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Sri Lanka's Sovereign Debt Restructuring: Lessons from Complex Processes

Peter Breuer, Sandesh Dhungana, and Mike Li

WP/25/175

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Prepared by Peter Breuer, Sandesh Dhungana, and Mike Li

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September 2025

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ABSTRACT: Sri Lanka's debt restructuring distinguishes itself from others by its complexity due to a particularly diverse creditor landscape and novel instruments issued in the restructuring. Not eligible for the G20 Common Framework for Debt Treatments, Sri Lanka had to navigate the challenges of a diverse creditor landscape, requiring complex coordination across many stakeholders. The majority of official debt was held by non-traditional creditors outside of the Paris Club and domestic borrowing played an important role in Sri Lanka's overall debt. Commercial creditors were particularly interested in new and complex instruments that would share up- and downsides to the macroeconomic framework and would offer additional debt relief for implementing governance reforms. For the first time, the IMF applied fully the newly developed Sovereign Risk and Debt Sustainability Framework to assess debt sustainability. The restructuring took place against the background of a very deep fiscal and balance of payments crisis that required sweeping policy solutions in the context of a complex IMF-supported reform program. This paper reviews the root causes of Sri Lanka's debt problem, the deliberation of its solution, and the designs, negotiations, and outcomes of the restructuring processes. Important lessons from Sri Lanka's experience regarding restructuring strategies and design, as well as the IMF's role in facilitating debt-creditor engagement, can inform future restructurings.

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WORKING PAPERS

Sri Lanka's Sovereign Debt Restructuring: Lessons from Complex Processes

Prepared by Peter Breuer, Sandesh Dhungana, and Mike Li [1]

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Glossary

AIP	Agreement-in-Principle
ARA	Assessing Reserve Adequacy
BOP	Balance of Payments
CDB	China Development Bank
CEB	Ceylon Electricity Board
CoT	Comparability of Treatment
CPC	Ceylon Petroleum Corporation
DDO	Domestic Debt Operation
DSA	Debt Sustainability Analysis
EFF	Extended Fund Facility
FX	Foreign Exchange
GFN	Gross Financing Needs
HRB	Hamilton Reserve Bank
ISB	International Sovereign Bond
JWF	Joint Working Framework
LIA	Lending into Arrears
LIC DSF	Low Income Countries Debt Sustainability Framework
LIOA	Lending into Official Arrears
MFC	Most Favored Creditor
MOU	Memoranda of Understanding
NDA	Non-Disclosure Agreement
NIIP	Net International Investment Position
NOP	Net Open Position
NPV	Net Present Value
OCC	Official Creditors Committee
PDI	Past Due Interest
REER	Real Effective Exchange Rate
SCAs	Specific and Credible Assurances
SLDB	Sri Lanka Development Bond
SOEs	State-Owned Enterprises
SRDSF	Sovereign Risk and Debt Sustainability Framework

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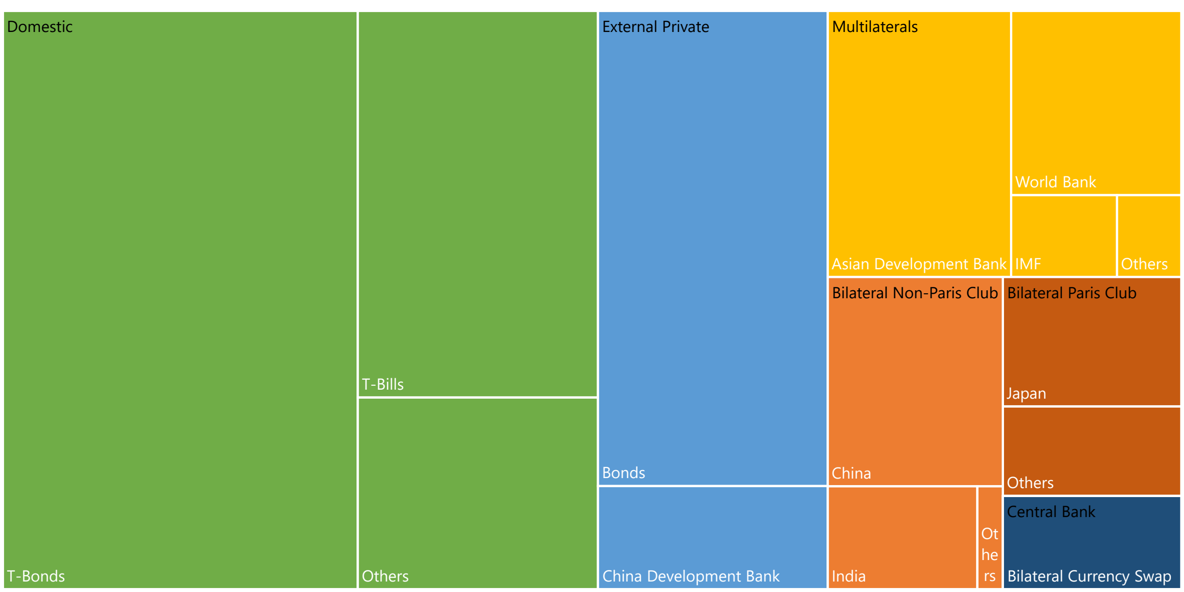
Introduction

1. **Sri Lanka's public debt became unsustainable in the run up to its 2022 crisis following policy missteps and insufficient preparation for shocks that subsequently struck.** Already among the emerging and developing countries with the lowest tax take in the world, government revenue was further reduced in 2019 amid a significant decline in tourism earnings in the wake of the Easter bombings and an earlier political crisis. The Covid pandemic exacerbated this vulnerability and by 2022 government revenue amounted to about 8 percent of GDP compared to about 12 percent in 2019 and 18 percent in the early 1990s. Moreover, the exchange rate had been maintained at levels that exceeded its equilibrium level, facilitating imports but hampering the economy's ability to earn foreign exchange through exports, leaving it vulnerable to balance of payments (BOP) shocks. The growth in access to international bond markets in the 2010s provided additional sources of foreign exchange and a temporary reprieve of BOP pressures, but increased future foreign exchange requirements to service external debts.

2. **The loose fiscal policies and a series of external shocks ultimately led to Sri Lanka defaulting on its external debt obligations in April 2022 for the first time since its independence.**[1] The authorities subsequently pursued a comprehensive sovereign debt restructuring, involving both foreign and domestic claims, in the context of an IMF supported adjustment program. The diverse creditor base made it one of the most complex sovereign debt restructuring cases to date (Figure 1). Almost three years after default, the restructuring process is nearing completion, and there are several lessons that can be useful for other sovereign restructuring cases.

Figure 1. Sri Lanka: Decomposition of Public Debt, 2022



Sources: IMF staff calculations.

[1] Sri Lanka announced suspension of external debt payments in April 2022, but default occured in May 2022.

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3. **The paper is organized as follows:** Section A provides an overview of Sri Lanka's debt problems and discusses the setting of quantitative debt targets. Section B focuses on complications in external creditor coordination. Section C reviews the restructuring designs, negotiations, and outcomes. Section D draws early lessons from the Sri Lanka experience, and Section E concludes with a forward-looking perspective.[2]

From Default to Restoring Sustainability

An Overview of Sri Lanka's Debt Problems

4. **An extended period of loose fiscal policies, a weak external position, and inadequate governance of state-owned enterprises (SOEs) left Sri Lanka vulnerable to shocks and with minimal buffers by 2018.** During 2005-18, government revenue averaged less than 13 percent of GDP (one of the lowest in emerging markets), and annual primary balances (not accounting for the interest bill) averaged -1.3 percent of GDP. The Real Effective Exchange Rate (REER) had appreciated by 30 percent in 2005-15 and remained 20 percent above its 2005 level by 2018 (Figure 2). Its misalignment with fundamentals added to underlying public debt risks.[3] The Net International Investment Position (NIIP), which represents the balance of Sri Lanka's assets abroad relative to its liabilities to foreigners, declined from USD -36 to -49 billion between 2012 to 2018. Such a large negative NIIP position was financed through accumulation of external debt, especially through international bonds with high interest rates. An overvalued exchange rate left Sri Lanka vulnerable to negative valuation effects from a large depreciation. Finally, quasi-fiscal exposures related to loss-making SOEs put the government at risk of having to assume contingent debt. In particular, the state-owned electricity company Ceylon Electricity Board (CEB) and petroleum company Ceylon Petroleum Corporation (CPC) had been operating with significant losses (including through quasi-fiscal operations) and accumulated unsustainable amounts of debt.

5. **Amidst these vulnerabilities, Sri Lanka was hit by a series of shocks in 2019-22.** As a tourism-dependent economy, Sri Lanka was severely affected by the Covid-19 pandemic in early 2020, with an economy yet to fully recover from the 2017 drought, the 2018 political crisis, and the 2019 Easter terrorist attack. These happened against the backdrop of a secular decline in Sri Lanka's economic growth and external strength (two factors that were essential to the country's earlier public debt reduction (see figure)).[4] A series of misfortunes and several policy missteps exacerbated the problem, including a major tax cut in 2019 that deprived the government of its buffers for counter-cyclical policies.

[2] A more thorough discussion of Sri Lanka's macroeconomic challenges in the lead up and during the debt crisis can be found in IMF Country Report No. 2023/116. Historically, Sri Lanka has traditionally had high levels of government debt, which reached over 100 percent of GDP in the late 1980s, and early 2000s before being reduced through strong growth and real exchange rate appreciation.

[3] The 2023 external sector assessment had identified an 8.2 percent REER gap relative to the level consistent with medium-term fundamentals even after the large nominal depreciation in 2022.

[4] Growth in 2018-21 (before the 2022 crisis) averaged 0.4 percent per year, relative to above 5 percent in the 1990s and 2000s, and the first half of 2010s.

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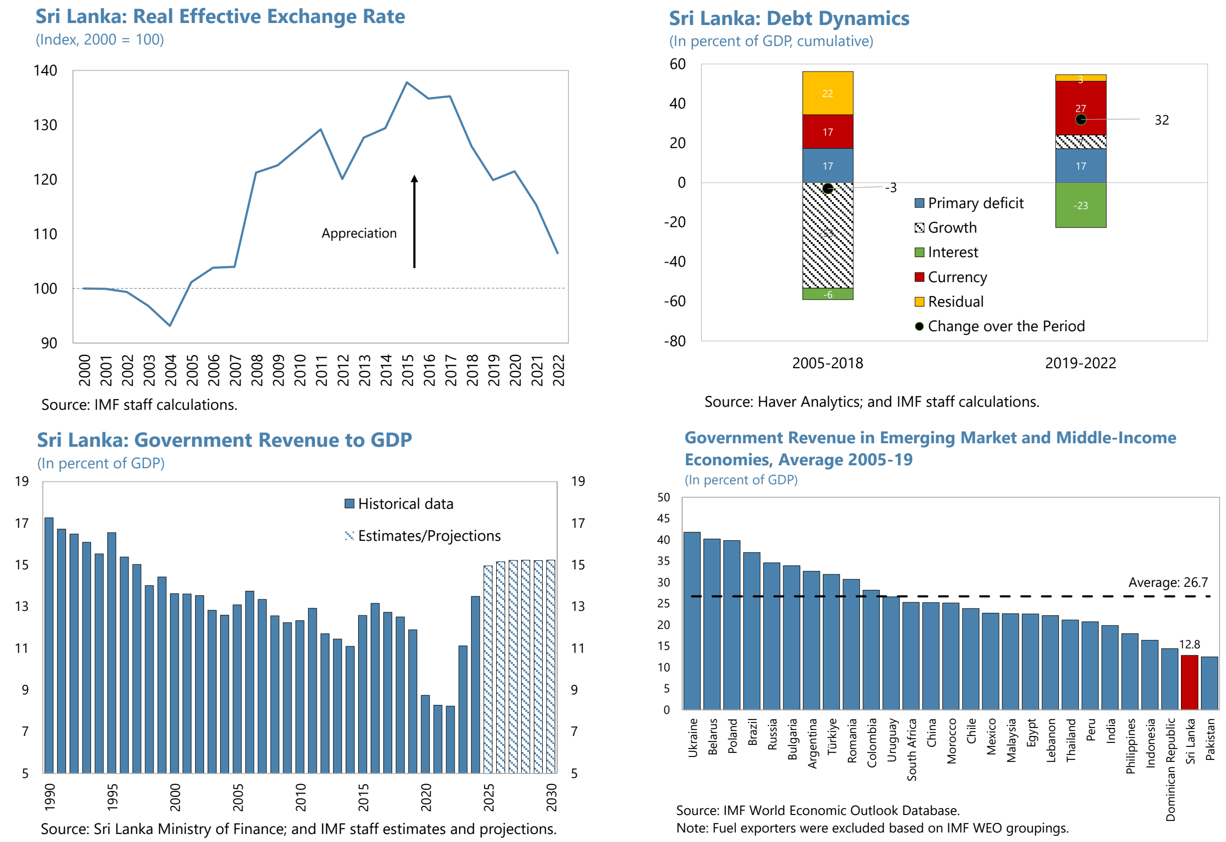
Figure 2. Key Macroeconomic Indicators



6. **Analysis of debt dynamics shows that both fiscal and external vulnerabilities contributed significantly to the massive increase in debt by 2022 (Figure 2, Top right panel).** In the pre-crisis period (2005-18), the increase in debt to GDP was driven primarily by 17 percent of GDP in cumulative primary deficits. In addition, currency effects added 17 percentage points to debt to GDP by 2018. These contributions were offset by strong annual growth (averaging 5.6 percent). However, the misaligned exchange rate regime collapsed with a large depreciation in 2022, adding 27 percent of GDP in debt, without any counter-veiling impact from growth. In addition, the loose fiscal stance in 2019-22 after the tax cuts added further 17 percent of GDP in debt. Finally, latent fiscal risks from SOEs materialized in 2022, as the central government had to take on debt from multiple SOEs into its books, increasing its debt stock by more than 4 percent of GDP. These were only partially offset by high inflation and negative real interest rates. Driven by these factors, debt to GDP rose to 126 percent in 2022, with the imminent possibility of a further explosive path without significant adjustments.[5]

7. **With such a significant increase in debt vulnerabilities, Sri Lanka lost market access and entered a full-blown crisis.** In April 2020, perceived by investors as one of the weakest BOP and fiscal positions among emerging markets, Sri Lanka's sovereign spreads—reflecting the sovereign risk above a risk-free benchmark—rose above 2,000 basis points, effectively shutting the country out of the international capital markets (Figure 3). However, several of its international sovereign bonds (ISBs) were coming due in the next

[5] The residual in the debt dynamics chart is driven by factors other than the listed debt drivers, and captures, e.g., stock and flow adjustments and materialization of contingent liabilities.

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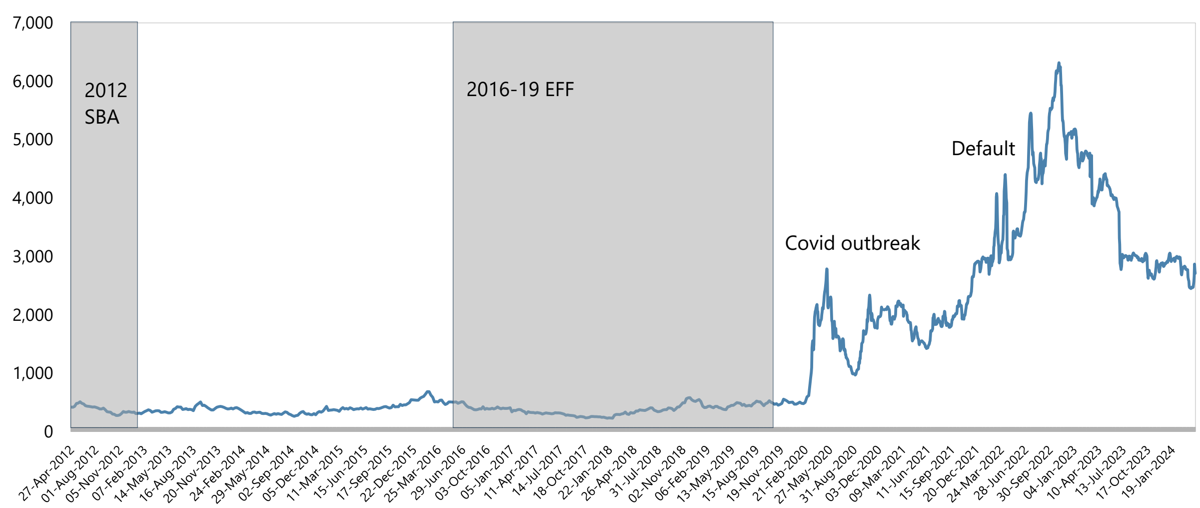
24 months and its FX reserves were in decline. An acute liquidity crisis was looming, and Sri Lanka's public debt was in deep distress.

