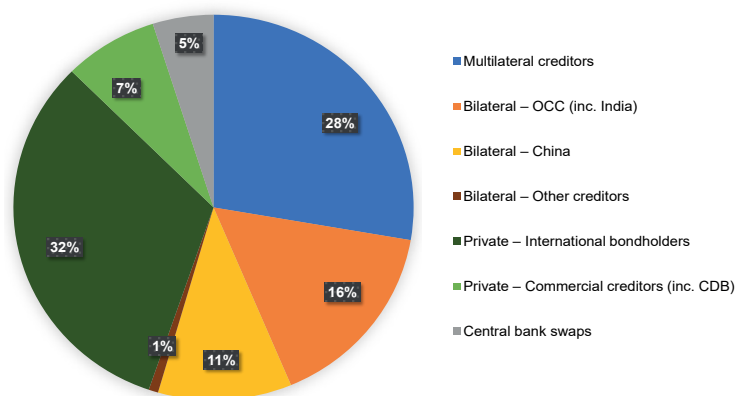


Coordinating Fragmented Creditors to Restructure Sovereign Debt: the Case of Sri Lanka

Agathe Madeline and Caroline Miller

- On 12 April 2022, with an already precarious debt situation exacerbated by the COVID-19 pandemic, Sri Lanka announced that it was defaulting on its external debt. The deterioration in the country's economic situation led Sri Lanka to negotiate an agreement with the IMF for a \$2.9-billion Extended Fund Facility for the 2023-2027 period to support a reform programme.
- In the wake of the COVID-19 pandemic, the G20 and the Paris Club adopted a Common Framework to coordinate debt restructuring for low-income countries, but Sri Lanka – a middle-income country when it defaulted – did not qualify. Nevertheless, the Common Framework's coordination channels served to set up an ad-hoc Official Creditor Committee (OCC) co-chaired by France, India and Japan and including Paris Club creditors, India and Hungary, which accounted for 16% of the external debt stock. At the same time, a “flexible” coordination arrangement was put in place with China, which held 11% of Sri Lanka's external debt stock.
- The bondholders, accounting for 32% of the foreign creditors, restructured their securities by introducing an innovative financial instrument indexed to Sri Lanka's GDP growth called macro-linked bonds. This contingent debt treatment complicated the official creditors' assessment of effective terms of treatment from the private creditors at least equal to those of the official creditors (“comparability of treatment”).
- Sri Lanka's experience demonstrates the possibility of coordination with China outside of the Common Framework in order to proceed in parallel with debt treatment and prevent delays with the IMF-supported programme. Timely and regular discussions with bondholders also served to rapidly reach an agreement on debt treatments compliant with both IMF programme targets and the principle of comparability of treatment.

Sri Lanka's external public debt stock as of end-2022



Source: DG Trésor, IMF data (March 2023).

1. In April 2022, Sri Lanka announced a default on its external debt payments

1.1 Sri Lanka's economic and fiscal situation deteriorated sharply in 2020 due to the COVID-19 pandemic, exacerbating vulnerabilities that had been building up since 2010

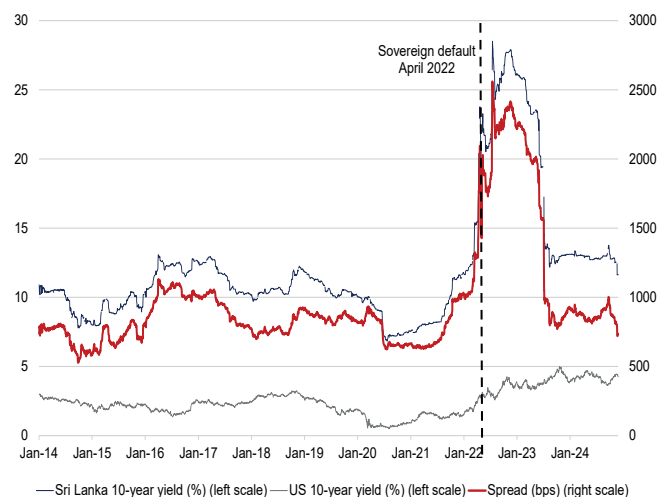
Sri Lanka had long suffered from fragile macroeconomic fundamentals due to structural twin deficits. Firstly, its chronic fiscal deficit had been worsening since 2010 due to poor public finance management, fuelling high public debt with massive foreign borrowing from bilateral creditors and financial markets alongside international syndicated loans at high interest rates. Secondly, the current account was in structural deficit due to Sri Lanka's low level of exports, reflecting an economy with little diversification concentrated in textiles, agriculture and tea.

