Domestic Debt Optimization Investor Presentation

7 July 2023

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The DDO is a Key Milestone on the Journey Towards Restoring Sri Lanka's Public Debt Sustainability

Restoring Public Debt Sustainability, one of the key objectives of Sri Lanka's IMF Program, requires policy actions and a comprehensive debt treatment

5 key pillars of Sri Lanka's USD 3bn IMF Program approved on 20 March 2023

1. Revenue-Based Fiscal Consolidation; Fiscal Structural Reforms; Protect poor and vulnerable
2. Restore Public Debt Sustainability
3. Restore Price Stability and Rebuild External Buffers
4. Safeguard Financial System Stability
5. Reduce Corruption Vulnerabilities; Growth-enhancing Reforms

How is debt sustainability assessed?

- **Debt Sustainability Analysis ("DSA") targets set by the IMF were calibrated to ensure that the country restores the sustainability of its public debt:**
  - ✓ Debt stock target: 95% of GDP by 2032
  - ✓ GFN target[1]: avg. 13% of GDP in 2027-32
  - ✓ FX debt service target[1]: max 4.5% of GDP in 2027-32
- In addition, **Sri Lanka will have to ensure that its "program is fully financed"** (i.e., that there is no external financing gap over the program period)

How will debt sustainability be restored?

A. An ambitious fiscal consolidation plan

B. A comprehensive public debt treatment

Note: (1) While the GFN and FX debt service targets only pertain to 2027-2032 period, the indicators both have to be on a downward trend between 2032 and 2035

The Government embarked on an ambitious and well-balanced fiscal consolidation path

Revenue-enhancement

- Increasing tax rates (Personal Income Tax (PIT), Corporate Income Tax (CIT), Value Added Tax (VAT), Telecommunication Levy and Betting and Gaming Levy)
- Broadening tax bases (PIT and VAT)
- Removing tax exemptions (CIT, VAT), reintroducing Withholding tax, abolishing SVAT
- Increasing tax compliance through strengthening tax administration and amendment of tax structures for corporates and individuals
- Introduction of Property Tax and Inheritance Tax

Expenditure-rationalization

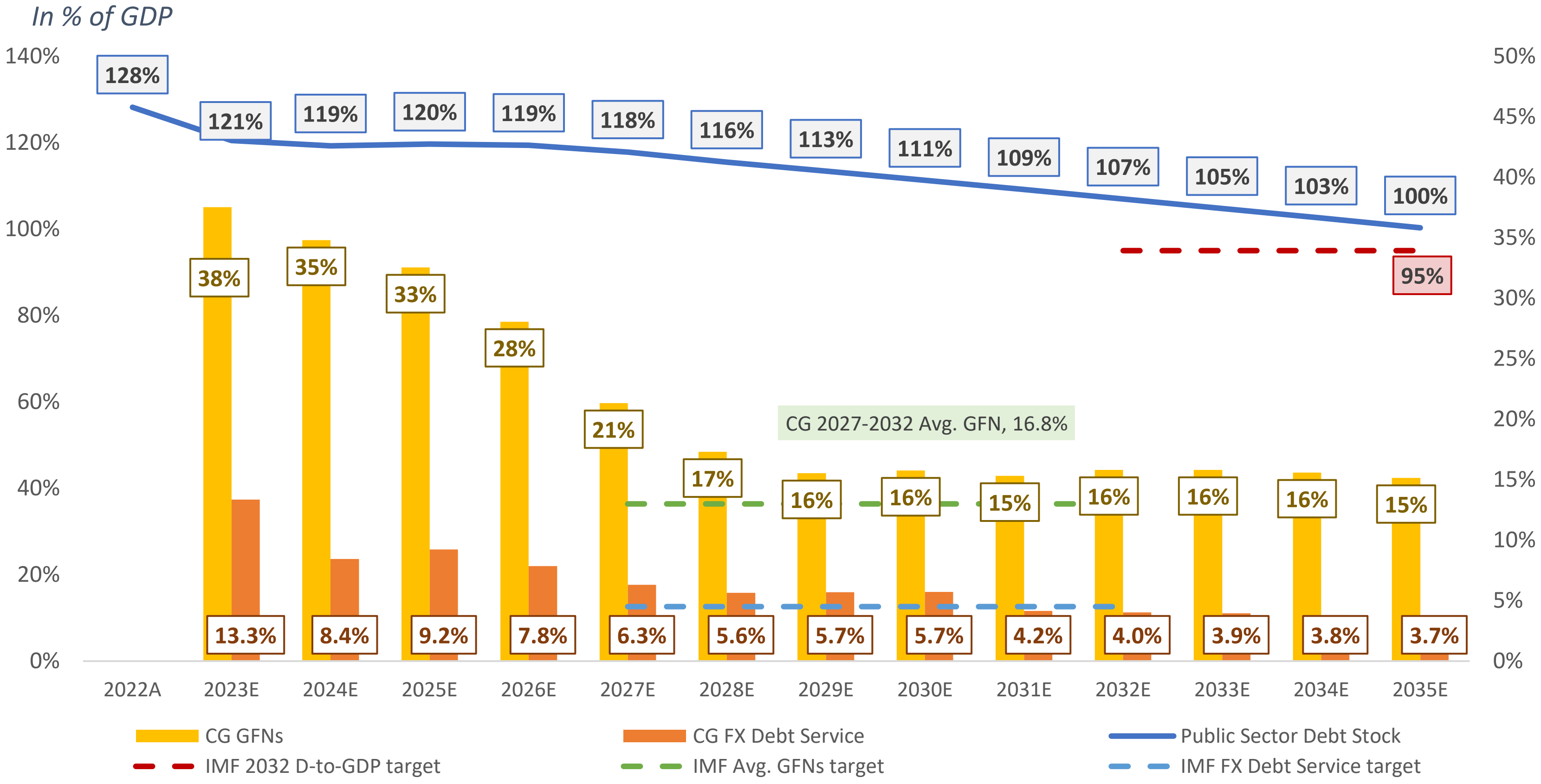
- Better targeted allocation of resources focusing on the most vulnerable segments of the economy
- Guidelines issued to the public to minimize electricity and fuel usage, and to restrict non-urgent/non-essential expenses
- Cabinet approval to reduce 6% of approved recurrent expenditure estimates of all Government institutions for 2023
- Reform of key SOEs, including cost-recovery based pricing for fuel and electricity