Figure 3. Sri Lanka: Sovereign Spreads
(Weighted average spreads, bps)



8. IMF debt sustainability analysis (DSA) confirmed an unsustainable situation. An updated DSA for Sri Lanka found its public debt on an explosive path under current and feasible policies, as growth collapsed, (structural) fiscal deficit widened, and the exchange rate came under tremendous pressures. The unsustainable assessment of Sri Lanka's public debt situation was published in the context of the 2021 Article IV consultation. The policy adjustment needed to reverse this trend was deemed neither politically feasible nor socially acceptable. The IMF's debt sustainability toolkits signaled elevated risk for near-term stress and significant solvency and refinancing risks — Sri Lanka's debt was assessed to have become unsustainable, and that the crisis was one of solvency.

9. After a substantial period of prioritizing debt payments over other spending commitments, Sri Lanka defaulted in 2022 and started to pursue a sovereign debt restructuring. The authorities exhausted most of their foreign exchange (FX) reserves to cover external debt payments, including the maturities of three ISBs (USD 2.5 billion in total) in October 2020, July 2021, and January 2022, in the hope of preserving Sri Lanka's unblemished debt payment track record. Faced by acute BOP financing pressures, which prompted a large and rapid exchange rate depreciation, and lack of resources to pay for essential imports, the authorities formally sought IMF financial support under the Extended Fund Facility (EFF) in March 2022, and announced moratoria on their foreign debt payments the month after. With these, the authorities formally embarked on Sri Lanka's first sovereign debt restructuring and hired financial and legal advisors for negotiations with creditors.

A. Restoration of Medium-term External Viability and Debt Sustainability

10. The design of Sri Lanka's EFF-supported IMF program focused on the dual goals of restoring medium-term external viability and debt sustainability. Macroeconomic policies needed to combine fiscal

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and external adjustments in a realistic and prudent macro framework. The gap between realistic and feasible policies and the required adjustment would be bridged by exceptional financing including through debt relief.

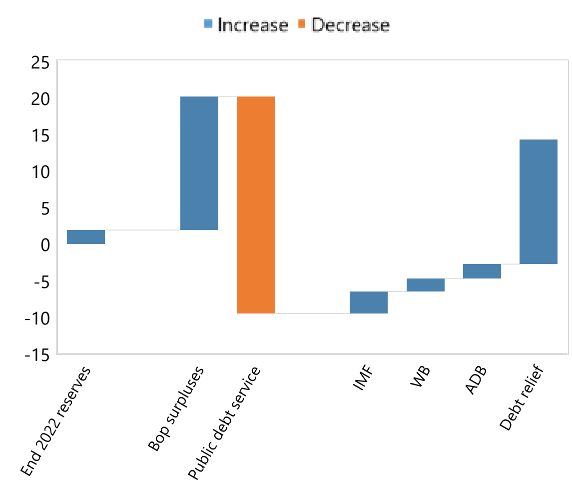
Medium Term External Viability

11. Medium Term External viability would be restored by bringing the country's balance of payments (BOP) position and central bank's reserves to safe levels. To identify the appropriate reserve coverage in market access countries, the IMF has developed the Assessing Reserve Adequacy (ARA) metric. It assesses the ratio of gross FX reserves against a weighted combination of short-term external debt (30 percent)[6], exports (5 percent), broad money (5 percent), and other external liabilities (15 percent). At 100 percent of the ARA metric in 2027 (the lower bound of the recommended levels for emerging markets (IMF 2011)), Sri Lanka's reserves are expected to reach over USD 13 billion, or 5.6 months of imports. The import metric is significantly above the 3 months of imports generally seen as safe thresholds for reserves in countries with floating regimes. As a small open economy with a relatively large money supply and significant external liabilities, Sri Lanka requires larger amounts of reserves than the average lower middle income emerging market economy as buffers for external shocks even under a floating exchange rate regime.

12. These considerations anchored the design of the BOP parameters for the program. The needed external adjustment to rebuild reserves to 100 percent of ARA metric by 2027 is expected to be achieved through an external sector adjustment to rebalance the current account. Such adjustment would primarily be achieved through the price mechanism (real exchange rate realignment with fundamentals). In a crisis where real assets are eroded by large inflation, the external adjustment is expected to be accompanied by a large import compression, including through the wealth effect.[7] The sharp Rupee depreciation at the onset of the crisis, which largely passed through to inflation, did not fully realign the real exchange rate, particularly with import restrictions in place. The program design therefore anticipated a further real effective exchange rate depreciation to support the external adjustment and help provide the room for reserves accumulation in line with restoring external viability. However, the large amount of external debt payments due during the program period (USD 28 billion) would imply that the real exchange rate adjustment needed to generate sufficient current account surpluses to offset these debt payments would be very large and infeasible.

13. To provide sufficient balance of payments relief and ensure the appropriate rebuilding of central bank FX reserves a reduction in external debt service by USD 17 billion was needed during the program period (2023-27) (Figure 4). This debt relief complements the USD 6.8 billion financing contribution jointly committed by the IMF, the World Bank, and the Asian Development Bank. To put this into context, the USD 17 billion relief target implies only USD 4 billion in debt service could be paid out during the program period on debt the authorities indicated would be subject to restructuring (out of total USD 28 billion claims over the program period). This, together with the FX debt service ceiling for the post-program period (discussed later), implies inevitable NPV relief.

Figure 4. Sri Lanka: Gross International Reserves
(In billions of USD)



[6] The short-term debt coverage metric itself contributed close to USD 3 billion to the reserve requirements.

[7] In the first two years of the program, external adjustment has occurred more through the wealth effect than through relative prices, as the real effective exchange rate has not depreciated significantly.

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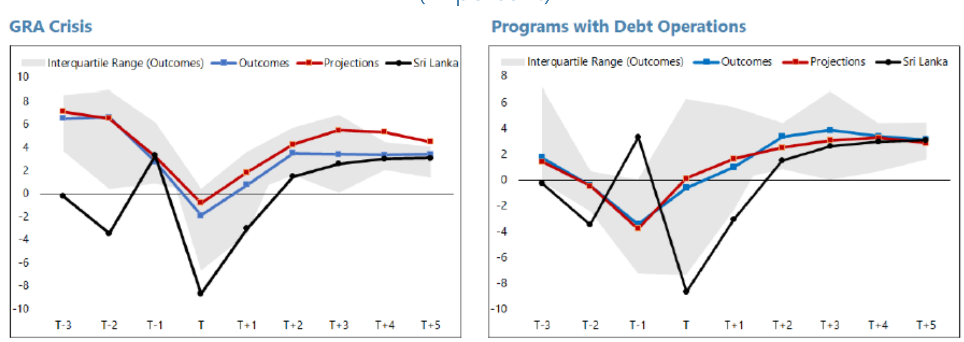
Debt Sustainability

14. The sovereign's debt sustainability would be restored through a combination of macroeconomic adjustment, concessional financing and debt relief. Restoration of debt sustainability would require adjustment beyond just the restoration of medium-term external viability to ensure reduction in debt stock and debt service beyond the program period. The required macroeconomic adjustment could include economic growth, fiscal adjustment, and financial and external sector policies (such as inflation, financial repression, real exchange rate appreciation) that reduce the real costs of debt. Key to the design was the frontier of feasible fiscal adjustment, which drew from Sri Lanka's historical experience and an assessment of what can realistically be achieved in a difficult macroeconomic environment. An overly ambitious fiscal adjustment would give rise to implementation risks and could choke off growth, hence providing little gains in terms of restoring debt sustainability. The Sri Lanka EFF design settled on a primary balance target of 2.3 percent of GDP along with a significant REER adjustment to balance these considerations. Any gaps between the results of macroeconomic adjustment and the restoration of debt sustainability in the program macroeconomic framework would need to be closed by creditor debt relief. The depth of this debt relief is expected to influence the timing and terms of the debtor country's re-access to new bilateral or market financing—as creditors reassess the risk premium—which must then be internalized in the macro framework.

15. The debt sustainability assessment was underpinned by a program framework that incorporated Sri Lanka's country-specific characteristics and the macroeconomic environment. Experience in other market access country BOP and debt crises pointed to subdued economic recovery post-default especially where much needed fiscal consolidation constrained growth, the balance sheets of domestic financial institutions were impaired, and a sizable real effective exchange rate adjustment was needed to enable durable external adjustments (see Figure 5). These considerations informed the design of the macroeconomic framework for Sri Lanka's IMF program, under which appropriate policies were formulated. Past debt forecast errors were used to inform the realism of debt reduction through *automatic debt dynamics*, which had, in other cases, been relied upon to substitute debt relief unsuccessfully.[8] After several rounds of deliberation, a full macroeconomic framework was formulated in the staff-level agreement reached between the IMF and the Sri Lankan authorities on September 1, 2022, for a four-year EFF-supported arrangement.

Figure 5. Growth Projections for the EFF Program Request
(In percent)



Sources: IEO, 2021. Growth and adjustment in IMF-supported programs; and IMF staff calculations.

[8] These refer to changes in debt ratios driven by interest-growth differentials and exchange rate effects, independent of primary balances.

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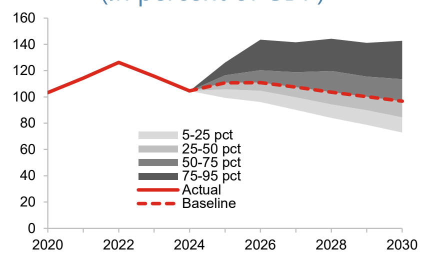
16. IMF policies stipulate that the Fund may only lend to countries with sustainable debt on a forward-looking basis. The Fund is precluded from lending if debt is assessed as unsustainable unless the member takes steps to restore debt sustainability.[9] In the case of countries involved in a debt restructuring, the post-restructuring macroeconomic framework must ensure debt sustainability, assessed through a debt sustainability analysis, which takes the macroeconomic framework as input and calculates the levels of debt and financing needs consistent with a sustainable position. Such levels of debt and financing needs are referred to as "the debt targets."

17. The relevant IMF debt sustainability analysis for Sri Lanka incorporated various recent technical advances and country-specific characteristics. To assess debt sustainability, the revamped DSA framework for market-access countries, the Sovereign Risk and Debt Sustainability Framework (or SRDSF) was applied in Sri Lanka's case.[10] This framework differed from its predecessor (the MAC DSA) by allowing i) time horizon specific risk assessments, ii) moving away from broad thresholds on debt and financing needs towards a richer country-specific assessment underpinned by a host of stochastic analysis and stress testing to capture the uncertainty in debt dynamics and its implications for sustainability. The analysis of debt sustainability included two key assessments:

a. An assessment of **solvency** risks with a debt fanchart (Figure 6) module representing the probability distribution of different debt levels based on the country's historical volatility. It analyzed the levels of baseline debt combined with institutional strength, uncertainties around the baseline projections, and the probability of debt stabilization, and generated a fanchart risk metric by averaging these factors. This module improved upon the previous framework's focus on fixed debt limits (70 percent of GDP for emerging markets and 85 percent for advanced economies), to incorporate the fact that certain countries could carry much larger debt than others, and vice versa. Factors analyzed in this module had been proven to be good proxies for debt carrying capacity by predicting sovereign risk and unsustainable events fairly accurately during the backtesting of the SRDSF framework.

Figure 6. Sri Lanka: Fan Chart
(In percent of GDP)



Metrics:
1. Probability of Debt Stabilization
2. Terminal Debt x Institutions
3. Fanchart Width

[9] See; Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework; IMF Policy Paper; April 26, 2013. In exceptional access programs, the requirement is stricter, as debt sustainability should be restored with a high probability. This requirement was not present in Sri Lanka because access to IMF resources was within normal limits.

[10] Discussed in SRDSF Guidance Note, Section VIII.B.

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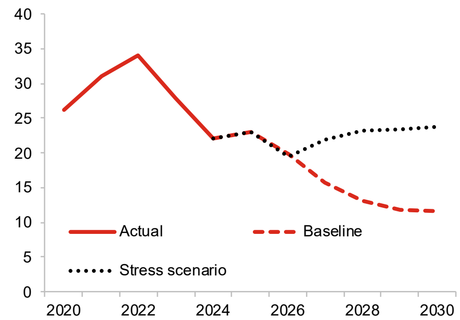
b. An analysis of **financing** risks was undertaken using a gross financing needs (GFN) module (Figure 7). This module analyzed GFNs and exposure of the banking sector in the baseline, and the increase in such exposure in the case of a stress scenario (Figure 7: dotted line) featuring fiscal and exchange rate shocks and sharply reduced financing by foreign private creditors. The final financing risk signal was an average of these concepts. The GFN module improved upon the previous frameworks' focus on fixed GFN limits (such as 15 percent of GDP for emerging markets and 20 percent of GDP for advanced economies) by recognizing that some countries can manage large gross financing needs because of the depth and maturity of their domestic financing systems and vice versa. The stress scenario was based on the country's own history rather than equalized across countries. By combining the issues of funding size and characteristics (currency exposure, sudden stop risks) with the concepts of funding supply, the tool had shown strong predictive performance in the back-tested sample across all market access countries.

Figure 7. Sri Lanka: Gross Financing Needs Module
(In percent of GDP)



Metrics:
1. Average GFN to GDP
2. Initial Bank Claims to Assets
3. Change in bank claims to assets in stress scenario

By combining the signals of these modules, the SRDSF generated a sustainability risk score, whose values needed to remain below levels consistent with a high enough probability for debt sustainability based on IMF board guidance. The probabilistic thresholds for the debt sustainability risk scores were set based on an extensive back testing exercise as part of the IMF board approved review of the DSA framework in 2021.

18. Based on the debt sustainability analysis with the SRDSF, Sri Lanka's debt targets were set in line with IMF policies. Both the debt fanchart and the gross financing module were estimated for an illustrative restructuring macroeconomic scenario to calculate the sustainability risk score. The targets were then set to ensure that the sustainability risk score remained below the threshold approved by the IMF board. This ensured that debt sustainability would be restored on a forward looking basis. This analysis incorporated debt sustainability concepts relevant to the case of Sri Lanka. For example, the high historical volatility of debt drivers and the large sovereign exposure of the banking sector as a share of total banking assets were significant risk factors that increased the sustainability risk score and were accounted for in the assessment. Conversely, Sri Lanka's large domestic banking sector contributed to mitigating the risk score. These probabilistic assessments and stress tests also helped ensure the macroeconomic framework was designed to be robust to downside risks, which is critical for avoiding future debt distress.

19. The procedure appropriately limits post restructuring external debt and debt service. The two main modules for assessing debt sustainability (the debt fanchart and the GFN module) both show higher risks when domestic debt is replaced by external debt. First, with higher foreign currency debt, the debt fanchart—a core measure of risk—is wider due to the real depreciation shocks. Second, the GFN module's shock scenario is more severe with a larger share of foreign currency debt (particularly those held by foreign private creditors) due to both the depreciation shock and a "sudden stop" shock.[11] With all these factors, the same sovereign with larger external (residency, currency) debt has a much riskier sustainability assessment than one with lower external debt. As the

[11] Sudden stops are sharp reversals in capital inflows, often triggering liquidity and exchange rate crises.

