SRI LANKA

Debt Management Reform Plan

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Prepared By

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GLOSSARY

ABP	Annual Borrowing Plan
AG	Auditor General
CBSL	Central Bank of Sri Lanka
CDS	Central Depository System
DDMC	Domestic Debt Management Committee
DeMPA	Debt Management Performance Assessment
DMIS	Debt Management Information System
DMO	Debt Management Office
DPO	Development Policy Operation
EFF	Extended Fund Facility
ERD	External Resources Department
GDP	Gross Domestic Product
IMF	International Monetary Fund
IT	Information Technology
MoF	Ministry of Finance, Economic Stabilization, and National Policies
MTDS	Medium-Term Debt Management Strategy
MTFF	Medium-Term Fiscal Framework
NFPS	Nonfinancial Public Sector
PD	Primary Dealer
PDD	Public Debt Department
PDM	Public Debt Management
PDMA	Public Debt Management Agency
PDMC	Public Debt Management Committee
PED	Public Enterprise Department
PFM	Public Financial Management
SARTTAC	South Asia Regional Training and Technical Assistance Center
SLDB	Sri Lanka Development Bond
SOE	State-Owned Enterprise
ST	Secretary to the Treasury
TA	Technical Assistance
TOD	Treasury Operations Department
WB	World Bank

PREFACE

At the request of the Ministry of Finance, Economic Stabilization, and National Policies (MoF), a joint World Bank (WB)-International Monetary Fund (IMF) mission co-led by Leandro P. Secunho (WB Senior Debt Specialist) and Eriko Togo (IMF Deputy Division Chief), and comprising Ximena Talero (WB Lead Counsel), M. Coskun Cangoz (WB International Consultant), Hui Miao (IMF Senior Financial Sector Expert), Mia Pineda (IMF Counsel), and Phillip Anderson (IMF International Consultant) visited Colombo during February 20–March 3, 2023, to support the government of Sri Lanka in designing a Debt Management Reform Plan, prioritizing the reform of the debt management institutional and legal framework. Establishing a National Debt Management Agency/Office is one of the priority reforms of the 2022 interim budget and is also a commitment under the IMF extended fund facility (EFF) arrangement and the proposed World Bank's Development Policy Operation (DPO). The mission also provided recommendations to strengthen public debt transparency and the management of government guarantees and on-lending.

The mission's main findings, summarized in this report and its annexes, were presented in a wrap-up meeting attended by representatives of the MoF and Central Bank of Sri Lanka (CBSL) under the chairmanship of Mr. Mahinda Siriwardana, Secretary to the Treasury. Ms. Chiyo Kanda (WB Country Manager) and Ms. Sarwat Jahan (IMF Resident Representative) attended the concluding meeting. The report incorporates comments provided by the authorities. The mission informed the authorities that it stood ready to provide follow-up technical assistance. The mission also informed the authorities of the recent approval by the Japan Sub-Account Trust Fund to finance a long-term debt expert to be stationed at the South Asia Regional Training and Technical Assistance Center (SARTTAC) to assist the Sri Lankan authorities in implementing the reform plan, which was welcomed by the authorities.

As at the date of publication of this report, the authorities drafted and submitted a new Public Debt Management Act to Parliament, which was enacted on June 18, 2024. The authorities are also in advanced stages of finalizing the Public Debt Management Office Regulations which will also be submitted to Parliament. With these actions, the stage is set for the establishment and operationalization of the Public Debt Management Office at the Ministry of Finance.

The mission team wishes to express its appreciation to the members of the Sovereign Debt Management Committee, all the counterparts at the MoF, especially from the External Resources Department (ERD) and Treasury Operations Department (TOD), as well as to officials of the Public Debt Department (PDD) and the Research Department of the CBSL; Ministry of Public Administration, Home Affairs, Provincial Councils and Local Government; and the National Audit Office for their engagement during the mission. The mission would like to extend special thanks to Ms. Himali Bogodagedara and Ms. Manisha Dandunna of ERD for their excellent support in organizing the mission agenda.

The mission was financed by the Debt Management Facility III, a multi-donor trust fund, www.dmfacility.org, and the IMF.

EXECUTIVE SUMMARY

There is consensus that the fragmented public debt management (PDM) legal framework and PDM functions across departments within the MoF and the CBSL have contributed to the lack of coherent management of the public debt in Sri Lanka. It has also contributed to a lack of comprehensive public debt reporting and management of public guarantees, leading to sub-par debt transparency. The establishment of a consolidated debt management office (DMO) and strengthening debt transparency is a government priority and a commitment under the Fund's EFF arrangement and WB's DPO. With the CBSL's decision to cease having PDM responsibilities in order to focus on its primary mandate (promote price stability), the PDM responsibilities will need to be relocated to the consolidated DMO underpinned by a new legal framework for PDM. The mission provided recommendations on the (1) legal framework; (2) location of the new consolidated public Debt Management Office (DMO); (3) internal organization of the DMO; and (4) debt transparency and management of government guarantees and on-lending of borrowed funds.

1. *Legal framework for PDM*. The mission recommends introducing a new PDM law, which would establish the DMO and define its mandate. More broadly, the new PDM law would define the governance and accountability framework for PDM. This would stem from the Parliament delegating the authority to borrow and issue guarantees on behalf of the state to the Minister of Finance, and setting the objectives for PDM. The PDM objectives set by Parliament would be operationalized by the DMO through the development and implementation of a MTDS and an annual borrowing plan (ABP), consistent with the medium-term fiscal framework and the annual budget. The need for transparency would also be embedded in the PDM law, including annual reporting to Parliament on the progress of the debt management strategy.

2. *Location of the DMO*. The mission recommended that the DMO be established inside the MoF, consistent with sound practices in a vast majority of emerging markets and developing economies. The mission assessed that preconditions in Sri Lanka for establishing the DMO as a "separate statutory body" were not met and were unlikely to be in place for the foreseeable future. Preconditions include a stable macroeconomic environment, a well-developed domestic debt market, access to the international capital market, and well-trained staff in both the principal entity (MoF) and the agency. Regardless of the location, a medium-term debt management strategy (MTDS) approved by the Cabinet of Ministers is the key instrument that would strengthen the DMO's operational independence.

3. *Internal organization of the DMO*. The mission considered two options for the internal organization of the DMO: including and excluding the multilateral and bilateral relationship management functions carried out by the ERD, where only 37 staff grade officials out of the 125 officials are performing functions related to borrowing activities. The mission recommended that the DMO exclude the nonborrowing functions of the ERD, so that the

DMO would comprise a small group of specialized professionals narrowly focused on PDM functions, retaining the ERD as a separate department.

4. *Public debt transparency and government guarantees and on-lending of borrowed funds*. The fragmented institutional arrangement and legal framework have led to the duplication of public debt databases and of recording and reporting of public debt. The issuance and management of guarantees lack a framework and control system. The new PDM law and consolidated institutional arrangement should help strengthen debt data management, unify debt reporting, and support the development of a policy for issuing and managing debt guarantees and on-lending, consistent with the overall government risk management framework.

Next Steps

The Secretary to the Treasury and CBSL representatives agreed with the mission's recommendations. As next steps, the authorities will begin drafting the PDM law and implement reforms that can be carried out ahead of the formal establishment of the new DMO. A high-level committee should be established to direct and monitor the DM legal framework reform and appointment of a "reform champion". The drafting of the PDM law will need to be closely coordinated with that of the public financial management law, supported by a separate IMF TA mission, as well as the WB team supporting the DPO. The mission stands ready to provide further technical assistance (TA).

Table 1. Key Recommendations[1]

Recommendation	Lead Institution	Timeline[2]	Priority
Legal Framework			
Draft a dedicated PDM law that would support sustainable debt objectives and promote transparency and accountability in the decision-making process (minimum content is specified in Section III).	MoF	ST	High
Strengthen the legal framework for loan guarantees and on-lending arrangements, as both can create excessive fiscal risks.	MoF	ST	High
Institutional Framework			
Establish the DMO as a department in the MoF, by consolidating the debt management functions of the ERD, TOD, and PDD, except for (1) the operations of LankaSecure, which should remain in the CBSL; and (2) the cash management function, which remains at TOD.	MoF	ST	High
Structure the DMO along functional lines: (1) front office (central government borrowing, guarantees and on-lending, ABP development, and investor relations); (2) middle office (debt strategy, risk management, compliance, and debt service forecasting); and (3) back office (debt recording, payment instructions, and reporting).	MoF	ST	High
Establish an advisory committee to support senior management oversight of the DMO.	MoF	ST	Medium
Establish a coordinating committee, chaired by the head of the DMO, with membership of the TOD, ERD, Department of Fiscal Policy (MoF), and Domestic Operations, International Operations, and Economic Research departments of the CBSL.	MoF	ST	High
Abolish the Tender Board and the DDMC.	MoF	ST	High
In consultation with the Fiscal Policy and the Budget departments as well as the ERD, TOD, and CBSL, develop a timeline to develop a MTDS, including when to submit a draft to the Debt Management Coordination Committee for feedback.	MoF	ST	High
Develop online staff training on MTDS and ABP. Other training needs include courses on understanding the yield curve, forward curve, and concept of interest rate parity.	MoF	ST	Medium
Conduct the MTDS analysis using the MTDS analytical tool and develop the ABP.	MoF	MT	Medium
Transfer domestic auction program responsibilities from the CBSL.	MoF	MT	Medium
Conduct business process reengineering to improve efficiency, remove duplication, and reduce operational risk.	MoF	MT	Medium
Prepare and publish a medium-term debt management strategy on a rolling annual basis, ensuring consistency with the MTFF and the budget.	MoF	MT	Medium
Publish the ABP and auction calendar.	MoF	MT	Medium
Debt Transparency			
Make decisions on the new debt recording system and acquisition of respective license.	MoF	ST	High
Include all debt-related data (including domestic securities and guaranteed debt) in the new debt recording system.	MoF	ST	Medium
Review all existing databases at the MoF and CBSL, and replace them to the extent possible to make data available for multiple purposes in the new debt recording system.	MoF	ST	Medium

Address the audit recommendations related to debt recording outlined in the *Special Audit Report on Financial Management and Public Debt Control in Sri Lanka 2018-2022*.	MoF	ST	High
Establish a working group/taskforce to review existing published debt reports and data, aiming to reduce duplication, improve timeliness, and eliminate inconsistencies.	MoF	MT	Medium
Resume the publication of quarterly auction calendars (once conditions permit) and potentially include indicative amounts for T-Bills.	MoF	MT	Medium
Shorten the time lag for publishing auction results to one hour or less.	MoF	MT	Low
Guarantees and On-Lending			
Develop a legal, institutional, and operational framework for the management of government guarantees.	MoF	ST	High
Transfer all guarantee-related functions from TOD to the DMO.	MoF	ST	High
Develop quantitative risk limits and propose introduction of guarantee fees as a risk mitigation instrument.	MoF	MT	Medium
Develop an on-lending policy.	MoF	MT	Medium
Disclose expected losses based on associated credit risks and probabilities of default.	MoF	MT	Medium

[1] Short-term (ST): within 12 months; medium-term (MT): within 24 months.

[2] See Annex 1 for complete reform plan.

I. INTRODUCTION

1. **The objective of the Debt Management Reform Plan TA mission is to assist the Sri Lankan authorities in meeting the commitments under the IMF-supported program and the World Bank's Development Policy Operation (DPO) to strengthen debt management.** Specifically, the authorities' commitment under the IMF-supported program is stated in the Memorandum of Economic and Financial Policy as follows: "We are committed to improving debt management and debt transparency.

- Currently, public debt is managed by the CBSL's Public Debt Department, the MoF's External Resources Department and Treasury Operation Department. To improve debt management, we will complete necessary legislative requirements to establish a public debt management agency (PDMA) in line with international best practices by December 2023 and complete the establishment of the agency by December 2024. The PDMA will (i) report to and be accountable to the Ministry of Finance but have significant operational autonomy; (ii) assume overall policy responsibility for debt management by formulating medium-term debt strategies and annual borrowing plans; and (iii) direct the implementation of annual borrowing plans, including taking decisions on auction cut-offs. The PDMA will oversee all domestic and international market-based financing decisions and participate in the evaluation of all debt, derivatives, and guarantees.

- We will further improve debt transparency. The MoF will regularly publish a quarterly bulletin of public debt and debt service. The first such bulletin was published in February 2023 and covers the debt situation as of end-September 2022. We will continue this debt bulletin on a quarterly basis and publish by end-April 2023 the debt situation as of end-2022. We are committed to gradually broaden the bulletin's coverage to stock and debt service flows of all liabilities and contingent liabilities of the budgetary central government and of extrabudgetary central government units. In line with international best practice, we will issue guidelines regarding the statistical treatment of guaranteed debt of distressed corporations, and the transfer of government liabilities to SOEs, to be approved by Cabinet."

2. **The World Bank's DPO also has among its conditions improving debt management practices and transparency.** "To improve debt management, Sri Lanka, has enacted a new Public Debt Management Law, established a single Debt Management Office (DMO), and issued rules and regulations for the granting of sovereign guarantees and on-lending."

3. **This TA mission builds on the work of several past debt management missions from the fund and the Bank.** These date as far back as 2002, with TA provided by the World Bank, and the latest, in 2019, by the IMF. The 2019 IMF mission recommended establishing a statutory agency outside the MoF as a way to carry out specialized

responsibilities and offer employment packages comparable to those at the CBSL. Under this proposal, the debt office would start with a relatively small staff, who would focus on external market borrowing, investor relations, middle office functions, and deciding on borrowing operations. Official financing would continue to be managed by the ERD in the MoF, and the auctions would continue to be performed by the PDD at the CBSL.[1] While some recommendations were implemented, the reform was interrupted by the economic crisis of 2021-22.

4. **In August 2022, the World Bank conducted a Debt Management Performance Assessment (DeMPA) mission.**[2] The 2022 assessment identified areas for improvement related to institutional and legal frameworks, debt management strategy, issuance of guarantees, and debt reporting, among others. It identified that the main driver of these weaknesses was the fragmentated debt management institutional setup, resulting in incomplete and duplicated functions, while the lack of proper institutional structures has resulted in a deficient separation of policy functions, creating heightened operational risks.

5. **The authorities are fully cognizant of the issues arising from the fragmented legal framework and institutional arrangement.** They recognize the urgency of establishing a consolidated DMO accountable for managing Sri Lanka's public debt—almost 130 percent of GDP in 2022.[3] Critical decisions have been made to establish a consolidated DMO. The authorities are committed to strengthening the institutional arrangements and the legal framework for public debt management and have formed a high-level committee to design and oversee the reform process. In turn, to secure central bank independence, divest the debt management functions from the CBSL, and prohibit monetary financing of the government, on July 20, 2023, the Parliament approved the amendment of the Monetary Law Act incorporating these changes.

6. **This TA makes recommendations for reforming both the legal and institutional frameworks.** The recommendations seek to ensure that the reform proposal for the institutional framework is grounded in an overall governance, accountability, and transparency framework enshrined in the legal framework. The recommendations set strategic reform priorities and do not cover details of implementation. Section II briefly presents the current macroeconomic conditions and public debt developments in Sri Lanka. In the following sections, four key reform areas are discussed, providing sound practice, an overview of the current situation, and a description of recommended action.[4] Section III

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[1] The current TA proposes the new DMO to be established within the Ministry of Finance.

[2] The DeMPA is a diagnostic tool used to evaluate a country's debt management processes and institutions.

[3] The term "debt management office" (DMO) is used throughout this report to refer to the area that manages the public debt of the country, consistent with common practice internationally. It does not imply any particular institutional arrangement. In practice, its name varies across countries, for example, department, agency, office, wing, division, center, etc.

[4] The sound practices are based on the World Bank-IMF *Revised Guidelines for Public Debt Management* (2014), which are based on lessons from global experience:

(continued...)

covers the legal framework; Section IV discusses the institutional framework; Section V explores public debt transparency; finally, Section VI examines the management of government guarantees and on-lending of borrowed funds. A logframe (Annex I) outlines the specific actions, sequencing, and expected outcomes for the proposed reform plan.

