WHAT WELCOMED A BRAND NEW LEGAL FRAMEWORK FOR ACTIVE LIABILITY MANAGEMENT?

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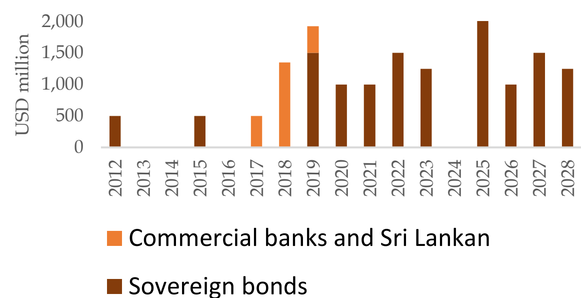
1. Introduction

Sri Lanka is faced with significantly large bullet repayments in International Sovereign bonds (ISBs), starting from 2019. Between 2019 to 2028, the country is expected to repay/refinance USD 12.15 billion in already issued ISBs, each worth above USD 500 million. Installment payments on project loans and recent term-financing facilities along with repayment of Sri Lanka Development Bonds are expected to elevate the debt service pressure in foreign currency. Outside the central government, maturing bonds of licensed commercial banks and Sri Lankan Airlines will also demand foreign exchange for repayment as depicted in Figure 1 below.

Figure 1: Sovereign liabilities in brief



Source: Central Bank of Sri Lanka, respective annual report of commercial banks and Sri Lankan Airlines

Large bullet repayments of over USD 500 million are new to Sri Lanka. In 2012 and 2015, the country repaid USD 500 million worth of ISBs from its reserves leading to a deterioration of reserve adequacy metrics on both occasions. Going forward, bullet

repayments falling due in almost every year could lead to significant strain on reserves and pressure on exchange rate. Such payments could expose the country to refinancing risk and the investors could become wary of the country's external liquidity leading to higher spreads. These factors could adversely influence macroeconomic stability.

In addition to refinancing of ISBs, there are other important risks of the debt portfolio, which need to be addressed. As a result of increasing income level, the concessional financing windows have been gradually drying up for Sri Lanka. The non-concessional and commercial component of the total external debt, which was negligible in early 2000's, rose to around 55 per centum by 2017, a transition expedited after the debut sovereign bond issuance in 2007. Along with this transition, the country experienced shortened maturities (Average Time to Maturity declined from 9.2 to 6.9 years between 2010 and 2016) and higher interest rates. A relatively high level of central government debt, large explicit contingent liabilities such as treasury guaranteed debt and implicit contingent liabilities in non-guaranteed State-Owned Enterprises (SOE) debt contribute to an adverse picture on the debt portfolio.

In response to these challenges, the authorities have initiated measures to improve the debt management function. Among them, the law passed to facilitate liability management activities is a key milestone, which is primarily aimed at managing the refinancing risk of ISBs while expecting improvements of domestic debt portfolio in the medium to long-term.

2. An overview of liability management

Liability Management or Active Liability Management (ALM) is the process of restructuring outstanding borrowing(s) in order to improve the composition of the public debt portfolio.

ALM encompasses could use various instruments with a view to improve the structure of the debt by adapting it to guidelines set by the Medium-Term Debt Strategy (MTDS). The instruments of ALM could entail, such as buying back old debt *(buy-backs)* or exchanging old debt against new debt *(switching)*; transforming fixed-rate coupons into floating-rate coupons or *vice versa (conversion)*; changing the currency denomination of old debt *(conversion)* or hedging the foreign exchange risk on external debt, *inter alia*. Whilst operation of these instruments could have varying characteristics and consequences, all ALM operations have one feature in common, i.e., *"they restructure an outstanding debt"*. Their objective is not to provide any additional funding, but to improve the composition of the outstanding debt.

Many countries use ALM either on a regular or occasional basis. An informal survey back in 2008 (Table 1) revealed that, almost all developed countries use some form of ALM regularly, while many developing countries use ALM either occasionally or on a regular basis.

Table 1: Manner ALM is practiced

	Country	Don't use	Occasional	Regular
Developed	US			X
	UK			X
	Germany			X
	France			X
	Italy			X
	Sweden			X
	Ireland			X
Developing	Brazil			X
	Mexico		X	
	Indonesia			X
	Turkey		X	
	Philippines		X	
	South Africa		X	
	Colombia		X	
	Thailand	X		

Source: Tenth Bond Market Forum of OECD/World Bank/IMF (2008) [1]

Literature suggest that, initially, ALM conceived primarily as a risk management tool. However, increasingly, ALM has been playing a broader role in the function of debt management. The objectives of modern ALM operations can encompass one or more of the following.

- Increase liquidity in government securities markets
- Decrease the cost of new funding
- Manage risks of the portfolio
- Correct or take advantage of market distortions
- Stabilize market during periods of stress

Whilst it can have far reaching consequences on the way both domestic and external debt is managed in Sri Lanka, more specifically, ALM could be used to deal with refinancing risks of ISBs, immediately. For example, the government could decide to buy-back one of the 2019 sovereign bonds (there are two bonds maturing in 2019: USD 500 and USD 1,000) now and issue a bond, maturing in 2024 – a year in which there is no sovereign bond maturing; or simply, build buffers now for redemption of those ISBs when they fall due. Whilst there are advantages and disadvantages of each approach taken for liability management, it is expected to help manage the refinancing risk as already highlighted by rating agencies, the IMF[2] and the World Bank[3].