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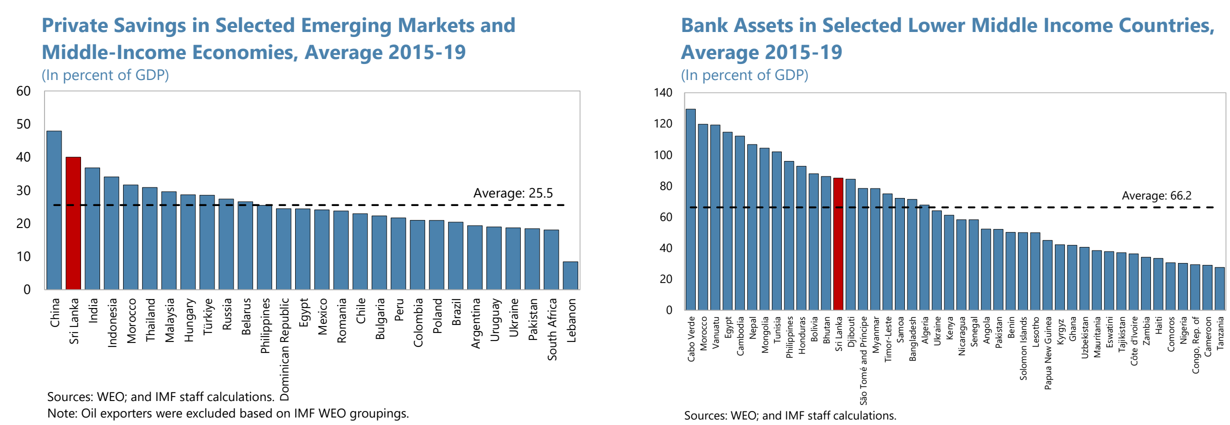
debt targets procedure ensured module results consistent with a sustainable risk score, the tools limited the post restructuring external debt consistent with restoring debt sustainability.

20. Country-specific characteristics are important determinants of a country's debt carrying capacity, which were reflected in the debt sustainability analysis. Sri Lanka underwent significant financial deepening during the credit and investment boom that followed the conclusion of its civil war in 2009. This, coupled with the government's substantial domestic financing needs (as it gradually lost access to grants and concessional financing), led to rapid expansion of the domestic financial sector. Its comparatively large private savings (see Figure 8) provides a deep investor base featuring (i) captive superannuation funds (with assets over 10 percent of GDP investing almost all of their assets in government securities) and (ii) a large banking sector (assets around 80 percent of GDP) compared to most other lower middle-income countries and other recent restructuring cases funded primarily through domestic savings. These financial institutions have played an important role in supporting historically high levels of domestic debt and gross financing needs (GFNs) in Sri Lanka, including during stress periods. Externally, Sri Lanka's susceptibility to shocks as a small open economy would suggest a low safe external debt level and high adequate reserves levels. Mitigating factors determining Sri Lanka's capacity to bear external debt include significant tourism (generating about USD 4 billion a year, or 4 percent of GDP) and remittances receipts (generating about USD 6 billion a year, or 6 percent of GDP).

Figure 8. Sri Lanka: Financial Sector



21. The debt sustainability targets for Sri Lanka's EFF program are carefully calibrated to these specific circumstances under the new SRDSF and need to be considered in their entirety. These debt targets were set by the Fund in the context of Sri Lanka's EFF request and were discussed with the Sri Lankan authorities and their creditors early on to inform timely deliberation and decision.[12] Multiple debt targets jointly determine what a sustainable debt path looks like for Sri Lanka, and none of them should be taken individually to foretell the depth of required debt relief. For example, the arrangement period external debt relief target and the post-program FX debt service target effectively confine the FX debt service envelope available to restructurable external claims and put a floor on the depth of compatible debt relief, which implies a meaningful

[12] In setting the targets, the Fund staff anchors the Fund supported program (which is reached on understandings with the member) around the maximum fiscal adjustment economically and politically feasible which then with the DSA determines the financing envelope necessary to restore debt sustainability. In addition, Fund policies such as the financing assurances policy ensure that the program is fully financed during the program period and that there are no post program financing gaps. IMF staff has a duty to neutrality and must remain neutral in disputes between members. Fund supported programs are designed to solve the member's balance of payments problem and restore medium term external viability. Any remaining financing gap needs to be filled with hew financing and/or a debt restructuring.

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NPV reduction.[13] Additionally, as discussed above, the framework's sustainability signals would be compromised by larger amounts of external debt, hence capping the external debt stock implicitly. In addition to the external viability target on the debt service reduction during the program period the following debt sustainability targets were formulated:

- **The post-program GFN target of 13 percent of GDP per annum (average over 2027-32),** set at a level consistent with a low rollover risk under both the baseline and a stress scenario where macro-fiscal and financing shocks (calibrated based on the SRDSF GFN module) lead to higher gross financing needs. A key objective is to keep potential additional financing needs that would need to be absorbed by domestic banks under the stress scenario at a manageable level. For reference, Sri Lanka's government gross financing needs averaged 23 percent per annum in 2013-22, implying significant reduction post-restructuring.

- **The debt stock target of 95 percent of GDP (by 2032)**, set at a level that ensures debt reduction and high probability of debt stabilization. This probabilistic assessment draws from a fan chart based on Sri Lanka's historical patterns of macro-fiscal shocks (consistent with the SRDSF fan chart module). The key objective was to ensure that the baseline debt path/level entails an appropriately high probability of debt stabilization at both 5- and 10-year horizons at levels consistent with debt sustainability. It should be noted that the target reflects high levels of domestic debt (see discussion below).

- **The post-program FX debt service target of 4.5 percent of GDP (annual ceiling for 2027-32)**, set at a level that mitigates post-program balance of payments pressures and is calibrated to Sri Lanka's ability to generate and sustain FX earnings (exports, remittances, terms of trade volatility), its domestic creditors' ability to provide FX credit, as well as the country's historical levels of FX borrowing. In particular, staff used the historical relationship between reserves, gross external financing and FX earnings (exports and remittances) to ensure that net reserves following the program could provide adequate coverage for FX debt service. This FX debt service target, through its direct and indirect effects on GFNs and the public debt level, is also implicitly subject to the liquidity and solvency assessments of the SDRSF (discussed above) to ensure alignment with the goal of restoring debt sustainability. This target also includes debt service associated with Sri Lanka's non-restructured FX claims, including to International Financial Institutions, and its new FX borrowing. A natural implication is that restructured debt service would be limited to a smaller portion (around 2 percent of GDP). This FX debt service target is motivated by the nature of Sri Lanka's current debt crisis, which stems from a BOP crisis. For reference, Sri Lanka's government FX debt service averaged 9 percent of GDP in 2013-22, implying substantial reduction post-restructuring.

22. The depth of the eventual debt treatment was determined by these targets and the underpinning macroeconomic assumptions. Debt targets are designed to reflect a country's debt carrying capacity. Such capacity is normally proportional to economic strength, which includes both national income and the balance of payments. Sustained and balanced improvements in these two sectors is consistent with improved debt carrying capacity. This explains why most debt targets in the Sri Lanka case are expressed as ratios to GDP, except for the program period debt service reduction which is derived from a dollar target for the end-of-program FX reserves level. As a result, the depth of the eventual debt treatment depends not only on

[13] With the expectation that the flow targets will also be respected in the long-term (an important part of the IMF's sustainability assessment, including through the long-term amortization module of the SRDSF), this is essentially a constraining external debt NPV target, akin to that of the LIC DSF.

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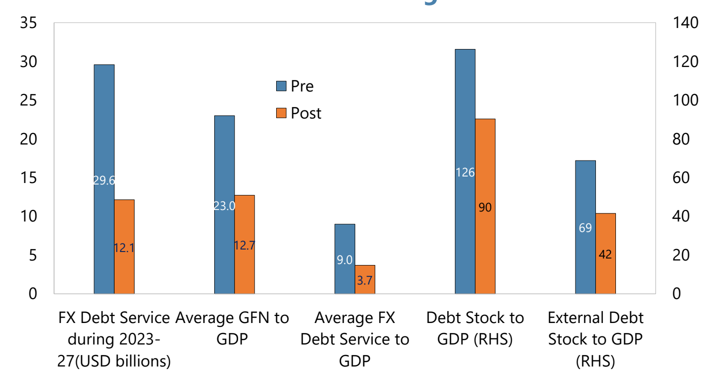
the debt targets (the ratios), but also the macroeconomic assumptions for the GDP trajectory (the common denominator). If the economy outperforms program assumptions, including as the economic situation improves under the stabilization program over the course of drawn-out negotiations, the amount of required debt relief to achieve the same debt sustainability targets will, ceteris paribus, be smaller, and vice versa. This inherent uncertainty motivated the discussion on state contingent debt treatments (discussed later).

23. The restructuring targets ensure a significant reduction in external debt. Based on the EFF Third Review framework, post-restructuring external debt is projected to decline from 69 percent of GDP in 2022 to 41.5 percent of GDP in 2032 (a reduction of 27 percent of GDP). As of 2032, present value of external debt will remain at 36 percent of GDP due to the concessional nature of most financing provided to Sri Lanka. Given market commentary on the possible discrepancies with the Low Income Country Debt Sustainability Framework, it is instructive that these levels are significantly lower than the present value of external debt-to-GDP threshold (55 percent of GDP) set in the Low Income Countries Debt Sustainability Framework (LIC DSF) for countries with high debt carrying capacity, and within the limits set for countries with medium debt carrying capacity (40 percent of GDP).

Figure 9. Sri Lanka: Pre vs. Post Adjustment and Restructuring

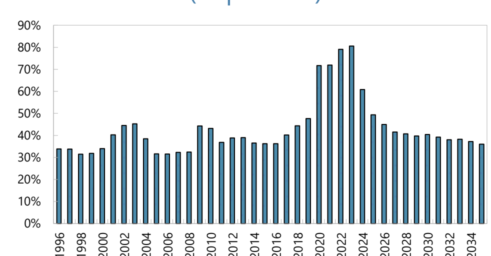


Source: IMF staff calculations.
Note: Flow metrics (GFN and FX debt service) are for 2027-32, compared against the previous decade (2013-22). Debt Stock is as of 2032, and compared against the debt stock in 2022. Projections based on based on EFF Third Review macroframework

24. Large domestic debt will continue to be a feature of Sri Lanka's economy, as it has been in the past. As of 2032, the majority of Sri Lanka's debt (50 percent of GDP) will be held domestically, at similar levels to the average government domestic debt in Sri Lanka in 1970-2018 (44 percent of GDP). Such domestic debt can be absorbed by its large domestic financial system (as discussed above). The health of the banking system is expected to continue to improve during the rest of the EFF arrangement and beyond. Additionally, the implications of the sovereign financial nexus were incorporated into the macro-economic framework's prudent growth estimates, hence limiting further downside risks.

25. These targets also ensure a return to safer position as measured by traditional debt service metrics. Metrics such as interest-to-revenue, while not part of the formal targets, also show significant improvement, declining from around 80 percent in 2022-23 to around 35 percent by 2035 (with 75 percent of such payments provided to the local financial system). These are levels Sri Lanka maintained in the 1990s before market access. While these ratios are higher than many peer countries, the differences are primarily driven by Sri Lanka's societal choice of a lower-than-median tax and spending fiscal

Figure 10. Sri Lanka: Interest to Revenue to Ratio
(In percent)



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framework (supported by a legally mandated primary fiscal expenditure ceiling of 13 percent of GDP as per the Public Financial Management Act 2024).[14]

External Creditor Coordination

26. Sri Lanka had a diverse creditor base. At the time of its default, Sri Lanka had about USD 80 billion government debt, split roughly 50/50 between foreign and domestic on a residency basis (Table 1). Among foreign creditors, international sovereign bond (ISB) holders had progressively risen to Sri Lanka's largest creditor group since it first tapped the market in 2007. The exposure by non-bonded foreign commercial creditors, including the China Development Bank (CDB), had been more stable.[15] Official sector debt was split roughly equally between multilateral development banks and bilateral official creditors, with the latter including both traditional Paris Club creditors and emerging non-Paris Club creditors, such as China and India. On the domestic front, a large chunk of government debt was held by captive superannuation funds and Sri Lanka's relatively large banking sector funded primarily by household savings, with the banks having taken a more active role in financing the government during the loss of market access. In addition, monetary financing by the central bank had led to substantial sovereign exposure in the central bank balance sheet (Figure 11). The diverse creditor base and the multiple tracks of restructuring operations have resulted in a complex and protracted negotiation process involving various stakeholders (Annex III).

Table 1. Sri Lanka: Decomposition of Public Debt

	Debt Stock (end of period, incl. arrears and past due interest) 2022			Debt Stock (end of period, incl. arrears and past due interest) 2023		
	(In US$mn)	*(Percent total debt)*	*(Percent GDP)*	*(In US$mn)*	*(Percent total debt)*	*(Percent GDP)*
Total public debt	**83,670**	**100.0**	**125.8**	**98,758**	**100.0**	**115.8**
External (foreign law)	**41,549**	**49.7**	**62.5**	**43,323**	**43.9**	**50.8**
Multilateral creditors[2]	11,519	13.8	17.3	13,175	13.3	15.4
IMF	1,062	1.3	1.6	1,579	1.6	1.9
World Bank	3,839	4.6	5.8	4,388	4.4	5.1
ADB	5,973	7.1	9.0	6,583	6.7	7.7
Other Multilaterals	645	0.8	1.0	625	0.6	0.7
Bilateral Creditors	11,471	13.7	17.2	11,100	11.2	13.0
Paris Club	4,784	5.7	7.2	4,834	4.9	5.7
o/w: Japan	2,828	3.4	4.3	2,676	2.7	3.1
Non-Paris Club	6,687	8.0	10.1	6,266	6.3	7.3
o/w: China	4,483	5.4	6.7	4,349	4.4	5.1
India	1,883	2.3	2.8	1,575	1.6	1.8
Bonds	13,364	16.0	20.1	14,130	14.3	16.6
Commercial creditors	3,159	3.8	4.8	3,498	3.5	4.1
o/w: China Development Bank	2,901	3.5	4.4	3,241	3.3	3.8
Central bank bilateral currency swaps	2,036	2.4	3.1	1,420	1.4	1.7
Domestic (local law)	**42,121**	**50.3**	**63.3**	**55,436**	**56.1**	**65.0**
T-Bills	11,364	13.6	17.1	12,634	12.8	14.8
Bonds	25,124	30.0	37.8	37,423	37.9	43.9
Others	5,633	6.7	8.5	5,379	5.4	6.3

27. The diverse creditor base posed significant challenges to external creditor coordination on financing assurances and debt relief (Annex I). The *G-20 Common Framework*, which brings all major bilateral creditors (Paris Club and non-Paris Club) together through an official credit committee and establishes a coordination forum, was unavailable to Sri Lanka given its middle-income status.[16] Creditor coordination around a creditor forum, even on an ad hoc basis, can support achieving a timely solution in the collective

[14] The interest-to-revenue ratio is systemically biased towards higher spending/higher tax countries where sustainability risks will be understated, and against lower spending/lower tax countries where risks will be overstated.

[15] The majority of CDB claims on Sri Lanka are considered commercial, as they do not carry a guarantee from the official export and credit insurance corporation ("Sinosure") which also had been triggered. The Fund determines the official perimeter for purposes of its own policies based on the totality of circumstances including also the creditor's representation. See: IMF 2022, [Reviews of the Fund's Sovereign Arrears Policies and Perimeter](). This classification is also consistent with the Chinese authorities' own representation.

[16] More details on eligibility can be found at https://clubdeparis.org/en/communications/page/common-framework.

