recent data from the EPF website reveals a rate of around 10.5% for 2015, 2016 and 2017, before dropping to 9.5% in 2018, and a further marginal drop to 9.25% for 2019 (Employees Provident Fund, 2023).

According to Verite Research, the EPF has historically focused on investing in government securities since inception. However, equity investment started happening from 1998 onwards. Furthermore, Verite Research states that by 2010, the equity exposure of the EPF was over 5% of the fund.

The EPF has also dabbled in stocks, with a return to the Colombo Stock Exchange in 2019 (Ada Derana Business, 2019). Administered by the Central Bank of Sri Lanka, then-Governor Indrajit Coomaraswamy stated that the monetary board had approved for up to 6% of the portfolio to be invested in equity.

Calculating an accurate figure for losses to the EPF under DDO has proved to be elusive, largely due to both lack of information by the Government of Sri Lanka, as well as inadequate understanding of the relationship between the DDO and the EPF. Economist and Executive Director of Verite research Dr. Nishan De Mel presented three scenarios, the most draconian of which exceeds Rs. 12 trillion (approx. USD 37 billion) in losses over a 15-year period (De Mel, 2023). More conservative scenarios still amount to Rs. 10.9 and 9.7 trillion (approx. USD 33 billion and USD 30 billion) respectively.

However, Central Bank Governor Dr. Nandalal Weerasinghe disputed that EPF losses under DDO would exceed Rs. 12 trillion over 15 years (Kotalawela, 2023). Dr. Weerasinghe stated that many of the assumptions made for this calculation were inaccurate or invalid.

Should the EPF be made more transparent?

According to Umesh Moramudali (Moramudali, 2023), an Economist at the University of Colombo, much of the discussion revolves around assumptions. The EPF bond portfolio's specifics, including the number of bonds and yield to maturity rates, remain undisclosed by the Central Bank. In light of this, he suggested that the Central Bank should make an exception and disclose this information publicly. This would ensure that the fund's shareholders are informed about the potential impact of the DDO on their retirement fund.

Moramudali observed that the government's exclusion of the commercial banking sector from the DDO indicates a desire to expedite economic growth. He noted that this approach could restore bank lending capacity and foster positive sentiment. Without the DDO, he believed that the economy could face further constraints, ultimately affecting worker salaries and potentially leading to higher inflation, thereby devaluing EPF holdings.

Expressing concerns about the long-term implications, Dr. Ravi Rannan-Eliya, Executive Director at the Institute of Health and Economist, noted two primary reasons for potential negative effects of the DDO (Rannan-Eliya R., 2023). First, the DDO may heighten the risk premium associated with government debt issued in Sri Lankan rupees, potentially leading to higher interest rates for future domestic borrowings.

Dr. Rannan-Eliya further stated, "This would make domestic borrowing more expensive relative to foreign borrowing, this is not a good thing."

Secondly, the DDO's impact on EPF assets could reduce retirement benefits for many EPF retirees, potentially placing greater fiscal pressure on the government to provide additional income support for the elderly. While the DDO might provide short-term benefits for the government's fiscal operations, it could exacerbate long-term fiscal challenges.

Dr. Rannan-Eliya emphasized that the burden of necessary sacrifices should fall more heavily on the well-off. He suggested that if the government was genuinely concerned about equity, it could have considered a progressive tax on EPF holdings through appropriate legislation, alongside higher taxes on higher incomes.

Dr. Rannan-Eliya asserted that the DDO underscores the shared macroeconomic realities that both funded and unfunded pension schemes face. He explained that if governments consistently run structural deficits, this could lead to lower returns on EPF investments due to market mechanisms or government policies.

Regarding transparency's potential impact, Dr. Rannan-Eliya expressed skepticism. He believed that the average citizen is not deeply interested in the EPF's intricacies, as it distracts from the primary reasons for underperformance. He maintained that substantial and sustainable EPF returns would require the government to curtail fiscal deficits and enhance overall economic policies to boost economic growth and investment returns.

In conclusion, would making the fund more transparent help secure it? Dr Rannan-Eliya said ‘no’.

“I don’t think the average citizen is interested in the workings of the EPF. It is a distraction from the main reason for under-performance.”

Dr Rannan-Eliya believed that EPF returns cannot be substantially raised on a sustainable basis unless (i) the government stops running large fiscal deficits as it has done since the late 1970s, and (ii) overall government economic policies raise the long run rate of economic growth by increasing the rate of return to investors in the real economy, and in particular exports.

"Without these happening, returns will remain lower than possible, regardless of whether EPF is transparent or not about its investment strategy," stressed Dr Rannan-Eliya.

Conclusion

DDO is going to be a painful process for many, and while the full extent of its impact on the EPF is hard to calculate at present, there is no doubt that there is going to be one. While a DDO has become unavoidable now given Sri Lanka's unsustainable debt, many question the method in which the government has chosen to restructure debt. Most importantly the lack of transparency in the process is a major obstacle in achieving a successful DDO. Further, as the government has set a bad precedence in choosing to restructure the common man's pension fund, leading to much unrest among the public. Better information sharing from the part of the government can assure a smoother transition in these volatile times.

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