



DOMESTIC DEBT OPTIMIZATION (DDO) – AN OVERVIEW

Capital TRUST

Capital TRUST Research (Pvt) Ltd.
— A Capital TRUST Group Company —

PROPOSED INDICATIVE TERMS OF THE DDO

1. Superannuation funds' (EPF/ ETC etc) T-bonds proposed to be swapped for longer term maturity T-bonds

- No Principal Haircut.
- 12 instruments of equal amount maturing from 2027 to 2038 for a total equivalent to the nominal value of instruments.
- Step-down Coupon structure of 12% (till 2025) and 9% till Maturity.
- In order to encourage Superannuation funds to participate in the DDO non-participating funds will be subject to Income Tax Rate of 30% compared to the current Rate of 14%. Non participation will result in an Average Return of 7.7% compared to 9.1%.

2. CBSL's T-bills only and Provisional Advances to the Government to be converted to T-bonds

- No Principal Haircut.
- 10 instruments maturing from 2029 – 2038 for a total equivalent to the nominal value of instruments.
- Bullet repayment.
- Step-down Coupon structure of 12.4% (until 2024), 7.5% (until 2026) and 5% until maturity.
- To be implemented in Phase 2.

IMPACT ON BANKING SECTOR

- Banking sector has faced significant stress with the economic crisis as reflected in the **increase in Non Performing Loan Ratio from 7.6% in 2021 to 13.3% in May 2023.**
- Further, Impairments made for Loans and other losses also increased over 2021 and 2022, with **Total Impairment on existing Loan portfolio recorded at LKR 916Bn.**
- Profitability has also been impacted with the **increase in Taxation from 39% to 48%.**
- Approximately 17% of Government Securities holdings of the Banking Sector consists of ISBs and SLDB. As such, the **restructuring of the Foreign Currency Debt will have a significant impact to the Banking Sector.**
- Considering the above and in order to **ensure Financial System stability**, the Banking Sector is minimally impacted by DDO.
- The **T-bills and T-bonds held by the Banking Sector will not be impacted by the DDO.**
- **However, some of the Domestic Banks are expected to contribute to Debt Restructuring through the ad hoc Bondholder Committee comparable with the ISB holders.**