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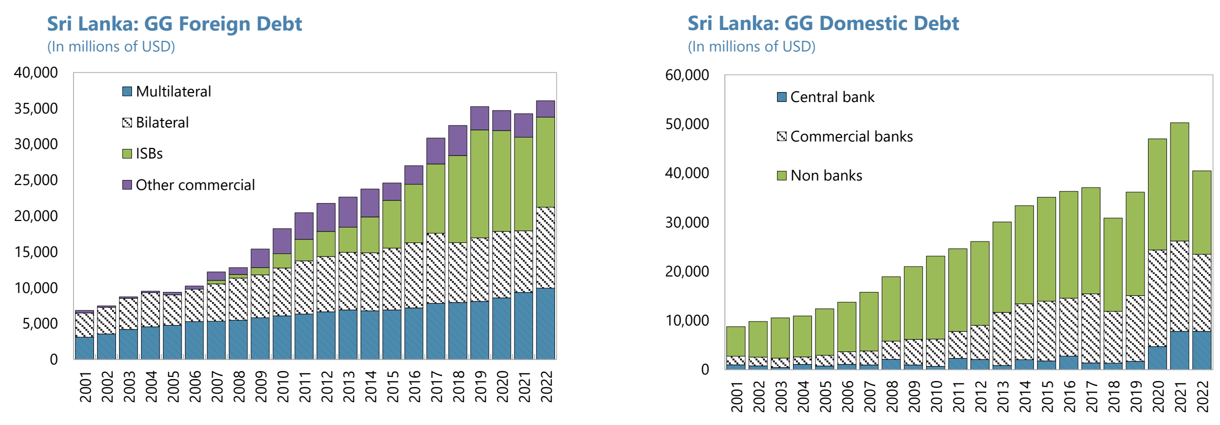
interest of creditors. Hence, at the request of the Sri Lankan authorities and its creditors, the Fund staff/management used its “good offices” and supported the Sri Lankan authorities’ efforts in orchestrating an official creditor coordinating platform open to all their bilateral creditors.[17] The authorities, supported by their advisors, convened three official creditor meetings between October and December 2022, where they presented their creditor engagement strategy and preliminary considerations on debt treatment parameters, and invited Fund staff to explain program parameters and options for creditor coordination and what was required for the Fund under its policies to proceed including financing assurances. The President of Sri Lanka also issued an open letter to the country’s official bilateral creditors on March 14, 2023 to encourage them to coordinate—in any form they deem appropriate—and made three specific commitments: (i) to communicate transparently on financial liabilities and agreed debt treatments; (ii) not to resume debt service without a treatment consistent with IMF program parameters and comparability of treatment (CoT); and (iii) to ensure comparable treatment of all external creditors (Annex II).[18]

Figure 11. Sri Lanka Debt Breakdown



28. Despite these efforts and commitments, full coordination among major bilateral creditors ultimately did not materialize. The EFF-supported arrangement could not proceed until sufficient assurances from creditors with whom the debtor country is in arrears were obtained that debt sustainability will be restored consistently with program parameters. The obtaining of these assurances, particularly in debt restructuring cases when arrears have accumulated, is governed by the Lending into Official Arrears (for official creditors, LIOA) and Lending into Arrears (for private creditors, LIA) policies (Annex I). With full coordination among all major bilateral creditors (Paris Club, China, and India had significant claims on Sri Lanka) remaining elusive as of end-2022 (four months after the staff level agreement reached on Sri Lanka’s EFF), focus was redirected to a parallel approach where discussions were held separately with different creditors and creditor groups. This parallel approach, however, proved demanding since the process was duplicative, information sharing among the different official creditor groups proved challenging, and ensuring comparability of treatment across creditors also presented challenges, along with new creditors’ lack of experience in providing Specific and Credible Assurances (SCAs) on debt relief.

[17] Under Fund policy, the Fund staff/Fund management may provide its good offices, at the request of both the debtor and its creditor(s). Fund staff/management has done so occasionally. See: Acting Chairman’s Summing Up, BUFF/84/107, July 13, 1984.

[18] https://www.treasury.gov.lk/news/article/185.

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29. SCAs from major bilateral creditors were eventually obtained through a parallel approach.[19] SCAs in writing by senior government officials from all major bilateral creditors on providing debt relief in line with program parameters and debt targets are needed before the IMF could assess debt sustainability restored on a forward-looking basis (given their significant contributions to close financing gaps) and move ahead with a financing program. The Paris Club's longstanding track record of providing these financing assurances and subsequent debt relief in a consistent manner under IMF-supported programs was not yet mirrored by emerging creditors like China and India. Therefore, in the case of Sri Lanka, Fund staff played an instrumental role in explaining to emerging creditors separately Fund policies including the required elements of SCA and the rationale in providing debt relief in line with program parameters and in facilitating data and information sharing with the creditors according to Fund policies (IMF 2023). IMF staff engagement also included explaining to creditors how shared data and information could support their analysis of the required debt relief (prior to being able to share the full DSA, in accordance with Fund policies) to guide their decisions in providing the necessary assurances. Through multiple rounds of engagement between Fund staff/management and the creditor country authorities at different levels, adequate SCA outlining clear understanding of Sri Lanka's debt problem and the contours of required debt treatment in line with IMF program parameters was obtained from India and China, through parallel tracks, between January and March 2023. These, combined with the financing assurances by Paris Club creditors (joined by Hungary) in February 2023, satisfied the LIOA requirements for the Fund to proceed with financial support to Sri Lanka under the EFF.

30. Dialogue between the Sri Lankan authorities and their private creditors commenced in parallel. Sri Lanka had two main groups of external private creditors: the China Development Bank and the ISB bondholders. The ISB bondholders consisted of the foreign group and the local group (under a consortium of eight domestic financial institutions that held ISBs at the time of Sri Lanka's default).[20] The foreign group organized themselves around a steering committee which initially claimed to represent around 50 percent of outstanding bondholders, though this dropped during the negotiations to below 40 percent. To facilitate a confidential dialogue and in line with requirements under securities laws, the authorities signed non-disclosure agreements (NDAs)—either directly with the creditors (CDB and local ISB bondholders) or with their advisors (foreign ISB bondholders, which themselves chose to preserve their right to trade and the option to enter a restricted stage of negotiations later)—soon after the authorities' debt moratorium. Dialogue started under these NDAs, and data and information needed to inform these creditors were shared soon after the program macroeconomic framework was finalized upon reaching the staff-level agreement. Several rounds of discussions followed suit, to understand the data/information shared and to reconcile the DSA modeling, sometimes with IMF staff's participation at the request of the Sri Lankan authorities. The authorities also invited their private creditors to investor presentations held in October and December 2022, where similar updates as presented to the official creditors were provided to a broader group of commercial creditors. These interactions provided commercial creditors with opportunities to provide inputs on the design of restructuring strategies and instruments. Based on these efforts made by the authorities, which were assessed to be in line with the good

[19] Given that the Paris Club alone did not constitute a majority of financing contributions during the program period strand 1 under the LIOA policy could not be met. Strand 2 (consent) alone from major creditors did not provide adequate safeguards to the Fund proceeding with approving an arrangement and additional safeguards were needed, In the end, all major creditors, Paris Club, India and China provided specific and credible assurances on financing/debt relief consistent with program parameters. For minority creditors consent under the LIOA was deemed sufficient.

[20] The institutions in the local group were technically domestic creditors and therefore not subject to the LIA policy.

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faith criteria under the LIA policy, and a need for prompt financial support by the Fund, the LIA policy requirements were satisfied.[21]

Restructuring Designs, Negotiations, and Outcomes

31. Debt restructuring discussions and operations pressed forward after the EFF program approval. Following receipt of financing assurances, the EFF arrangement was approved by the IMF's Executive Board on March 20, 2023, nearly seven months after the staff-level agreement, and about a year after Sri Lanka's formal request for financial support (Annex III). Following the approval of the EFF arrangement and the publication of full DSA details along with the IMF staff report, the restructuring negotiations intensified and started to focus on the treatment parameters that are in line with program debt targets.[22] In this phase, the IMF's role focused on supporting adjustment/reforms under the EFF arrangement and ensuring that all the debt treatments proposed/agreed are in line with program parameters. This required constant engagement with the authorities and their creditors in line with the IMF's policies and respecting its duty of neutrality. As required under Fund policy, the progress in debt restructuring to restore debt sustainability was assessed more formally at each program review with a financing assurances review. The IMF was not a party of the restructuring, and played no role in the negotiations, and on issues of determination of comparability treatment and inter creditor equity.

32. The designs of the negotiation strategy and parameters are the authorities' prerogative. Designs of the restructuring terms are guided by (i) the debt sustainability targets defined under the IMF supported program and (ii) the IMF baseline macroeconomic framework. While the debt targets explicitly cover only the 10-year period through 2032, they would remain the most appropriate debt sustainability benchmarks for Sri Lanka in the post-2032 period unless the Sri Lankan economy evolves significantly in the long-term. In other words, if these targets were to be breached in the post-2032 period, risks to Sri Lanka's long-term sustainability would rise.

33. Guided by these principles, the authorities pursued their parallel engagement and negotiations with the different groups of creditors. Historically, where both domestic and external restructuring was needed, the domestic debt operation (DDO) often preceded external debt restructuring as the government usually possesses more leverage over domestic creditors including through more advantageous legal tools, and can more easily implement a debt treatment. The Sri Lankan authorities opted for a parallel approach and expected that such an approach, by expressing the authorities' willingness to negotiate with whomever comes first, would foster a quicker resolution through competition. This strategy later proved a toll on their capacity and a costly strategy as the punitive domestic financing conditions persisted with a prolonged process for foreign debt restructuring. Under acute domestic financing challenges, the authorities went ahead with first implementing their DDO in September 2023. They advanced further with reaching Agreements in Principle with official creditors in November 2023, which allowed them to shift focus to the negotiations with private creditors

[21] Since 1989, the LIA determines Fund requirements if there are arrears to the private sector. No formal financing assurances are required. The authorities did receive a positive commitment by foreign bondholders in February 2023 to negotiate in line with program parameters.

[22] The DSA published along with the EFF program request staff report included IMF staff's illustrative restructuring assumptions and its key purpose was to illustrate what a sustainable debt scenario looks like for Sri Lanka, without prejudice against any restructuring strategies and/or designs that were considered by debtor and creditors.

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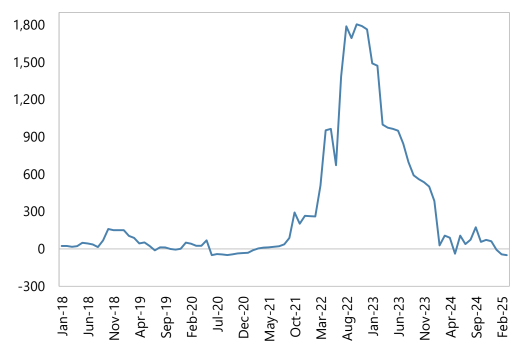
from there on. Negotiations with official creditors continued in earnest until the finalization of the agreement with China EXIM and signature of Memoranda of Understanding (MOUs) with OCC in June 2024 (discussed later).

A. Domestic Debt Operation

34. Sri Lanka was able to preserve its access to the domestic debt market during the external debt default, though at high costs. Despite the moratorium on external debt service, Sri Lanka continued to honor its domestic local currency debt obligations. This allowed the government to continue rolling over existing debt and placing new debt in domestic markets to finance its operations during the loss of external market access. However, uncertainties in the authorities' restructuring strategy and progress persisted for a certain period, including due to a lack of clear communication on whether domestic debt would be subject to restructuring and how it might be restructured. As a result, default premia were increasingly priced into domestic debt issuances, and the Treasury bill-policy rate spread widened to almost 2000 bps at its peak (Figure 12). This added to the government's refinancing challenges and made a quick domestic debt resolution imperative.

Figure 12. Sri Lanka: 3-Month T-Bill Rate – Policy Rate Spreads
(In basis points)



Sources: Haver Analytics.

35. The sheer size of domestic debt and its relatively high costs rendered it difficult to be left out from the eventual debt resolution. The punitive financing conditions during Sri Lanka's sovereign default and debt crisis pushed domestic debt to 63 percent of GDP at end-2022 and its interest costs to 7 percent of GDP. Refinancing risks remained elevated with domestic debt maturities amounting to 25 percent of GDP needing to be rolled over in the market in 2023, and total gross financing needs expected at around 33 percent of GDP. The need to resolve the domestic debt overhang was obvious but it needed to be achieved in a way consistent with preserving financial and social stability, by carefully considering any debt operations' impact on domestic creditors' balance sheets (IMF 2021).[23] Unlike external debt relief, the cost of domestic debt restructuring must be borne locally, and it is ultimately a question of loss distribution.[24]

36. Sri Lanka's domestic financial sector held large exposures to government debt, thus bringing any possible plans for a deep domestic debt operation and financial stability in conflict. Commercial banks (with assets close to 80 percent of GDP) held around 40 percent of their assets in government securities, with a mix between T-bills, T-bonds, local law FX denominated debt (Sri Lanka Development Bonds (SLDB) and others) and holdings of ISBs. Pension funds (with assets above 10 percent of GDP) held close to all their assets in government securities, mostly in the form of T-bonds. Through the crisis, the central bank increased its holdings of T-bills through monetary financing. With these exposures, the financial system was at high risk of being undercapitalized

[23] Additionally, some foreign creditors had also demanded a domestic debt operation as prerequisite for their own participation on comparability of treatment grounds.

[24] Foreign participation (defined on residency basis) in the local currency debt market has significantly diminished since 2019. In cases where foreign participation is greater, some of the cost of domestic debt restructuring can be borne by foreign creditors.

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significantly if a deep debt operation was initiated. Such an operation could have led to large financial instability, requiring state recapitalization and hence neutralizing any fiscal benefits to the sovereign, in addition to causing larger shocks to the real economy (see IMF 2021).

37. Authorities designed their domestic debt operation strategy in light of these considerations. The DDO implementation began with a series of consultations with domestic creditors. The nature of the domestic debt problem—large near-term maturities and punitive market interest rates—and the financial stability considerations together shaped the contours of the DDO strategy, which focused on reducing rollovers and interest costs while minimizing fair value losses to domestic creditors. This balance aimed to help the government finance itself during the program period, while protecting financial system stability. To illustrate this trade-off, the authorities' decision not to mandate a restructuring of commercial banks' holdings of Treasury bonds was to avoid depleting banks' capital positions (already considerably affected by the deteriorating economic environment and their exposure to FX-denominated government debt subject to restructuring) and destabilizing the financial sector, which could prolong the crisis and erode Sri Lanka's capacity to repay their foreign debt and raise domestic funding.[25] In the event, the high interest paid on domestic securities contributed to shoring up bank capital through their holdings. Details on the authorities' DDO strategy and its expected impact on different domestic creditors were provided in an Investor Presentation on July 7, 2023. The implementation followed suit and consisted of four major operations:

i. **Redenomination of commercial banks' holdings of FX local law bonds and loans.** At the time of default, Sri Lanka had two major types of FX-denominated debt issued under the local law—the Sri Lanka Development Bonds (SLDBs) and the FX loans by local commercial banks.[26] They constituted about 3 and 7 percent, respectively, of total domestic debt. As these debts added to the government's FX debt obligations which had become increasingly difficult to manage, three restructuring options were offered to the holders of these debts: a principal haircut option, a maturity extension plus interest reduction option, and a redenomination option. Concerned about locking in large upfront fair value losses, 99.6 percent of these creditors (predominantly banks) opted for the redenomination option that replaced their existing FX claims on the government with a 10-year amortizing local currency bond carrying a floating rate indexed to the monetary policy rate (Standing Lending Facility Rate plus 1 percent). This debt treatment provided important FX liquidity relief (of around USD 1 billion during program period) to the government and contributed to lowering the medium-term gross financing needs of the government (by an annual average of 0.11 percent of GDP in 2027-32) and associated refinancing risks. However, an important complication arose as the redenomination created a large net open position (NOP) on banks' balance sheets, beyond what could be tolerated under the regulatory requirements. To avoid a liquidity crunch in an FX market that was already struggling with thin volumes and wide spreads, the central bank intervened by net lending state banks USD 225 million (0.27 percent of GDP) to allow them more time to cover their NOPs and avoid them from having to rush to the FX market to close the position which could risk market disruptions.[27] The execution of FX local law debt restructuring started in July 2023 and concluded in September 2023.

ii. **Reprofiling of superannuation funds' holdings of Treasury Bonds.** Superannuation funds in Sri Lanka have been important investors of the government's treasury bonds. As of end-2022, they collectively held more than Rs 3.2 trillion worth of Treasury bonds (over a third of total outstanding). Compared to banks,

[25] The design of the EFF-supported program incorporated a banking sector recapitalization contingency to absorb primarily the loss from restructuring banks' holdings of FX denominated government debt.