The economic and fiscal situation deteriorated sharply as of 2019: external shocks (drought in 2017 and COVID-19 pandemic in 2020) were compounded by destabilising domestic factors (political crisis in 2018 and terrorist attacks in 2019). The situation was also exacerbated by substantial cuts in high-yield taxes (VAT and income tax) in late 2019, when tax revenues represented just 12.6% of GDP in 2019, making for revenue losses estimated by the IMF at over 2% of GDP.¹

Debt service doubled from 2018 to 2019, with the Sri Lankan government posting one of the highest interest bills in the world at 6.5% of GDP in 2019, absorbing nearly half of government revenues.² The 2020 COVID-19 pandemic shock sent tourism and remittances – the two main sources of foreign exchange inflows – plummeting by 86% and 18% respectively in 2021 from their pre-pandemic levels. The shock played a role in Sri Lanka's loss of access to international capital markets with a 30% haircut on bonds already in circulation.

Sri Lanka delayed making the necessary adjustments to roll back its debt overhang. It continued to draw on its reserves – depleted from \$7.6 billion at end-2019 to \$3.1 billion at end-2021 – in order to honour its maturity obligations and it also monetised its fiscal deficit. This made the debt trajectory increasingly unsustainable as it deepened from 76% of GDP in 2015 to 87% in 2019 and then 147% in 2022. Unable to meet their payment obligations, the Sri Lankan authorities officially announced a default on their external debt in April 2022.

Chart 1: Yield spread for bonds issued by Sri Lanka versus US Treasury bonds



Source: DG Trésor, Bloomberg data.

1.2 Sri Lanka borrowed from an array of external and domestic creditors

The general trend in low- and middle-income countries over the last two decades has been to increase the level of Chinese and private non-concessional finance.³ Sri Lanka is no exception as shown by its massive use of this borrowing method starting in 2010, with the share of non-concessional debt rising from 15% of the country's public debt in 2008 to 55%

(1) Note also a ban on chemical fertilisers, which triggered a drop in agricultural output and food shortages, and the setting of an artificially high exchange rate.

(2) The increase in debt servicing costs was due mainly to growth in the external debt associated with an increase in interest rates and the containment of inflation since 2009, which drove an upturn in real interest rates on domestic debt ("Article IV Consultation", IMF, March 2022).

(3) The share of private donors grew from 29% to 43% from 2009 to 2014. Chinese sovereign finance rose from \$3.6 billion per year in 2000 to a peak of \$77 billion per year in 2017. Source: Malik et al. (2021), « [Banking on the Belt and Road: Insights from a new global dataset of 13,427 Chinese development projects](#) », AIDDATA, A Research Lab at *William & Mary*.

in 2022. China's investments in Sri Lanka tie in with a regional development strategy under the Belt and Road Initiative. Mahinda Rajapaksa's government (2005- 2014) used these Chinese investments to support the country's attractiveness strategy focusing on public infrastructures designed to attract foreign investment.

At the same time, Sri Lanka, like many other countries, stepped up the domestic financing of its debt.⁴ When international finance dried up in 2020, Sri Lanka turned to the domestic markets to raise more expensive debt even though the financial sector was highly exposed to sovereign risk (40% of total banking assets in 2021). Domestic debt thereby came to account for 50% of total public debt by the end of 2022.

Sri Lanka's debt at the time of the default was therefore highly diversified in terms of foreign exchange, legal

status (local or foreign law) and debtholders (local banks, international markets and sovereign lenders). The country's bilateral public debt (28% of the external debt at end-2022) was held by both Paris Club creditors⁵ (12%), with Japan as the majority creditor, and non-Paris Club creditors including China via China Eximbank (11%) and India (4%). Other official bilateral creditors (Hungary, Iran, Kuwait, Pakistan and Saudi Arabia) had also granted smaller sums of loans to the country. Sri Lanka's debt to multilateral creditors represented 28% of its external debt.⁶ Among the private creditors, the majority group comprised international sovereign bondholders (32% of the external debt at end-2022) followed by the hybrid-status China Development Bank (CDB) with 7%.⁷ Sri Lankan banks holding bonds issued in dollars compounded this complex landscape.