II. MACROECONOMIC BACKGROUND

7. **The government of Sri Lanka defaulted on its international sovereign bond obligations in April 2022 amid an unsustainable debt burden and very low international reserves.** Preexisting vulnerabilities and policy missteps, including large tax cuts, set the stage for a full-blown crisis following the shocks from the COVID-19 pandemic, aggravated by the Russian invasion of Ukraine. Debt rose to unsustainable levels, international reserves were depleted, and sizable monetary financing to meet fiscal obligations contributed to a surge in inflation and sharp exchange rate depreciation. A four-year extended fund facility (EFF) arrangement was approved by the IMF Executive Board on March 20, 2023, following the staff-level agreement reached on September 1, 2022. The priorities of the arrangement are to achieve revenue-based fiscal consolidation accompanied by strong social safety nets; restore public debt sustainability, including through debt restructuring; and restore price stability and rebuild reserves.

8. **Sri Lanka's public debt is expected to remain elevated for some time and decline only gradually over the medium term.** Public debt reached 128 percent of GDP at end-2022 due to a large fiscal deficit (-10.6 percent), exchange rate depreciation (57 percent), and economic contraction (-8.7 percent). Given its reliance on short-term financing, annual gross borrowing needs rose to 34.6 percent of GDP in 2022. In 2023, the economy is projected to contract by 3 percent and only gradually recover to its +3 percent trend by 2026. In 2022, fiscal primary expenditure (20 percent of GDP) was much larger than the revenue (8 percent of GDP), and the large fiscal gap is expected to narrow gradually over the long run with reforms on the revenue side, while the interest burden will be reduced through debt restructuring. Thus, debt levels are likely to remain high (about 95 percent of GDP) over the medium term, while the gross financing needs level is expected to fall from 34 percent to below 13 percent of GDP, assuming the debt restructuring. Rebuilding international reserves will take time considering the balance of payments outlook, and the authorities have imposed emergency import restrictions to manage the foreign exchange shortage.

9. **The large public debt portfolio carries a legacy of exposure to foreign exchange, interest rate, and maturity rollover risk.** A public debt restructuring will help address the risk exposures, but with new financing over the program period predominantly from external official sectors, the share of foreign-currency debt, currently comprising about half of the total debt, is likely to increase. The debt restructuring is expected to lower costs and extend maturities, contributing to the reduction in the annual gross financing needs. On the domestic

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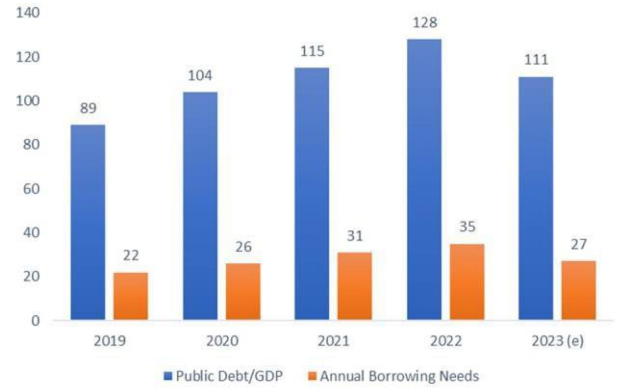
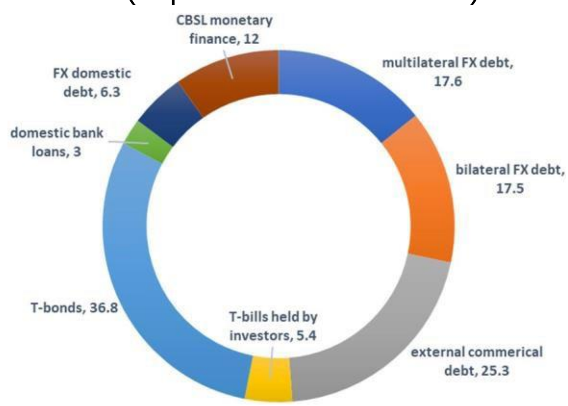
https://documents.worldbank.org/en/publication/documents-reports/documentdetail/539361468170971115/revised-guidelines-for-public-debt-management side, interest rates are currently at elevated levels (about 30 percent) across the domestic government bond yield curve, due to high inflation and a large sovereign risk premium associated with the uncertainty of debt restructuring. Inflation was 46 percent in 2022 and is projected to fall to 28 percent in 2023 and gradually decline to the long-term trend of 5 percent. As the monetary finance provided by the CBSL (by way of overdraft and T-bill purchases) is set to gradually unwind, domestic market financing needs will increase.

Figure 1. Public Debt and Gross Financing Needs, 2019–23
(in percent of GDP)



Sources: MoF, CBSL, and IMF staff estimates.
Note: 2023 projection as presented in IMF Staff Report, March, 2023.

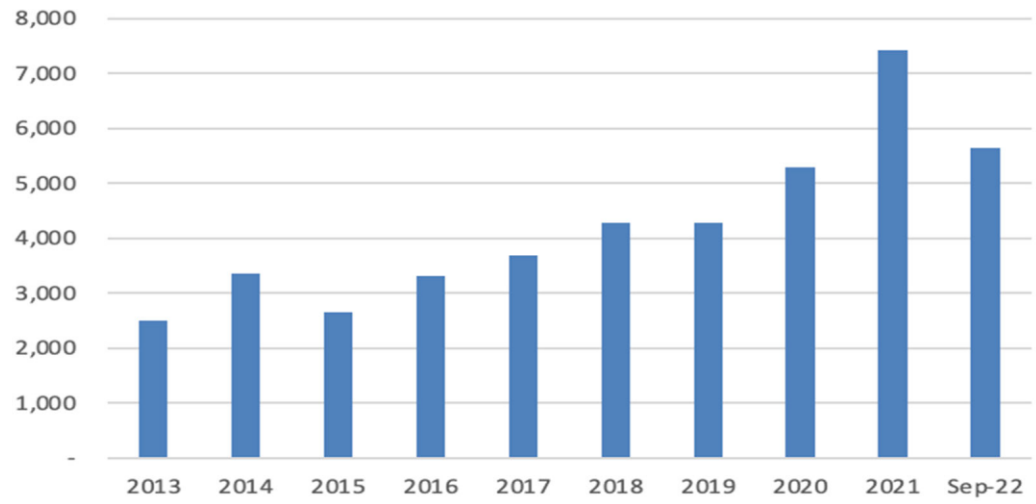
Figure 2. Breakdown of Public Debt by Instruments
(in percent of 2022 GDP)



Sources: MoF, CBSL, and IMF staff estimates.

10. **The outstanding stock of government-guaranteed debt increased significantly in 2021.** With the calling of guarantees in 2022, guaranteed debt decreased at end-September from US$7.4 billion to US$5.6 billion (Figure 3), as these obligations were reclassified as central government direct debt. Ceylon Petroleum Corporation, Road Development Authority, National Water Supply & Drainage Board, Ceylon Electricity Board, and Sri Lankan Airlines Limited account for almost 90 percent of the remaining guaranteed debt stock.

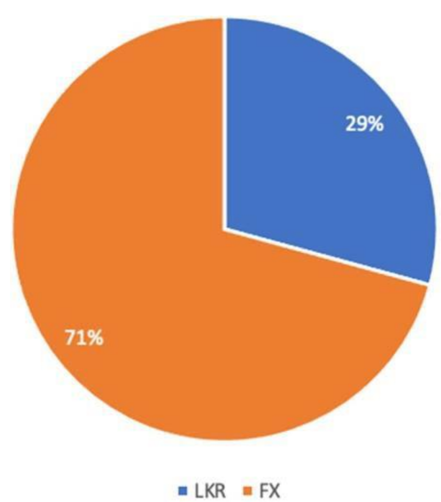
Figure 3. Outstanding Government Guaranteed Debt
(in millions of US dollars)



Sources: MoF, CBSL.

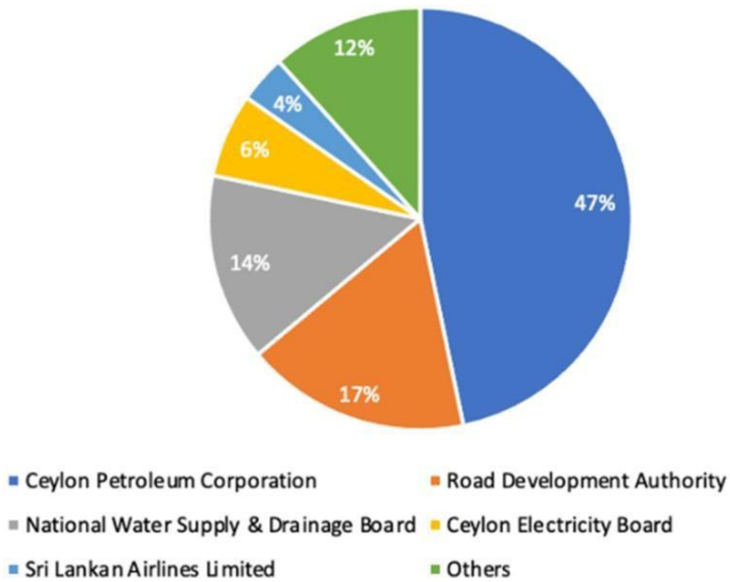
11. **Only 11 percent of 240 government guarantees are in foreign currency.** However, the value of the foreign currency guarantees account for 71 percent of the total stock. In this regard, the guaranteed debt portfolio has a sizable exposure to exchange rate volatility, in particular to the US dollar (Figure 4). The main contributor to the currency exposure is the US$2.6 billion guaranteed debt of Ceylon Petroleum Corporation, which accounts for 46.7 percent of the total guaranteed debt portfolio. The size of Ceylon Petroleum Corporation's debt also creates significant concentration risk (Figure 5).

Figure 4. Currency Composition of Guaranteed Debt
(September 2022)



Source: MoF.

Figure 5. Beneficiaries of Guaranteed Debt
(September 2022)



Source: MoF.

12. **Sri Lanka's options for debt management are limited, given the current unfavorable market conditions and prolonged uncertainty over debt restructuring.** Renewed access to international capital markets will take some time. Domestic market financing is supported by large pension funds and the reasonably sized financial sector (about100 percent of GDP), but the banking sector exposure to the public sector is already large at over 40 percent of total assets, and some state-owned banks have government exposure over 60 percent of total assets. Domestic market access is limited and expensive due to the uncertainty of the debt restructuring, and issuing long-term bonds at an elevated interest rate at this juncture will negatively affect debt sustainability. Debt management reform will be critical in the process of restoring market confidence and the eventual market re-access, and to mitigate the resurgence of a debt crisis.

III. LEGAL FRAMEWORK

Sound Practice

13. **A PDM legal framework consolidated in a single law supports sound management of the public debt.** Box 1 presents alternative approaches to consolidating the legal framework. Unifying legal provisions will help to:

- set guiding principles and a consistent framework for public debt management;
- clarify the governance, accountability, and transparency framework by establishing the responsibilities of the government units participating in managing the public debt;

- establish a framework for managing contingent liabilities stemming from loan guarantees and borrowing by public enterprises; and
- avoid the risk of adopting piecemeal reforms that may further fragment the legal framework.

Box 1. Approaches to Consolidating the PDM Law

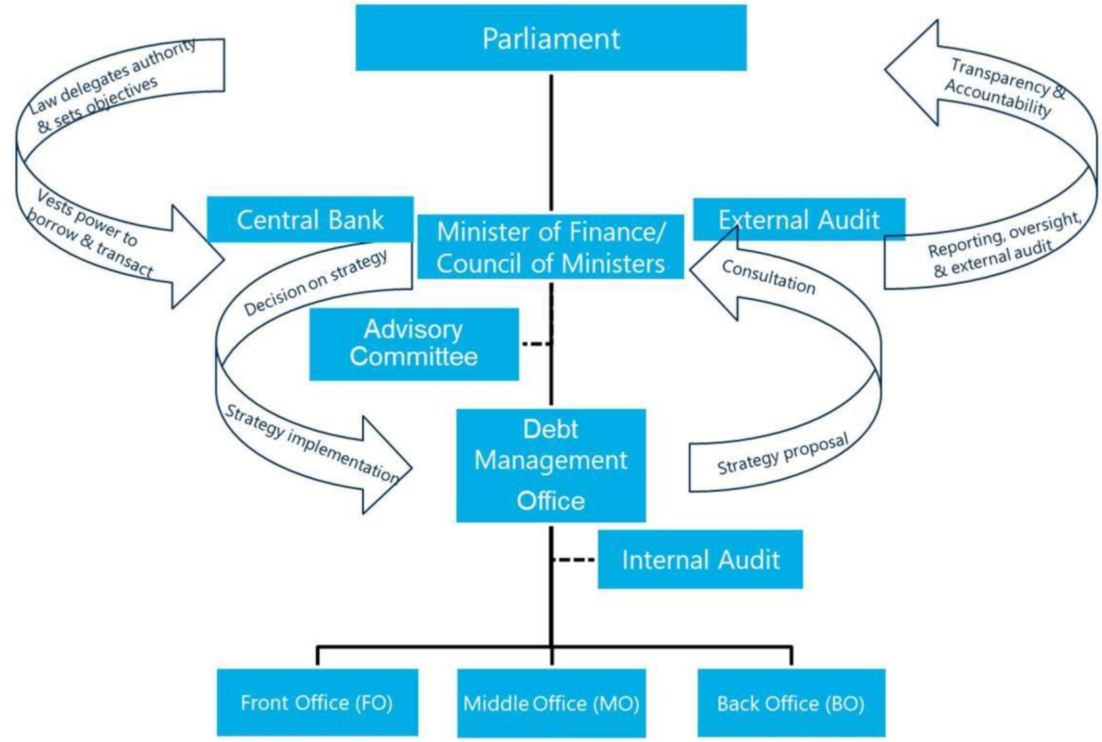
There are two approaches to consolidating the PDM legal provisions in a single law: as a single chapter in a public financial management (PFM) law or as a dedicated PDM law.

Consolidating the legal framework for public debt, whether as a dedicated law or a single chapter in a PFM law, assists in bringing clarity, ease of reference, and consistency in the overall framework for public debt. Locating the PDM legal provisions in the PFM law tends to facilitate greater consolidation, because the PFM law covers other aspects of public finance, including fiscal policymaking, budget processes, and cash management. In some countries that allow for organic laws, incorporating the PDM provisions into the PFM law also adds more stability to the PDM legal framework.

Alternatively, a dedicated law can be framed to avoid overlaps, inconsistencies, or gaps in the legal framework. While the dedicated law approach may largely depend on pragmatic considerations and the timeframe for achieving reform objectives, well-crafted PDM laws can nonetheless ensure the coherence of the framework.

14. **The governance framework for PDM should be clearly articulated in the PDM law**. Strong governance entails a clear division of responsibility between stakeholders, with the sovereign authority (for example, Parliament) setting overall long-term debt management objectives, the executive approving the strategy, and a designated entity (the DMO) mandated to formulate and implement the strategy, service the debt, settle transactions, and record and report the debt (Figure 6). In countries where the central bank is mandated to conduct debt management activities (for example, auctions of government securities on behalf of the principal debt management entity), roles and responsibilities of the central bank should be formalized in an agency agreement with the principal debt management entity or through a secondary legislation. Information on the roles, responsibilities, and objectives should be publicly disclosed.

Figure 6. Governance, Transparency, and Accountability Framework for Public Debt Management



Source: IMF staff.