[26] Includes FX loans issued to the Ceylon Petroleum Corporation—an SOE—to compensate below-market energy prices, which were later assumed by the government.

[27] State banks are expected to gradually repay this intervention to CBSL to offset the reserves drain.

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superannuation funds' hold-to-maturity investment mandate and their long duration liabilities make them less sensitive (and more tolerant) to fair value losses and appear most capable to support the government's debt restructuring efforts. However, account holders of these funds had already suffered a significant loss in the real value of their account balances in the high inflation and large depreciation environment of 2022. Any further erosion of these retirement savings could risk compromising social cohesion and public support for the adjustment program. Faced by multiple constraints, the authorities chose a strategy that focused on lengthening the average weighted maturity (by around 5 years) of superannuation funds' holdings of Treasury bonds at a 12 percent initial coupon rate (roughly equal to the existing yield to maturity) before stepping down to 9 percent in 2026 in line with a projected declining inflation trajectory. A regulatory incentive was provided to exempt participating funds from a planned increase in superannuation fund investment income tax rate (from a special rate of 14 percent to the common corporate rate of 30 percent). This operation attracted high participation and was executed in August 2023. By H1 2025, domestic interest rates have normalized significantly faster than expectated in 2023, leading to smaller ex post fair value losses for the EPF relative to the ex-ante expected losses based on high discount rates.[28] The superannuation funds' real value losses occurred in large part due to the high inflation environment of 2022, which meant negative real returns.

iii. **Restructuring of the CBSL's holdings of Treasury Bills.** As of end-2022, the CBSL held Rs 2.7 trillion (or 11 percent of GDP) worth of Treasury bills, acquired through primary market purchases during the pandemic to directly finance the government's day-to-day operations. Such large-scale unconventional monetary financing helped avert a sharp fiscal contraction after the government was shut out of international capital markets, but it also inevitably contributed to inflation.[29] With their short maturities and relatively high interest rates amid acute government financing conditions, these Treasury bills gave rise to large refinancing needs, which needed to be met in the market with the CBSL prohibited from rolling them over after changes to the Central Bank Act. The restructuring of these holdings was therefore designed with a special focus on reducing near-term refinancing needs by lengthening the maturities and reducing the interest rates. These objectives had to be met while minimizing the fair value loss to the central bank's balance (which could hamper monetary policy credibility). CBSL's short-term claims on the government were exchanged into a new 15-year debt instrument with a gliding interest rate path (12.4 percent through 2024, 7.5 percent through 2027, and 5 percent thereafter) with an aim to align it with the projected disinflation trajectory. This operation was executed in September 2023. The fair value loss from this operation is smaller than initially expected as the prevailing market interest normalized more quickly than expected. As of end-2024, CBSL's equity position has improved to 1 percent of GDP.[30]

iv. **Restructuring of CPC's FX loans from State Owned Banks.** Liabilities from the state petroleum corporation (CPC) towards the two state owned banks of around USD 2.3 billion were transferred to the government after the crisis broke out. The authorities discussed the restructuring of these loans with the banks through 2023 and 2024. An agreement was reached in late 2024, with the loans restructured into long term (20-year maturity) USD-denominated instruments with grace periods until 2027. Ad hoc accounting treatments will be allowed to mitigate the negative impact on the banks' FX net-open-positions (NOPs) from the market value loss associated with the loan restructuring.

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[28] A 19 percent discount rate was chosen to align with the assessed country risk premium, ensuring a more accurate reflection of market conditions for the restructured bonds. This approach is crucial to avoid misestimating the fair value implications of the restructuring, particularly for tradable securities. The NPV/NPV loss from the operation falls from 21.5 percent to 10 percent assuming a drop in discount rates from 19 percent to 11 percent. This being said, the fair value loss estimate is less relative for a portfolio that's held to maturity, as in many pension funds.

[29] See more on this in IMF Country Report 2022/341 "Selected Issues for the 2022 Article IV Consultation".

[30] Relative to a 19 percent discount rate, the NPV/NPV loss with a 11 percent discount rate is nearly halved.

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38. The implementation of the DDO significantly reduced gross financing needs and debt while retaining financial and social stability and setting the stage for the external debt restructuring. The domestic debt operations were geared toward providing significant liquidity relief to the government and reducing future GFNs. Using a fully calibrated alternative debt sustainability analysis without a domestic debt operation (counterfactual "no DDO scenario"), we assess the positive impact of the operation. The first three elements of the DDO, which were concluded in 2023, lowered debt service by an annual average of 1.2 percent of GDP in 2023-27, during a period where financing would be difficult. As a result of these operations, gross financing needs in 2027-32 also fell on average by 1.7 percent of GDP per year. This was an important contributor to meeting the GFN targets under the program. While the primary goal of the DDO was to provide financing relief, it also helped avoid a situation where large borrowing in 2023-24 at high interest rates (15 percent and more) would lead to significant debt accumulation. This contributed to a 5 percent of GDP reduction in debt. These contributions were achieved while balancing success in retaining stability of the financial system, followed by recovery towards healthier levels in 2024-25. The decision to complete the domestic operation before moving on to external restructuring provided clarity to external creditors on what the domestic financial system could contribute towards debt relief and set the stage for the external restructuring negotiations.

B. External Debt Restructuring

39. Once the DDO was largely completed, focus turned to the deliberations and negotiations of the external debt restructuring. The Sri Lankan authorities decided on the restructuring perimeter. On the external side, loans from multilateral lenders, bilateral currency swaps from foreign central banks, and emergency financing received during the debt crisis in 2022 were carved out. Together, these constituted about a third of total foreign debt. With most foreign creditors accepting this proposed perimeter, the authorities then focused their external debt restructuring negotiations on the four major groups of creditors, which collectively held 97 percent of the total restructurable external claims as of end-2022 (Table 2).

Table 2. Sri Lanka: Restructurable External Claims
(In USD billions)

	End-2022	End-2023
Official Sector	**10.3**	**10.6**
OCC (Paris Club, India, and Hungary)	5.7	5.9
China (including ECA backed)	4.3	4.4
Other non-OCC bilaterals	0.3	0.3
Private Sector	**16.4**	**17.8**
ISBs	13.2	14.2
China Development Bank	3.0	3.3
Others	0.2	0.2
Total	**26.7**	**28.3**

Note: The difference in exposure between end-2022 and end-2023 is primarily driven by accumulation of arrears.

40. The external viability and debt sustainability targets jointly constrain external debt service and have therefore been the focus of the external debt restructuring. The USD 17 billion program period external debt relief target put a cap on the total amount of debt service that can be paid out to restructurable creditors through 2027. The two flow targets (4.5 percent of GDP post-program FX debt service and 13 percent of GDP in post-program GFNs) imposed a similar limit on the 2027-32 period to avoid exerting undue pressure both on the domestic financing environment and on Sri Lanka's balance of payments. The two flow targets were complemented by the 95 percent of GDP debt stock target to avoid any restructuring design circumventing these constraints by "bunching" debt payments in the post debt targets periods.

41. The space for debt service to external restructurable creditors was further constrained by the scheduled and projected payments on non-restructurable claims and new debt. Of the 4.5 percent of

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GDP FX debt service allowed for the post-program period, about 2.5 percent of GDP was allocated to service non-restructurable debt and the payments on projected new financing. The EFF program assumed new financing to be sourced in three forms: program financing from international financial institutions, project financing to support the government's public investment programs, and market financing through new ISB issuances starting 2027. This new financing is critical for covering BOP gaps and rebuilding FX reserves, without which the burden of external adjustments (including external debt relief) would be greater. The terms of the new debt issuance were calibrated based on Sri Lanka's historical financing conditions before the crisis.

42. Different preferences of official and private creditors shaped the negotiations, restructuring design and preferred debt treatments. Official creditors normally prefer to provide debt relief through maturity extension and interest rate reduction, and to avoid principal haircut. Private creditors, which would often have already marked to market their losses, are normally more open to accepting a principal haircut in exchange for earlier payments and higher interest. Certain commercial creditors may also demand contingent debt treatments to capture upside risks of macro developments outperforming program assumptions.

Official Debt Restructuring

43. The restructuring of bilateral official debt was spearheaded by the Official Creditors Committee (OCC). France, India, and Japan (as co-chairs) jointly announced the formation of the OCC—which they made open to all bilateral creditors—on the sidelines of the 2023 IMF-World Bank Spring Meetings (Annex III). A series of meetings took place from May 2023, to discuss the coordination process, the restructuring perimeter and burden-sharing, the OCC Secretariat's debt treatment proposal, and the eventual Agreement-in-Principle (AIP). The OCC broadly endorsed the Sri Lankan authorities' restructuring perimeter, welcomed the Sri Lankan President's commitment to transparency and comparability of treatment (CoT), and considered their restructuring proposal shared in May 2023 a constructive basis for negotiations. Based on this proposal, the OCC Secretariat developed a Working Paper laying out its own proposed debt treatment, which was presented to OCC members for discussion in a meeting in September 2023.

44. The debt treatment proposals put forth by Sri Lanka and the OCC exhibited significant similarities, which contributed to a more straightforward negotiation. Both featured: (i) a grace period during the EFF program as a direct contribution to closing the BoP financing gap; (ii) a long maturity extension (with final maturity in the 2040s) along with a progressive amortization, to greatly reduce near-to-medium debt payment pressures; and (iii) a significant interest reduction critical for delivering a net present value (NPV) relief to Sri Lanka. Differences were mostly on the margins, stemming from the different views between Sri Lanka and the OCC on how to assess CoT across different classes of creditors. The IMF's participation in OCC meetings and bilateral engagement with creditors also facilitated this process.

45. Sri Lanka made significant subsequent progress in reaching a debt resolution with the OCC. An AIP between Sri Lanka and the OCC, in line with the program parameters, was reached in November 2023. After agreeing on the financial terms, the OCC shifted the focus of its discussions to safeguards to ensure that non-participating creditors would not be able to extract a better deal and that Sri Lanka would remain committed to the EFF program, which they viewed as essential to preserve its payment capacity. In June 2024, Sri Lanka reached agreement with the OCC on codifying the agreement in the form of a Memorandum of Understanding. As of June 2025, the authorities have reached bilateral agreements with Japan and France and are working on finalizing bilateral agreements with other individual OCC creditors.

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46. Negotiations with China EXIM Bank progressed in parallel (Annex III). An AIP between Sri Lanka and the China EXIM Bank, in line with the program parameters, was reached in October 2023. The China EXIM Bank did not formally join the OCC but participated most of the OCC meetings as an observer. After providing financing assurances in March 2023, the China EXIM Bank continued its engagement with Sri Lanka's debt advisors. Several rounds of discussions were held, including in person in Beijing and Colombo, to reconcile the DSA and negotiate the financial terms. In October 2023, China EXIM announced Agreement-in-Principle with Sri Lanka. Details of the agreement were shared in confidence with the OCC Secretariat to ensure compliance with the CoT principle and with the IMF to check compliance the program debt targets. The extensive discussions among major creditors regarding the sharing of Agreements-in-Principle while fully respecting confidentiality, and China's role as an observer in the OCC meetings, contributed to moving the two parallel processes along and ensuring comparability of treatment between the two major creditor groups. In June 2024, Sri Lanka finalized its amendment agreements with China EXIM and started paying on the restructured facilities starting July 2024.

47. The remaining small bilateral creditors continued to consent to Fund lending into official arrears. Sri Lanka remained in arrears to Saudia Arabia, Kuwait, Iran, and Pakistan. Some of these creditors had signaled their readiness to negotiate along the terms offered by the OCC. Until an agreement to restructure is reached, these arrears would remain outstanding.[31]

Private Debt Restructuring

48. Private debt restructuring negotiations proceeded in parallel. Almost immediately after the EFF arrangement approval, the Sri Lankan authorities organized an investor presentation to engage their commercial creditors. Soon after, the authorities received an initial restructuring proposal from the foreign bondholders' advisors on April 11, 2023 (on the sidelines of the IMF-World Bank Spring Meetings). The proposal was underpinned by a more optimistic GDP path and featured a coupon step-up structure that was assessed to be inconsistent with meeting the debt targets under the IMF macro framework. This proposal prompted the authorities to prepare their own indicative debt treatment scenario to underpin their engagement with all foreign creditors. On October 13, 2023, the foreign bondholders group presented (publicly) a revised proposal, featuring a macro-linked bond with state-contingent debt service that steps down from its initial high levels anchored by alternative macro assumptions should the dollar GDP underperform its benchmarks. They engaged further with the authorities' advisors on the sidelines of the October 2023 IMF-World Bank Annual Meetings in Marrakech. Sri Lanka underwent an initial restricted round of discussions with the bondholder's committee in April 2024.[32] Ultimately, progress was constrained by the need to ensure comparability of treatment with official creditors with whom agreements had not yet been reached.

49. Authorities reached agreements with bondholder groups in September 2024. Discussions continued with the foreign bondholders' committee (represented by Rothschild and White & Case), where both parties built on previous scenarios with state-contingent features. Such scenarios were underlined by bondholders' consistent interest in a macro-linked structure to bridge differences in macroeconomic forecasts

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[31] Until the second review, Fund policies required consent by creditors to move ahead with continued disbursements of the EFF arrangement. Starting from the third review, based on the enhanced safeguards approach under the amended LIOA policy, commitment provided towards restructuring by a sufficient set of creditors (OCC and China EXIM) implied that arrears were considered eliminated for the purposes of the LIOA policy. See: IMF 2024, Policy Reform Proposals To Promote The Fund's Capacity To Support Countries Undertaking Debt Restructuring.

[32] As required under securities laws, restricted discussions prevent participating creditors receiving confidential information from trading the affected securities. To resume trading the information must be disclosed publicly in a "cleansing statement".

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relative to the IMF framework. Authorities entered a second round of restricted negotiations with the committee and reached an agreement on a Joint Working Framework (JWF) in early July 2024. The framework included the use of macro linked bonds where both coupon rates and principal payments would rise if Sri Lanka's dollar GDP and economic growth stay above certain levels by 2027. Using the new methodology developed for the assessment of debt sustainability under state contingent instruments (Box 1), IMF staff assessed the JWF as not meeting the debt sustainability requirements under the IMF program and the OCC also assessed the JWF as not meeting comparability of treatment principles. Sri Lanka entered a third restricted period with external bondholders on September 12 and reached Agreement-in-Principle with the committee on September 18. This scenario was assessed by IMF staff as consistent with the program's debt sustainability targets, using the same methodology for assessing debt treatments with state contingent features (Box 1). The OCC also assessed the AIP (including the contingent upside payments) as consistent with comparability principles. Finally, the committee representing local ISB holders (local consortium), who held 12 percent of ISBs, had been requesting a non-contingent option with some portion of the bonds being transferred to local currency bonds. Authorities also reached AIPs with the local consortium on September 18, with treatment that remained compatible with the program's objectives.