The benefits of such ALM operations in Sri Lanka will be many. These include offering strong support to manage the refinancing risk; perhaps the most important risk in Sri Lanka in relation to debt management as it

[1] Tenth Bond Market Forum of OECD/World Bank/IMF (2008) <https://www.imf.org/external/np/seminars/eng/2008/bondmkt/pdf/makoff.pdf> accessed 30 September 2019

[2] International Monetary Fund, *Article IV Consultation and the Fourth Review Under the Extended Arrangement Under the Extended Fund Facility - Press Release, Staff Report and Statement by the Executive Director for Sri Lanka* (2018) < file:///C:/Users/Kishan/Downloads/cr18175.pdf> accessed 04 October 2019

[3] World Bank Group, *Sri Lanka Development Update* (2017) <https://www.openknowledge.worldbank.org/bitstream/handle/10986/28826/120728-REVISED-Sri-Lanka-Development-Update-November-2017-final-31102017.pdf?sequence=1&isAllowed=y> accessed 27 September 2019

stands; improving the maturity profile of the debt portfolio in line with the MTDS; and gradually lowering the cost of debt. Finally, successfully conducted ALM operations could contribute to help improve the country's sovereign credit rating in the medium-term.

However, it is noted that ALM could create some fiscal costs related to buy-backs and higher interest rates due to extension of maturities as also acknowledged by Templeman (2007), where;

> *"in addition to the burden of principal repayment that falls on future generations, there is an economic cost of borrowing. Just as a lender receives interest in return for postponing consumption from the present to the future, so a borrower must pay interest for the ability to increase consumption in the present without paying for it until sometime in the future"*[4].

3. Is not the existing legal framework sufficient?

The CBSL acts as the agent of the government in managing public debt in terms of the **Monetary Law Act, No. 58 of 1949**. Debt raising and management have been executed under the **Registered Stock and Securities Ordinance, No. 7 of 1937** and Local Treasury Bills Ordinance, No. 8 of 1923, domestically. Whilst the procedures for public debt issuance and management, appointment of primary dealers, regulatory supervision of primary dealers and the procedures for market operations are mainly specified in these laws, the ISBs and other foreign loans/foreign currency denominated loans are raised under the **Foreign Loans Act, No. 29 of 1957**. In addition, the payment and settlement for government securities is governed under the provisions of

[4] J H Tempelman, *The Independent Review* (Vol. XI, n. 3, Winter 2007) p. 438

the Monetary Law Act, **the Payment and Settlement Systems Act, No. 28 of 2005** and the System Rules (Version 2.1) issued thereunder. Apart from that, there are multiple legislations pertaining to matters relating to public debt including the **Tax Reserve Certificates Ordinance, No. 22 of 1957**, **Treasury Certificates of Deposit Act, No. 9 of 1989**, **Fiscal Management (Responsibility) Act, No. 3 of 2003** and the annual Appropriation Acts.

The main borrowing assignment to the government can be found in the annual Appropriation Act. The provisions of section 2 of an annual Appropriation Act states,

> *"the expenditure of the Government which is estimated … for the service of the period beginning from January 01, .. and ending on December 31, ..,… shall be met… from the proceeds of loans which are hereby authorized in terms of the relevant laws to be raised whether in or outside Sri Lanka, for and on behalf of the Government, so however that the balance outstanding of such borrowing at any given time during the financial year … or at the end of the financial year … shall not exceed rupees …".*

There is also a separate limit on outstanding Treasury bills given by the Parliament, and a separate limit for the guarantees as proportion of the Gross Domestic Product (GDP) under the Fiscal Management (Responsibility) Act.

Hence, the ceiling imposed in the annual Appropriation Act, i.e., the Gross Borrowing Limits (GBL) would curtail the ability of the government to borrow in the current financial year, to service debt liabilities which would arise in a financial year beyond the current financial year. By its very nature, an annual Appropriation Act only covers a period of 12 months and will not authorise the repayment of debts falling outside a financial year. This is why an Appropriation Act must be passed annually which will be

effective for the next financial year. The Appropriation Act, therefore, does not make provisions for early settlement of debt liabilities or for the building of cash reserves for the settlement of debts which would become payable on a date beyond the current financial year.

4. Active Liability Management Act, No. 8 of 2018 in brief

- Parliament by resolution is required to approve the limit to which moneys can be borrowed by the government for the purposes of pre-financing or refinancing public debt.
- Parliament can only approve as a loan in any particular financial year, a sum of money not exceeding ten per centum of the total outstanding debt of the preceding financial year.
- All moneys raised, whether in or outside Sri Lanka should be obtained in accordance with the provisions of currently applicable laws and procedures.
- The Minister of Finance is required to decide on matters pertaining to the refinancing or pre-financing of public debt such as the sum of money to be raised by a loan, the mode of raising such loan and the manner in which the debt shall be settled, on the advice of the Monetary Board and with the approval of the Cabinet of Ministers.
- The Minister is required to communicate his decision in writing to the Registrar (the Superintendent of Public Debt), who in turn is required to make all such arrangements to give effect to such decision and settle obligations of the government on the most favourable terms that may be obtained in the interest of the government.
- Loans obtained under this Act are to be maintained in

designated bank accounts and all moneys including interest lying in such bank accounts are to be treated as part of the Consolidated Fund but are to be maintained as ring- fenced accounts.