15. **The definition of public debt is fundamental to a coherent PDM legal framework.** The definition of public debt may be found in the PFM legislation, and where such a definition exists, consistency across all laws on public finance, including the PDM law, must be ensured. Regardless of where public debt is defined, it is important to consider two dimensions: (1) *the institutional coverage,* that is, the public institutions whose debt liabilities are subject to the requirements of the PDM law; and (2) *the coverage of debt and liability management instruments*, for example, debt securities and loans, and derivative instruments. In terms of institutional coverage, only the main financial obligations controlled by the central government should be covered for the purpose of debt management. For debt recording and debt reporting, extending the scope beyond the central government's control could be considered, including to the nonguaranteed debt of entities from the nonfinancial public sector (NFPS). This would facilitate oversight of contingent liabilities and encourage those entities to implement transparent borrowing procedures.

16. **The primary law should set out the debt management objectives, as well as the requirement to develop a MTDS and adopt an ABP.** There is broad international consensus that the main objective of PDM is to raise the resources needed to cover the government borrowing needs, while minimizing the cost of servicing debt over the medium to long-term, subject to a prudent degree of risk. Establishing the legal requirement to produce the MTDS, including its approval at the Cabinet level, and its publication, followed

by ex-post reviews, helps to operationalize debt management objectives and accountability. Including a legal requirement for the development of the ABP in line with the MTDS will ensure that the annual borrowing activities are in line with long-term debt management objectives.

17. **The PDM law should clarify the sole delegation of authority to the Minister of Finance to borrow on behalf of the state.** Clarity on how the authority is delegated can be achieved by specifying (1) the entity that possesses the borrowing authority, its mandate and powers, as well as the delegated authority; (2) limitations on the borrowing authority; and (3) the processes related to borrowing operations, in general and/or relating to individual transactions. Clarity on the borrowing authority is likewise necessary to undertake liability management operations and debt restructuring. These provisions help to hold the relevant entities accountable.

18. **The primary legislation should define clearly which entity has the authority to issue guarantees and on-lend borrowed funds** (Section IV)**.** Ideally, the issuance of guarantees and on-lending operations should follow a policy framework containing the following components: (1) control: setting limits and centralizing issuance; (2) decision-making process: setting the purpose, eligibility criteria, conditions, evaluation of costs and risks, charging of fees, establishing of processes and procedures; and (3) monitoring: recording and reporting on risks, ensuring payment, and planning for recovery.

19. **Legal provisions for transparency and accountability are key components of a robust PDM framework**. Transparency is essential to providing markets with a clear understanding of the government's objectives, issuance plan, and indebtedness level and to facilitating proper oversight and evaluation of PDM performance. PDM publications and reports are important requirements for upholding transparency. Accountability is enforced through several mechanisms, including through the reporting and control framework and internal and external audits, and scrutiny by the legislature and the public at large.

20. **The legal provisions should give a minimum level of detail for debt management publications and disclosure of debt-related information.** These publications typically include the MTDS, the ABP, and the annual debt management report and other debt data reports (for example, debt bulletins). The PDM law should set forth (1) roles and responsibilities for the preparation and approval of the specific publication; (2) frequency for preparation and updates; (3) general minimum content of the publication while leaving flexibility to the Executive Branch to define in regulations the detailed format and content; and (4) channel and timeframe for publication. Some PDM legal frameworks stimulate consequences or penalties for failing to record or disclose debt.

21. **The Audit Act should grant legal mandate to the supreme audit institution and a broad institutional coverage that would subject PDM activities to external scrutiny**. The goal of external audits is to promote accountability in debt contracting and management. Debt management audits should include financial, compliance, and performance evaluations.

There should be set mechanisms that ensure the adoption of corrective measures to address issues highlighted in audit reports and the appropriate responses from decision makers. External audit reports should be publicly disclosed within a reasonable timeframe.

22. **It is preferable that quantitative debt limits, including limits on government guarantees, are not included in the PDM law**. Quantitative debt limits are fiscal decisions. Long-term debt targets are better situated in the PFM law or the Fiscal Responsibility Management Law, and annual borrowing limits in the annual budget or appropriation law.

Current Situation[5]

23. **Sri Lanka's legal framework for PDM is currently fragmented.** The constitution sets broad norms that relate to managing public debt, including granting Parliament "full control" over public finances, restricting provincial councils from enacting statutes on the government's public debt, and providing a mandate to the Auditor General to audit public debt. The Finance Act of 1971 regulates public corporations, including the borrowing powers of such entities. While there is no overarching law on public finance, the Fiscal Management (Responsibility) (FMR) Act 2003, which is the main law on fiscal planning and responsibility, establishes ceilings on public debt and the stock of guarantees and imposes a restriction on the government's borrowing from the central bank.[6] Other relevant laws that involve the issuance of public debt are the Foreign Loans Act 1957 as amended, the Local Treasury Bills Ordinance 1929 as amended, the Registered Stock and Securities Ordinance 1937 as amended, and the Active Liability Management Act 2018. The Financial Regulations 1992 provide some rules and procedures on contracting foreign loans.

24. **The institutional scope of the definition of "public debt" is unclear.** The term "government" is not defined in any of the primary laws on public debt, so it is unclear whether the term constitutes only the budgetary central government or includes other entities in the public sector. The legal framework is also unclear on whether extrabudgetary units are part of the central government whose debt should be included in central government debt.[7]

[5] The regulatory framework for the managerial structure and institutional organization is treated in Section IV.

[6] Article 3 of the Fiscal Management (Responsibility) Act of 2003 includes within the objectives underlying responsible fiscal management that need to be adhered to by the Government "… v. Ensuring that the sum which is calculated as the guarantee and given as a percentage of the Gross Domestic Product for the current financial year along with the two preceding financial years, does not in the aggregate exceed [15] per centum; …" At the time of its introduction, the limit was 4.5 percent of GDP. This limit was amended by Act No. 15 of 2013, Act No. 13 of 2016, and Act No. 12 of 2021, which increased the limit to 15 percent of GDP (effective January, 1 2021).

[7] Extrabudgetary units are usually established for specific functions, such as road construction, construction and maintenance of the electric grid, nonmarket production of health and education services, and so on. In performing such functions, these units may be allowed to have their own revenue sources and determine the volume and composition of their spending. For more details, see R. Allen and D. Radev, IMF Technical Notes and Manuals on Extrabudgetary Funds, 2010.

Some public entities in Sri Lanka appear to be extrabudgetary units authorized to incur liabilities and enter contracts, including borrowing funds.[8]

25. **The range of instruments that comprise public debt is not exhaustively captured.** There are multiple laws on specific debt instruments, which cover loan agreements, T-bills, T-bonds, and government promissory notes. The definition also includes the issuance of debt securities as part of a rescheduling scheme of outstanding liabilities. However, the laws do not cover other financial obligations that have characteristics similar to loans carrying fixed repayment schedule, such as supplier's credit agreements and finance leases.[9]

26. **The existing legal framework does not state the long-term objectives for public debt management.** Likewise, there are no requirements for the development, approval, publication, and implementation of a MTDS and an ABP.

27. **The legal framework allows for an excessively broad fiscal agency role of the CBSL.** Instead of clearly distinguishing the government's role as principal, the Monetary Law Act requires the CBSL to manage public debt. The sweeping language on the scope of the agency relationship may also result in inconsistency with the CBSL's core mandate. In addition, it allows for the purchase of government securities in the primary market and monetary financing to the government. The authorities plan to amend these provisions.

28. **The legal framework guiding the issuance of government guarantees and on-lending is limited.** The Foreign Loans Act No. 29 of 1957, as amended, authorizes the President to sign on behalf of the state, government guarantees relating to foreign loans to a public corporation or public enterprise.[10] There are no other legal or regulatory provisions that guide the issuance of guarantees or on-lending.

29. **The legal framework requires regular reporting by the central government on its borrowing activities, but it does not require reporting the debt of public sector entities**. The FMR Act Articles 10, 11, and 12 state that semi-annually, the MoF shall publish and submit to Parliament a Mid-year Fiscal Position Report that includes a statement of the estimated and actual borrowings for the first four months of the fiscal year. Articles 13, 14, and 15 state that annually, the MoF shall publish and submit to Parliament a Final Budget Position Report that includes a statement of, among others, the estimated and actual

[8] For example, the Urban Development Authority (Section 9.1.c, Law No. 41 of 1978 as amended) and the Roads Development Authority (Section 14.2.c, Law No. 73 of 1981 as amended) are authorized under their respective charters to borrow funds.

[9] "Public debt" is defined in the Active Liability Management Act 2018 as "all financial obligations attendant to loans raised or guaranteed and securities issued or guaranteed by the Government and includes interest on that debt, sinking fund charges, the repayment or amortization of debt and all expenditure in connection with the raising of the loans on the security of revenues of the Government and on the service and redemption of the debt thereby created."

[10] The Foreign Loans Act No. 29 of 1957 has been amended by the Foreign Loans (Amendment) Act No. 2 of 1962, the Foreign Loans (Amendment) Act No. 23 of 1980, and the Foreign Loans (Amendment) Act No. 33 of 1984.

borrowings for the fiscal year. There is no requirement for the central government to report the debt of public sector entities together with their guarantees.

30. **The legal framework provides for internal and external audits.** Under the Sri Lankan constitution (Articles 153 and 154), the Auditor General (AG), who is appointed by the President, is responsible for external financial audits of all government accounts.[11] In addition to government accounts, the AG has a constitutional mandate to review accounts of local authorities, public corporations, business undertakings vested in government, and companies registered under the Companies Act in which the government or a public corporation or local authority holds 50 percent or more of its shares. The AG is required to submit to Parliament annual financial audits of Sri Lanka's Consolidated Fund and of all entities under its audit remit. These audits include debt-related transactions.[12] All audit reports are submitted to Parliament and published on the official website of the National Audit Office. While establishing internal audit units in the large departments of the MoF is required under the Financial Regulations (FRs 133-134), the internal auditors' inspections, appraisal, and review of debt management operations would lack comprehensiveness, given the fragmentation of the institutional framework.

Issues and Recommendations

31. **Consolidating the fragmented legal framework should be a key driver of the PDM law reform process.** The fragmented legal framework perpetuates the fragmented institutional framework (Section IV) and can impede institutional reform. The forthcoming revision of the Monetary Law Act, which dispenses with the central bank's mandate to manage public debt, would require the vesting of a new mandate to the MoF and the debt management entity. Equally important, this would appropriately position debt management within the broader fiscal management framework. In this regard, the reform should stipulate the production of an MTDS consistent with the medium-term fiscal framework (MTFF) that is updated on a rolling annual basis, as well as the production of an ABP consistent with the annual budget.

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[11] Article 154 of the Sri Lankan constitution states: "154 (1) The Auditor-General shall audit all departments of the Government, the Office of the Secretary to the President, the Office of the Secretary to the Prime Minister, 119 [the Office of the Secretary to the Cabinet of Ministers, the Offices of the Ministers appointed under Article 44 or 45, the Judicial Service Commission, the Parliamentary Council, the Commissions referred to in Schedule I to Article 41A, the Provincial Public Service Commissions, the Parliamentary Commissioner for Administration, the Secretary-General of Parliament, local authorities, public corporations, business and other undertakings vested in the Government under any written law and companies registered or deemed to be registered under the Companies Act, No. 7 of 2007 in which the Government or a public corporation or local authority holds fifty per centum or more of the shares of that company, including the accounts thereof.]"

[12] Article 149 of the Sri Lankan constitution states: "149. (1) The funds of the Republic not allocated by law to specific purposes shall form one Consolidated Fund into which shall be paid the produce of all taxes, imposts, rates and duties and all other revenues and receipts of the Republic not allocated to specific purposes. (2) The interest on the public debt, sinking fund payments, the costs, charges and expenses incidental to the collection, management and receipt of the Consolidated Fund and such other expenditure as Parliament may determine shall be charged on the Consolidated Fund."

32. **The enactment of a PDM law would support the establishment of the new DMO.** A legal support of the DMO stating responsibilities, accountability, and transparency frameworks will strengthen its mandate and enable a degree of operational independence from political interference. It also codifies the separation of debt management and monetary policy objectives and accountabilities.

33. **The legal framework should define "public debt" comprehensively.** In terms of instrument coverage, the law should be sufficiently broad to include liabilities that do not stem from borrowing. It should encompass (1) instruments that create debt-like financial obligations; and (2) the assumption of payment liabilities under a loan guarantee. A comprehensive definition helps ensure that the MoF is involved in decisions concerning arrangements that are economically equivalent to debt and that the financial terms of those arrangements are comparable with other options.

34. **The legal reform should centralize the debt management authority.** Existing laws that scatter the borrowing authority among the President, the Minister of Finance and, in the case of public corporations, concurrent authority of the MoF and the supervising line ministries, should be amended. Granting sole authority to the Minister of Finance to issue central government debt and guarantees would promote efficiency and accountability and help create a holistic view of the entire public debt portfolio. Clarifying the scope of the agency relationship (which may include, among others, managing auctions and registry services) through a fiscal agency agreement or a memorandum of understanding between the MoF and the CBSL will be critical after passage of the Monetary Law Act amendments.

35. **The PDM law should encompass issuing guarantees and providing funds through on-lending arrangements**. The law should clearly assign the responsibility for managing government guarantees and on-lending contracts. The mission further recommends that the legal framework stipulates a policy statement that clarifies in which cases guarantees, on-lending, or other forms of government support can be extended. This would introduce discipline in the use of government guarantees and minimize possible market distortions.

36. **The legal framework should enhance accountability and transparency for PDM.** A comprehensive framework on debt management-related disclosures should be included in the new PDM law. The DMO should be required to report debt management activities annually, evaluating outcomes against stated objectives and the MTDS. Public entities should be required to report borrowing activities to the central government, which in turn should be required to report the debt of NFPS entities (together with their guarantees). To support the DMO in its reporting obligations, the PDM law should provide the necessary powers and tools to collect information from all NFPS entities. These mandatory reports should be made publicly available within established timeframes. In the context of audits performed by the AG, the law could require the DMO to agree on an action plan or follow up on the audit recommendations.

37. **The reform of the PDM legal framework should be coordinated with other reform efforts that may impact PDM.** The authorities are working to revamp the overarching PFM legislation and carry out a broader reform of the public enterprises sector. The new PFM law is expected to contain high-level provisions that relate to PDM, such as the definition of "public debt," the mandate to borrow, and general conditions for granting guarantees and on-lending arrangements. Coordinating such reforms would prevent subject matter overlaps and conflicting provisions.

Summary of Recommendations

Short-Term Measure

- Draft a dedicated PDM law to promote transparency and accountability in the decision-making process. At a minimum, the PDM law should:
    - Consolidate the PDM legal framework.
    - Establish a consolidated DMO in the MoF.
    - Strengthen the institutional arrangements for PDM functions, including the authority to borrow and to issue new debt, hold assets for cash management purposes, and undertake other transactions on the government's behalf.
    - Define "public debt" as appropriate for the purpose of public debt management.
    - Establish long-term objectives for debt management to serve both as the anchor for the debt management strategy and the benchmark for evaluating its outcomes.
    - Require the preparation of an MTDS, its approval at the Cabinet of Ministers level, and its publication. The law must specify the MTDS' scope and content, require its update on a rolling annual basis, and require reporting on implementation against the objectives.
    - Require the preparation of an ABP and its publication in line with the MTDS.
    - Require the submission to Parliament of the annual report, which evaluates the compliance of debt management operations with the MTDS.
    - Require the publication of debt management policies and operations.
    - Establish mechanisms to enforce accountability and provide assurances of integrity.
    - Require NFPS entities to inform the DMO of their borrowing activities and require the central government to report the debt of NFPS entities.

- Establish the legal authority to issue guarantees and undertake on-lending operations, clarify the purpose of such operations, require evaluation and credit risk assessment before issuance, and establish and monitor risk mitigation measures.

- Clarify the CBSL's fiscal agency mandate through a fiscal agency agreement or memorandum of understanding and define the operational details of the agency relationship.