50. Bondholder agreements featured multiple innovative features.

- **Step-up Baseline Structure**: In the baseline, nominal haircuts on principal amounted to 27 percent, with 11 percent haircut on past due interest (PDI) based on the March 2024 PDI stock. Amortizations on non-PDI bonds start in 2029, and end in 2038, with USD 3 billion amortized by 2032, and the remaining USD 6.2 billion amortized by 2038. The PDI bond amortizes in 2024-28. The treatment featured low coupons in 2024-32 (average of 3.7 percent), with them stepping up post 2032 on the remaining stock (9.4 percent, for an average length of 3.7 years). NPV/NPV relief at a 9 percent discount rate was 42 percent.

- **Macro-linked Payments**: The macro-linked bonds featured coupon and principal changes based on two triggers, average dollar GDP in 2025-27, and a control variable on cumulative real GDP growth in 2024-27. The structure also allowed for a novel feature with two downside and three upside scenarios. Based on the mapping of average dollar GDP in 2025-27 (Table 3), and whether cumulative real growth was above 11.5 percent of GDP in 2024-27, both principal and coupons can rise or decline relative to baseline levels. The principal adjustments ranged from additional principal *haircuts* amounting to 17 percent (on new bonds, in the lowest category) to additional principal *reinstatement* amounting to 16 percent (in the highest category). Effective coupon increases were 1.4 percent at their maximum levels, with no coupon reductions for downside scenarios.

Table 3. Sri Lanka: Average GDP in Different Scenarios

Baseline	US$ nominal GDP (avg. 2025-2027, billion)	Nominal GDP upside vs. IMF baseline
GDP threshold #1	107.0	+21%
GDP threshold #2	99.0	+12%
GDP threshold #3	94.0	+6%
IMF baseline	88.6	-
Threshold below IMF baseline #1	86.7	(2%)
Threshold below IMF baseline #2	84.7	(4%)

- **Governance-Linked Bonds**: The agreement also featured the first instance of a governance linked bond. Creditors agreed to provide more coupon relief (75 bps) from one of the restructured bonds if Sri Lanka met two transparent criteria related to fiscal governance (meeting targets on revenue to GDP by 2027 and publishing fiscal strategy statements). The revenue targets would be verified through publication of the statistics in the IMF's World Economic Outlook.

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- **Local Option**: The local consortium and state-owned banks, who held 14 percent of ISBs, agreed to a separate option without contingency payments. This agreement featured the exchange of 70 percent of exposure into dollar bonds with 10 percent nominal haircuts, low coupons and long maturity. These dollar bonds included a novel provision where Sri Lanka retains discretion to make debt payments in local currency. The rest of the exposure was exchanged for local currency (and local law) bonds at Sri Lankan market interest rates plus a small margin.
- **Contractual Clauses**: New bonds issued in the debt exchange have "most favored creditor" clauses (MFC) to prevent the debtor from settling with other commercial creditors on terms better than those offered to the bondholders under the exchange. However, the MFC clause excludes payments of any judgment which is final and non-appealable. In addition, the bonds also featured a "loss reinstatement clause" which allows creditors upon the occurrence of certain events to increase the principal amount of debt thereby clawing back in part or fully the relief delivered. Finally, a novel mechanism to allow a change of the governing law of the exchanged ISBs to English or Delaware law from New York law based on supermajority consent was included, possibly in reaction to potential legislative changes in New York law introducing statutory mechanisms into sovereign debt restructuring.

51. **The authorities successfully completed the bond exchange in December 2024 (Annex III)**. The exchange was launched on November 25, with a consent solicitation sent to all investors in the bonds, with a deadline of December 12. By the deadline, 96 percent of investors had accepted to enter the bond exchange. The previous bond portfolio featured seven bonds with aggregate CAC features (2nd generation CACs) and four without (1st generation CACs).[33] A minimum participation threshold was used by the authorities to ensure sufficient participation. It required a minimum of 80 percent participation for the exchange to go forward and committed the authorities to complete the exchange if participation exceeded 90 percent while allowing them to exercise discretion if participation were in between these two reference points. Participation in ten of the eleven bonds went from 98 percent to 100 percent after use of the collective action clauses. On the remaining bond with the holdout creditor (Hamilton Reserve Bank (HRB), Box 2), the participation was lower at 73 percent. 14 percent of bondholders (domestic investors) chose to take the domestic non-contingent option.

Figure 13. Sri Lanka: EMBI Spreads
(In basis points)

Sources: Bloomberg L.P.; and IMF staff calculations.

52. **Post-restructuring, the bonds have shown strong performance.** During the negotiations prices of defaulted Sri Lankan bonds increased from about 23 cents per dollar of face value (corresponding to a weighted average spread of about 6,300 bps) in November 2022 to about 65 cents (corresponding to a weighted average spread of about 1,900 bps) just ahead of the restructuring as expectations of the recovery value evolved. The exit yields on the bonds hovered around 9 percent at the completion of the exchange.[34] Sovereign spreads had fallen sharply from a weighted average of 1,900 basis points just prior to the restructuring to around 520 bps in mid-January on the non-macro-linked bond (2035 maturity with governance-

[33] CACs with aggregation features permit aggregation for purposes of CACs across different series of bonds. As the two-limb features was used, aggregation required both one vote across the aggregated series of bonds and one bond-by-bond voting.

[34] Given the yields on the macro-linked bonds would be affected by the probability of the higher states, the most appropriate benchmark would be the 2035 governance linked bonds, with a yield of around 9.4 percent on December 20, 2024. These yields overstate sovereign risks, as the governance linked conditions may allow for lower coupon payments by 75 bps.

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linked features), which was well within the range of emerging markets with market access.[35] Finally, Moody's and Fitch upgraded Sri Lanka's sovereign rating three notches after the bond restructuring, while S&P has opted to wait until the government guaranteed USD 175 million Sri Lanka Airlines bond restructuring is complete.[36]

[35] This spread overstates sovereign risks slightly as coupon rates could be reduced by 75 basis points if authorities meet conditions linked to governance reforms. Spreads rose markedly following the United States' announcement of tariffs in April 2025.

[36] Moody's also assigned a Caa1 rating to the new MLB issuance. Authorities have now hired financial and legal advisors on the Sri Lankan Airlines bond restructuring. This bond is guaranteed by the central government.

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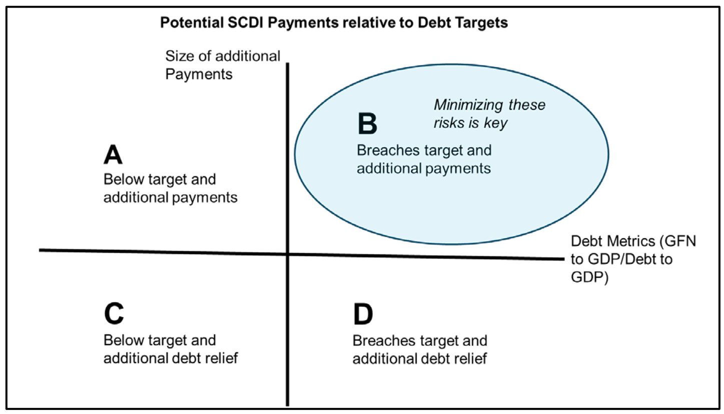
Box 1. Methodology for Assessing SCDI Debt Sustainability Risks[1]

IMF staff developed an innovative methodology to assess the debt sustainability risks from state contingent instruments. Three key elements of risks were assessed through a fully stochastic analysis:

- **Probability of breaching debt targets**: Without SCDIs, the IMF's debt sustainability definition requires debt indicators to be below or at their targets in the baseline macroeconomic framework. Assuming a baseline with debt indicators exactly at their target, the probability of exceeding the target in a distribution derived from historical data is set to be close to 50 percentas the target is the median of the distribution).[2] The methodology thus tests whether introducing the SCDIs will increase the probability of breaching the debt targets relative to such a baseline scenario where debt indicators are exactly at target. In Sri Lanka, given the SCDIs are designed to tie extra payments or extra relief to upside and downside scenarios, this probability of breaching targets would depend on the respective probabilities of the lower and higher relief economic scenarios, and the size of extra payments/relief.



- **Quality of the SCDI trigger and Size of Contingent Payment**: The methodology analyzed the quality of the trigger in the form of its relationship to durable debt carrying capacity. A good trigger only elicits higher payments when durable debt carrying capacity is higher.[3] This means the chances of the sovereign paying out extra payments in downside scenarios (where debt targets are already breached without the SCDI) should be low.[4] In the illustrative chart, this would mean minimizing the probability mass of outcomes in Quadrant B, the zone where debt metrics are already above target and the SCDI still leads to additional payments from the debtor.

- **Tail Risks**: Finally, staff analyzed tail risks in the form of nominal caps and SCDI contributions to debt indicators in the highest deciles of the debt distribution.

[1] Discussed in Sri Lanka EFF: Third Review Staff Report, IMF Country Report No. 2025/056.

[2] This probability is exactly 50 percent in the case of a single target such as debt to GDP but can be around 50 percent for an average target like GFN to GDP. The probabilities are derived in the SRDSF through a debt fanchart based on historical observations in 2002-2022.

[3] Generally, a state contingent instrument with periodic tests on macroeconomic variables has the benefit of resetting payments if the economic outlook changes. However, this is not the case with the one-time tests of the SCDI used in Sri Lanka. In such a case, a plausible scenario could see Sri Lanka's exchange rate relatively highly valued until the test date, leading to higher payments. Then, the exchange rate could correct itself through a large depreciation. The country would be locked into higher payments even if debt metrics were higher than the targets. The importance of this risk depends on the probability of materializing. IMF staff's new methodology incorporated these risks.

[4] Given that the baseline in a DSA with SCDI may have some buffers, the methodology looks at the probability of additional payments which are larger than the buffers to the targets in the baseline.

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Box 1. Methodology for Assessing SCDI Debt Sustainability Risks (concluded)

The methodology was implemented using the SRDSF's debt fanchart module. First, based on historical debt drivers, staff built the distribution of debt and gross financing needs around the baseline in the form of a debt and GFN fanchart.[5] Next, the payments from the SCDI (both upside and downside) were added to realizations of the fancharts in line with the trigger design of the SCDI. This generated two fancharts, one with the SCDI and another without. To assess the risks added by the SCDI, the method compared outcomes with the restructuring including SCDIs to outcomes of a restructuring in which SCDIs were replaced with plain vanilla bonds that completely exhausted any buffer to the targets under the baseline (which we will refer to as the non-contingent restructuring). The method then considered: i) whether the SCDI implies a higher probability of breaching the targets than under the non-contingent restructuring; ii) whether under downside scenarios (scenarios in which at least one target is breached), the restructuring with SCDIs leads to higher debt burden indicators (debt or GFN) than the non-contingent restructuring; and iii) whether the tail risks from the SCDI are acceptable.

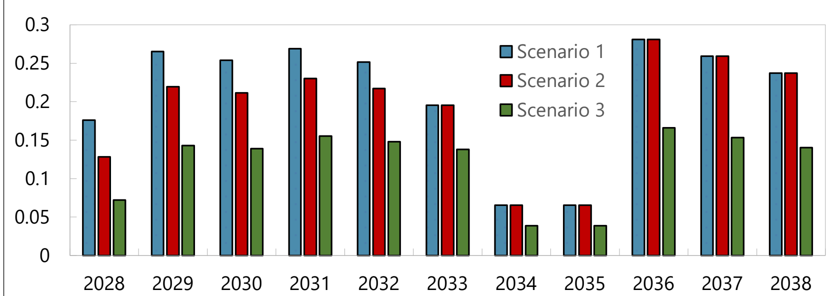
Staff employed this methodology in assessing debt sustainability for various proposals discussed between the authorities and bondholders in 2024, and the authorities' September 18 AIP, which was consistent with debt sustainability objectives. The last scenario met all the conditions of the assessment as below:

- The probabilities of breaching the debt and GFN targets were both below the acceptable thresholds. In the case of the debt/GDP target, the probabilities were easily below the 50 percent threshold. For the GFN/GDP target, the probabilities were just below the threshold as defined by the probabilities of breaches in noncontingent DSAs exactly at the GFN target.

- In addition, in adverse scenarios where the GFN target is already exceeded, the SCDIs did not with high probability add to GFNs relative to the plain vanilla bonds that they replaced. This metric was more benign for the debt-to-GDP ratio given much larger buffers in the baseline DSA.

- Finally, the maximum contributions from the SCDI in tail scenarios were also acceptable, with the 90th percentile contributions to average GFNs below 0.4 percent of GDP. The SCDI is nominally capped, with maximum payments capped at around USD 250 million annually.

Additional Debt Service due to SCDI in Upside Scenarios
(billions of USD)



Note: Scenarios 1, 2, and 3 are triggered if dollar GDP in 2025-27 exceeds USD 107 bllion, 99 billion and 94 billion, and 2024-27 cumulative real growth exceeds 11.5%.

[5] The GFN fanchart was an innovation relative to the SRDSF, which already features a debt fanchart. The GFN fanchart was generated by approximating GFNs through the debt drivers and a measure of financing type consistent with the DSA.

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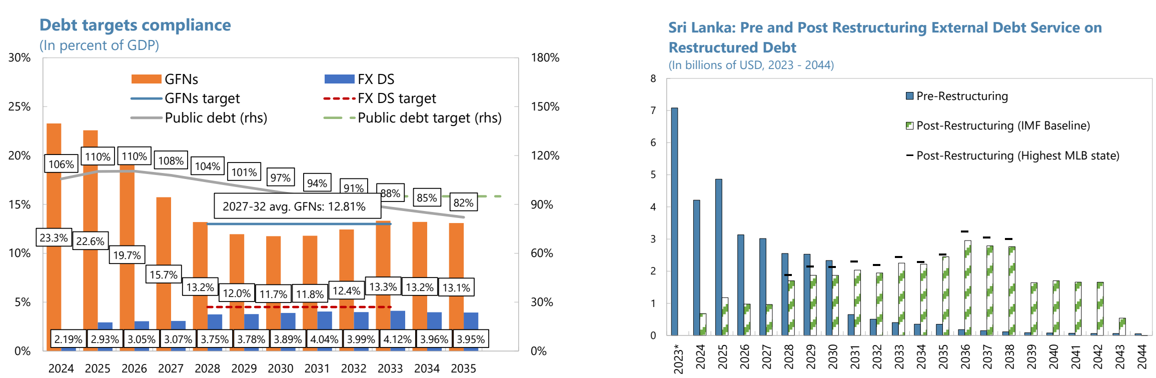
Box 2. Litigation Brought by the Hamilton Reserve Bank

A minority holder of the 2022 ISBs—Hamilton Reserve Bank—started litigation against Sri Lanka in US courts in June 2022, demanding full payments on the defaulted bond. Sri Lankan government's motion to dismiss the complaint from Hamilton Reserve Bank (HRB) was denied by the court. The judge, however, granted a one-month stay to allow more time for Sri Lanka to complete its discovery process against HRB in April 2023. The stay was subsequently extended for multiple times to allow the country more time to finish its negotiations with bondholders, and no judgement has been made to date. Considering the imminent ISB exchange, Sri Lanka filed a motion to extend the stay further in November 2024. Litigation continues as of the time of writing.

53. **The authorities also made significant progress in their negotiations with other commercial creditors.** The authorities started with technical exchanges with the CDB, including in person in Colombo in May 2023 and in Beijing in October 2023, to reconcile their DSA modeling and advance technical discussions. They reached AIP with CDB in November 2024, assessed by IMF staff as consistent with debt sustainability. The OCC assessed this revised AIP as consistent with COT.