Box 1: Restructuring Sri Lanka's domestic debt

Following a risk-cost-benefit analysis with the assistance of the IMF, Sri Lanka decided to restructure its domestic debt to help restore public debt sustainability.

It is not always necessary to restructure domestic debt at the same time as external debt. This is a political decision for the sovereign country to make, because it concerns debt issued under local law. Domestic restructuring may prove necessary to reduce gross financing needs and restore debt sustainability, as with Sri Lanka, but it also has the potential to trigger a negative feedback loop between sovereign and bank risks. It can be counterproductive for the macroeconomic situation by impacting on local financial institutions (banks and pension funds), reducing their capacity to finance the local economy and depressing growth. The increased financing difficulties caused by local debt restructuring, where the restructuring cost is borne by savers, can raise its political cost. Ultimately, domestic debt restructuring is a political decision to share losses among the country's agents (savers, depositors, commercial banks and taxpayers), which is by nature different to external debt restructuring where the cost is borne by non-residents.

Sri Lanka's domestic debt restructuring from July to September 2023 helped meet the IMF-defined debt sustainability targets by reducing the government's gross financing needs by 1.6 percentage points of GDP per year on average from 2027 to 2032. The restructuring included Treasury bills and advances granted to the government and held by the central bank, Treasury bonds held by the pension funds, and Sri Lanka Development Bonds and other foreign currency loans granted to the government and held by the banks. The impact on the pension funds prompted an outcry from the opposition.

(4) The IMF estimates that the share of domestic debt has risen from 31% to 49% of total public debt for low-income countries over the last two decades (IMF, *Macroeconomic Development and Prospects for Low-Income Countries – 2024*).

(5) The [Paris Club](#) is a group of official sovereign creditors formed to find solutions to debtor countries' difficulties.

(6) Mainly the Asian Development Bank, the World Bank and the IMF. The Paris Club accords these lenders preferred creditor status as they intervene at highly concessional rates (weighing little on debt service) or by means of grants, including during difficult periods for the country.

(7) As part policy bank, the hybrid CDB can grant finance at the request of the Chinese authorities.

2. The committee of official bilateral creditors put in place flexible coordination with China to facilitate Sri Lanka's debt restructuring

2.1 Sri Lanka's main bilateral creditors, with the exception of China, formed an original committee under the umbrella of the Paris Club

IMF Executive Board approval for an IMF programme for any country with unsustainable debt is conditional on a commitment from the bilateral creditors to grant a debt treatment consistent with the IMF programme targets, i.e. capable, alongside the efforts expected from the other creditors, of restoring medium-term debt sustainability. This is called the financing assurances procedure,⁸ which led to the approval of a four-year \$2.9-billion IMF programme for Sri Lanka in March 2023.

The method of coordination is set out for low-income countries eligible for the Common Framework⁹ adopted by the G20 with the support of the Paris Club: Paris Club bilateral creditors and non-Paris Club G20 bilateral creditors (primarily China, India, Saudi Arabia and Türkiye) form a committee to provide requesting countries with debt treatment in a coordinated manner in keeping with the IMF programme parameters.

Sri Lanka did not qualify for the Common Framework when it defaulted, given that it was a middle-income country. The Paris Club therefore proposed an original form of coordination. India is not a member of the Paris Club but, on the strength of the coordination experience gained from Chad and Zambia's debt treatments, it accepted a proposal to form a committee of creditors co-chaired by France (Chair of the Paris Club), Japan

and India. These three creditors represented the highest level of exposure to Sri Lanka alongside China. China opted out of joining the committee, as it did not wish to extend the Common Framework's coverage beyond low-income countries. The committee granted a debt stock treatment,¹⁰ consisting of rescheduling all payments with a maturity extension and a grace period¹¹ as well as a reduced interest rate. The creditors therefore registered a loss in net present value terms, but not in face value.