IV. Institutional Framework

Sound Practice

38. **A strong institutional framework requires that PDM responsibilities be consolidated into one entity.** Over the past 30 years, there has been a clear trend to achieve this in countries across the income spectrum. Historically, in many countries, different entities were responsible for managing different types of debt, for example, foreign-currency marketable debt, foreign-currency loans, domestic securities, and so on. Consolidation into one entity facilitates the development of a single database for public debt, which supports efficient reporting and analysis. It also facilitates the development of a coherent debt management strategy and an annual borrowing plan. Lastly, it supports more efficient execution, as borrowing from all sources is managed by one team.

39. **A wide range of institutional arrangements can support a consolidated DMO—from within the MoF to as a statutory body and in between.** Emerging markets and developing countries overwhelmingly favor the within-the-MoF approach. Statutory bodies and other forms of agencies outside the MoF mainly exist in high-income countries, where the reliance on `f agencies is commonplace for the operational parts of government, with ministries more focused on policy. In these cases, it is a well-established organizational form, with clear contracting between the agent and the principal (the MoF). This may have advantages in allowing more flexible management of resources but requires a reasonably stable macroeconomic policy-setting environment, deep and developed local bond market, easy access to international capital markets, and availability of human capital to clearly contract with the agency. In emerging markets and developing countries, there is greater need for coordination across the MoF, in particular when there is a significant share of bilateral and multilateral borrowing. In addition, there is more likely a need for an iterative approach in setting the debt management strategy as macroeconomic circumstances change.[13]

40. **International sound practice for the internal setup of a DMO is based on a model adopted from the private sector, where tasks are distributed across front, middle, and**

[13] See Anderson, Phillip (2006). "Should Public Debt be Managed by a Separate Agency?" In *Government Debt: New Trends and Challenges*, edited by Mike Williams. London: Central Banking Publications. Currie, Elizabeth, Jean-Jaques Dethier, and Eriko Togo (2003). "Institutional Arrangements for Public Debt Management" World Bank Policy Research Working Paper No. 3021.

back offices. This approach is designed primarily to control operational risk through the segregation of responsibilities. The front office is typically responsible for negotiating loans and executing transactions in financial markets, including the management of syndicated issues, auctions, and other forms of borrowing. The middle office is usually charged with developing the debt management strategy, monitoring risks, and ensuring that the front- and back-office operations comply with the established limits and controls. The back office usually handles settling transactions and maintaining financial records.

41. **An effective DMO requires adequate staffing and information technology (IT).** Remuneration levels and promotion prospects need to be designed to ensure adequately skilled staff are recruited and retained, and the DMO should be headed by a technically qualified and experienced official. Turnover in a DMO is inevitable, but it is important to manage transitions so that critical human capital is not lost every time a member leaves the debt office. Formal staff training programs also help build skills and retain staff. A specialized IT system provides a centralized public debt database, which facilitates the accurate management of payments, comprehensive reporting, and development of a debt management strategy. More advanced systems are interfaced with financial management and payment systems, reducing redundant data entry and operational risk.

42. **Because of their policy and operational interdependencies, debt managers, fiscal authorities, cash managers, and central bank staff have to coordinate regularly.** At a policy level, this is to ensure that monetary and fiscal policy settings and the debt management strategy are consistent with a sustainable policy mix.[14] At an operational level, information needs to be shared to ensure consistent baseline macroeconomic forecasts as well as regular government cashflow projections to facilitate an efficient borrowing program and management of financial system liquidity. Coordination may be bolstered by establishing a committee(s) with a clearly defined mandate, membership, and meeting schedule.

Current Situation

43. **Borrowings from official and commercial external sources are arranged and managed by the ERD at the MoF.** ERD is responsible for managing the relationship with each bilateral and multilateral development partner, and borrowing forms part of this function. Official financing requires a multistage process that includes coordination and input from the National Planning Department, line ministries, implementing agencies, the Attorney General's Department, other Treasury departments, and the Monetary Board. In addition, the ERD has a back office responsible for external debt data recording and payment procedures.

44. **Domestic debt is largely managed by the PDD of the CBSL, which is organized along functional lines.** The front office is responsible for all securities issued in the local market, primarily through auctions, including Sri Lanka development bonds denominated in

[14] See Togo, Eriko (2007). "Coordinating Public Debt Management with Fiscal and Monetary Policies: An Analytical Framework" World Bank Policy Research Working Paper No. 4369.

US dollars. Auction results are decided by the Tender Board, which primarily comprises senior CBSL staff and representatives of the MoF. The front office also facilitates the Domestic Debt Management Committee (DDMC), which recommends the forthcoming month's domestic borrowing plan for approval by the Governor of the CBSL. The middle office conducts a significant volume of reporting, records domestic debt, performs debt service forecasting, prepares an annual borrowing plan, and provides input to periodic work on the MTDS. Lastly, the back office is responsible for settlements and for domestic and foreign-currency payments.

45. **The TOD of the MoF has several responsibilities in debt management.** It produces an annual borrowing plan, prepares debt service forecasts, participates in the Tender Board and DDMC, arranges debt-related payments, and records debt transactions in the financial management systems.

46. **The issuance of Eurobonds has a separate structure.** When the Cabinet decides to explore the issuance of Eurobonds, it appoints a steering committee to guide the process. The steering committee is appointed for the issuance program of a year or other predefined period. Its members from the MOF include the Deputy Secretary to the Treasury, TOD, Fiscal Policy, and ERD Directors General; from the CBSL, members include the Deputy Governor, Assistant Governor, and the heads of the Public Debt, Economic Research, International Operations, and Legal departments. The actual Eurobond issuance process is handled by the CBSL. After the issuance, the ERD is responsible for recording and initiating payment instructions.

47. **There is currently no requirement to develop and publish the debt management strategy.** A debt management strategy for Sri Lanka was last produced and published in 2019 and covers the period 2019-23. It has not been updated since. The existing practice is to plan financing on an annual basis. This approach lacks a medium-term orientation and thus is subject to frequent change in direction without an end target for the cost and risk profile of the debt portfolio.

48. **At present, the annual financing strategy consists of first estimating the net external borrowing, and treating domestic financing as a residual.** Net external financing is determined by considering upcoming maturities and available sources of financing, with input from the ERD. Net domestic financing is a residual. Specifically, the domestic financing is determined by the Annual Government Borrowing Program, produced by the TOD and approved at the Revenue and Cash Flow Management meeting. The program establishes a limit on T-bills (issued to the market), as well as the target issuance of Sri Lanka Development Bonds (SLDBs). Targets to borrow from offshore banking units are also specified. Residual financing needs are allocated to T-bond issuance. The draft Annual Government Borrowing Program is submitted to the Monetary Board, which then proposes it to the Secretary to the Treasury for approval. The plan is not published. Information on annual financing is made available through the annual budget, where aggregate net external and domestic financing is disclosed. Because the domestic borrowing assumptions are not

derived from the bottom up, based on analysis of available financing sources, the financing assumptions have been unrealistic over recent years. When the funding requirement cannot be met in full through the auction, the balance is met by issuing Treasury bills to the CBSL. This has led to a large accumulation of CBSL holdings of government paper.

Issues and Recommendations

49. **The mission recommends establishing the DMO as a department in the MoF.** In discussions during the mission, finance ministry and central bank officials expressed support for this structure. The DMO would have equal standing to other MoF departments (the Fiscal Policy, National Budget, Treasury Operations, External Resources, State Accounts, Public Enterprises, and Legal Affairs) with which it will have to coordinate.

50. **To accommodate all the functions of a modern DMO, the following requirements will have to be met:**

- First, the legal framework should ensure that debt management is established as a separate policy area, with a specialized function, accountability, and transparency. Developing and publishing a MTDS, as well as regular reporting, are central to this policy requirement. This is discussed in detail in Section V.

- Second, the DMO must attract and retain staff experienced in financial markets and have the financial modeling skills to develop a public debt management strategy. The process takes time to master, and frequent staff turnover might result in a loss of institutional knowledge. The mission was informed that base pay for public servants is low but that it is supplemented by allowances and noncash benefits, as well as a defined-benefit pension scheme. There is a range of tools, most requiring Cabinet approval, available to departments with qualified officers, including secondments, staff on individual contracts, establishment of a specialized cadre, and special incentives. It is also possible to override the usual rotation policy (five years). It is essential that the flexibility made available is fully used in order to retain skilled staff and, if necessary, that new employment measures be introduced in order to ensure appropriate staffing. Importantly, this flexibility should not be seen as an entitlement for being in the DMO, but rather should be available to specific positions where specialized skills and experience are needed to perform the job. Approval of the professional staff's salary levels by the Public Service Commission would ensure fairness and would control the wage bill and other expenses.

- Third, the DMO will need financial and technical resources for specialized IT and information services. For example, the CBSL currently has a Bloomberg terminal to support the domestic financing program. The current IT infrastructure for debt management is fragmented and the new DMO should develop and/or acquire a fully integrated IT solution (see Section V for further discussion).

51. **Consolidating the debt management functions will require combining activities currently managed in the PDD of the CBSL, the ERD and TOD of the MoF, as well as introducing important new functions.** However, it would be best to leave LankaSecure in the CBSL—DMOs typically do not house the central securities depository and the settlement system. These are contestable services that are often managed by central banks. The mission also recommends that the CBSL continues its role of providing banking services for debt-related payments and receipts in both local and foreign currencies. Lastly, TOD would continue in its role as cash manager, although the DMO would conduct any market transactions required to smooth cash balances (for example, issuing Treasury bills). In addition, the DMO should manage guarantees and on-lending.

52. **The ERD performs many of the functions of a DMO, so the department could be expanded to become the Public Debt Management Office (the "One Department" option; Figure 7).** This would place all borrowing activities of central government in one department. However, it would also add many functions that are not directly related to financing. For example, the front office of the ERD allocates significant resources to donor and stakeholder coordination, including country partnership strategies, country programming, coordination with line ministries and implementing agencies, and mission organization.[15]

53. **An alternative would be to form a smaller ERD with the bilateral and multilateral Additional Director Generals (ADGs), and move the debt and policy and capital markets divisions to the DMO ("Two Departments" option; Figure 8).** This structure would provide the advantage of a DMO exclusively focused on financing the central government. Management time would not be devoted to the broader development agenda and relationships with bilateral and multilateral development partners. The ERD would also have its own Director General, focused on core activities associated with managing the relationships with the official sector, including borrowing functions. A problem with this approach is that the smaller ERD would no longer have a back office, so the ERD would need to coordinate across departments and with the DMO front office.

[15] For example, in 2022, the ERD organized 190 missions for the World Bank and Asian Development Bank, which included organizing 230 meetings.

Figure 7. Option 1 for the DMO Structure – One Department

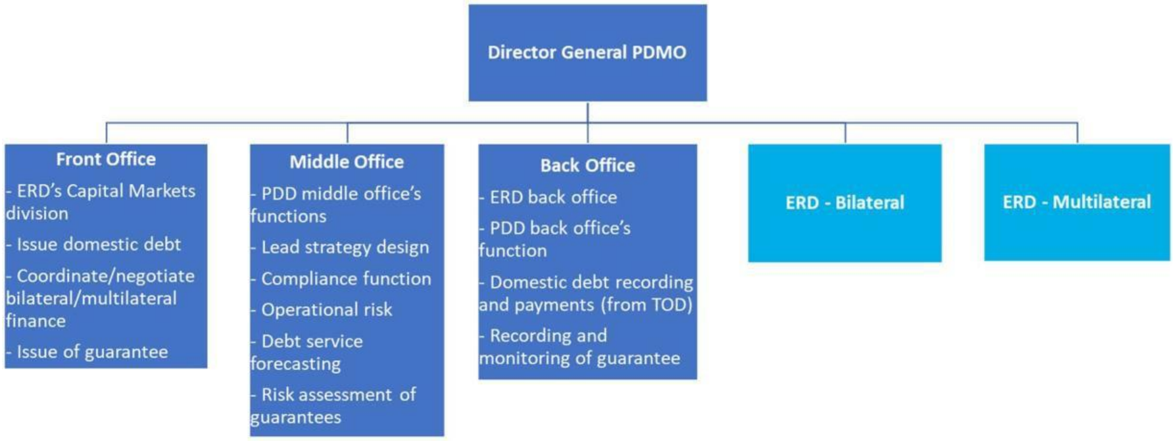
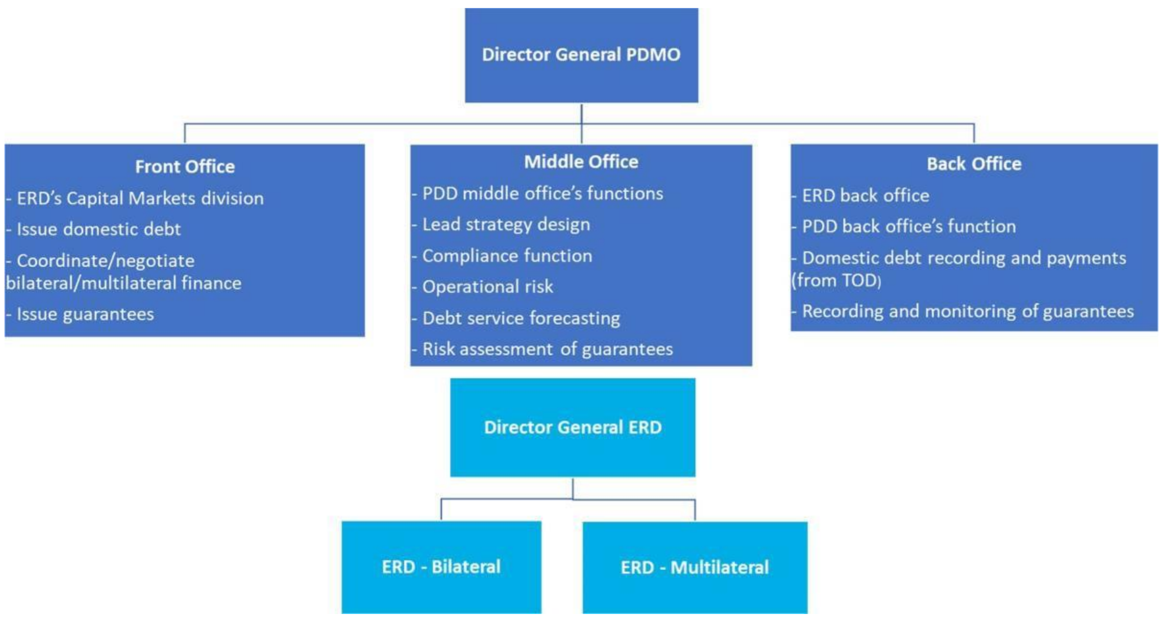


Figure 8. Option 2 for the DMO Structure – Two Departments



54. **Recognizing that both options have advantages and disadvantages, the mission recommends the "Two Departments" option**. Establishing the DMO within the MoF will facilitate this coordination. Of note, this recommendation takes into account the demands associated with the large public debt stock, which is projected to remain close to 100 percent of GDP over the medium term, even after the debt restructuring, and the significant new responsibilities to (1) conduct domestic auctions, (2) develop the MTDS, (3) manage guarantees and on-lending, and (4) maintain a consolidated and accurate debt records and report and publishing them in a timely manner.

55. **The functions of the front, middle, and back offices are identical in the two options.** The offices are described below, together with the locations from which the component functions would be moved. The divisions performing the remaining ERD bilateral and multilateral functions would be identical between the two options.

Front Office

56. **The front office of the DMO would have the responsibility and oversight of central government borrowing from all sources.** These include international bonds and loans, the financial terms of official sector loans (bilateral and multilateral), and all domestic securities and loans. Performing these tasks will require a team that fully understands the all-in costs and relative merits of each source of financing and thus supports the development of an annual borrowing plan and efficient financing of the government.

57. **Responsibility for international bonds and syndicated loans (currently with the ERD's Capital Markets Division) would be moved to the DMO front office.** The CBSL has co-led the issuance of international bonds; this suggests that when market access is regained, training and/or additional resources may be required to perform this function.

