For Sri Lanka, a Governance-Linked Bond might just be the ticket

By Nishan de Mel

It is a truth universally acknowledged that if Sri Lanka under-performs on its governance corrections, it will underperform on its economic recovery also (with apologies to Jane Austen), the first provides the foundation for the second.

Sri Lanka secured IMF board approval for the second tranche of the current IMF programme exactly 102 days after the scheduled date for the first review. It is not normal for a second tranche to be so delayed, and it is a red flag for Sri Lanka's creditors. But there is something that current bond-holders can do to help Sri Lanka reduce the risk that is being flagged. It is a novel debt restructuring instrument that Verité Research has termed as a "Governance-Linked Bond". It has great potential to be a win-win solution. Clarifying the problem will help to understand the benefit of the solution.

Problem: Sri Lanka's performance needs to pick-up.

A recent Sri Lanka debt update by Verité Research had data on 16 countries, apart from Sri Lanka, that have undergone debt restructuring since 2009 with IMF assistance. There is data on the scheduled date for completion of the first IMF review, and the date of board level agreement to release the second tranche. When countries perform according to plan, the gap between these two dates should be no more than three weeks.

But not all countries perform the same. Half of the countries (eight) performed as expected taking an average of 12 days. Of the balance eight underperformers, four took an average of 56 days. Sri Lanka falls among the underperformers within the underperformers by taking 102 days. This is now a pattern. Since debt repayments were suspended in April 2022, Sri Lanka is progressing poorly on several measurable comparisons with other countries that have restructured debt in the last 15 years.

The problem is more internal than external.

While it is expedient for interested parties to blame external factors (China, bondholders, Paris Club), the evidence suggests that the reasons for slow progress are mainly internal. In the present review, the IMF listed out areas that it thinks are critical for Sri Lanka to improve such as "prevent program slippages and past policy shortcomings" and "continued commitment to improving governance and timely implementation of the report's recommendations".

The above "report" refers to the Governance Diagnostic Assessment (GDA) published by the IMF in September 2023 – the first time for an Asian country – recognising that Sri Lanka's governance weaknesses were, in IMF speak "macro-critical". It had the following over-arching observation:

> "The GDA revealed **systematic and severe governance weaknesses and corruption vulnerabilities across state functions**, with particular macroeconomic impact in: budget credibility; expenditure control; public investment management and control of spending); public procurement; management and oversight of State-Owned Enterprises (SOEs); transparency of revenue policy and the integrity of revenue administration; the governance and legal frameworks of the Central Bank; the application of financial sector regulations; and clarity and security of land ownership and the integrity of the judicial sector." (IMF-GDA, p. 11)

Similar sentiments were echoed in an alternative governance diagnostic published and endorsed by a large coalition of local civil society organisations in Sri Lanka (Local-GDA).

The organisations at the core of the Local-GDA also released a statement this week, pointing to examples where the "Government has failed to implement basic commitments around transparency and anti-corruption that are mentioned in the current program". These are noted in the IMF review as well.

Democratic solutions and incentives are logjammed in Sri Lanka.

Just as the IMF program was started in March 2023, local government elections were postponed beyond the allowed legal limits.

The traumatic experiences of shortages of essentials, days long queues for fuel, long power cuts etc. have left the population in a quandary. The public protest movement against corruption and incompetence – called the *Aragalaya* – which led the previous president to flee the country, has since been squashed. Laws to stifle social media, muzzle speech and criminalise democratic protests arrive in the bullet train, while the laws needed to fix governance and the economy are on the slow train that is always breaking down.

As the core group of the local-GDA has observed: "by these failures, the Government has signaled that it will under-deliver or renege on anti-corruption commitments if there is space within the program to do so."

Solution: Governance-Linked Bond, how will it work?

The basic design of a Governance-Linked Bond is to have a coupon (interest rate) reduction, which is triggered when specific governance actions are achieved by a certain date. This structure makes the bond "index eligible" (an important feature for bond-holders), as opposed to the Value Recovery Instrument, which has also been mooted in current negotiations. The same structure was recently proposed by bond-holders in a GDP-Linked rather than a Governance-Linked Bond.

A good set of criteria for the Governance-Linked Bond will be that they (a) improve the probability of sustainable recovery, (b) are easily observable and verifiable, (c) have a high level of public support.

Unique Win-Win Feature of the Governance-Linked Bond

The proposed Governance-Linked Bond has the unique feature of being welfare-improving for the country and the creditors, in relation to the standard sovereign bonds and also standard Economic Social and Governance (ESG) bonds. When it incentivises the political leadership to deliver on governance improvements by offering a reduction in interest, it also reduces the risk for bondholders that the country's governance could deteriorate in the future – thereby improving the secondary market value of the bond, against the counterfactual of completing the debt restructure without such a governance-linked instrument. That is, when the country wins by improving governance and reducing its interest payments, those trading the bond can also win, by the reduced risk perception leading to a higher price on the bond.

Governance-Linked Bond can unclog the logjam of internal incentives.

The proposed Governance-Linked Bond for Sri Lanka can also align incentives in three important ways. **(1)** It incentivises the country to succeed on the trigger criteria by offering to lower interest cost, instead of increasing it, as in the GDP-linked proposal by bondholders **(2)** It aligns the interests of bondholders with Sri Lanka by tying the benefit to Sri Lanka to governance actions that would improve the secondary market price of the bonds. **(3)** It aligns democratic political incentives within Sri Lanka, as it fosters increased public interest and therefore, political competition and accountability for honouring the commitments. This can be particularly important as Sri Lanka will inevitably head into election season in the next two years.

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In short, Sri Lanka has a problem. It is underperforming on what it needs to do for economic recovery, and the reasons are internal and highly tied up with the lack of political will to improve governance. Internal democratic engagement on anti-corruption is being politically suppressed. This increases the risk for creditors and makes it even more difficult for Sri Lanka to achieve a sustainable restructuring of its debt. The proposed Governance Linked-Bond can help. It creates a win-win solution for the country and the creditors in the current negotiation, and it aligns political incentives beyond impending elections to sustain commitments to improving governance.

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