2.2 The Official Creditor Committee for Sri Lanka coordinated its work with China Eximbank and oversaw comparability of treatment by non-OCC official creditors

"Flexible" coordination was proposed to China in order to encourage lender coordination. This was facilitated by the working relationship built between the Paris Club and China under the Common Framework. The committee invited China to attend its meetings as an observer and shared its analyses and proposed debt treatment in a move to expedite an agreement between the two parties. These discussions helped conclude two separate agreements with very similar financial terms: one between China and Sri Lanka, and the other between the Official Creditor Committee and Sri Lanka, both signed on the sidelines of the Paris Forum on 26 June 2024.

This flexible coordination arrangement was specific to China Eximbank, a Chinese official loan institution, since Chinese lending entities categorised as

(8) Creditor countries that do not make such a commitment are generally in the minority or have to consent to the debtor country remaining in arrears to the creditor country in keeping with the IMF's Lending into Official Arrears Policy, see *Guidance note on the financing assurances and sovereign arrears policies and the Fund's role in debt restructuring*, IMF, Nov. 2024.

(9) The Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative (DSSI), known as the Common Framework, is a unique mechanism designed to provide low-income countries with coordinated debt treatments involving a broad array of creditors. Created in 2020 under Saudi Arabia's Presidency of the G20 and approved by the Paris Club, the framework's purpose is to provide debt treatments to countries eligible for the DSSI put in place during the COVID-19 pandemic.

(10) Unlike flow treatments, which close a financing gap identified by IMF programmes, stock treatments apply not only to the payments due over a given period of time, but to the entire stock of debt.

(11) Freeing up fiscal space over the coming years to finance the IMF programme.

private lenders each negotiate their treatment terms separately. Hence, China Development Bank subsequently negotiated a debt treatment with Sri Lanka independently of coordination with the OCC and China Eximbank. The Official Creditor Committee oversaw compliance with the principle of comparability of treatment by China Development Bank, as with all the other external creditors.¹²

Lastly, no particular coordination arrangement was set up with the other minority bilateral creditors (Iran, Kuwait, Pakistan and Saudi Arabia). These countries are negotiating treatment with Sri Lanka in a side arrangement, which needs to be at least as favourable to Sri Lanka as the effort made by the OCC.

3. The introduction of new financial instruments by private creditors complicated coordination with the official creditors

3.1 The Official Creditor Committee held regular discussions with bondholders

The traditional practice of debtor country negotiations with external creditors is to first seek an agreement with official creditors, thereby clearing the way for an array of possible terms that private creditors will subsequently have to provide to meet the debt targets defined by the IMF programme. Private creditors can intervene first, but at the risk of having to make a greater effort should the treatment granted by the sovereign creditors ultimately be more favourable to the debtor country.

By setting minimum standards for agreements with other external creditors, the principle of comparability of treatment enables the Official Creditor Committee to move forward first, reflecting its particular status under IMF policies: the IMF asks the OCC for financing assurances and regular progress, whereas proceeding with negotiations in good faith is sufficient for the other creditors. This mitigates the risk of moral hazard by reducing the incentive for each group of creditors to wait for other creditors to alone bear the

cost of the debtor country's debt restructuring. The comparability requirement also helps the debtor country in its negotiations with its other creditors by setting an expected benchmark of effort for them. Lastly, this principle plays a key role in improving the debtor country's financial situation by ensuring that all debt treatments taken together make for a sustainable level of debt in compliance with the IMF programme parameters.

More recently, debtor negotiations with official creditors and bondholders have tended to be conducted in parallel, calling for restricted negotiations and information sharing to ensure compliance with the comparability of treatment.¹³ Such was the case with Sri Lanka where regular discussions were held between the representatives of the bondholders' committee and the OCC. These discussions enabled the bondholders to propose an innovative financial instrument compatible with the comparability of treatment as assessed by the Official Creditor Committee (see below).

(12) Comparability of treatment is a fundamental principle underlying Paris Club debt treatment. According to this principle, a debtor country that signs an agreement with Paris Club creditors should obtain from its other official bilateral or private creditors terms of treatment at least as favourable as those granted by the Paris Club.

(13) See above. The three criteria for comparability of treatment detailed on the [Paris Club](#) site are: (i) nominal debt service effort over the programme period, (ii) effort in terms of duration, and (iii) effort in terms of net present value.