58. **The front office would be responsible for negotiating and selecting the financial terms and conditions of official sector loans.** The structure and functions of bilateral and multilateral ADGs would remain the same, as the origination of borrowing is bundled with the overall relationship with each development partner. However, because the financial terms have to be consistent with the MTDS, the front office of the DMO should be in charge.[16] In addition, the front office would analyze the all-in cost of financing from each source and maintain knowledge of the most beneficial terms, as well as the relativity to market-based financing.

59. **The most significant change would be the shift in responsibility for all domestic borrowing from the CBSL to the MoF.**[17] At present, the MoF has relatively little involvement in this activity, other than the TOD's membership on the Tender Board and accounting for and making payments related to domestic borrowing. Because this is a major undertaking and given the MoF has little experience in the area, the new DMO would require support to build institutional capacity. This support could be provided in two ways:

- The front office of the CBSL's PDD could act as the agent for the DMO for a transitional period to execute auctions and other activities related to domestic

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[16] Under this arrangement, an officer from the front office would accompany officers in the bilateral or multilateral section of the ERD when the financial terms of the loans are being negotiated.

[17] Domestic borrowing is defined in this context as all securities issued or other borrowing undertaken in the local jurisdiction.

borrowing.[18] The relationship would be documented by an agency agreement specifying the roles of each institution, including the DMO's role as principal with decision-making rights for auction results and transactions. Under this option, the front office of the DMO should appoint two or three staff to work closely with the CBSL and market participants to build their skills and experience in the area.

- An alternative approach would be to transfer the function when the DMO is formed. This would require secondments from the CBSL and possibly hiring staff from the private sector or consultants for a transitional period.

60. **The primary dealer (PD) agreements would have to be between the government (through the DMO) and each dealer.** PD agreements set out the privileges and obligations of each dealer, for example, the right to participate in auctions in exchange for an obligation to bid and distribute securities to investors, among other terms. Under option 1, the PD agreement would specify the CBSL's role in implementing the domestic borrowing program, including the day-to-day relationship with the PDs.[19]

61. **Management of the domestic borrowing program also would include developing and adopting measures to improve the functioning of the domestic debt market.** This complex process would require coordination between the finance ministry, central bank, regulators, market participants, and the providers of market infrastructure. As the DMO develops its capacity for managing the domestic debt market, it would become the main entity with decision making authority in the primary market, and its actions would also play a role in the liquidity of the secondary market. Continued coordination with the CBSL would be required.

62. **If overdrafts with state-owned commercial banks remain in use, the DMO would be responsible for negotiating the terms and conditions.** These would include the maximum size and the applicable interest rates. The TOD, as cash manager, would have the flexibility to draw on the overdrafts. The mission recommends that the DMO plan borrowing activities to maintain positive cash balances, for example, issuing T-bills, consistent with the practice in most countries.

63. **The front office should lead the development of the ABP and quarterly (or monthly) auction calendars.** This role would require close liaison with the TOD (for cashflow needs), the middle office (for consistency with the MTDS), and the CBSL (for views on market conditions).

[18] The length of the transition does not need to be specified at the outset but is likely to be at least two years. In some countries, the agency role has continued for many years.

[19] The CBSL also would continue to regulate and supervise the primary dealers as financial institutions, that is, as licensed commercial banks or dedicated primary dealer companies, consistent with its mandate for financial stability.

64. **It is recommended that the front office conducts the investor and stakeholder relations activities.** This would include management of the relationship with rating agencies. The mission team was informed that ERD's Capital Markets Division currently performs some activities in this area and that the PDD manages the relationships with rating agencies, including coordinating with other CBSL departments and the MoF. An effective investor relations team will be critical for regaining market access and to maintain it afterwards. The Institute of International Finance (IIF) has developed a tool to assess the quality of investor relations and data dissemination practice for 38 emerging market countries that are active in the international capital markets. This could provide a template for Sri Lanka to improve its practice in this area. The IIF periodically publishes results of this assessment.

65. **The mission recommends that the front office be responsible for the issuance of government guarantees.**[20] The guarantees issuance process would be as follows: the front office conducts an initial compliance check and forwards the SOE's guarantee request to the middle office for analysis and risk assessment. The front office, considering the terms and conditions, evaluates the certified copy of the bank agreement to be signed by the SOE and the relevant bank (or other financial institution) and submitted to the DMO within the scope of the SOE's guarantee request. The front office presents the opinion prepared by the middle office, together with its assessment of the bank agreement, to the ST recommending the approval, who will forward it to the Cabinet for a decision. Following the Cabinet's approval, the front office prepares the necessary contracts and documents for the signature of the DST and ST. While transmitting the signed contract to the relevant bank, the front office also forwards the documents and information required for registration into the debt management information system (DMIS) to the back office. These functions are currently performed by the TOD and would be transferred to the new DMO.

Middle Office

66. **The main roles of the middle office would be to lead the development of the MTDS and oversee risk management.** At present, there is no entity in Sri Lanka that develops a comprehensive and coherent MTDS, so this would be a new function.[21] Performing this function requires strong analytical and modeling skills; maintenance of institutional knowledge is also important. The focus of the MTDS should be on the medium-term time horizon. The results of the MTDS analysis should be presented to the DMCC, and the costs and risks of alternative financing strategies should be assessed. The head of the DMO should select the strategy that will be proposed to the Cabinet of Ministers at a meeting chaired by the Minister of Finance. A debt management strategy document discussing the chosen strategy should be prepared for submission to the Cabinet of Ministers. After the decision has been made, the strategy document should be published, preferably together with

[20] Borrowing for on-lending would be conducted as part of the central government borrowing activities.

[21] A specially convened team produced a debt management strategy in 2019, and the CBSL has produced strategies for domestic debt in the past.

the MTFF. The budget financing assumption should also be consistent with the debt management strategy. The middle office should develop an annual timetable for developing a MTDS synchronized with the MTFF. Staff should receive training on developing MTDS, including through online learning.

67. **The mission recommends that the middle office leads the development and implementation of an operational risk management framework.** At present, the MoF has procedures in place for backup of IT. However, this falls short of a comprehensive framework to manage a broad range of operational risks, including from fraud, human error, noncompliance, threats to reputation, failure by third parties, cybersecurity issues, and lack of access to premises.[22] Strong DMOs typically adopt frameworks to manage operational risk that follow guidance from entities such as the Bank for International Settlements.[23] This reflects the DMO's role of conducting transactions in financial markets, an undertaking that calls for operational risk safeguards like those in financial institutions.

68. **The middle office should perform the compliance function for the DMO, which would be a new function in the MoF.** The task involves monitoring compliance with the MTDS, risk limits, operational risk policies, code of conduct, and contractual and statutory obligations.

69. **The mission recommends that the middle office be responsible for debt service forecasting.** This forward-looking activity would require having forecasts of interest and exchange rates, as well as debt service projections on new debt, which the middle office would need for developing the MTDS. This function is currently undertaken by the TOD and the CBSL.

70. **As part of the DMO's role to manage contingent liabilities, the middle office should assess the risk levels of guarantees and on-lending.** The middle office should develop quantitative risk indicators and risk models for the measurement of credit risk associated with granting guarantees and on-lending. Within the scope of risk analysis of guarantee requests, the middle office would analyze the financial capacity of the recipient while considering the previously determined risk indicators and limits (Section VI).

Back Office

71. **The back office would handle the settlement of transactions and the maintenance of the financial records.** The back office of the ERD (Debt Management Division) would be expanded to include domestic debt functions currently performed by the back office of the PDD at the CBSL**.** The ERD Debt Management Division has the general skills and experience in settling and recording debt instruments and issuing payment instructions,

[22] The CBSL informed the mission that it has procedures in place for the comprehensive management of operational risks.

[23] See [Revisions to the Principles for the Sound Management of Operational Risk (bis.org)]

which provides a good basis for this expanded role. There may be in the initial stages a need for secondments from the CBSL for specialized functions, such as issuing SLDB certificates and managing unclaimed government securities accounts. The domestic debt management operations of the TOD would also be transferred to the expanded DMO back office.

72. **In summary, the main activities of the back office would include:**

- Confirming and settling all loans and securities transactions.
- Entering all loans and transactions into the debt recording system(s).
- Entering debt transactions into the financial management system (responsibility transferred from the TOD).
- Issuing payment instructions for all debt instruments.
- Validating and reconciling data and transactions.
- Maintaining the debt recording system, including recording of guarantees and on-lending (see Section IV), and updating exchange and interest rates.

73. **The mission recommends that the DMO back office takes the lead in debt reporting and provision of information.** The ERD Debt Management Division already has considerable responsibilities in the area. The consolidation of functions would require shifting the reporting activities of the PDD's middle office, and to a lesser extent its back office, thus eliminating duplication. Other areas of the DMO would contribute to reporting, for example, the middle office on risk indicators and the front office on market conditions, requiring coordination. The need for coordination would increase as the investor relations function becomes more active.

74. **The back office should be responsible for the provision and maintenance of the specialized IT systems that the DMO requires.** At present, this is maintained in the CS-DRMS system for official borrowing and international bonds, operated by the ERD Debt Management Division. The CBSL PDD does not have specialized IT systems for recording domestic debt and instead uses Excel and Access databases. The mission team was informed that a process is underway to replace CS-DRMS with Meridian or DMFAS. As part of the upgrade, the intention is to consolidate all debt (including domestic) in the new DMIS, improve the IT infrastructure and security, and develop an interface with financial management systems (Section V). The new DMO should improve efficiency and reduce operational risk, for example, through fewer manual processes and less repeated data entry.

75. **As part of the DMO's role to manage contingent liabilities, it is recommended that the back office keeps track of government guarantees and on-lending.** To do this, the back office should enter the guarantees and on-lending data into the DMIS based on the documents and information provided by the front office, and verify the data after performing

the necessary controls. The back office should also record into the DMIS disbursement and debt service transactions of guarantees and on-lending. If the guarantees/on-lending recipient cannot fulfill debt service payments, the back office makes the necessary payments. The back office also should record and monitor the collections due from on-lending. It is also responsible for the recovery of amounts from nonperforming sub-borrowers. In addition to the central government debt, the back office reports both outstanding balance and flows of the guarantees and on-lending. These functions are currently performed by TOD and would be transferred to the new DMO.

Other Functions

76. **In addition to the core functions described above, the DMO would have to perform the following functions**:

- Internal audit: the Internal Audit Division of the MoF could cover this function.

- Legal advice: to be provided by the MoF's Legal Affairs Department and the Attorney General's Department, the current practice. The mission was informed that there is sufficient expertise to provide advice on domestic and international borrowing.

- Organizational support: Human resources, general IT, resource management, and general administration. As a department within the MoF, the DMO would have the same support of these functions as other departments.

Advisory Committee

77. **During the discussions, senior officials sought the mission's views on establishing an advisory committee.** Some countries establish an advisory committee to assist senior management in the finance ministry and the minister overseeing the DMO. The unique nature of the work of the DMO sets it apart from other areas in a finance ministry, and the skills set required for such oversight often do not align with those of senior management, which has a public policy orientation. DMO advisory committees usually comprise individuals with ample experience who collectively can cover public debt management, finance, reporting, financial markets, and operational risk. The main roles of the advisory committee typically are:

- Provide opinions on the strategy suggested by the DMO.

- Provide opinions on strategic initiatives, such as new instruments or enhanced outreach.

- Provide quality assurance of the DMO's performance, integrity of processes, follow-up on audit recommendations, and management of operational risk.

78. **The mission supports the establishment of a DMO advisory committee in Sri Lanka, to support senior management in its oversight of the DMO.** If the authorities decide to establish an advisory committee, they would need to ensure that members do not have any conflict of interest and will engage in confidentiality agreements. This common practice in countries with such committees. The composition of advisory committees varies across countries; they could include recently retired senior bankers or investors, finance academics, senior staff of other countries' DMOs acting in a private capacity, senior staff of major accounting firms, consultants active in PDM, seasoned governance professionals (for example, on several private and public sector boards), and recently retired senior finance ministry or central bank staff.

Coordination

79. **Complying with debt management objectives requires coordination among agencies.** Debt management seeks to cover the government's financing needs and meet payment obligations over the medium to long term at the lowest possible cost and with a prudent degree of risk. Because the budget determines the government financing needs, coordination with fiscal policy is essential. While monetary policy affects the cost of government borrowing through interest rates, exchange rates, and inflation, the debt management strategy can also impact the term structure of interest rates and the exchange rate. This implies that coordination between the DMO, other MoF departments, and the CBSL should take place at the policy level. This coordination should include the Fiscal Policy, National Budget, Treasury Operations, External Resources, and Public Enterprises departments of the MoF, and the Domestic Operations, International Operations, and Economic Research departments of the CBSL.

80. **At the operational level, the government's cash flows (including debt-related cash flows) will influence liquidity in the banking system, and debt inflows and payments in foreign currencies have implications for reserves levels and the exchange rate.** Therefore, coordination with the Domestic Operations and International Operations departments in the CBSL is required.[24] Within the MoF, the TOD, as government cash manager, is also a crucial participant in the coordination process.[25]

81. **The mission recommends that coordination between the DMO and other agencies be implemented through a Debt Management Coordinating Committee (DMCC), in line with sound practices employed in many countries.** The DMCC would replace the Domestic Debt Management Committee of the CBSL and would be chaired by the Director General of the DMO and comprise representatives of the CBSL, TOD, ERD,

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[24] As the government of Sri Lanka conducts much of its banking through two state-owned banks, the impact of government cash flows on banking sector liquidity is less than in countries where the government has a treasury single account at the central bank only.

[25] If the CBSL acts as the agent for conducting auctions, coordination with the CBSL conducting this function would also be needed. This relationship would be governed by an agency agreement.

and Department of Fiscal Policy in addition to the managers of the front, middle, and back offices. The functions of the DMCC could be as follows:

- Review the debt management strategy prepared by the middle office.
- Review the annual borrowing plan and auction calendar.
- Coordinate with cash management, including sharing information on debt service forecasts, new borrowing, cashflow forecasts and financing needs, and treasury single account balances.
- Evaluate domestic and international market conditions, and money market liquidity.
- Discuss the risks of government debt and opportunities in the market and from official sources.

82. **The establishment of the DMCC and its operating principles should be planned carefully.** It will be necessary to set the terms and conditions for the appointment of members, the meeting period and invitations, the agenda, minutes and other records, and the allocation of the secretariat function. It will be important to state clearly that the purpose of the DMCC meetings is coordination; the entities that are represented are responsible for their own decisions, consistent with legislation and delegated authorities.

83. **The Tender Board will no longer be required, as domestic debt market operations will be controlled by the DMO.** Once the DMO has the skills and mandate to decide on auction results, it will be important to assign to it responsibility in this area which will be separated from monetary policy. Even if the PDD of the CBSL acts as the agent for conducting domestic auctions, the PDD would provide the results to the DMO for its decision (and may provide recommendations). The decision would be made in the context of the ABP, auction calendar, cashflow needs, volume and dispersion of bids, recent macroeconomic developments, developments in the domestic money market, and recent trends and movements of primary and secondary market yields. The DMO should determine the issuance volume and act as a price taker, leaving the market to determine the yield.

Transitional Issues

84. **As noted above, the most significant change in responsibilities in the formation of the DMO will be transferring domestic debt operations from the CBSL to the DMO in the MoF.** The timeframe and sequencing will need to be assessed and ultimately based on practical considerations. The PDD's back and middle office functions could be moved earlier, given that the ERD Debt Management Division has generic skills and experience in transaction processing and reporting through its role in external debt. However, as noted in paragraph 71, it may be necessary initially to second staff from the PDD back office to build skills and knowledge in specialized areas of domestic borrowing. Also, detailed planning

would be required to redesign processes linking the PDD front office (if it continues as an agent) to the DMO's back office, as well as the DMO's back office links to LankaSecure. In the area of reporting, a detailed analysis would be required, explaining how the PDD's current functions would be transferred, as well as where duplication could be eliminated (Section V).