The ambitious fiscal reforms implemented by the Government set its public finances on a sustainable path, enabling the Government to reduce its financing needs, hence impacting positively its debt trajectory

However, such measures are insufficient to restore debt sustainability in the absence of a comprehensive debt treatment

Despite the ambitious fiscal consolidation efforts, Sri Lanka's public debt trajectory is set to remain unsustainable in the absence of a comprehensive debt treatment, both on flows and stock indicators

Sri Lanka's Public Debt trajectory and DSA indicators, in the absence of debt treatment



Compliance with IMF DSA Targets

1. × **Debt stock target**: 95% of GDP by 2032
2. × **GFN target**: avg. 13% of GDP in 2027-2032
3. × **FX debt service target**: max 4.5% of GDP in 2027-2032
4. × **Fully financed IMF program** *(external financing gap not covered over the program period)*

Sri Lanka's external debt restructuring strategy should deliver a significant share of the necessary relief, but is insufficient to meet all DSA targets

While it significantly improves Sri Lanka's DSA, the envisaged external debt restructuring strategy does not allow Sri Lanka to meet the Gross Financing Needs target set by the IMF, under realistic treatment assumptions for external creditors

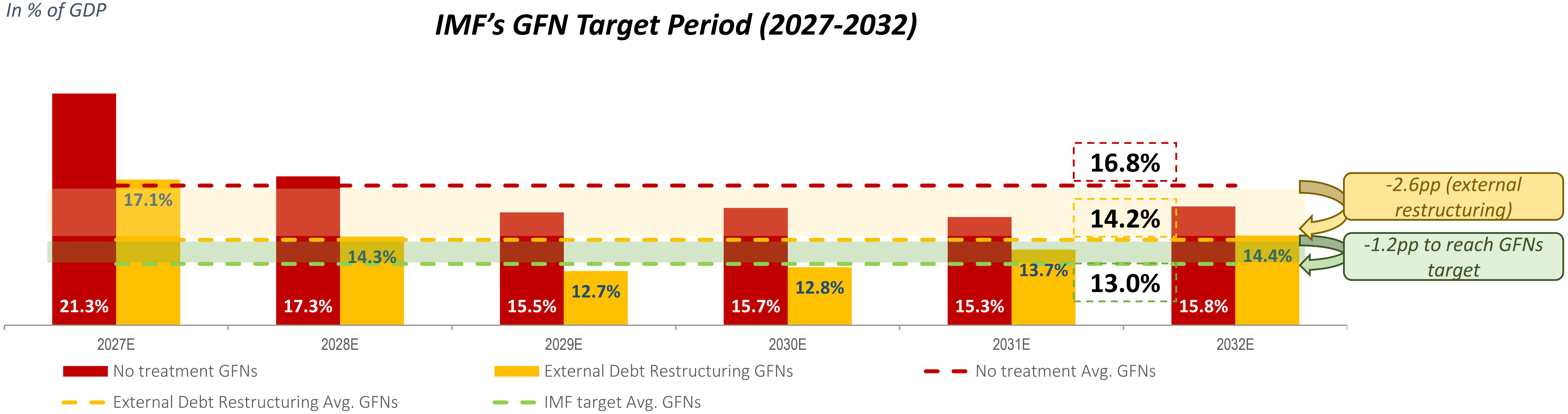
The envisaged external debt restructuring strategy…

1. …enables to meet the debt stock target of 95% of GDP by 2032…
2. …allows to meet the FX debt service target of max 4.5% of GDP in 2027-2032…
3. …ensures a fully financed IMF program… *(USD 16.9bn external debt service reduction over program period)*

✘ … but does not reduce avg. GFNs to the target of 13% of GDP in 2027-2032

Impact on Sri Lanka's Gross Financing Needs under the envisaged external debt restructuring strategy (relying on realistic debt treatment assumptions)