54. **Taken together, the debt treatments agreed with creditors were consistent with program parameters, led to a significant reduction in debt service for the next decade, and also implied meaningful NPV relief.** External creditors have forgiven USD 3 billion in debt and stretched another USD 25 billion due in the near term or already overdue over a much longer time horizon over the next 20 years with much reduced interest rates. External debt relief during the program is consistent with restoring external viability and FX debt service is projected to remain below the debt sustainability target (4.5 percent of GDP) during the 2027-35 period. The gross financing needs target (average 13 percent of GDP) is met. Together with the contributions from the DDO, the public debt stock is projected to fall below its sustainability target. All targets are met with some buffers given the probability of additional payments through the macro-linked bonds.[37] NPV relief for total restructured debt was around 41 percent NPV/NPV (at 9 percent discount rate corresponding approximately to the bond restructuring exit yields) in the baseline case of the MLBs, and 37 percent NPV/NPV relief in the highest growth state under the MLB. These metrics are close to the median NPV haircuts (around 39 percent) in restructurings (at exit yields) over the 1998-2020 period, as measured by von Luckner et.al. (2024).

Figure 14. Debt



Sources: IMF staff estimates and projections.

* 2023 pre-restructuring debt service includes arrears for 2022-23.

[37] These metrics are based on the macro framework as of Sri Lanka's third review under the EFF.

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Lessons from Sri Lanka's restructuring

Important lessons can be drawn from Sri Lanka's debt restructuring that may be of relevance to future country experiences. In Sri Lanka, the restructuring design carefully considered the implications of a domestic debt operation on financial and social stability, of state-contingent debt instruments for the assessment of debt sustainability and comparability of treatment, and of complexity for debt management. More clarity regarding the application of comparability of treatment and a better incentive structure around past due interest could have potentially accelerated the debt restructuring process. The damage to the economy could similarly have been mitigated by deciding sooner to restructure the debt. Support from IMF staff and financial and legal advisors helped navigate the new creditor landscape and complex restructuring designs. Intense communication between stakeholders, including IMF staff, helped resolve uncertainties on debt targets and the restoration of debt sustainability. These considerations are discussed in detail below.

A. Restructuring Designs

- **The DDO successfully balanced sovereign financing relief with preserving financial and social stability.** Sri Lanka's financial system was in distress as banks' balance sheets and capital positions were eroded as a result of the crisis. The lack of buffer in the financial sector to absorb DDO losses rendered any net gain from the operation difficult to achieve, with debt relief to the government potentially leading to larger capital gaps of the financial sector and in turn larger public sector costs for recapitalization. It was therefore important to assess the benefits of a DDO through multiple lenses, including whether regulatory forbearance could hinder the rebuilding of confidence in the financial sector. Similarly, the restructuring of the holdings of the pension vehicle in Sri Lanka led to social dissatisfaction and risked political instability, which was ultimately prevented by the design of the operation and communication. Sri Lanka's experience also showed that it is important to use a proper discount rate to crystallize the fair value impact of the DDO on financial institutions. An ex-ante underestimation of the discount rate used to value bank assets would have forced the recognition of higher losses on bank balance sheets at the time of the completion of the restructuring. The emergence of higher bank recapitalization needs would have undermined confidence just as the completion of the exchange provided positive momentum to the economic recovery. Finally, the speed of DDO resolution is crucial, as uncertainty surrounding the treatment triggered adverse market developments that deepened the debt problem and further complicated the government's financing strategy. Hence, the design, scope and speed of a DDO need to consider how financial and social stability can best be preserved and whether existing buffers can be used.

- **State-contingent debt treatments helped address concerns about macroeconomic uncertainties, but designing them prudently was important.** SCDIs had already featured in previous restructurings including Argentina, Greece, and Ukraine. As discussed in IMF (2020), such instruments have provided an effective way to resolve different views on the macroeconomic outlook and prevent them from holding up negotiations. They effectively allow creditors to trade upfront value recovery for potential future recovery by sharing some of the upside risks. However, in Sri Lanka, SCDIs constituted a core part of creditors' recovery and prolonged the negotiations due to their complexity. They can introduce political complications in the future in case higher payments are triggered but are not socially accepted. While the Fund does not get involved in the details of the instruments' design in specific cases (this is an issue for the authorities, their creditors, and respective legal and financial advisers), the Fund needs to assess the impact of these instruments on program goals, i.e., the restoration of macroeconomic and debt sustainability. This would involve considerations of

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(i) their impact on the balance of risks around the baseline; (ii) their impact on debtor-creditor relations given implications for comparability of treatment; and (iii) the risk inherent to specific designs such as uncapped exposures, potential mismatch between contingent payoffs and repayment capacity. These assessments involve complex modeling under the SRDSF framework, which informs the extent to which upside risks can be shared with creditors without compromising debt sustainability. In the case of Sri Lanka, the one-time adjustment nature of the macro linked bonds presents risks to Sri Lanka as higher payments after 2028, once triggered, would persist even if economic performance were to deteriorate thereafter. These risks were accounted for in the new IMF methodology's stochastic analysis, but some risks remain as no methodology can perfectly capture such complex uncertainties (Box 1).

- **SCDIs complicated the assessment of CoT, which also had a bearing on the IMF's debt sustainability assessment.** State-contingent debt treatments imply that the debt payment streams would adjust up or down based on the evolution of macroeconomic conditions and the chosen triggers. This creates a possibility for the ex-post debt relief to differ from the ex-ante agreed debt treatment should the macro conditions evolve differently from the macro framework used to underpin the baseline treatment. In Sri Lanka, this gave rise to the question whether CoT should be assessed/tested based on the ex-ante agreed debt treatment or the ex-post debt relief for SCDIs. This complicated the forward-looking debt sustainability assessment which was needed to inform the Fund's lending decisions. To address the tension between the Fund having to assess debt sustainability ex ante and creditors executing their right to assess CoT ex post, it is important for the DSA analysis to internalize creditors' reaction functions to state-contingent debt treatments by their peers. In Sri Lanka, based on discussions with official creditors, IMF staff assumed that other external creditors take similar upside as the bondholders.

- **Restructuring terms were complex in order to "optimize" creditor recovery under multiple debt target constraints, which led to debt management challenges.** In Sri Lanka's external debt restructuring, a progressive amortization schedule was used to delay principal payments to outer years where the flow constraints are less demanding; coupon step-ups and interest capitalization were utilized for similar reasons to preserve space in the near-term, including to settle large Past Due Interest (PDI). Domestically, coupon step-downs were included in the Treasury bill and bond exchanges to accommodate ad hoc accounting treatment to minimize upfront fair value losses. While these design features have been used before and they help "optimize" the restructuring, together they have increased the complexity of the debt contracts, making it even more important for the Sri Lankan authorities to understand comprehensively their post-restructuring debt portfolio risks and rapidly strengthen their public debt management capacity. Such novel instruments have also impacted other elements of macroeconomic policy such as monetary policy given the challenges in offloading novel instruments in secondary markets without deep liquidity.

B. Comparability of Treatment and Inter-Creditor Issues

- **The continued accrual of Past Due Interest (PDI) at contractual interest rates reduced the opportunity cost to the creditor of a prolonged negotiation and compounded the debt burden for the debtor.** The Sri Lankan authorities' foreign debt service moratorium announced in April 2022 was a unilateral suspension of its financial obligations. As a result, (unpaid) interest payments continued to accrue on contractual terms during the moratorium, and as the negotiations dragged on, they accumulated to significant amounts, especially on commercial claims with high interest rates. As of end-2023, the PDI on ISBs stood at USD 1.7 billion compared to the total USD 12.5 billion outstanding principal balance. While creditors have a contractual claim on this past due interest, it inevitably added to the debt burden and did not incentivize faster

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debt resolution. As it rises to a significant amount, the treatment of this PDI, which traditionally enjoyed more favorable terms, also has a direct bearing on the relief efforts by other creditors in a “competition” for the debtor’s limited FX resources. It can further complicate the CoT considerations as PDI “inflates” the total claims private creditors have on the debtor and thereby their estimated NPV relief.[38] Achieving consensus on addressing the lack of incentives to prevent further accumulation of PDI and resolving the complexities and disagreements on how it is treated in CoT considerations will be crucial for promoting quicker debt resolution.

- **More clarity on how to assess CoT could potentially have helped speed up the negotiation process.** While the traditional Paris Club CoT assessment preserves flexibility for judgment and room for reconciliation with different CoT matrices by other creditor groups, a lack of absolute clarity on how exactly CoT is assessed makes ex-ante compliance difficult. In Sri Lanka, the authorities’ advisors and the bondholders’ advisors worked around this constraint by relying on the OCC Secretariat as the “CoT court” where they tested CoT compliance of their proposed debt treatments. An alternative way can involve simplified CoT matrix and greater disclosure of debt treatment terms. Some emerging creditors have argued that a rules-based system with clearly defined CoT parameters (vs. the traditional constructive ambiguity), agreed among all creditors, would reduce the need for coordination. The debtor country authorities’ financial advisors would be tasked with finding the most efficient way to allocate the needed relief across different creditors while respecting the CoT parameters.

C. Restructuring Process

- **Delaying the restructuring proved to be a risky strategy**. When default was inevitable, procrastinating led to deepening of the debt crisis. In 2021-22, the Sri Lankan authorities “gambled” for a narrow path to redemption as they endeavored to protect their unblemished foreign debt payment track record and continued to service maturing ISBs after being shut out of international capital markets. FX reserves were dropping to unprecedented low levels and the government was running out of resources to provide the essential goods for its population. As the economy suffered and output collapsed, the debt crisis deepened, and the country’s debt repayment capacity was significantly eroded. While the decision to restructure is the sovereign’s prerogative and there are many trade-offs, it ultimately depends on the cost of default and how it stacks against the cost of continuing paying in an unsustainable situation.

- **Clearer and more effective communication on the decision to restructure domestic sovereign debt could have helped minimize uncertainty and preserve market confidence.** The government’s announcement to restructure its domestic debt and the lack of clarity in the specific perimeter, parameters, and the expected timeline of the restructuring triggered a strong market reaction with a sharp increase in domestic debt yields to compensate for increased default risks and heightened uncertainties. Speculation on what will be restructured and how it will be undertaken exacerbated market volatility and undermined investor trust. An early and proactive engagement with creditors, investors, and the public throughout the restructuring process, including by laying out the clear rationale behind the decision could have helped allay investor concerns and foster stability, predictability, and credibility.

- **The changes in creditor landscape and restructuring design complexity required IMF staff to play an active support role in Sri Lanka**. The IMF is not a direct party of the debt restructuring negotiations but

[38] See Lazard (2022).

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plays two key roles. The first role involves setting the macroeconomic framework and debt sustainability targets. This is particularly vital in situations where large uncertainties cloud the macroeconomic outlook, and overly optimistic assumptions may jeopardize both the debtor and its creditors, risking a subsequent restructuring later. In this type of environment, it is important to make realistic assumptions in the macroeconomic framework and debt sustainability analysis. The second role involves facilitating debtor-creditor engagement, guiding creditors and allaying their concerns. This is especially important where a diverse investor base complicates creditor engagement absent established coordination platforms. In the case of Sri Lanka, the IMF provided "good office" support to facilitate the restructuring negotiations. This included direct high-level engagement between IMF management and key creditor country authorities (complemented by technical support at the staff-level) to secure financing assurances. It also involved explaining various elements of IMF debt policies especially to new creditors across multiple platforms and facilitating information sharing between creditors. It included IMF staff providing bespoke support on the assessment of state contingent instruments to the authorities and their advisors, bondholders' advisors, and official creditors. While the authorities' and creditors' advisors can normally construct DSAs themselves to test restructuring proposals, given the complexity of the state contingent instruments and their assessment, it was not possible in this case. IMF staff were therefore asked to provide and explain complex assessments in real time.

D. Debt Targets and DSA

- **Engaging with external stakeholders was important to enhance their understanding of the implicit limits on external debt established by the SRDSF modules**. In Sri Lanka, some observers had an impression that the debt targets had not taken account of external debt risks. However, debt targets were set to take account of the higher risks stemming from external shocks (Page 9). In the SRDSF, a sovereign with larger external (residency, currency) debt would show a much riskier sustainability assessment than the otherwise similar borrower with lower external debt. Given that the debt targets setting procedure needs to generate a sustainable signal in the post-restructuring scenario, it implicitly limits external debt. Continued engagement with external stakeholders is important to enhance this understanding and avoid the false impression that the SRDSF does not include external debt in its analysis.

- **The procedure used in setting Sri Lanka's debt targets mitigated a small probability that the IMF's debt sustainability frameworks could miss some external risks.** The debt targets in Sri Lanka were established based on the SRDSF framework which operates through a back-tested set of models where risk thresholds provide signals for sustainability. The back-testing events are fiscal crisis events where a sovereign defaulted, went through hyperinflation, or received extraordinary support. Many fiscal crisis events are also balance of payments crisis events, including the one Sri Lanka underwent in 2022. Through this correlation between the two events, the framework captures the risks not only to fiscal financing, but also to the balance of payments. In addition, the baseline macroeconomic framework underpinning a restructuring program is required to lead the country to external viability in the form of sufficient reserves buffers by program-end, premised on a sustainable current account adjustment. Through this, a large part of the external risks was modeled and incorporated into the debt targets in Sri Lanka, and more specifically, through the external debt relief floor during the program and the FX debt service ceiling after the program. The calibration of these debt targets reflects IMF staff's thorough assessment and judgment on the balance of payment risks, including prudence on the needed external sector adjustment to re-establish Sri Lanka's external viability by the end of the program and thereby mitigate its external debt risks. This procedure helped mitigate potential risks stemming from the lack of an off-baseline balance of payments model of external sustainability separate from

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the fiscal sustainability model. This risk is particularly relevant where a country's FX generation capacity is weaker than expected, especially after the program period, exposing it to external debt distress risks even if the sovereign can raise domestic financing.

- **Assessing the effectiveness of the debt relief was complicated.** Discussions on the Sri Lanka restructuring have shown that there can be an excessive emphasis on the depth of relief measured through particular approaches, belying the fact that every approach has certain weaknesses. Focusing solely on nominal haircuts overlooks the contributions to debt relief through coupon reductions and maturity extensions, which may combine to generate similar debt relief. Similarly, while NPV is a useful concept for the present value of future cash flows, it does not always comprehensively capture the impact on debt sustainability and can be measured differently (e.g., NPV of new debt over NPV of old debt vs. NPV of new debt over face value) for different purposes. The NPV concept is also highly sensitive to the choice of discount rate: a light NPV relief measured at a 5 percent discount rate would be nearly doubled in size if the discount rate is increased to 10 percent in an environment of higher global interest rates, making cross-event comparison often inconsistent. Similarly, the emphasis on the tightness of the debt targets can also be excessive, overlooking the fact that the depth of relief is jointly determined by the debt targets and the underlying macroeconomic and financing assumptions. For example, tight debt targets could appear more demanding for creditors but are in fact not if they are "compensated" by optimistic underlying assumptions.

E. The Way Forward

55. Sri Lanka's sovereign debt restructuring is near-complete and domestic financing conditions have normalized. After the bond exchange, Sri Lanka's international sovereign spreads have dropped to levels consistent with other post-restructuring cases and its sovereign rating has been upgraded by multiple rating agencies. The Treasury bill interest rates have normalized to around 8.5 percent by March 2025, and the authorities have begun to issue a substantial share of their domestic debt in longer term T-bonds, which is key to manage refinancing risks and achieve a durable reduction in the GFNs. While the domestic debt overhang has been greatly alleviated thanks to the DDOs, significant efforts in improving the debt management function are needed to fully restore the functioning Treasury bonds market Sri Lanka had before the debt crisis. A full-blown banking crisis was averted, the recapitalization contingency set aside by the program was eventually not needed, and private credit growth resumed, which supported the ongoing economic recovery—essential for restoring stability and enhancing Sri Lanka's debt repayment capacity following restructuring.

