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TECHNICAL ASSISTANCE REPORT

SRI LANKA

Preparing a Fiscal Risk Statement

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Prepared By

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Authoring Department

IMF Fiscal Affairs

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Abbreviations and Acronyms

CBSL	Central Bank of Sri Lanka
CD	Capacity development
CEB	Ceylon Electricity Board
CPC	Ceylon Petroleum Corporation
DFD	Department of Development Finance
DG	Director General
DMC	Disaster Management Centre
DSA	Debt Sustainability Analysis
DTO	Department of Treasury Operations
EFF	IMF Extended Fund Facility
FMIS	Financial Management Information System
FPD	Department of Fiscal Policy
FRAT	Fiscal Risk Assessment Tool
FRM	Fiscal Risks Management
FRR	Fiscal Risks Register
FRS	Fiscal Risks Statement
FSCMC	Financial Sector Crisis Management Committee
FSOC	Financial Sector Oversight Committee
FSS	Fiscal Strategy Statement
GDP	Gross Domestic Product
GFSM	Government Finance Statistics Manual
GFSM	2014 Government Finance Statistics Manual
GoSL	Government of Sri Lanka
IRC	Insurance Regulatory Commission
IRD	Department of Internal Revenue
LKR	Sri Lankan Rupees
MFT	Macroeconomic Foundations Tool
MFU	Macro Fiscal Unit
MIS	Management Information System
MIS	Management Information System
MoE	Ministry of Environment
MoF	Ministry of Finance
MTDS	Medium-term debt strategy
MTFF	Medium-term fiscal framework
NAPPP	National Agency for Public Private Partnership
NBD	Department of National Budget
NDCs	Nationally Determined Contributions
NDMP	National Natural Disaster Management Plan
NPD	Department of National Planning
NWS&DB	National Water Supply and Drainage Board
PDM	Public debt management
PDMA	Public Debt Management Act
PDMO	Public Debt Management Office
PED	Department of Public Enterprises
PFM	Public Financial Management

PFMA	Public Financial Management Act
PFRAM	PPP Fiscal Risk Assessment Model
PMMD	Department of Project Management and Monitoring
PPP	Public private partnerships
SLA	Sri Lankan Airlines
SLC	Sri Lanka Customs
SLDILSS	Sri Lanka Deposit Insurance and Liquidity Support System
SLPA	Sri Lanka Ports Authorities
SOB	State Owned Banks
SOE	State Owned Enterprises
SOEHCT	State Owned Enterprise Health Check Tool
TWG	Technical Working Group
WEO	World Economic Outlook

Preface

At the request of the Ministry of Finance (MoF) of Sri Lanka, a team from the IMF's Fiscal Affairs Department (FAD) in collaboration with World Bank staff visited Colombo during the period January 15–28, 2025 to conduct a capacity development mission on preparing a fiscal risk statement. The team was led by Mr. Guohua Huang (Senior Economist of FAD) and comprised Mr. Raju Sharen (IMF Resident PFM Advisor at Colombo), Ms. Marie-Hélène Le Manchec, and Mr. Matt Crooke (both IMF Experts), and Mr. Sebastian Michael Essl (Senior Economist of the World Bank). Ms. Martha Tesfaye Woldemichael, IMF's Resident Representative in Sri Lanka, participated in the closing meeting.

The team discussed key issues in the opening meeting with Secretary to the Treasury, Mr. K. M. Mahinda Siriwardana and Directors General of the Departments of Fiscal Policy, National Budget, State Accounts, Treasury Operations, National Planning, Public Enterprises, and Public Debt Management Office. The main counterpart of the mission was the Department of Fiscal Policy, whose staff attended all the meetings of the mission with various departments and other agencies.

The mission held individual meetings with the Department of Fiscal Policy, the Department of National Planning, the Department of Treasury Operations, the Public Enterprises Department, Department of Project Management and Monitoring, Department of State Accounts, and the Public Debt Management Office. The mission also benefitted from meetings with Dr. P. Nandalal Weerasinghe (Governor, Central Bank of Sri Lanka) and his team, Prof. K.T.M. Udayanga Hemapala (Secretary, Ministry of Energy), Mr. Ananda W. Atukorala (Chairman, National Agency for Public Private Partnerships) and his team, Mr. Sarath Clement Ganegoda (Chairman, Sri Lankan Airlines) and his team, and Major General (Retired) Udaya Herath (Director General, Disaster Management Centre) and his team. The mission presented its main findings and key recommendations to the Secretary to the Treasury and other senior officers in the MoF.

The mission delivered a CD workshop of 2 days on Fiscal Risks Analysis and Preparation of Fiscal Risk Statement, with 25 participants, from various departments of the Treasury. During the mission, presentations were made by team members on various types of fiscal risks, especially those associated with macroeconomic risks, financial sector, state owned enterprises, guarantees, natural disasters, and public private partnerships. Participants were introduced to the Fiscal Risks Assessment Tool (FRAT) and the SOE Health Check Tool (HCT-SOE) and completed two exercises to develop a better understanding of the fiscal risks. The workshop concluded with participants preparing an outline of a possible Fiscal Risk Statement.

The team would like to thank the Sri Lankan authorities for their open and active engagement across all ministries, departments, and agencies. The mission is especially grateful to Ms. Jayanie Wickrama Arachchi and Ms. Manisha Dandunna (Department of Fiscal Policy) for the excellent coordination of the meetings and logistical support.