Box 2: One private creditor’s holdout against debt restructuring threatened the coordination process

It is vital to have a maximum number of bondholders on board to restore the debtor country’s debt sustainability. Nevertheless, some recalcitrant bondholders^a use litigation to demand non-discounted repayments that not only can the country no longer make, but that would juniorise the debt held by its other creditors. These holdout bondholders use clauses in the contracts between debtor countries and their creditors, often under the law of New York State or UK law.

During the negotiations over Sri Lanka’s external debt, Hamilton Reserve Bank (HRB) was the only bondholder to take legal action against the Sri Lankan authorities for the repayment of \$250 million in principal in sovereign bonds in default since 2022. Contractual provisions protecting the debtor country, known as collective action clauses (CACs), have been in widespread use for a decade to contain this kind of situation. However, they do not yet cover all securities issued by Sri Lanka, enabling HRB to bring its suit.^b

A New York district court ruling in favour of HRB on the grounds of breach of contract could have compromised negotiations with the other bondholders and thrown the entire debt treatment process off balance. To prevent this from happening, several members of the Official Creditor Committee for Sri Lanka, members of the Paris Club, decided at the initiative of France and the United Kingdom to support via an *amicus curiae* the Sri Lankan authorities’ motion for a stay of proceedings and its extensions in July 2023, February 2024 and August 2024 respectively. At the same time, all the bondholders other than HRB stood by the steering committee they had joined and concluded an agreement with Sri Lanka in October 2024.

At this point, these actions by the official creditors and bondholders have therefore cut off the one uncooperative creditor, for which a judgment from the New York court is still pending.

- a. The most well-known case was Argentina’s holdout creditors known as “vulture funds”, see Cailloux G. (2014), “Argentina, the vultures and the debt”, *Trésor-Éco*, No. 136.
- b. These clauses are contractual provisions in the legal documentation of bonds that allow a qualified majority of bondholders to modify the bond’s terms, including its face value, interest rate or repayment schedule. In other words, a majority can impose a restructuring deal on other bondholders even if they do not consent to it. In theory, however, a holdout could be exempt from the change if it held a sufficient blocking minority.

3.2 The bondholders restructured the debt using an innovative financial instrument called macro-linked bonds (MLB)

Macro-linked bonds are a form of contingent debt instrument, which had already been used in a number of restructuring cases to facilitate negotiations between creditors and the debtor. This instrument is appropriate when the debtor country’s repayment capacities could evolve considerably in the future (such as in the case of Zambia, close to the threshold between low and medium debt-carrying capacity, as defined by the IMF) or when an external element identifiable upstream could substantially change growth prospects (such as in the case of Suriname where there was uncertainty at the time of restructuring as to whether the decision would be made to exploit the country’s energy resources with their significant implications for public revenues). In the case of Zambia (2023) and Suriname (2023), the two creditor groups (bondholders and official creditors) chose to introduce a contingent variable, since the factor of uncertainty was undisputed and well identified.

These instruments increase debt service in the event of an improvement in the debtor country’s economic situation. Consequently, they can facilitate negotiations with bondholders who are more optimistic than the IMF as to the debtor country’s future prospects. Such was the case with Sri Lanka: the MLB proposed by the bondholders was based on different macroeconomic projections to the IMF. The official creditors, however, chose to retain a “classic” treatment in the absence of any objective external factor justifying a more complex treatment.

The innovative feature of the MLBs proposed in the case of Sri Lanka’s restructuring is their “symmetry”, since they also protect the debtor country in the event of lower GDP growth than IMF projections, by automatically reducing Sri Lanka’s future repayments to its creditors. The MLBs allow for the coupon and amortisation schedule to be adjusted upwards or downwards in 2028 (the end of the IMF programme) depending on average nominal GDP growth over the 2025-2027 period and cumulative real GDP growth over the 2024-2027 period (see Table 1). The instrument’s symmetry was necessary to ensure comparability of treatment, since the official creditors had negotiated a simple treatment based on the IMF’s baseline scenario.

Table 1: Macro-linked bond debt service adjustment trigger thresholds

MLB Scenario	Average nominal GDP, 2025-2027		Cumulative real GDP, 2025-2027	
	Nominal GDP (average 2025-2027, \$bn)	Nominal GDP in % versus IMF baseline	Cumulative growth greater than 11.5%	Cumulative growth lower than 11.5%
Upside threshold 1	107	+21%	Activated	Not activated
Upside threshold 2	99.0	+12%	Activated	Not activated
Upside threshold 3	94.0	+6%	Activated	Not activated
IMF baseline	88.6	–	–	–
Downside threshold 1	86.7	-2.0%	Not activated	Activated
Downside threshold 2	84.7	-4.0%	Not activated	Activated

Source: Announcement of an agreement in principle between Sri Lanka and bondholders, September 2024, London Stock Exchange.