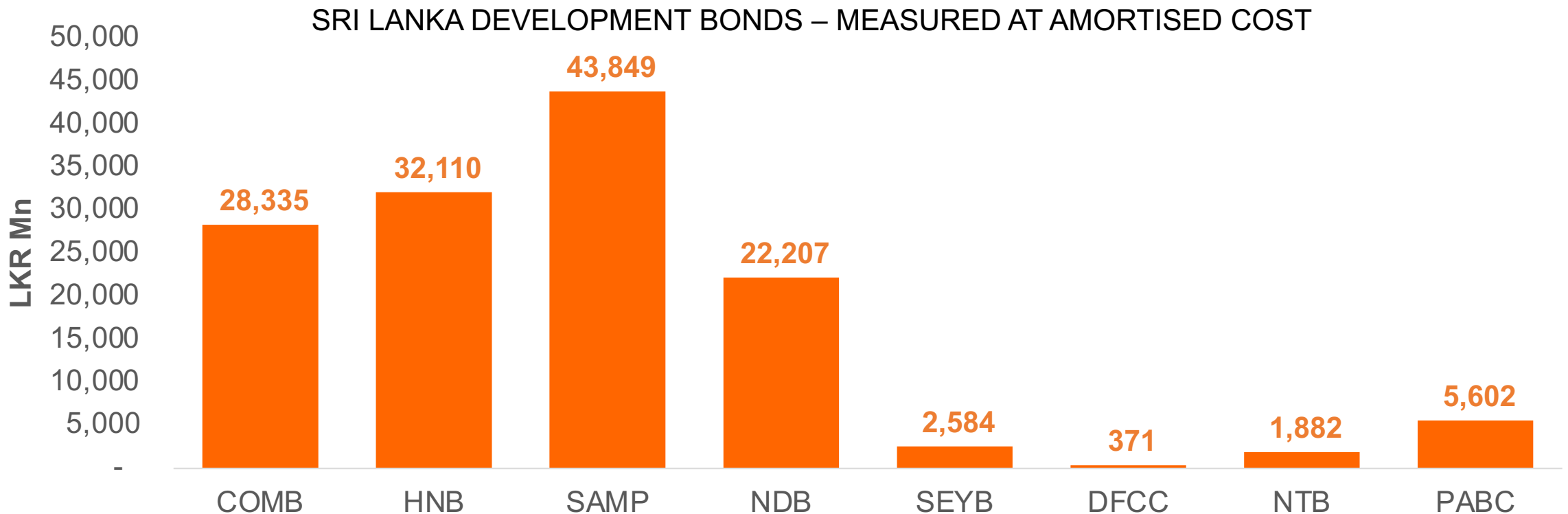
BANKS TO BE IMPACTED POSTIVELY IF OPTED FOR SLDB SETTLEMENT IN LKR

CBSL has proposed 3 Options for the settlement of SLDBs as highlighted below:

SLDBs and FCBU	USD Option 1 <i>("ISBs-like")</i>	<ul style="list-style-type: none"> Exchange of outstanding SLDBs/FCBUs against new USD-instruments 	<ul style="list-style-type: none"> Nominal haircut: 30% 6-year final maturity (2029), no grace-period (first 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)
	USD Option 2 <i>("Official creditors-like")</i>		<ul style="list-style-type: none"> No nominal haircut 15-year final maturity (2038), 9-yr grace-period (first 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)
	LKR Option	<ul style="list-style-type: none"> Exchange of outstanding SLDBs/FCBUs against new LKR-instruments 	<ul style="list-style-type: none"> No nominal haircut 10-year final maturity (2033), no grace period (first amortization: 2024) Amortization profile: linear 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)

BANKS TO BE IMPACTED POSITIVELY IF IT OPTS FOR SLDB SETTLEMENT IN LKR (CONT)

- During 2022 and early part of 2023, SLDB holders such as Banks opted to get payment via LKR denominated Bonds as settlement for SLDBs. Therefore, it is reasonable to assume that most Listed Commercial Banks may opt for the LKR Settlement Option.
- Some Banks such as SAMP, COMB, HNB and PABC have made Provisions up to 10% of its SLDB holdings. If these Banks opt for the LKR payment option we expect these Banks to make significant Write-Backs to its P&L in 2023 resulting in a **POSITIVE** Impact to the P&L.



INDICATIVE TERMS OF SRI LANKA'S FOREIGN DEBT RESTRUCTURE

International Sovereign Bonds

- Exchange of outstanding ISBs against new USD instruments

- Nominal Haircut 30%
- 6 year final maturity (2029), no grace period (first 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)