85. **The shift in responsibilities to the DMO would require the review of all transaction processing, recording, and reporting.** With the elimination of the PDD's back office and some TOD functions transferred to the DMO, processes would need to be redesigned; this would provide an opportunity to improve efficiency, remove duplication, and reduce operational risk. A consulting firm (for example, one of the Big 4 accounting firms, with branches in Sri Lanka) with expertise in the Treasury process could be engaged to assess all the processes and make recommendations for improvement.[26]

Summary of Recommendations

Short-Term Measures

- Establish the DMO as a department in the MoF, by consolidating the debt management functions of the ERD, TOD, and PDD, except:
    - The operations of LankaSecure, which should remain in the CBSL.
    - The cash management function, which should remain with the TOD.
- Structure the DMO along functional lines, where:
    - The front office has the responsibility or oversight of central government borrowing from all sources, as well as guarantees and on-lending. Borrowing in the domestic market may be delegated (through an agency agreement) to the CBSL for a transitional period. The front office develops the ABP and manages investor relations.
    - The middle office prepares the debt management strategy, analyzes and manages risk, and undertakes compliance and debt servicing forecasting.
    - The back office settles, records, and issues payment instructions for all instruments and is responsible for reporting and specialized IT platforms.
- The mission supports the authorities' suggestion to establish an advisory committee to support senior management in its oversight of the DMO.

[26] This is referred to as "business process reengineering."

- Establish a coordinating committee, chaired by the head of the DMO, with membership of the TOD, ERD, Department of Fiscal Policy (MoF), and Domestic Operations, International Operations, and Economic Research departments (CBSL).

- Abolish the Tender Board and DDMC.

- In consultation with the Fiscal Policy and the Budget departments and the ERD, TOD, and CBSL, the DMO should develop a MTDS and prepare its annual timeline, including when to submit a draft to the DMCC for feedback.

- For all middle office staff, develop online training on MTDS, and for front office staff, on ABP. Other needs include training to understand the yield curve, forward curve, and interest rate parity.

Medium-Term Measures

- Transfer domestic auction program responsibilities from the CBSL.

- Conduct business process reengineering to improve efficiency, eliminate duplication, and reduce operational risk.

- Conduct the MTDS analysis using the MTDS analytical tool.

- Prepare and publish a rolling annual debt management strategy that is consistent with the MTFF.

- Publish the debt management strategy together with the budget.

- Publish the ABP and auction calendar.

V. DEBT TRANSPARENCY

Sound Practice

86. **Regular reporting of public and publicly guaranteed debt, as well as of contingent liabilities, is a key factor for transparency and accountability in government finance.** According to the World Bank-IMF *Public Debt Management Guidelines* (2014), "the debt manager/government should regularly (monthly or quarterly) publish information on the outstanding stock and composition of its debt liabilities and financial assets, and,

where they exist, loan guarantees and other contingent liabilities, including their currency denomination, maturity, and interest rate structure."[27]

87. **Debt transparency necessitates transparent planning and borrowing practices, well-defined and efficient debt recording, and periodic monitoring and evaluation, supporting information disclosure.** This process should be underpinned by a strong legal and regulatory framework that defines clear responsibilities and requirements (for example, information sharing by SOEs with the DMO, by the DMO with parliamentary and auditing bodies), and periodic and timely publication of public debt data and borrowing transactions and strategies on the DMO website.

88. **Sound debt recording encompasses the segregation of duties and formalized processes, comprehensive data coverage, and an efficient and updated DMIS.** There needs to be timely information sharing between staff who negotiate/execute the transactions and those responsible for entering data into the system. Once data are entered, other staff should verify data accuracy before final clearance. The DMO should be responsible for updated debt data covering central government domestic and external debt instruments, and sovereign guaranteed debt and on-lending operations.[28] SOEs and sub-national governments' nonguaranteed debt data should also be available for comprehensive reporting of the NFPS debt data (less commonly stored in the DMIS).

89. **The DMIS should ensure data integrity, quality, and, ideally, permit interfacing with other financial management systems within the government.** Data should be protected through carefully assigned access to data entry, authorization for editing records, and audit trails. In addition, business continuity should be safeguarded by documented procedures for debt and transaction data recording and validation, safe data storage, and backup procedures. Finally, the DMIS should enable easy data extraction for monitoring, strategy development, and reporting activities.

90. **Sound practices on debt reporting reflect data accessibility, completeness (and accuracy), timeliness, and publication of the public debt management strategy.**[29] Debt data should be accessible to the public through a single or few sources, cover central government and other public entities' debt instruments, and be published periodically and with short time lags from the end of the reporting period. Moreover, disclosure of debt

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[27] See also IMF, *Manual of Fiscal Transparency* (2007), paragraph 207; *Data Quality Assessment Framework* (2003); *Public Sector Debt Statistics Guide;* and *External Debt Statistics Guide for Compilers and Users* (2003). https://www.imf.org/external/np/sta/ed/ed.htm. See also World Bank (2021), *Debt Transparency in Developing Economies* https://documents.worldbank.org/en/publication/documents-reports/documentdetail/743881635526394087/debt-transparency-in-developing-economies.

[28] Institutional mechanisms for information sharing with lenders, implementing agencies, and guarantees and on-lending entities (if not the DMO) must be in place.

[29] The WB Debt Transparency Heatmap and the Domestic Debt Securities Heatmap are useful tools for assessing debt transparency practices across different countries and guiding authorities on improving the practices.

management strategies and annual borrowing plans increase transparency and accountability of future borrowing transactions. Finally, close monitoring and disclosure of debt-related contingent liabilities and information on recently contracted loans including the amount and financial terms of each loan help stakeholders keep track of information beyond regular central government marketable borrowing transactions.

91. **Debt reports should also cover transactions carried out in the reference period and their alignment with the MTDS and the ABP.** The publication of the plans and results of the domestic placement of government debt should also follow a timely and standardized approach.[30] This should include the securities placed through auctions, the publication and consistent implementation of the auction calendar, publication of results, and disclosure of secondary market information. Likewise, though usually issued through different mechanisms (syndicated book building), the timely and comprehensive publication of information on issuing international sovereign bonds is a critical aspect of the transparent implementation of the debt management strategy.

Current Situation

92. **A wide range of central government debt is disclosed, but timeliness, coverage, and consolidation of information could be improved.** While coordination mechanisms exist, the fragmentation of debt management (and so of debt recording and reporting) between the MoF and the CBSL results in duplication of processes and outputs.

Debt Recording

93. **Debt recording is fragmented, and there are duplicated databases that serve different purposes.**

- The ERD records central government external borrowing (both loans and bonds) comprehensively in its own debt recording system (CS-DRMS provided by the Commonwealth Secretariat). Data on SLDBs are recorded by the PDD's middle office into its own Excel-based database for reporting purposes. The PDD back office maintains a register of SLDB holdings for debt servicing purposes.

- The PDD back office has access to the Access database, which facilitates SLDB issuances, to print physical certificates and generate reports on interest payments. Domestic government securities (T-bills and T-bonds) records are kept at the Central Depository System (CDS) hosted under the PDD (LankaSecure System), and the PDD middle office maintains separate databases for domestic and external debt

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[30] Likewise, a detailed methodology to assess transparency practices on domestic securities transactions is available on the Domestic Debt Securities Heatmap methodology referred to before.

instruments for reporting and analysis purposes. The PDD back office manages its own database for each instrument type to support its debt service reporting function.[31]

- The TOD is responsible for recording/accounting of new borrowing and debt service payments of domestic and external debt in the government Treasury Financial Management System, which is not integrated with the CS-DRMS. The TOD plays a role in managing domestic debt payments in coordination with the PDD back office, and for that purpose, the former maintains an internal Excel database.

94. **The PDD and ERD have a well-established two-step process for debt recording and a well-defined coordinated work process, but multiple and overlapping databases add up to operational risk and inefficiencies.** The PDD has an updated and comprehensive procedures manual, while ERD performs its activities following checklist-format internal instructions. Within the PDD, the back office main functions related to settlement of T-bill and T-bond issuances (in coordination with the PDD front office) and payments of domestic and external debt (in coordination with LankaSecure and the TOD in the MoF), while the back office is responsible for recording only debt service payments. In contrast, the PDD middle office has a central role in managing debt databases for analysis, but still with limited risk analysis in place.

95. **The CS-DRMS recording system has been used in Sri Lanka since 1986, and the current version is outdated and has important limitations.** According to the authorities, the system has limited capacity to record domestic securities and has limited reporting features. The existing license of the system expired in June 2022, and although the ERD can still use the system, the vendor does not provide further maintenance or improvements, posing a significant operational risk. MoF/ERD is assessing the possibility of upgrade of CS-DRMS to Meridian (a more modern system provided by the same vendor) versus acquiring the license of DMFAS, provided by UNCTAD.

96. **Domestic securities clearing, settlement, and depository functions are administered with the support of the LankaSettle System (Figure 9).** The system was developed by an external vendor in 2004, and while the CBSL IT department and the vendor support the maintenance and improvements, the system is unsophisticated and is missing key functionalities, for example, related to trading.[32] The CDS maintains the registry of scripless T-bills and T-bonds at the investor level, but the number of accounts has steadily increased. Scripless Securities Settlement System (SSSS) facilitates the settlement of government securities transactions on a delivery versus payment (DvP) basis or delivery free (DvF) basis, ultimately resulting in ownership changing. The transfer of funds associated with DvP transactions is facilitated by Real-Time Gross Settlement System (RTGS).

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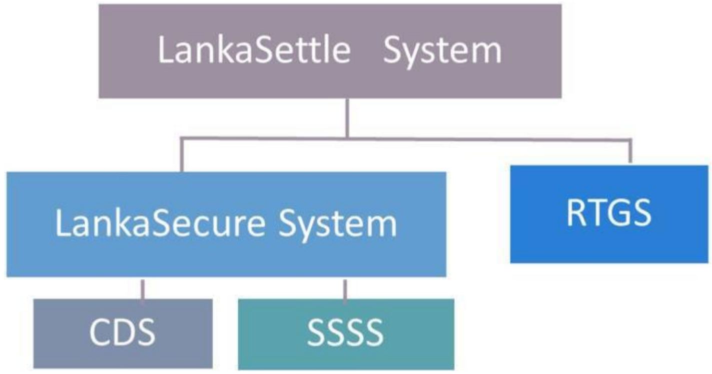
[31] The PDD middle office has databases for upcoming debt cashflows.

[32] A Term of Reference to develop a new system was drafted, but currently there is no budget for this project.

Figure 9. Sri Lanka Government Securities Clearing, Settlement, and Depository Architecture



Source: CBSL.

97. **Debt data are mostly complete and recorded on a timely basis; however, the National Audit Office has cited areas for improvement.** Whereas new loans and securities are recorded within a month of their origination, disbursements of existing external debt by some lenders are often recorded with a time lag of up to six months. In its Special Audit Report on Financial Management and Public Debt Control in Sri Lanka 2018-2022, the National Audit Office observes inconsistencies between the external debt stock registered in CS-DRMS and the government financial statements. Moreover, the report points out that public enterprise debt is being serviced by the government through the budget, but it is not registered as government direct debt. It further states that clearer definitions of public debt management responsibilities and the concept of public debt are needed.

Debt Reporting

98. **Information about central government debt and guaranteed debt is published in several reports from the MoF and the CBSL.** There are dedicated debt reports/bulletins available on the websites of both entities, and debt is reported in their annual reports. Table 1 summarizes the existing reports and relevant contents.

99. **The PDD's *Public Debt Management in Sri Lanka* report could be considered Sri Lanka's annual debt report.** However, the report is normally published more than six months after the end of the base year. Although there is no updated debt management strategy in the country, the 2022 report is the only publication that presents a thorough discussion on the implementation of the 2019–23 MTDS, with a detailed description of the evolving domestic and external environment in 2021, and implications for domestic T-bill and T-bond issuances. The scope of the report is central government debt, and it does not cover sovereign guarantees or NFPS debt.

Table 1. Debt Reports Produced by the Ministry of Finance and the CBSL

Responsible	Report	Content	Latest Version (Base/Publication dates)
CBSL/PDD	Annual Public Debt Management in Sri Lanka [1]	- New borrowing for external and domestic debt (by creditor type, economic sector and instrument) - Domestic and external debt stock (by creditor, instrument and currency) - Debt service for domestic and external (historic and projection) - Cost and Risk indicators - Stock taking of strategy implementation against the MTDS	2021/Not published
CBSL	Annual Report - Chapter 6 - Fiscal Policy and Government Finance [2]	- Domestic and external debt stock (by instrument, creditor and currency) - Debt service cost to GDP and revenues - Stock of domestic and external debt guarantees - Outstanding foreign project loans to SOEs (non-guaranteed)	2021/Apr 2022
MoF	Public Debt Summary [3]	- Domestic and external debt stock (by creditor and instruments) - Arrears by creditor - Domestic and external debt guarantees (by creditor)	2022/Feb 2023
MoF	Annual Report - Chapter 6 - Cash Flow Management, Deficit Financing and Debt [4]	- New borrowing for external and domestic debt (by creditor and instrument) - Domestic and external debt stock and maturity profile (up to 2027) - Debt service cost to GDP and revenues	2021/May 2022
MoF	Quarterly Public Debt Bulletin [5]	- Domestic and external debt stock (by creditor and instrument) - Domestic and external guaranteed debt (by contract)	Sep 2022
MoF	General External Debt Information [6]	- Debt level indicators by year - New loans by year (terms and conditions) - Disbursements by year - Stock summary by creditor	- 2020 - 2022 -2022 - Apr 2022

[1] https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/otherpub/public_debt_management_in_sri_lanka_2021.pdf

[2] https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2021/en/10_Chapter_06.pdf

[3] https://www.treasury.gov.lk/api/file/e4c03d36-6831-470c-aa34-450de02317e2

[4] https://www.treasury.gov.lk/api/file/a7a35d1a-556f-49b2-81e0-20294eb5a519

[5] https://www.treasury.gov.lk/api/file/d857ad94-e632-4fc6-a221-cab9965d7085

[6] http://www.erd.gov.lk/index.php?option=com_content&view=article&id=66&Itemid=290&lang=en

Sources: MoF and CBSL.

100. **The annual reports of the MoF and CBSL include aggregate information on debt stocks and debt service, with less information on debt composition (management).** However, both include discussions of central government borrowing in the domestic market and implications of the changing environment. The MoF's annual report presents detailed terms and conditions of external loans contracted in the year and historical statistics about domestic debt. The CBSL's annual report includes information on the public debt stock, defined as the sum of central government, foreign loans received by state-owned business enterprises, and public guaranteed debt.

101. **In line with its commitments under the current the IMF-supported program, in 2022 the MoF began publishing a quarterly debt bulletin with more timely debt information.** The first edition, jointly produced by the MoF (the ERD and TOD) and the CBSL (the PDD), discloses data as of September 2022. It includes information on outstanding total public debt (including guaranteed debt and CBSL debt) broken down by currency, instrument, and creditors (in the case of external loans). A list of outstanding Treasury guarantees with their beneficiaries, amounts, and issuance and expiration dates is also presented. Information on the debt maturity profile is not included.

102. **Sri Lanka is assessed as follows under the World Bank Debt Reporting Heatmap:**

1. Public debt reporting						**2. Debt Management**		**3.Contingent liabilities (CLs) reporting**
Data acessibility	***Completeness***			***Timeliness***		**Debt strategy**	**Annual borrowing plans**	
	Instrument coverage	Sectorial coverage	Info on new loans	Periodicity	Time Lag			

Source: WB staff.

- Data accessibility: debt data are available; however, they are scattered among multiple reports published on the MoF's and CBSL's websites (Table 1).
- Instrument coverage: data of domestic, external, and guaranteed debt are published.
- Sectoral coverage: the CBSL annual report discloses debt data of the central government and SOEs (guaranteed and nonguaranteed foreign project loans).[33]
- Information on recently contracted external loans: the MoF's annual report includes detailed information about terms and conditions of new loans and disbursements of external loans in the reference year.