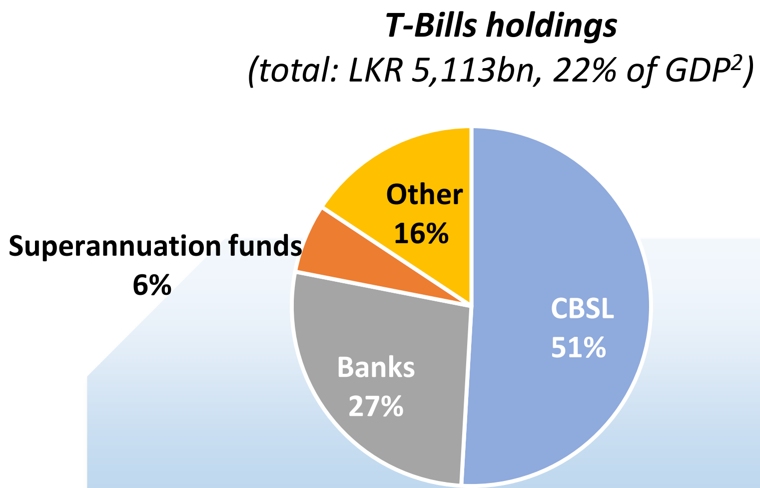
In % of GDP

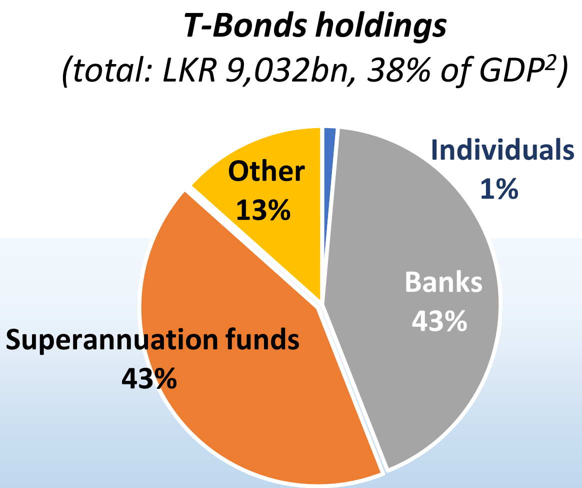


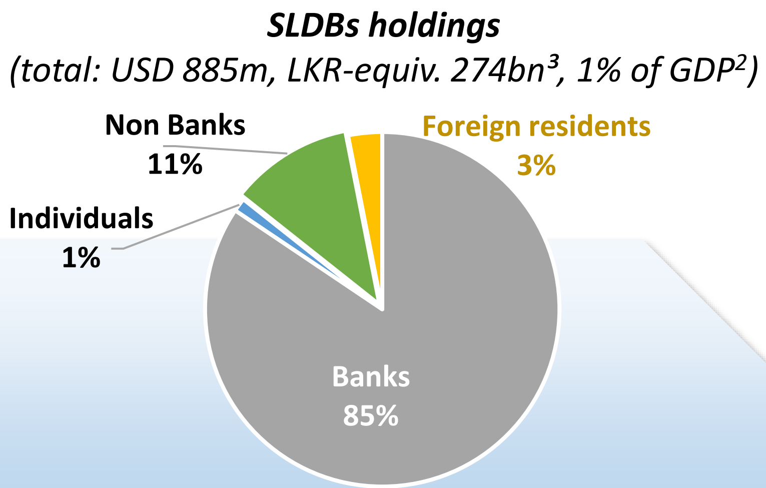
Local creditors' participation, through a domestic debt optimization, is required to lower the Government's refinancing needs

A treatment of the domestic debt is necessary to meet the GFN target, reduce rollover risks and ensure a fair contribution from all creditors to the resolution of Sri Lanka's debt problem

SRI LANKAN DOMESTIC DEBT[1] AS AT END MAY 2023, BY HOLDERS







The authorities engaged with largest holders of domestic debt and conducted an in-depth assessment of the domestic financial sector to design a DDO strategy that meets these objectives:

Safeguarding financial stability ⇄ ***Providing short to medium-term liquidity relief to the Government***

Notes: (1) Only the main components of Sri Lanka's Public Domestic Debt are displayed on the above pie charts. The DDO will focus on these elements, as well as on FCBUs, (2) 2022 Actual GDP, (3) Using USD/LKR FX rate prevailing on 3 July 2023 (308.8)

Domestic Debt Optimization: Proposed Terms of the Exchanges

Overview of the Domestic Debt Optimization – *Key building blocks*

1 CBSL's T-Bills holdings and Provisional Advances to the Government **converted into longer-term T-Bonds** *(subject to relevant legislation being enacted)*

Central Bank's T-Bills and Provisional Advances to Gov.