Official Creditors

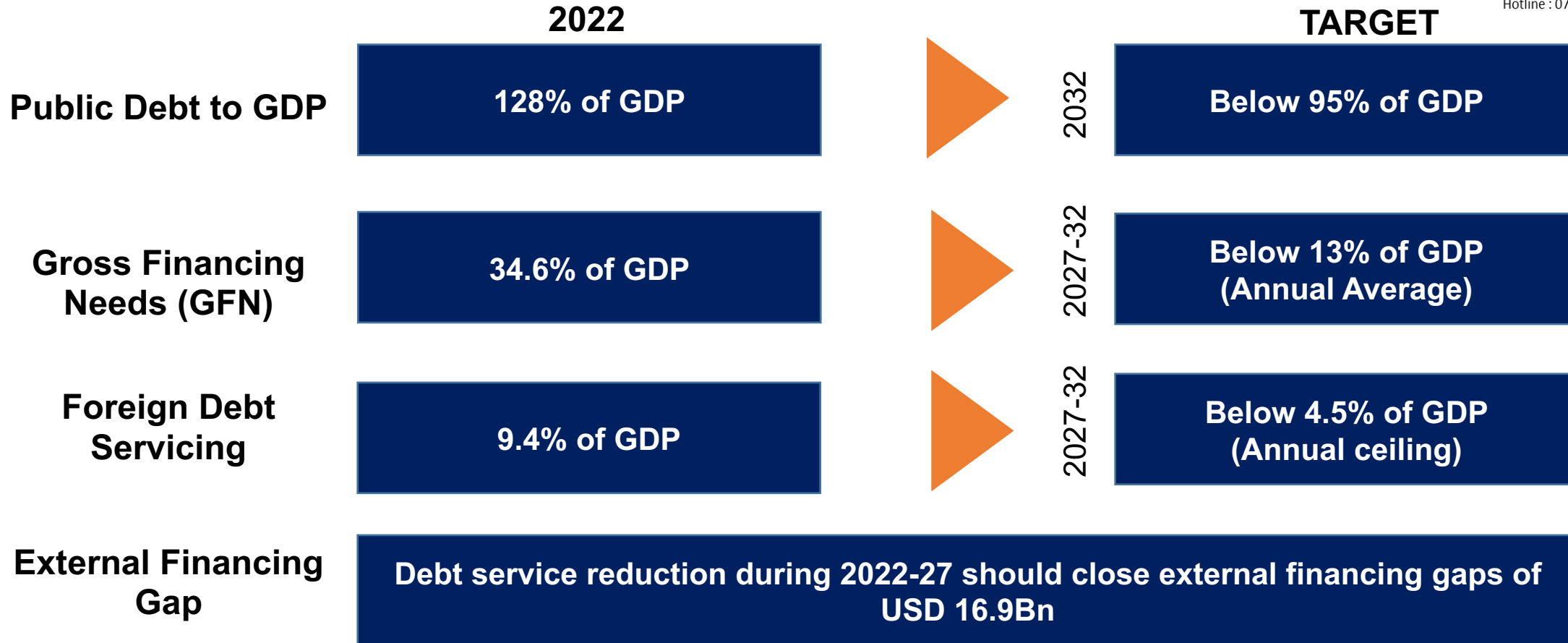
- Exchange of outstanding debt against new USD instruments

- No nominal haircut
- 15 year final maturity (2038), 9 year grace period (first 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)


TIMELINE ASSOCIATED WITH OBTAINING APPROVAL FOR THE DDO



DEBT SUSTAINABILITY TARGETS



SUCCESSFUL IMPLEMENTATION OF DDO TREATMENT WILL ENABLE SRI LANKA TO MEET IMF GFN TARGET

	GFNs (avg. between 2027-2032)	Is GFN target met? (avg. 13% between 2027-2032)
Absence of Debt Treatment	16.8%	x
External Debt Restructuring ¹ (No DDO)	14.2%	x
External debt restructuring and domestic debt optimisation	12.7%	
DDO impact on GFN	1.5 percentage points	n.a

Note.1. as per the illustrative debt scenario shared with Sri Lanka's external creditors

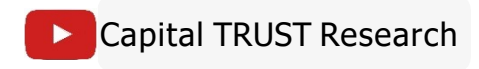
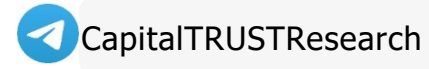
1-YR T-BILL RATES AND AWPR FORECASTED TO DECLINE TO 13% AND BELOW 15.00% RESPECTIVELY

- Inflation is expected to decline to **single digit by end July 2023** as mentioned by the Governor. Therefore, we forecast **Policy Rates to decline a further 250 bps** with the SDFR and the SLFR to decline to 11.5% and 12.5% **by end of September 2023**
- With the expected decline in Policy Rates and normalisation of Risk Premiums upon obtaining approval for the DDO, **we forecast 1-Yr T-Bills to decrease to c. 13.00% by end of September 2023.**
- We expect a T-Bonds to follow a similar trend with **decline in Yields across longer term maturities.**
- With the expected decline in 1-Yr T-Bill Rates to c.13.00%, we forecast Average Weighted Prime Lending Rates (**AWPR**) **to decrease below 15.00%** by End of September 2023.
- With the expected decline in AWPR below 15.00%, we can expect **GDP growth of 5% in 4Q2023** and **result in a pick up in Corporate Earnings.**
- Against this backdrop, **Equities are expected to perform** due to lower Interest Rates on Margin Facilities, movement of funds from Fixed Income to Equities, Expectations of Earnings Growth due to a pick up in Economic Activity and the Rerating of Market Multiples.

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