56. Restructuring alone is not enough to durably restore Sri Lanka's debt sustainability. It also requires continued prudent fiscal and macro policies and stronger institutions during and after the current EFF arrangement. There is no room for slippage on the fiscal front. Renewed efforts are needed to strengthen public debt management given a more complex post-restructuring debt portfolio. Importantly, new borrowing programs should closely align with the program objectives, in order to support strong fiscal constraints and mitigate debt vulnerabilities. The EFF program monitors the primary fiscal balance target from both above and below-the-line to ensure any government borrowing is captured. On the structural front, the program also aims at guiding the authorities toward wise PFM and PDM decision making. From the PFM angle, a sensible public investment program and a sound procurement process would help the authorities get a bigger bang for the buck. From the PDM angle, a thorough cost/risk analysis before signing any new debt contract would help the authorities work out the debt service consistent with preserving sustainability. In the longer term, the

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government would have a strong incentive to maintain fiscal prudence to regain and sustain its market access, which is critical for funding its development needs as a middle-income country with limited access to official financing. All of these together are essential for placing public debt on a sustainable downward trajectory, thereby averting another debt crisis.

Conclusion

57. Sri Lanka's public debt crisis emerged from a series of policy missteps and external shocks, leading to unsustainable debt levels. By 2019, the country had one of the lowest tax-to-GDP ratios among emerging markets. The Covid-19 pandemic further exposed Sri Lanka's balance of payments vulnerabilities, exacerbated by an overvalued exchange rate. The government's international bonds issued in the 2010s contributed to a rapid accumulation of external debt and associated future repayment pressures. Ultimately, a combination of lax fiscal policies and a series of shocks culminated in Sri Lanka defaulting for the first time on its external debt obligations in April 2022, prompting the initiation of a sovereign debt restructuring process.

58. The design of Sri Lanka's EFF-supported adjustment program aimed at restoring medium term external viability and debt sustainability. This involved ambitious macroeconomic policies combining fiscal and external adjustments within a realistic macroeconomic framework. The macro framework was anchored in Sri Lanka's specific characteristics and based on the experience in other market access country BOP and debt crises, which pointed to subdued economic recovery post-default especially where much needed fiscal consolidation constrained growth, the balance sheets of domestic financial institutions were impaired, and a sizable real effective exchange rate adjustment was needed to enable durable external adjustments. Exceptional financing and sovereign debt relief were needed to rebuild FX reserves to safe levels, thereby restoring external viability. The program also set out specific debt sustainability targets calibrated to Sri Lanka's unique economic circumstances, on external debt service, gross financing needs, and the level of public debt, to guide the restructuring toward restoring debt sustainability. These targets in combination with the macroeconomic framework were essential in determining a sustainable debt path and ensuring that the necessary adjustments were achievable without jeopardizing economic growth and stability.

59. Overcoming the complex creditor landscape in Sri Lanka's debt relief coordination required a multifaceted approach. Sri Lanka's diverse creditor base included international sovereign bond holders, bilateral creditors, multilateral creditors, and domestic financial institutions. Absent an established coordinating forum among traditional and nontraditional bilateral creditors for an emerging market economy like Sri Lanka, a parallel approach was adopted to secure the necessary financing assurances for debt relief. An official creditor coordinating platform was later established to enable transparent sharing of information and discussions of debt treatment parameters among bilateral creditors. The IMF supported Sri Lanka's creditor coordination and debtor-creditor engagement by explaining and ensuring full understanding of the macroeconomic framework and debt sustainability targets by all stakeholders.

60. Debt restructuring designs focused on treatment parameters aligned with the program debt targets. Negotiations were guided by these targets and the baseline macroeconomic framework, with Sri Lankan authorities engaging simultaneously with various creditor groups. Although this parallel approach aimed to expedite discussions by encouraging competition among creditors, it ultimately strained resources and was constrained by comparability of treatment requirements. Concerns about transparency and comparability of treatments and the introduction of innovative state-contingent debt instruments contributed to prolonging the restructuring process. The domestic debt operation (DDO) was implemented first in September 2023, followed

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by agreements in principle with official creditors by the first half of 2024, setting the stage for concluding the negotiations with private creditors later in the year. Overall, the restructuring process required careful balancing among diverse creditor groups, ultimately making progress toward debt sustainability.

61. Key lessons from Sri Lanka's debt restructuring can inform future experiences in other countries. The design of restructuring must carefully consider the impact of domestic debt operations on financial and social stability, the use of state-contingent debt instruments for assessing comparability and sustainability, and the complexities involved in debt management. Clarity in applying comparability of treatment and improving incentives around past due interest can expedite the restructuring process. Swift action by authorities, supported by IMF staff and financial advisors, is crucial to mitigate economic damage and navigate the complex creditor landscape. Effective communication among stakeholders is essential to address uncertainties regarding debt targets and restore sustainability.

62. Safeguarding hard-earned debt sustainability requires ongoing prudent macroeconomic policies and strengthened public debt management. Financing conditions remain challenging in the near-term, and a swift normalization is critical for managing refinancing risks and reducing gross financing needs going forward. The government must align new borrowing programs with program objectives to mitigate debt vulnerabilities and maintain fiscal discipline, which is essential for regaining market access and funding development needs as a middle-income country.

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Annex I. External Creditor Coordination – General Considerations

1. **The burden sharing and coordination issues among foreign creditors warrant careful considerations.** Multilateral creditors have historically enjoyed a de facto *preferred creditor status*, because of the public good nature of their financing which has been recognized by both official bilateral and private sector creditors. These creditors however have not legally subordinated their financing to IFI financing. In lieu of debt relief, they often provide, at a time of highest risk when no other financing is available, concessional/semi-concessional financing contributions to the program to reduce the financing gaps that need to be closed by debt restructuring. This type of financial contribution avoids credit impairments on their balance sheets which could hamper their own funding operations and their support to other member countries. When the Fund provides financing, a Fund supported program is designed to restore the member to medium term external viability and solve the member's BOP problem thereby enabling the member to repay future obligations which benefits the debtor and the creditors but also the global financial system at large. Bilateral creditors, on the other hand, have traditionally organized themselves around the Paris Club to provide coordinated debt relief. Before bonded debt became popular, commercial creditors often joined force through the London Club. The creditor landscape has since evolved, outpacing developments in creditor coordination mechanisms. The *G-20 Common Framework* brings all major bilateral creditors (Paris Club and non-Paris Club) together through an official credit committee and establishes a rather explicit coordination procedure with commercial creditors (bonded and non-bonded).

2. **A timely and orderly debt resolution was needed to avert a deeper crisis**. However, creditors would normally refrain from agreeing on a particular debt treatment until there is a credible IMF program that underpins the authorities' adjustment and reform efforts, which are critical to ensuring maximum recovery of their claims on the country. The IMF's arrears policies set out the conditions to allow timely financial support of the Fund to countries running sovereign external arrears to support a debt resolution that is in train to restore sustainability. These conditions link closely to debtor-creditor engagement and creditors' commitment to deliver debt relief and are formulated based on decades of practice under a traditional coordination framework centered around the Paris Club.

3. **The IMF's role is explaining its policies and assessing the proposals to restore debt sustainability.** This requires the Fund to closely engage with all creditors to better understand the negotiation dynamics, while keeping an arm's length from the actual negotiations in line with the Fund's duty of neutrality. The IMF's role in supporting the authorities' restructuring efforts and creditor engagement focuses on ensuring timely sharing of the macro and financing assumptions underpinning the program; explaining its policies and program designs and debt sustainability targets; providing DSA modeling support to creditors to enable their assessment of the scale of debt problems for informing their solution; and, at a later stage, assessing debt treatment proposals' consistency with program parameters.

4. **Where arrears on official claims exist, debtor-creditor engagement is governed by the IMF's Lending into Official Arrears (LIOA) policy.** The LIOA policy allows the Fund to lend into official arrears (i) when a representative Paris Club agreement is in place, (ii) absent such representative agreement, the creditor(s) to whom arrears are owed consents to Fund lending which may require additional safeguards if a majority creditor is involved, (iii) absent either representative agreement or creditor consent, conditions are in place to justify prompt Fund financial support, the debtor is making good faith efforts to reach agreement, and

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the IMF’s lending into arrears would not have an undue negative effect on the IMF’s ability to mobilize official financing packages in future cases, and , since the Fund policy changes adopted in 2024, (iv) when (i) – (iii) cannot provide a pathway forward, the Fund shall seek additional safeguards for lending into official arrears which would follow either a standard or an enhanced strand dependent on the specific circumstances such as exceptional access or the involvement of a significant creditor.

5. **Expectations on the commitment to provide debt relief by major bilateral creditors are stronger than that by small bilateral creditors.** The 2022 review of the LIOA policy clarifies that where there are significant uncertainties that the creditor(s) will restructure their claims and such a restructuring is critical to achieving debt sustainability and medium-term viability, the Fund may seek additional assurances from such creditor(s) that their debt relief will be consistent with program parameters.

- **Obtaining SCA from Paris Club creditors is generally straightforward thanks to a long-standing collaboration with the Fund.** Historically, official sector involvement was typically delivered through the well-established Paris Club process, in which financing assurances were often provided not long after the debtor country’s request (which can be derived from the Club’s chair summing up of discussions of a working paper that lays out the scope and considerations for the debt treatment) and an eventual debt treatment could be agreed in a timely manner shortly after (in the form of an Agreed Minute signed by all participating PC creditors). This well-developed and tested process and the many decades of collaboration between the Fund and the Paris Club has been very important for unlocking OSI and restoring debt sustainability to enable Fund financial support.

- **Obtaining SCA from non-Paris Club creditors is an evolving process.** Some nontraditional creditors were still building capacity to independently construct a full DSA to assess the depth of required debt relief. For this reason, they sometimes hesitated to provide an upfront specific and credible assurance in a written form, which mimics the Paris Club process and internalizes new creditors’ lack of track record in providing and subsequently implementing their financing assurances. In part, this is because the provision of such upfront commitment is not always aligned with these creditors’ internal process.

6. **Private creditor engagement is governed by the Lending into Arrears (LIA) policy**. The LIA policy allows the Fund to lend into arrears on private sector claims when prompt Fund financial support is essential, and the member is pursuing appropriate policies while making good faith efforts to reach agreements with private creditors. The good faith efforts are assessed based on early engagement, timely information sharing, opportunity for creditors to provide inputs on the design of restructuring strategies and instruments.

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Annex II. Comparability of Treatment – General Considerations

1. **Comparability of Treatment is an important principle to address first mover and free riding problems, especially where multiple creditor groups are present.** Traditional official creditors have often been the first mover in sovereign debt restructuring where its debt treatment is expected to be instrumental to restoring debt sustainability. To avoid its debt relief being used to create space to repay other foreign creditors on better terms, for decades Paris Club has included a CoT clause in its debt relief agreement. The Paris Club has traditionally relied on the constructive ambiguity around the three metrics it uses to assess CoT—debt service reduction (vs. contractual terms) during the program period, the weighted average maturity extension, and the NPV relief (against pre-restructuring NPV) measured with a unified discount rate. This comprehensive matrix enables a comparability assessment between distinct treatments due to different creditors' different preferences. For example, commercial creditors receiving more payments upfront and providing shorter duration extension will be expected to provide larger NPV relief for CoT. However, such CoT clause/matrix, while clear in principle, is often hard to be quantified. The lack of reverse CoT (from commercial to official creditors) under the Paris Club principles also effectively disincentivizes the debtor from agreeing with its private creditors first without taking the risk of having to reopen any agreed debt treatment.

2. **CoT is often reinforced through contractual clauses in debt treatment agreements.** Such clauses provide safeguards to participating creditors that they will not be taken advantage by nonparticipating creditors, and can include: (i) a claw back of debt relief if more advantageous treatment is offered to other creditors (akin to a Most Favored Creditor Clause, a legal provision that seeks to ensure a lender receives the same or better terms as any other creditor of the same borrower); (ii) a condition precedent clause that renders debt treatment implementable only if the debtor makes comparable offers to other foreign creditors and stays in arrears until comparable agreement is reached; and (iii) a transparency clause that obliges the debtor to disclose details of its debt treatments with other creditors.

3. **Lastly, the IMF does not get involved in intercreditor equity issues and CoT matters or opine on burden sharing provided the strategy restores debt sustainability and achieves high private sector creditor participation.** The Fund's role focuses on ensuring that the program's debt targets are met so as to restore debt sustainability. On CoT, this is a creditor issue on which the Fund defers to the creditors and has relied on (i) the PCS for a robust assessment of its own debt treatment terms vs. that of the other creditors, and (ii) the debtor country's advisors to engage closely with all groups of creditors to ensure their debt treatment proposals' compliance with CoT principles (which may vary across creditors) and to internalize the consequences of violating CoT principles, which could lead to reopening of previously concluded debt treatments and potentially challenging the prospects of restoring debt sustainability. To the extent that CoT affects creditor participation in the restructuring it can have an impact on debt sustainability.

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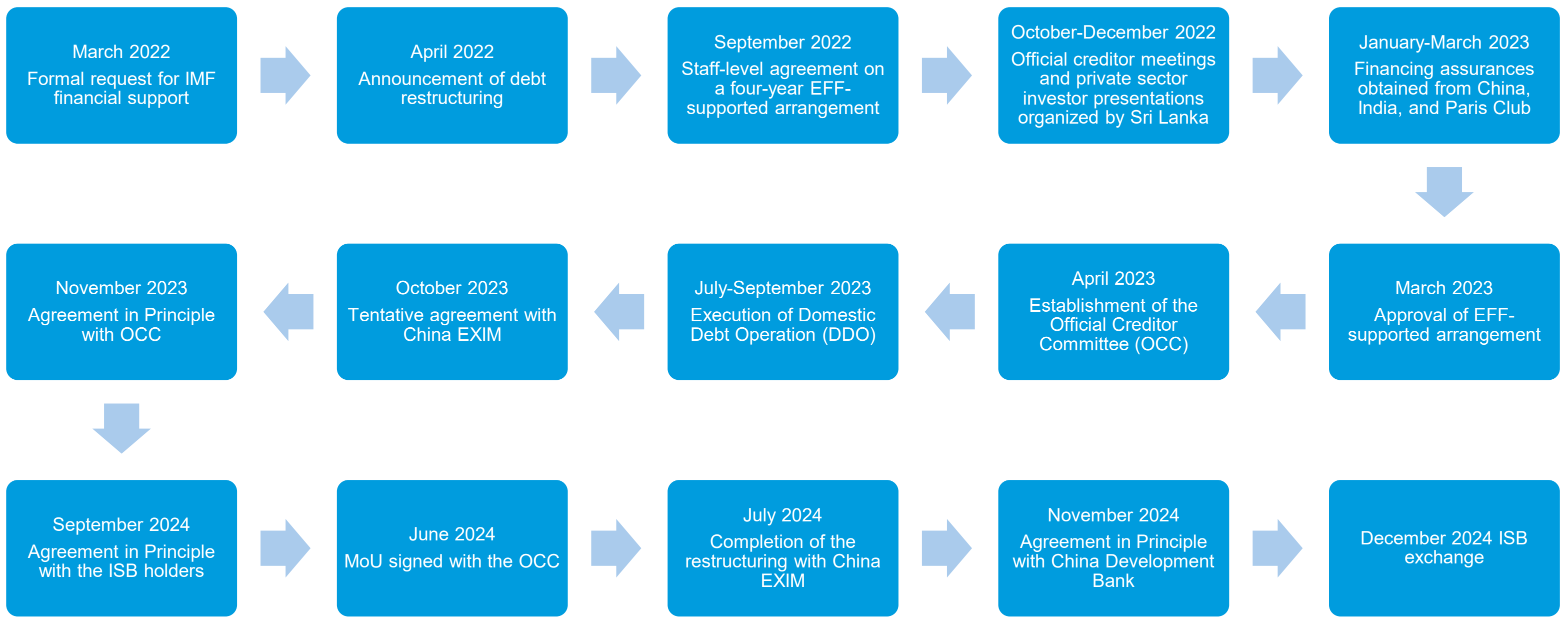
Annex III. Timeline of Sri Lanka's Sovereign Debt Restructuring Process



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