[33] The mission understands that projects executed by subnational government are financed through central government's budget support, and therefore there is no debt at the local level.

- Periodicity: the MoF has started publishing a simplified quarterly debt bulletin; however, a large portion of debt data disclosed by Sri Lanka is only published annually.

- Time lag: most of the published debt reports and data are disclosed three or more months following the end of the reference period.

- Debt management strategy: the latest published debt management strategy is for 2019.

- Annual borrowing plan: there is no published ABP.

- Contingent liabilities: the CBSL's and MoF's reports/bulletins include data on guarantees to SOEs. No fiscal risk statement or information about other contingent liabilities is published.

Domestic Debt Market Operations

103. **Domestic debt management led by the CBSL's PDD generally follows high standards of transparency and relies on market-based practices and instruments.** T-bills with maturities in 91-, 182-, and 364-days and T-bonds with maturities ranging from two to 30 years are issued through weekly and fortnightly auctions, respectively. As an agent acting on behalf of the government, the PDD publishes auction announcements and results, as well as a quarterly auction calendar, on the CBSL website. Auctions are organized in a phased structure, involving specific benefits and duties for primary dealers (PDs). SLDBs are issued infrequently, under a different competitive arrangement (securities issued in script format). The PDD meets market participants at least monthly, in pre-bid meetings, which create a permanent communication channel between the issuer and investors.

104. **The PDD can undertake direct bilateral placements to PDs, subject to approval by the Monetary Board**. Direct issuances to the CBSL are also made, and in neither case is a press release published. Although market participants can distinguish securities issued for government financing and for monetary policy purposes, as the operations are conducted by different departments within the CBSL and are offered on different days of the week, when it comes to aggregate data, they are combined, making the amounts indistinguishable and reducing transparency.

105. **Domestic debt operations in Sri Lanka under the World Bank Domestic Debt Securities Heatmap are assessed as follows:**

Domestic market				
Use of market-based issuance mechanisms	**Dissemination of issuance calendar and results**			**Secondary market information**
Share of domestic debt issued through auctions	Publication of the issuance calendar	Implementation of the issuance calendar	Publication of the auction results	Post-trade transparency

Source: IMF staff.

- Use of domestic debt issued through auctions: the mission understands that more than 80 percent of domestic debt issuances are placed through auctions.
- Publication of the issuance calendar: a bimonthly domestic auction calendar is published on the CBSL website, and auction announcements are published no later than three working days before issuance. Indicative amounts for T-bonds (but not T-bills) are included in the calendar.
- Implementation of the issuance calendar: less than 5 percent of auctions were canceled in the past year; however, large amounts were underwritten by the CBSL.
- Publication of auction results: auction results are published on the same day as the offer, but more than an hour after the auction closing.[34]
- Post-trade transparency: the CBSL collects and publishes daily information on secondary market quotes, as well as a resulting theoretical yield curve, on its website.[35]

Issues and Recommendations

106. **The MoF should urgently make a decision about the acquisition of a new debt recording system.** The current license expired several months ago, exposing ERD to elevated operational risk. The vendor will no longer provide any required maintenance. The purchase of a license from the Commonwealth Secretariat to use Meridian or a license from UNCTAD to use the latest version of DMFAS should not wait for the new DMO to be established.

107. **All central government debt data currently recorded across scattered databases at the MoF and CBSL should be consolidated in the new debt recording system.** The

[34] Auctions close at 11 a.m. and results are published from 2 p.m. onward, after the deliberation of the Tender Board Committee.

[35] https://www.cbsl.gov.lk/pd-daily-report.

new database should include government-guaranteed debt, on-lending, and domestic government securities data. LankaSecure should continue recording T-bill and T-bond debt data at the level of individual investor accounts (under its CDS) and LankaSettle operating as Sri Lanka Settlement and Depository architecture. The development/purchase of a more modern system to provide currently missing functions should be pursued as soon as resources are available.

108. **The multiple domestic and external debt databases maintained by the CBSL and MoF should be reviewed.** The (new) debt recording system should allow recorded data to be used for different purposes.[36] Debt recording processes should also be reviewed (to reduce duplication) and properly formalized in procedures manuals. Integration with the Treasury Financial Management System is advisable.

109. **Audit recommendations related to failures on debt records should be addressed following a predefined action plan.** A new debt recording system and improved processes will help address the reported inconsistencies and prevent future observations by the National Audit Office.

110. **A working group to review all published debt reports and data should be established to eliminate unnecessary duplication, ensure consistency, and reduce publication lags.** Initial steps should define reporting functions at the new DMO and followed by the development of revised reports and reorganization of the MoF's and CBSL's websites, as needed. In the medium term, an investor relations area could be created on one or both websites (see Section IV).

111. **The mission recommends that a revised MTDS and an ABP be published on the MoF's and CBSL's websites**.

112. **The publication of quarterly auction calendars should be resumed as soon as conditions permit.** The publication of indicative volumes for T-bill auctions could also be considered over time, when cash management practices have been strengthened.

113. **Once the auction decision-making process is reviewed, upon the establishment of the new DMO, auction results should be published within an hour of the auction closing.** Shortening the gap between auctions and results publication will enhance transparency and allow investors to adjust their positions in the market accordingly. This will be especially important once secondary market liquidity is further developed.

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[36] The system should provide streamlined features to extract information at the level of debt cashflows. This will support activities such as the development of a Medium-Term Debt Management Strategy and of an Annual Borrowing Plan, both currently missing in Sri Lanka.

Summary of Recommendations

Short-Term Measures

- Choose a new debt recording system and acquire the license.
- Include all debt-related data in the new debt recording system (including domestic securities and guaranteed debt).
- Review all existing databases at the MoF and CBSL and replace them to the extent possible so that data are available for different purposes in the new debt recording system.
- Consider using a predefined action plan to address audit recommendations on debt recording included in the *Special Audit Report on Financial Management and Public Debt Control in Sri Lanka 2018-2022*.

Medium-Term Measures

- Establish a working group/taskforce to review the information in published debt reports, aiming to reduce duplication, improve timeliness, and eliminate inconsistencies.[37]
- Develop and publish a MTDS and ABP (Section IV).
- Resume the publication of quarterly auction calendars (once conditions permit) and potentially include indicative amounts for T-bills.
- Shorten the time lag for publishing auction results to up to one hour.

The development of business continuity and disaster recovery plans are critical for debt recording; however, these should be addressed by the new DMO.

VI. Management Framework for Government Guarantees and On-Lending

Sound Practice

114. **The management of government guarantees and on-lending should be grounded in a policy document.** This document should define: (1) the authority to issue guarantees and on-lending and their purpose; (2) eligibility criteria for the applicants; (3) the type of risk assessment required before a guarantee or on-lending is issued; (4) the fees to be charged to

[37] The working group should include representatives of all MoF and CBSL units responsible for producing and publishing any kind of public debt data (for example, the ERD, TOD, and PDD).

the recipients; (5) the reporting, monitoring, auditing, and publication requirements; and (6) the quantitative limits on issuing guarantees and on-lending. The policy document in turn should be accompanied by another document explaining supporting procedures (Annex IV).

115. **Government guarantees and on-lending can lower the borrowing cost for the beneficiaries, but it could be a major source of fiscal risk for the central government.** Because of this risk, credit guarantees should be recorded as contingent liabilities on the government's balance sheet. Compared with the government's direct borrowing, a guaranteed debt may have higher funding costs and may entail higher financial risks. In turn, a well designed (partial) guarantee allows the government to share credit risks with the lenders.

116. **Debt managers are well positioned to manage contingent liabilities arising from the guarantees and on-lending.** DMOs measure and manage the costs and risks of the debt portfolio through a broad risk management framework. Integration of the guarantees and on-lending into this process allows DMOs to better manage the cost and risk trade-off by adjusting the regular debt portfolio, and employ credit risk management instruments, as well as risk mitigation tools.

117. **Insights from credit risk analysis and measurement can be used to design and improve risk mitigation and management tools.** Some countries use a combination of tools, such as budgetary limits, guarantee fees, and partial guarantees based on context-specific factors (for example, the recipients' credit quality), while others choose to extend guarantees to any entity, irrespective of its creditworthiness. Guarantee/on-lending limits can be set either on the stock or flow, but in either case, the limits should be determined based on the sustainability of public finances. Standardization of the decision-making and issuance processes of the guarantees and on-lending, structuring of the guarantee and on-lending (or subsidiary) agreements, setting a framework for the financial provisioning for losses, and risk monitoring and reporting requirements through secondary law or ministerial regulations are other tools widely used by governments.

118. **Regular reporting and strong transparency and accountability mechanisms are crucial to effectively manage guarantees and on-lending.** Guarantees should be disclosed in the budget document and reports to the legislature.[38] These reports should also include information on the type of guarantee (for example, the creditor, residency classification, instrument, currency, interest-rate basis, and original and residual maturity), the beneficiary, and the amount outstanding at the beginning and end of the reporting period, as well as the amount already amortized. Some basic risk data should also be included, such as the guaranteed debt-to-GDP ratio, the ratio of guaranteed loans in foreign currency to total guaranteed debt, and the share of total guaranteed debt in the past five years.

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[38] See IMF's Code of Fiscal Transparency (2007) and the International Public Sector Accounting Standards (IPSAS).

Current Situation

119. **Guaranteed loans and on-lending are used interchangeably by the government to provide financial resources to SOEs.** Guarantees may also be employed to infuse capital into a SOE because of its deteriorated financial performance.[39] The decision to guarantee or on-lend is determined by the lender's preference as to whether the borrower should be the government or not, rather than the beneficiary's ability to pay.

120. **CBSL and MoF reports include data on guaranteed debt with different details, but there are no publicly available data on the outstanding balance of on-lent loans.** The government's loan guarantees are disclosed in the financial statement of the central government, annual and quarterly reports of the MoF, and annual reports of the CBSL.

121. **The Fiscal Management Responsibility Act of 2003 imposes limits on the stock of debt guarantees, while there has not been any limit set on on-lending.[40]** In November 2021, Parliament increased the guarantee limit to 15 percent of GDP from 10 percent of GDP. The guarantee limit is only for loan guarantees and does not cover any other type of guarantee provided by the State such as through public-private partnerships.

122. **The President is the authorized body for signing the guaranteed external loan agreements, according to the Foreign Loans Act 29 of 1957.** The President uses this authority by delegating it to senior Treasury officials on a transaction basis.

123. **The TOD is the principal entity responsible for the issuance of loan guarantees and on-lending, in coordination with the PED and ERD.** However, there is no legal or regulatory framework defining the TOD's roles and responsibilities. The PED's main role is the assessment of guarantee requests considering the limits and the financial capacity of the SOEs. The ERD is involved when there is a request for external financing. Based on the donors' conditionalities, the ERD decides whether the loan will be taken by the SOE as a guaranteed loan or in the name of the central government to be on-lent to the SOE. On-lending is extended when the SOE have weak borrowing capacity. The decision to on-lend is frequently made during loan negotiations between the government and the lender. The on-lending terms and conditions are determined based on the financial capacity of the sub-borrower and are usually identical with the primary loan agreement. However, if the financial position of the sub-borrower is weak, the financing terms can be modified to be more

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[39] Considering the deteriorated financial performance of SriLankan Airlines (SLA) amid the pandemic, the government decided to infuse capital to SLA while issuing guarantees and a letter of comfort to SLA in order to improve its financial viability (source: Annual Report 2021, Central Bank of Sri Lanka).

[40] Article 3 of the Fiscal Management Responsibility Act of 2003 includes within the objectives underlying responsible fiscal management that need to be adhered to by the government "… v. Ensuring that the sum which is calculated as the guarantee and given as a percentage of the Gross Domestic Product for the current financial year along with the two preceding financial years, does not in the aggregate exceed [15] per centum; …" At the time of introducing the act, the percentage was 4.5 percent. It was most recently increased to 15 percent (effective January 1, 2021).

beneficial to the sub-borrower. The final decision to issue a guarantee and to on-lend is made by the Cabinet of Ministers after receiving an opinion and recommendation from the MoF and all relevant Treasury departments.

124. **The central government does not have formal policies for the issuance of government guarantees.**[41] PED's assessment of the guarantee request is limited to the analysis of cashflows and financial tables of the SOE, rather than assessing its creditworthiness and quantification of the probability of default. On-lending decisions are made based on the conditionalities of the lender, not the sub-borrower's ability to repay the government. The process followed by the authorities is as follows:

- SOEs request guarantees from the line ministry.
- The line ministry requests the Cabinet for approval to issue the guarantee for the SOEs.
- The Cabinet sends a memo to the MoF requesting the analysis of the guarantee.
- The SOE and relevant bank or financial institution sign a certified copy of the bank agreement.
- The relevant Treasury department (PED/DFD/NBD/ERD) makes a recommendation with the approval of the Secretary to the Treasury (ST).
- The MoF sends its recommendation to the Cabinet.
- The Cabinet decides to approve or reject the request, and if it approves, whether it will be a guarantee or on-lending.
- Following the Cabinet's instruction, the MoF (TOD) prepares the Treasury guarantee (TG) /loan contract (LC) according to the standard format.
- The MoF (TOD) forwards the TG/LC for signature by the Deputy Secretary of Treasury and ST.
- The MoF (TOD) sends the original TG/LC to the relevant bank.
- The MoF (TOD) updates its records.

125. **The MoF's recommendations against the issuance of a guarantee are not binding, and at times, the legal limit has been exceeded.** The Cabinet frequently approves the issuance of guarantees despite a negative assessment by the MoF, based on "national

[41] On-lending is decided and carried out as described in the previous paragraph.

interest." The Cabinet has also approved guarantees in amounts that exceeded the limit included in the FMR Act.

126. **The MoF does not have risk mitigation tools.** The government does not charge any fees to the recipients of guarantees or the sub-borrowers of on-lent funds. Other risk mitigation tools, such as partial guarantees, spreads on-lent loans, contingency accounts, or collateral, do not exist.

127. **There are no documented procedures in place applicable to the oversight of guarantees.** Once the guarantee or on-lending is issued, based on the Cabinet's approval, the TOD records the transaction in an Excel spreadsheet and monitors the outstanding balance. Called guarantee payments are made by the TOD. For on-lending, the sub-borrower is expected to pay its loan into the consolidated fund. The TOD monitors the risk that the sub-borrower does not repay.[42] If nonpayment is identified, this is communicated to the PED for follow-up.

Issues and Recommendations

128. **Considering the large stock outstanding of guaranteed debt (Figure 3), priority should be given to establishing a robust guarantee and on-lending management policy backed by a strong legal, institutional, and operational framework.** This framework should include a clear definition of the authority to issue guarantees and on-lending and the objectives, roles, and responsibilities of related entities. The framework also has to clarify the governance of the process framework, including (1) eligibility criteria for the applicants; (2) checking compliance with existing regulations; (3) risk assessment protocols and quantitative risk limits of the guarantees and on-lending; (4) risk mitigation tools and strategies, which include determination of the limit considering the sustainability of public debt; (5) recording, monitoring, and reporting requirements; and (6) calling and recovery procedures.

129. **Given that the assessment of the guarantee request is not based on creditworthiness, the mission recommends developing a credit risk analysis and management approach.** A credit risk analysis focused on the borrower's capacity to repay should be performed before each guarantee's issue, and the current practice of issuing government guarantees to nonperforming borrowers should be discontinued.

130. **Risk mitigation tools to be employed in the management of credit risk from guarantees and on-lending should be clearly identified and integrated into the guarantee and on-lending framework**. Guarantee fees can be calculated based on the actual credit outstanding or the issuance amount according to the credit risk of the issuing entity. In

[42] It is unclear to the mission which information is used for this monitoring process and how associated risks are measured.

the latter case, the fee can be collected as a one-time payment when the guarantee is signed. Collected fees could be deposited into a contingency fund to hedge against default risks.