2 Superannuation Funds' holdings of T-Bonds converted into **long-maturity instruments,** with tax incentive mechanism (banks are not expected to participate to the exchange)

Superannuation Funds' T-Bonds

3 Sri Lanka Development Bonds and Foreign Currency Banking Units **treated, with three options** (incl. an option with conversion to LKR) available to holders (excluding individuals)

SLDBs and FCBUs

Impact on Sri Lanka's GFNs under the envisaged DDO

In % of GDP

-0.9 p.p. avg. GFN reduction over 2027-2032

-0.5 p.p. avg. GFN reduction over 2027-2032

-0.1 p.p. avg. GFN reduction over 2027-2032

-1.5 p.p. avg. GFN reduction from the DDO

Sri Lanka's Domestic Debt Optimization Strategy, tailored to the different types of domestic debt instruments, provides the required debt relief while seeking to safeguard the stability of the domestic financial sector

Note: (1) FBCUs are not formally included in the exchange that was launched on 4 July 2023. Their treatment (similar that the one envisaged for SLDBs) will be subject to bilateral discussions between the authorities and the banks holding the instruments

1 Envisaged treatment of CBSL's T-Bills and Provisional Advances to Government

- **The Central Bank of Sri Lanka will contribute to reduce the Government's Gross Financing Needs, through the treatment of its holdings of T-Bills** (51% of outstanding T-Bills as at end May 2023 - LKR 2,602bn) **and Provisional Advances to the Government** (LKR 343.1bn, as at end June 2023)

The operation will take place in a second stage after the Parliament has passed the Central Bank of Sri Lanka Bill and an amendment to the Appropriation Act
(expected: August 2023)

T-Bills and Provisional Advances held by the CBSL will be converted into longer-term T-Bonds to alleviate the Government's short-term refinancing needs

The impact on the CBSL's equity level will be limited and manageable: the CBSL will be running in negative equity but should return to positive equity territories as early as 2025

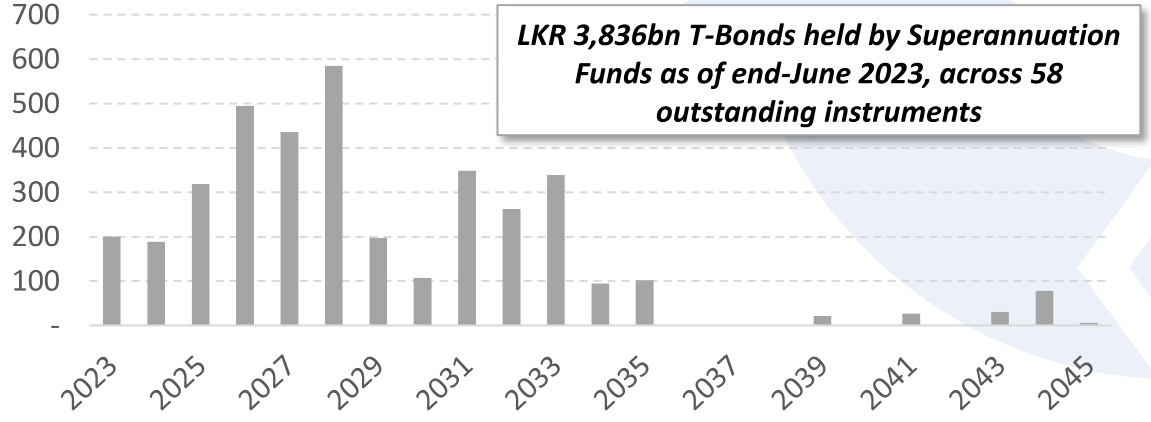
2 Overview of the Superannuation Funds' T-Bonds Exchange

Superannuation Funds' T-Bonds represent a significant share of the outstanding…

Outstanding T-Bonds as of end June 2023[1], in LKRbn

No.	ISIN No.	Series Name	Maturity Date	Out. Principal Amount (LKRbn)
1.	LKB01123I017	09.00%2023A	1 September 2023	87.23
2.	LKB01023I019	11.20%2023A	1 September 2023	99.88
3.	LKB02023J016	07.00%2023A	1 October 2023	223.22
4.	LKB00323K150	06.30%2023A	15 November 2023	180.59
		…		
61.	LKB03044A010	13.50%2044A	1 January 2044	10.97
62.	LKB03044F019	13.50%2044B	1 June 2044	77.86
63.	LKB03045C013	12.50%2045A	1 March 2045	10.06
TOTAL				**8,903.73**
TOTAL – SUPERANNUATION FUNDS				**3,836.19**

EXISTING SUPERANNUATION FUNDS' T-BONDS PRINCIPAL REPAYMENT[1] (LKRbn)

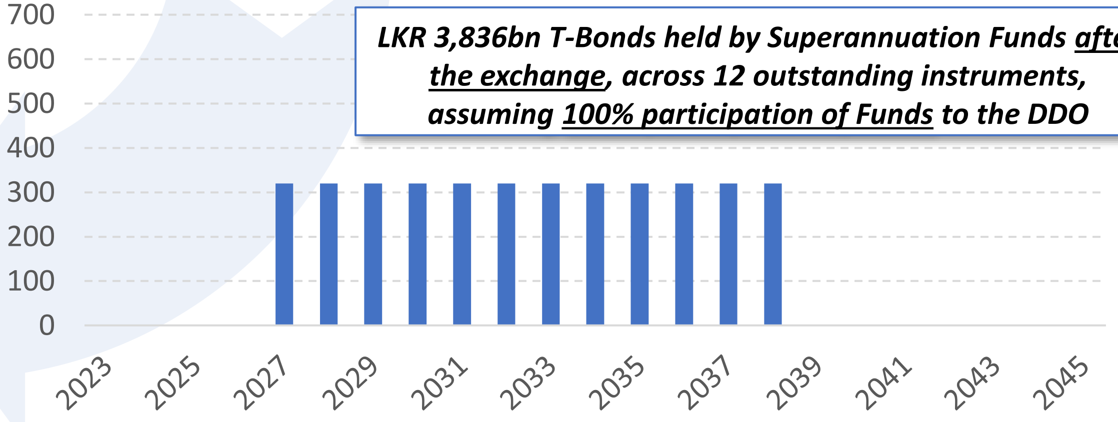


LKR 3,836bn T-Bonds held by Superannuation Funds as of end-June 2023, across 58 outstanding instruments