- Details of all loans obtained and money retained in the accounts are to be tabled in Parliament under the Fiscal Management (Responsibility) Act, No. 03 of 2003.
- The Minister is authorised to make regulations on the advice of the Monetary Board. However, the said regulations must be placed for approval before Parliament within 3 months of the date of the *Gazette*.

5. The role of Active Liability Management Act in facilitating ALM

4.1 Departure from GBL

For liability management purposes, it is imperative that there is authority for the debt manger to raise cash in addition the gross financing requirement determined by the government budgetary operations. In the context, the present GBL of the annual Appropriation Act, which is one of the most important legal provisions aimed at maintaining fiscal discipline, acts as a constraint to the flexibility needed for ALM operations. Due to its reliance on *'gross flows'*, it restricts the ability of the government to borrow in gross terms over and above the annual borrowing limit. As such, new borrowings carried out for ALM purposes with the intention of pre-financing or refinancing of debt will likely to breach the GBL or affect the space available for financing the budget deficit. For example, if the government raises USD 2 billion for buying-back a Eurobond as part of an ALM operation, it will not be used for deficit financing. However, it will consume close to LKR 360 billion of the annual GBL (assuming an exchange rate of 1 USD = LKR 160)

or contribute to breaching the GBL if the annual borrowings have been already close to the GBL. Supposing this money is used to buy-back an existing ISB, the stock of ISBs outstanding will come down when the net effect is considered.

It was, therefore, necessitated for Parliament to provide for a special law to authorise a separate borrowing limit to carry out ALM and also to provide for the manner and mode in which such ALM should be carried out to meet the objectives of reducing public debt at the lowest possible cost with a prudent degree of risk.

4.2 Parliament's prerogative over public finance

Article 148 of the Constitution specifies that Parliament has the *"full control"* over public financing including debt.

The provisions of section 3 of ALM Act provide for Parliament, by resolution, to authorise the government to raise a sum of money as a loan, during a particular financial year, whether in or outsider Sri Lanka, for the purposes of refinancing and pre-financing public debt of the government. However, the maximum sum of money that Parliament can approve as a loan in a particular financial year shall not exceed ten per centum of the total outstanding debt at the end of the preceding financial year. These debts should be raised in accordance with applicable laws including the Monetary Law Act, the Local Treasury Bills Ordinance, the Registered Stocks and Securities Ordinance and the Foreign Loans Act through which Parliament has already laid down the principles, procedures and controls.

The Supreme Court in Case No. *SC SD 19/2013*, which challenged the constitutionality of the Appropriation Bill for 2014, having considered the provisions of all relevant laws relating to public finance including the Monetary Law Act determined that:

"Thus, one would find that the legislature has enacted several means and agencies to perform the task of monitoring the raising of loans and this only goes to prove that the Appropriation Act is not the only means to control public finance and the pervasive provisions that have been recited above demonstrate the zealous concern that the legislature has displayed towards giving true meaning to the constitutional imperative stipulated in Article 148 of the Constitution that Parliament shall have full control over public finance.

Parliament exercises this control through several of its agencies because it cannot engage in the continuous micro management of public finance. If the whole members of Parliament were to gather every time a loan is about to be raised simply for the purpose of approving the terms and conditions of a particular loan, it would frustrate the democratic governance of the country for which principal task the people of the nation bestowed them with all the important palladium of legislative power, privileges and immunities."

(emphasis added)

Considering the above, the Supreme Court went on to determine that the ALM Bill, in fact would further strengthen Parliament's *"full control"* over public finance when the constitutionality of ALM Bill was challenged in the Supreme Court Case Nos. *SC SD 01/2018 to SC SD 06/2018*.

6. Conclusion

Sri Lanka is faced with significantly large bullet repayments in ISBs leading to significant impact on macroeconomic stability. However, the present legal framework on budgetary operations, i.e., the annual Appropriation Act only gives the space to service the debt maturing in the budget, and does not allow explicitly for the building up of cash buffers and early retirement of

debt maturing beyond the budget year. This welcomed a brand new legal framework broadly setting out the procedure in raising debt for the purposes of ALM, without being curtailed from budgetary ceilings but helping fiscal consolidation. However, in carrying out ALM activities, it is noteworthy to consider not to shut into Buchanan's (1958) connotation that:

> *"by financing current public outlay by debt, we are, in effect, chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever"*[5].

[5] J M Buchanan, (1958). "Public Principles of Public Debt: A Defense and Restatement", *The Collected Works of James M. Buchanan,* (Vol. 2. Indianapolis, Ind.: Liberty Fund 1958).