131. **A policy for on-lending needs to be developed.** The on-lending policy should be based on the institutional requirement and/or credit risk assessment. On-lending should be made available to public entities that need to be subsidized or when there are some "national interests" in financing the institution. When the results of risk assessment are unfavorable but satisfying the request is required, the government may consider on-lending at subsidized rates. However, in these cases, a direct budget subsidy may be more appropriate, less expensive, and less administratively cumbersome than on-lending. Using subsidies or transfers instead of guarantees or on-lending would also enhance budgetary transparency and facilitate the assessment of the fiscal impact of the decision and compare it against other expenditure priorities. The roles of line ministries should also be clarified.

132. **There should be clear and enforceable procedures for recording, monitoring, and reporting, as well as calling and recovery of guarantees.** Timely and reliable recording of guarantees and on-lending in a modern, centralized DMIS improves reporting and monitoring capacity of the DMO. It also enables servicing these liabilities when needed. The operations manual should lay out who will be responsible for recording these liabilities and how the verification will be carried out, and specify the stages of control, monitoring, reporting, and inspection processes. The reporting should be in line with international standards. In addition, a mechanism should be established to provide the DMO advance warning of any issues that may result in the guarantees being called. In this regard, the recipient should be required to report regularly on its financial capacity and the likelihood of being able to make the next debt payment.

Summary of Recommendations

Short-Term Measures

- Develop a legal, institutional, and operational framework for the management of government guarantees and on-lending.
- Transfer all TOD guarantee-related functions to the DMO.

Medium-Term Measures

- Develop quantitative risk limits and introduce guarantee fees as a risk mitigation instrument.
- Develop an on-lending policy.
- Disclose expected losses based on associated credit risks and probabilities of default.

ANNEX I. PROPOSED DRAFT DEBT MANAGEMENT REFORM ACTION PLAN

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
A. Legal Framework							
Consolidate the current PDM legal framework	Action 1. Draft a policy note for Cabinet approval of the need for a PDM Act that: (1) supersedes relevant debt-related existing legislation; (2) includes missing provisions considered international sound practices; and (3) establishes a single debt management office at the MoF	Mar-23	Apr-23	MoF (ERD, TOD, Legal Department) / CBSL	Policy Note with the justification for the draft and enactment of a PDM Act	Internal	Greater clarity and comprehensive-ness of debt legal framework. Better debt management governance, including management of guarantees and on-lending
High-level Committee	Action 2. Establish a high-level committee to direct and monitor the DM legal framework reform and appointment of a "reform champion"	Apr-23	Apr-23	MoF (ERD, TOD, Legal Department) / CBSL	Formal document that establishes the committee	Internal	Assurance that reforms will be implemented under the agreed timeline with the WB/IMF

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
							Oversight of reform development process (quality control)
Technical team to work on drafting the PDM Act	Action 3. Establish a technical-level committee to agree on the content and structure of the DM legal framework	Apr-23	Apr-23	MoF (ERD, TOD, Legal Department) / CBSL	Formal document that establishes the committee	Internal	Assurance of involvement of all relevant parties Clear responsibilities and action plan
PDM Act drafting	Action 4. Draft the PDM Act, including review of existing laws, consultation with relevant stakeholders, reporting to high-level committee	May-23	Jul-23	MoF (ERD, TOD, Legal Department)/ Legal Draftsman / CBSL / High-Level Committee	PDM Act draft	(WB/IMF can review the draft legislation) – TA mission	Initial proposal for the reform of the debt-related legal and institutional framework Improved DM efficiency, transparency, and accountability

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
Submission of PDM Act for approval of the Attorney General (AG), and of the Cabinet	Action 5. Submission for AG approval (after periodical consultation during previous stages) and for Cabinet approval	Aug-23	Aug-23	MoF (ERD, TOD, Legal Department)/ Legal Draftsman / CBSL / High-Level Committee	Letters to AG and Cabinet (accompanied by the PDM Act draft)	Internal	Compliance with legal processes and requirements
Cabinet approval, publication in Gazette, and submission to Parliament	Action 6. Cabinet approval and submission to Parliament for approval	Sep-23	Nov-23	Cabinet	Cabinet approval and submission to Parliament	Internal	Improved DM efficiency, transparency, and accountability
B. Institutional Framework							
Establish a DMO as a department of the MoF	Action 7. Formally (legally) establish the DMO within the MoF under the supervision of the Secretary of the Treasury and overseen by a Director General. Publish in the Gazette.	Mar-23	Dec-23	MoF (ERD, TOD, Legal Department)/ Legal Draftsman / CBSL / High-Level Committee	Creation of the DMO as a department of the MoF	Internal, with the support of the WB/IMF on the review of the new PDM Act	Consolidated debt functions under a single body Improved DM efficiency, transparency, and accountability

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
Transfer relevant responsibilities of the CBSL, TOD, ERD to the DMO	Action 8. Responsibilities and tasks transfer, including required secondary legislation and capacity building (including possible secondment arrangements)	Jan-24	Mar -24	MoF (DMO, ERD, TOD, Legal Department)/ Legal Draftsman / CBSL / High-Level Committee	Secondary legislation defining new roles and responsibilities and staff administrative arrangements	Internal Process mapping needed (WB/IMF or external advisory firm)	Clear roles and responsibilities of the new DMO and its relevant stakeholders
Agency Agreement with the CBSL	Action 9. Signature of an agency agreement with the CBSL to act as a financial agent of the MoF – including the CBSL's operational roles on auctions (as relevant) and debt payments	Jan-24	Jan-24	MoF (DMO and Legal Department) / CBSL	Agency agreement	Internal (the WB/IMF can review the draft responsibili-ties)	Increased transparency and mitigation of conflicts of interest.
DDMC and Advisory Committee	Action 10. Issuance of regulations creating the DDMC and the Advisory Committee	Mar-24	Mar-24	MoF (DMO and Legal Department) / CBSL	DDMC regulation Advisory Committee regulation	Internal (the WB/IMF can review the draft responsibili-ties)	Strengthened coordination (and separation) between debt/cash management

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
							and monetary policy Strengthened DM capacity and accountability
Appointment of specialized DMO staff	Action 11. Based on new tasks and functions, hire new staff as needed (particularly to support front and middle office functions)	Mar-24	Jun-24	MoF/DMO / CBSL / PSC / Cabinet	Finalization and formalization of administrative arrangements and legal document appointing staff	Internal	Strengthened capacity of the DMO
MTDS and ABP development process	Action 12. Development of yearly timeline to develop a DMS and an ABP, in consultation with relevant stakeholders	Jun-24	Ago-24	MoF (DMO, ERD, TOD, Fiscal Policy, Budget)/ CBSL	Formalization of the DMS/ABP development, update, approval, and publication process	Internal (the WB/IMF can review the draft responsibili-ties)	Strengthened DM planning and implementation processes Improved DM efficiency,

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
							transparency, and accountability
DMS development (and ABP)	Action 13. Conduct the MTDS analysis using the MTDS analytical tool, followed by the development of an ABP	Oct-24	Dec-24	MoF (DMO, ERD, TOD, Fiscal Policy, Budget) / CBSL	Publication of updated DMS and ABP	WB/IMF TA mission	Strengthened DMO analysis capacity Improved DM efficiency, transparency, and accountability
Strengthen DMO capacity – training program	Action 14. Based on new tasks and functions, develop a training program (particularly to support middle office functions)	Jun-24	Ago-24	MoF-DMO / CBSL	Training program approved by ST	Supported by the WB/IMF	Strengthened capacity of the DMO
Implementation of a training program	Article 15. Implement a training program to enhance capacity of staff, including on cost-risk indicators and	Aug-24	Continuo us	MoF-DMO / CBSL	Training program designed and implementati-on started	Supported by the WB/IMF	Strengthened capacity of the DMO

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
	future design and implementation of a debt management strategy						
C. Debt Transparency							
Debt recording system	Action 16. Make a decision on the new debt recording system and acquire the respective license	Mar-23	May-23	MoF (ERD, TOD, Legal Department) / CBSL	Approved decision on the acquisition of a debt recording system license	Budgetary resources	Consolidated and complete public and publicly guaranteed debt (and on-lending) Improved debt reporting/trans-parency
Complete debt records	Action 17. Include all debt-related data in the new debt recording system (including domestic securities and guaranteed debt)	Jun-23	Dec-23	MoF (ERD, TOD) / CBSL	Complete debt records and easy extraction of data for debt reporting	Internal	Completed database – facilitate reporting and enhanced debt transparency
Review of all existing debt databases	Action 18. Review of all existing databases at the MoF and CBSL –	Jun-23	Dec-23	MoF (ERD, TOD) / CBSL	Complete debt records and easy extraction	Internal	Completed database – facilitate

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
	replace them to the extent possible, with data to be available for different purposes in the new debt recording system				of data for debt reporting Duplications eliminated		reporting and enhanced debt transparency Support for debt restructuring
Debt data audit recommendations	Action 19. Address audit recommendations related to debt recording of the *Special Audit Report on Financial Management and Public Debt Control in Sri Lanka 2018-2022*	Jun-23	Jun-24	MoF (ERD, TOD) / CBSL	Complete verified and audited debt database	Internal	Improved debt transparency and accountability
Working group for review of debt reports and published debt data	Action 20. Establish a working group to review existing published debt reports and data, aiming to reduce duplication, improve timeliness, and eliminate inconsistencies	Jun-23	Jun-24	MoF (ERD, TOD) / CBSL	Appointment of staff for the task and definition of activities calendar	Internal	Improved debt transparency and accountability Reduced operational risk and duplication of activities

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
Disclosure of auction information	Action 21. Resume the publication of quarterly auction calendars (once conditions permit), and potentially include indicative amounts for T-bills; shorten time lag for the publication of auction results to up to one hour	Jan-24 (tentative)	Continuous	MoF (DMO)	Quarterly auction calendar and auctions results (published within one hour of the end of the auction)	Internal	Improved debt transparency and accountability
D. Management Framework for Government Guarantees and On-Lending							
Guarantees and on-lending legal, institutional, and operational frameworks	Action 22. Develop a legal, institutional, and operational framework for the management of government guarantees and on-lending	Mar-23	Dec-24	MoF (DMO, ERD, TOD, PED)	PDM Act, secondary legislation, regulations and procedures manual with roles and responsibilities	WB/IMF TA to support	Improved risk analysis capacity and management of contingent liabilities Increased debt and fiscal transparency
Staff capacity	Action 23. Transfer the TOD's guarantee-related functions to the	Jan-24	Jun-24	MoF (DMO, ERD, TOD, PED, Fiscal	Establishment of the DMO's responsibilities on the	The WB/IMF can review	Improved risk analysis capacity and management of

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
	DMO (see Actions 8 and 11, and 15)			Policy, Budget)	management of guarantees and on-lending	related documents	contingent liabilities Increased debt and fiscal transparency
Risk management and mitigation	Action 24. Develop quantitative risk limits and introduce guarantee fees as a risk mitigation instrument	Jan-25	Dec-25	MoF (DMO, ERD, TOD, PED, Fiscal Policy, Budget)	Internal procedures and/or regulation defining the introduction of risk management and mitigation tools	WB/IMF TA to support	Improved risk analysis capacity and management of contingent liabilities Increased debt and fiscal transparency
On-lending policy	Action 25. Develop an on-lending policy	Jan-25	Dec-25	MoF (DMO, ERD, TOD, PED, Fiscal Policy, Budget)	Legislation/regulation defining on-lending policy (e.g., eligibility, conditions, appropriate use, etc.)	WB/IMF TA to support	Improved risk analysis capacity and management of contingent liabilities

Issues/Project Components	Actions	Initiate	Deadline	Lead Entity (and Other Units Involved)	Expected Outputs of the Actions	Budget (for External Assistance)	Expected Outcome of the Project Components
							Increased debt and fiscal transparency
Quantify and disclose guarantees and on-lending associated risks	Action 26. Disclose expected losses based on associated credit risks and probabilities of default	Jan-26	Dec-26	MoF (DMO, ERD, TOD, PED, Fiscal Policy, Budget)	Methodology to quantify risks and publication of potential losses	WB/IMF TA to support	Improved risk analysis capacity and management of contingent liabilities Increased debt and fiscal transparency

ANNEX II. GOVERNMENT OFFICIALS MET

Ministry of Finance

No	Name	Designation	Department
01	R.M.P Rathnayake	Deputy Secretary to the Treasury	
02	A.K. Senevirarhna	Deputy Secretary to the Treasury	
03	Ajith Abeysekara	Director General	External Resources
04	H.C.D.L.Silva	Director General	Treasury Operations
05	P.A.S. Athula Kumara	Director General	Public Enterprises
06	K.A.Vimalenthirarajah	Director General	Trade and Investment Policies
07	Udeni Udugahapattuwa	Additional Director General	External Resources
08	Visakha Amarasekara	Additional Director General	External Resources
09	A.K.D.D.D. Arandara	Additional Director General	Legal Affairs
10	Damitha Rathnayake	Additional Director General	Treasury Operations
11	W.D.R. Krishantha	Director	External Resources
12	Sajeewani Dayaratne	Director	Treasury Operations
13	Hemantha Pubudusiri	Director	External Resources
14	Ranga Nishantha	Director	External Resources
15	Prabhash D. Jayalath	Director	External Resources
16	Samantha Bandara	Director	External Resources
17	P.P.S.R. De Silva	Director	External Resources
18	A.R. Wickramasinghe	Director	Public Enterprises
19	Gayani Kariyawasam	Director	Treasury Operations
20	R.A.L. Udaya Kumara	Director	Public Enterprises
21	Himali Bogadagedara	Director (Acting)	External Resources
22	Jayanie Wickrama Arachchi	Director (Acting)	Fiscal Policy
23	K.Sudarshana De Silva	Director (Acting)	National Budget
24	G. Ranjith	Deputy Director	External Resources
25	Tharindu Kariyawasam	Deputy Director	External Resources
26	Uditha Fernando	Deputy Director	External Resources
27	Sewwandi Amarasekara	Deputy Director	External Resources
28	K.A.C. Priyadarshani	Deputy Director	Public Enterprises
29	Erandi Udagama	Deputy Director	Public Enterprises
30	Chandrika Senanayake	Deputy Director	External Resources
31	Anupama Monorathna	Deputy Director	External Resources
32	Upendra Wijerathna	Deputy Director	External Resources
33	Ajith C. Kumara	Deputy Director	External Resources
34	Thisitha Narasinghe	Deputy Director	External Resources
35	Kumuduni Chandrasekara	Deputy Director	External Resources
36	Sachith Fernando	Deputy Director	External Resources

Ministry of Public Administration, Home Affairs, Provincial Councils, and Local Government

No	Name	Designation	Department
01	P.G.D. Pradeepa Serasinghe	Additional Secretary	Human Resources Development
02	K.D.N. Ranjith Ashoka	Additional Secretary	Public Administration
03	R. Vijayalechumi	Additional Secretary	Reforms
04	W.M.A. Wijekoon	Additional Secretary	Languages
05	P.W. Rajapaksha	Additional Secretary	Project Monitoring - Local Government
06	A. Jagath D. Dias	Director General	Pensions
07	M.N. Gammanpila	Additional Secretary	Internal Administration
08	Waruna Sri Danapala	Additional Secretary	Regional Administration Reforms
09	M. Kodippiliarachchi	Additional Secretary	Local Government and Provincial Councils
10	S. Alokabandara	Director General	Combined Services
11	H.A.C. Kumarasinghe	Director General	Establishment
12	A.H.M.K.K.A. Herath	Chief Financial Officer	
13	Prince Senadeera	Commissioner General	Official Languages
14	A.V. Janadara	Additional Director General	SLIDA
15	G.L. Sajeewani Perera	Senior Assistant Secretary	Human Resources Development
16	P.E.M.D.K. Palipana	Legal Officer	Public Administration
17	S. Palliyaguru	Legal Officer	Home Affairs
18	Gayani Premathilaka	Legal Officer	Provincial Councils and Local Government