… and will be exchanged into 12 new T-Bonds instruments of equal size

New Bonds	Maturity Date	Interest Rate	Other Characteristics
New 2027 Bond	15 March 2027	• 12.0% up until 2025 (incl.) • 9.0% until maturity	• Semi-annual interest payments • Bullet principal repayment
New 2028 Bond	15 April 2028		
New 2029 Bond	15 May 2029		
New 2030 Bond	15 June 2030		
New 2031 Bond	15 January 2031		
New 2032 Bond	15 February 2032		
New 2033 Bond	15 March 2033		
New 2034 Bond	15 April 2034		
New 2035 Bond	15 May 2035		
New 2036 Bond	15 June 2036		
New 2037 Bond	15 January 2037		
New 2038 Bond	15 February 2038		

NEW SUPERANNUATION FUNDS' T-BONDS PRINCIPAL REPAYMENT[2] (LKRbn)



LKR 3,836bn T-Bonds held by Superannuation Funds after the exchange, across 12 outstanding instruments, assuming 100% participation of Funds to the DDO

Note: (1) Figures do not include the T-Bond LKB00523G153 maturing on 15 July 2023, which is not included in the exchange

2 Key principles of the envisaged exchange of Superannuation Funds' T-Bonds

The envisaged exchange relies on simple and fair principles

Exchange of instruments <u>with no nominal haircut</u>	• Outstanding T-Bonds would be exchanged against a basket of 12 instruments (see full description on slide 12), for a total equivalent to the tendered instruments' nominal value (**<u>no nominal haircut</u>**)
New instruments with a step-down coupon structure	• All new T-Bonds would bear a coupon rate **of 12% p.a. until 2025 (included), decreasing to 9% p.a. thereafter** and until maturity
Accrued interest paid in cash on Settlement Date	• On Settlement Date, holders of T-Bonds who submit successful offers[1] will receive an amount equal to interest accrued and unpaid up to the Settlement Date, **<u>meaning that all interest payments already accrued will be paid to Superannuation Funds</u>**
Combined with a tax incentive, to ensure participation	• **A tax incentive is combined with the exchange offer to ensure Superannuation Funds' participation:** ➢ The income tax rate applicable to Superannuation Funds will increase from 14% to 30% for those which do not participate to the exchange ➢ The income tax rate applicable to Superannuation Funds will remain unchanged for those who participate to the exchange • **How is participation defined?** A Superannuation Fund is considered to have participated if it submits successful offers to exchange which, in aggregate, relate to: ➢ Not less than 50% of holdings of each series of Eligible Bonds maturing in 2023 ➢ 100% of the relevant Superannuation Fund's holding of Eligible Bonds maturing between 2024 and 2032 (inclusive)

Note: (1) Offers which are valid and accepted by the Government

2 Superannuation Funds will be incentivized to participate in the exchange through an adequate tax incentive

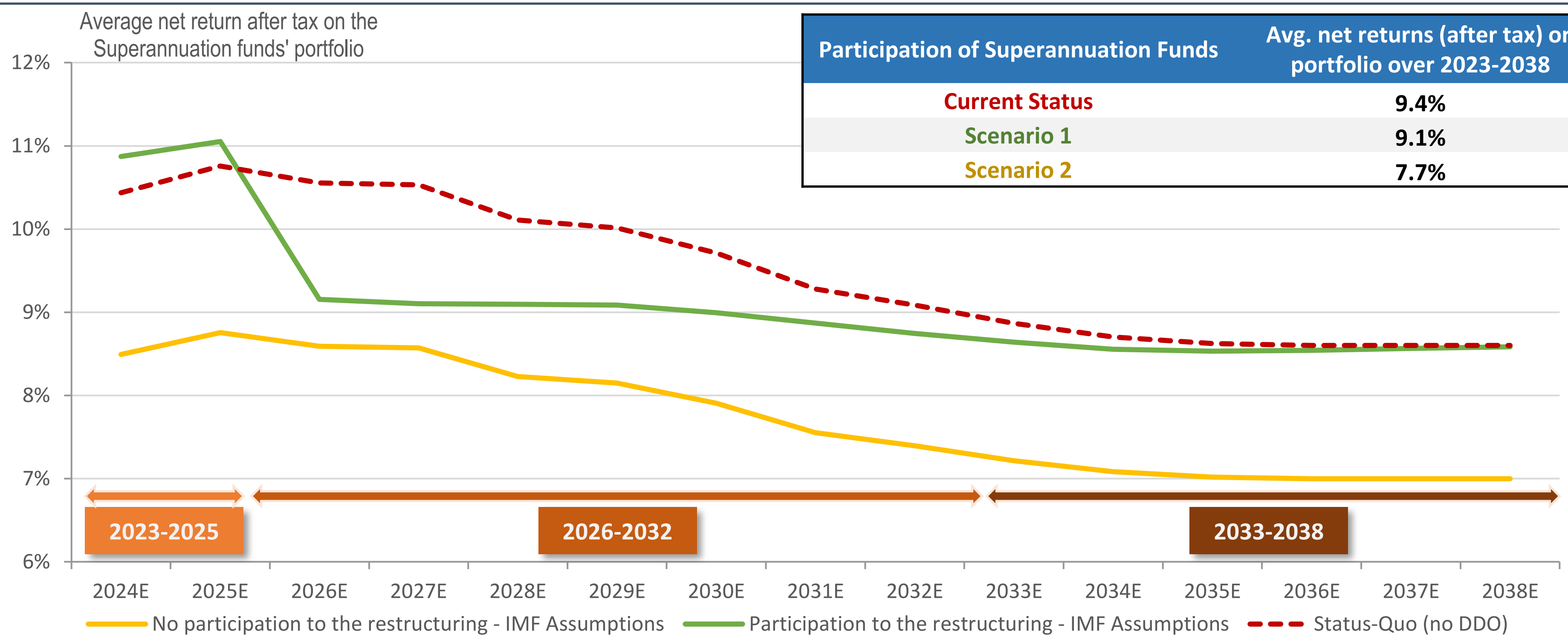
Superannuation Funds would secure a substantially higher return on their portfolio, by participating to the exchange