3.3 These instruments complicated the assessment of compatibility of the bondholders' effort with IMF parameters and the principle of comparability of treatment

Comparability of treatment is easy to assess when bondholders and official creditors negotiate the same type of contingent treatment with the debtor country: the bondholders' effort must be at least as favourable to the debtor country for each of the contingent scenarios.

In the case of Sri Lanka, the introduction of MLBs complicated this assessment, since the Official Creditor Committee had not negotiated a contingent instrument. The IMF developed a methodology to ensure debt treatment compliance with debt sustainability thresholds, whereby it defined probabilities for the eventuality of the different scenarios included in the bondholders' contingent instrument. For its part, the Official Creditor Committee also adjusted how it assessed comparability of treatment, accepting that the bondholders reduce their effort in the event of an upside situation provided that they also covered the risk in the event of a downside macroeconomic situation.

The comparability of treatment analysis defined the following principles: (i) advance knowledge of all bondholder contingent treatment scenarios (ceiling and floor on future debt service) in order to reduce uncertainty for stakeholders; and (ii) compliance with the principle of comparability of treatment in the IMF's baseline scenario, which is the benchmark scenario for the Executive Board's vote on the programme, and also in "weighted average" terms (i.e. on the basis of future average flows for all future scenarios weighted by the probability of the eventuality of each scenario calculated by the IMF – in this, the IMF also demonstrated agility in adapting its methodology).

With these principles in place, the MLB has to present a reasonable symmetry of effort between the upside scenario and the downside scenario to ensure that risk coverage is not unfavourable to the debtor country.

Added to this is a political acceptability criterion: the bondholders' effort in the upside scenario must be reasonable compared with their effort in the baseline scenario. If the most optimistic scenario were to materialise in the coming years, the official creditors – including France – would encounter political difficulties when trying to justify the private sector's meagre effort compared with the official creditors, i.e. the taxpayers.

This methodology used in the case of Sri Lanka will be a useful benchmark for other similar cases, and one that could evolve on a case-by-case basis adopted by consensus within the Paris Club and creditor committees.

The first agreement in principle between bondholders and Sri Lankan authorities (Joint Working Framework) obtained in July 2024 respected neither the Official Creditor Committee's comparability of treatment assessment nor compatibility with the IMF's debt sustainability analysis, delaying a final agreement for the bondholders' debt restructuring. Close cooperation by Sri Lankan authorities and bondholders with the Official Creditor Committee and the IMF over the summer of 2024 paved the way for a new agreement compatible with the comparability of treatment and the IMF's debt sustainability analysis.

Sri Lanka's experience shows the importance of holding timely and regular discussions between the OCC and bondholders and other external creditors in coordination with the debtor country. The OCC needs, in particular, to be transparent in terms of how it will assess comparability of treatment.

4. Conclusion

The case of Sri Lanka illustrates the benefits of extending Common Framework coordination beyond low-income countries. The involvement of India, not a Paris Club member, as co-chair of the Official Creditor Committee and flexible coordination with China show that it is possible to put in place broader-reaching coordination structures. Extending the Common Framework to middle-income countries would bring this approach to scale.

Timely and regular discussions between official and private creditors regarding the assessment of comparability of treatment need to be developed to rapidly reach agreement on treatments that will restore debt sustainability and ensure that private creditors' efforts are at least comparable with official creditors' efforts.

Sri Lanka's experience has also opened up new opportunities to use contingent instruments in debt treatments. Discussions between the different creditors regarding these instruments have shown that the majority of stakeholders prefer "simple" debt treatments wherever possible, but that contingent treatments can facilitate restructuring in the event of uncertainty or disagreement over the debtor country's future repayment capacities. Going forward, private creditors could propose general principles for the use of these instruments, by way of the Institute of International Finance for example. For their part, official creditors could develop a benchmarking paper for internal use to facilitate a coordinated approach.

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