Assessed scenarios

1 **Current Status: No DDO and annual income tax at current rate of 14%**

2 **Participation to the DDO**

3 **No participation to the DDO**



Participation of Superannuation Funds	Avg. net returns (after tax) on portfolio over 2023-2038
Current Status	9.4%
Scenario 1	9.1%
Scenario 2	7.7%

2023-2025

Positive short-term impact on Superannuation Funds and beneficiaries (higher returns)

2026-2032

Potential limited opportunity costs (or gains) in the medium-term, from locking interest rates at 9% (vs. prevailing market rates)

2033-2038

No impact in the long-term, average net returns converging at the same rate

The tax mechanism provides a clear incentive to Superannuation Funds to participate in the DDO

Participating in the DDO entails a marginal opportunity loss for Superannuation Funds… but is much more attractive than being subject to a higher income tax

2

What happens to LKR 100bn invested by Superannuation Funds in 2023?

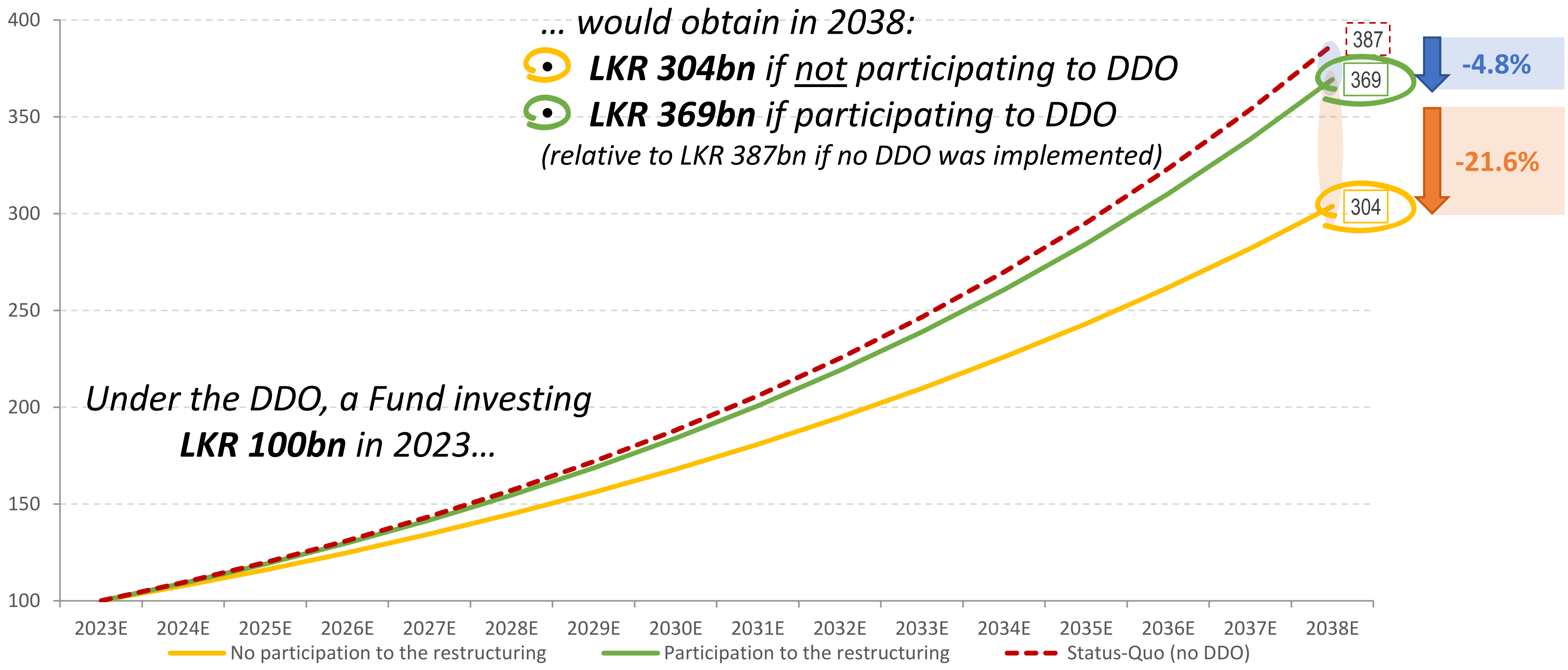
in LKRbn

Assessed scenarios

1 **Current Situation:** No DDO and annual income tax at current rate of 14%

2 **Participation to the DDO**

3 **No participation to the DDO**



Participating to the exchange would result in an opportunity loss of 4.8%, compared to the current situation without any restructuring – while not participating would lead to an additional opportunity loss of 21.6%

2 The envisaged treatment is tailored to Superannuation Funds and their beneficiaries

Key features of the envisaged treatment

A **No impact on Superannuation Funds' balance sheets and on their beneficiaries' savings**	• Due to their peculiar nature, **superannuation funds are allowed by the regulator to adopt derogatory accounting rules[1]. This will spare them from any restatement of their assets and liabilities** (i.e., no restatement in their beneficiaries' accounts balances)
B **Reflective of the country's economic situation**	• **<u>During the next two years and a half</u>, in which inflation is projected to remain high[2], Superannuation Funds will receive a coupon rate of 12%** (slightly above the current average coupon rate on their current portfolio) ➢ *This should allow them to maintain and even increase the return offered to beneficiaries in the current difficult economic environment* • **<u>Once the country's economic situation will stabilize</u>, with inflation coming down to stable levels, the coupon rate on the new T-Bonds will decrease to 9%** ➢ *Such rate should still guarantee returns to beneficiaries between 1% and 2% higher than projected inflation levels*
C **May represent an opportunity gain for Superannuation Funds and their beneficiaries**	• **In locking down today a return at 9% (above inflation), Superannuation Funds will be able to guarantee beneficiaries a certain level of remuneration that the Funds may not have been able to afford in a situation where interest rates would turn out to be lower in the future than currently expected, creating an opportunity gain for Superannuation Funds and their beneficiaries**
D **Aligned interests between the debtor and its creditors**	• **Restoring promptly Sri Lanka's debt sustainability and its creditworthiness is in the interest of all its creditors, and in particular, domestic ones which are the most exposed to its credit quality**

Note: (1) Superannuation Funds will be allowed to record their new instruments at transaction price (i.e., cost value), (2) International Monetary Fund projections

3 Overview of the envisaged treatment of SLDBs and FCBUs

- Since introducing the Interim Debt Policy (April 2022), the authorities allowed SLDBs holders to be repaid through the issuance of Treasury Bonds ("LKR repayment arrangement")
- While it enabled to reduce the stock of outstanding SLDBs, **this arrangement has been terminated and is replaced by an exchange offer that includes a menu of 3 different options, of which one includes the conversion of the instruments in LKR ("LKR option")**
- **Holders of SLDBs are encouraged to opt for this "LKR option"** (see next slide) **as it includes favorable terms, aiming to take into account potential concerns relating to the comparability of this offer with the LKR repayment arrangement previously in place**
- **The menu also includes USD options, to ensure that SLDBs holders willing to keep USD-denominated instruments are able to do so**
  - ➢ *USD options are however more in line (although not identical) with treatment terms currently foreseen for external creditors, in the context of our external debt restructuring strategy*
- <u>**The authorities do not intend to resume contractual debt service payments due to holders not participating to the exchange**</u>
- **Further to the treatment of SLDBs, authorities intend to treat Foreign Currency Banking Units (FCBUs) owed to Banks on the basis of the same menu of options.** Given the different nature of these instruments, their treatment will be discussed bilaterally with relevant banking institutions

3 Proposed terms for SLDBs and FCBUs

SLDBs holders, excluding individuals, will be able to choose between three options

USD Option 1	USD Option 2	LKR Option
Exchange of outstanding SLDBs against 1 new USD-instrument	**Exchange of outstanding SLDBs against 1 new USD-instrument**	**Exchange of outstanding SLDBs against 5 new LKR-instruments**
• Nominal haircut: 30% • 6-year final maturity (2029), no grace-period (1st amortization: 2024) • Amortization profile: linear • Interest rate: 4.0% (fixed) • Past due interest and interest accrued up to the settlement date will be settled in LKR (cash)	• No nominal haircut • 15-year final maturity (2038), 9-yr grace-period (1st amortization: 2033) • Amortization profile: linear • Interest rate: 1.5% (fixed) • Past due interest and interest accrued up to the settlement date will be settled in LKR (cash)	• No nominal haircut • 10-year final maturity (2033), 1-yr grace period (1st amortization: 2025) • Amortization profile: linear, every two years • Floating interest rate: SLFR (policy rate) + 1.0% • Past due interest and interest accrued up to the settlement date will be settled in LKR (cash)

+ FCBUs

Holders of Foreign Currency Banking Units will be offered the same options as holders of SLDBs, but **will be treated bilaterally and not as part of the exchange**

Next Steps

Timeline of the DDO and next steps

DATE	ACTION
• 4 July 2023	**Launch Date** On this date the Republic will distribute this Exchange Memorandum describing the terms of the Invitation to Exchange. Eligible Holders may submit Offers.
• 7 July 2023 at 10:00 a.m. (IST)	**Presentation** Presentation to Eligible Holders regarding the Invitation to Exchange.
• 25 July 2023 at 4:00 p.m. (IST)	**Expiration Date** Deadline for Eligible Holders to submit Offers.
• On or about 28 July 2023	**Announcement Date** Announcement of acceptance of Offers by the Republic via Designated Agents and in local newspapers.
• 31 July 2023	**Settlement Date**

How to participate in the Exchange? – *Focus on T-Bonds process*

Holders of T-Bonds

- **Send an Offer or Exchange Instruction to the relevant Dealer Direct Participant or Custodian via: (a) email, or (b) an internal communication platform provided by the relevant Dealer Direct Participant or Custodian to customers (if any), or both**
- **Eligible Holders should strictly adhere to the format provided in Microsoft Excel on the MOF Website when filling out the Exchange Form. Accordingly, Eligible Holders shall:**
  1. Download a copy of the Exchange Form in Microsoft Excel.
  2. Fill out the (electronic) form in full with all due care.
  3. Save the duly completed Exchange Form in Microsoft Excel format (searchable electronic version).
  4. Print the duly filled form and place the authorised signatures and the official stamps (signed printed original of the Exchange Form).
  5. Scan the signed printed original of the Exchange (scanned copy of the Exchange Form).
- **All Offers and Exchange Instructions sent electronically as above must include both the searchable electronic version of the Exchange Form and a scanned copy of the signed Exchange Form.**
- The signed printed original of the Exchange Form shall be provided to the Registrar by 4:00 p.m. (IST) at ddo.tbond@cbsl.lk on the Expiration Date.
- **It is the Eligible Holder's responsibility to maintain constancy (i.e. have NO discrepancy) between the electronic copy and the signed printed original of the Exchange Form.**

Additional details for holders of T-Bonds and for Dealer Direct Participant and Custodians are provided in the relevant exchange memorandum on the Ministry of Finance's website

How to participate in the Exchange? – *Focus on SLDBs process*

Holders of SLDBs

- **Send an Offer or Exchange Instruction to the relevant Designated Agent via: (a) email or (b) an internal communication platform provided by the relevant Designated Agent to customers (if any), or both**
- **Eligible Holders should strictly adhere to the format provided in Microsoft Excel on the MOF Website when filling out the Exchange Form. Accordingly, Eligible Holders shall:**
  1. Download a copy of the Exchange Form in Microsoft Excel.
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- **The signed printed original of the Exchange Form shall be provided to SPD by 4:00 p.m. (IST) at ddo.sldb@cbsl.lk on the Expiration Date**
- It is the Eligible Holder's responsibility to maintain constancy (i.e., have NO discrepancy) between the electronic copy and the signed printed original of the Exchange Form.
- **When submitting the signed original of the Exchange Form to SPD, an Eligible Holder must enclose the certificate representing the relevant Eligible Bonds to be cancelled by SPD.**

Additional details for holders of SLDBs and for Designated Agents are provided in the relevant exchange memorandum on the Ministry of Finance's website

Contact information

T-Bonds exchange

- Eligible Holders (other than Designated Non-Dealer Bidders) should contact their Dealer Direct Participant or Custodian for assistance with regard to matters related to the Invitation to Exchange processing or matters related to the submission of Offers in the first instance.
- The Registrar may be contacted for assistance and with regard to matters related to the Invitation to Exchange processing or matters related to the submission of Offers at:

The Registrar and the Superintendent of Public Debt

Central Bank of Sri Lanka

30 Janadhipathi Mawatha

Colombo 00100

Sri Lanka

Inquiries:

Local: 1935 (Hotline) (9am – 4pm IST)

Foreign: +94 11 2477 000 (9am – 4pm IST)

+94 11 2477 966 (9am – 4pm IST)

Email address: ddo.tbond@cbsl.lk

Website: https://treasury.gov.lk/web/ddo

For information and announcements relating to the Invitation to Exchange please refer to the MOF Website.

SLDBs exchange

- Eligible Holders should contact their Designated Agent for assistance with regard to matters related to the Invitation to Exchange processing or matters related to the submission of Offers in the first instance.
- Individual Investors should contact their Designated Agent to discuss a resolution for their Eligible Bonds.
- SPD may be contacted for assistance and with regard to matters related to the Invitation to Exchange processing or matters related to the submission of Offers at:

The Registrar and the Superintendent of Public Debt

Central Bank of Sri Lanka

30 Janadhipathi Mawatha

Colombo 00100

Sri Lanka

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Local: 1935 (Hotline) (9am – 4pm IST)

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Website: https://treasury.gov.lk/web/ddo

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Concluding Remarks

Sri Lanka's macro-economic stabilization and the restoring of its public debt sustainability requires the support of all creditors, including domestic ones

The Government of Sri Lanka has endeavored to build a DDO strategy which is both fair and with low risks of implementation, and which puts the overall debt restructuring strategy on the right path for success

In parallel, the Government of Sri Lanka is fully engaged in further pursuing the foreseen reforms, to restore fiscal sustainability and foster long-term economic growth

Overall, the correct implementation of the DDO will allow Sri Lanka to progress in its interactions with external creditors, and to secure additional disbursements from international donors

Q&As