Executive Summary

Sri Lanka has faced significant fiscal challenges in recent years, exacerbated by inadequate monitoring and management of fiscal risks. In the absence of a focal point for fiscal risk oversight, there is no centralized compilation or analysis of fiscal risk data. As a result, a comprehensive picture of the risks to the fiscal outlook and of the overall state of the public finances is lacking. These weaknesses have contributed to the materialization of substantial fiscal risks over the past few years, particularly in the wake of a series of economic shocks. In response, the authorities have implemented reforms to mitigate these risks. These reforms include the introduction of cost-recovery pricing for fuel and electricity, a reduction in the ceiling on the stock of guarantees, and the enactment of the Public Financial Management Act (PFMA) and the Public Debt Management Act (PDMA), both of which incorporate robust provisions for fiscal risk management. While fiscal risk situation has improved, it appears that the following fiscal risks remain substantial in Sri Lanka:[1]

- Macroeconomic risks. The fiscal position is vulnerable due to volatile GDP and revenue growth, a narrow export base, and high dependency on tourism receipts and oil imports.
- Debt risks. Although the public debt situation has improved following restructuring and fiscal adjustments, portfolio risks still require thorough assessment.
- State-owned enterprises (SOEs) risks. The extensive footprint of the SOE sector, characterized by weak financial positions and performance, coupled with close financial linkages with the government, represents a significant source of fiscal risk.
- Guarantees and on-lending risks. The extensive use of government guarantees, estimated at around 5.5 percent of GDP as of 2024, has exposed public finances to substantial contingent liabilities.
- Public-private partnership (PPPs) risks. There are over 175 projects reaching financial close, involving an estimated investment of USD 5.3 billion (over 6 percent of 2023 GDP) and an additional 80 projects worth USD 2 billion in the pipeline.
- Financial sector risks. Key exposures stem from the performance of state-owned financial institutions. In 2024, state-owned bank (SOB) subsidies costed 0.4 percent of GDP, with lower net inflows to the budget (dividends and levies less budget support) accounting for another 0.2–0.3 percent of GDP.
- Natural disasters and climate change risks. Previous studies indicate that the average expected fiscal cost of natural disasters is between 0.5–1 percent of GDP per annum, and likely to increase due to climate change. This necessitates greater investment in adaptation measures to enhance resilience.

The Government of Sri Lanka (GoSL) aims to publish its first Fiscal Risk Statement (FRS) by June 2025, as mandated by the PFMA.[2] This marks a significant step towards enhancing fiscal transparency and accountability.

However, several challenges exist in preparing the FRS. Data availability and quality are relatively limited, and the depth of analysis conducted for different types of fiscal risks varies. Furthermore, fiscal risk information is scattered across ministries, departments, and agencies (MDAs), and a systematic

[1] Policy implementation risks are not discussed in this report. However, some of the methodologies discussed in this report can be used to assess these risks. For example, fiscal forecast error analysis.

[2] The FRS will be part of the Fiscal Strategy Statement.

information exchange mechanism has not been established. There is also a lack of clarity regarding roles and responsibilities among MDAs for preparing the FRS.

Considering the constraints of data availability, staff capacity, and a tight timeline, the preparation of the first FRS needs to balance credibility and feasibility. While macroeconomic risks, public debt, SOEs, natural disasters, financial sector, guarantees and on-lending, and PPPs should be covered due to their significance, the depth of analysis may vary depending on data availability and analytical capacity. For those sources of risks, if data are not available in the near term, a qualitative description of the risks can be prepared for the first FRS.

The FRS should be focused and closely coordinated with other publications. It should convey key strategic points and quantify risks wherever possible to support informed decision-making and prioritization. It should clearly communicate risk management efforts, specifying actions taken to mitigate and manage relevant fiscal risks. Additionally, the FRS should ensure consistency and complementarity with respect to other official publications related to fiscal risks.[3]

To ensure close coordination among MDAs and smooth preparation of the FRS, a near-term priority is to clearly allocate roles and responsibilities among them. A Treasury Circular should be issued to delineate these roles and responsibilities, specifying tasks, timelines, and reporting protocols to ensure timely data supply and output achievement. The Department of Fiscal Policy (FPD) is well-positioned to lead and coordinate the FRS preparation, given the close linkage between fiscal risk analysis and the FPD's mandate on macroeconomic and fiscal assessment and policy analysis. Relevant departments of the MoF should prepare the sections of the FRS for those risks under their responsibility, and line ministries/agencies should be responsible and accountable for identifying, assessing, and monitoring specific fiscal risks that fall within their functions.

Clear communication with stakeholders is critical to ensure support and avoid potential misunderstandings. The authorities should convey to politicians and the public that comprehensive reporting of fiscal risks, based on robust analysis, can help government respond to a range of potential future economic and fiscal shocks. A better understanding of fiscal risks, greater transparency, and effective risk management practices can reduce the magnitude of negative effects on fiscal balances and the economy.

In the medium term, a phased strategy should be adopted. The authorities should strengthen the legal framework relevant to fiscal risk management (e.g., PPP Act, SOE Act, and PFM regulations);[4] improve the coverage and quality of fiscal risk datasets (e.g., SOEs, PPPs, natural disasters); enhance analysis of fiscal risks (e.g., stress testing and sensitivity/scenario analysis, credit risk assessments for guarantees); and strengthen mitigation measures (e.g., limiting fiscal exposure to PPPs, insurance and risk transfer, financial stability fund). As these reforms progress, the FRS can be enhanced with expanded coverage (e.g., adding sub-national governments and legal claims) and deepened analysis.

[3] While the details of some specific risk information may exist in other relevant documents, the high-level summary of those information and analysis in the broad fiscal risk context should be covered in FRS.

[4] The PFM Law has overarching requirements on fiscal risk management. New legal documents relevant to fiscal risks should be consistent with PFM Law on the requirements.

Table 1 summarizes the key recommendations. The detailed recommendations for respective fiscal risks are discussed in sections II-VII. A proposed outline for the 2025 FRS is presented in Annex 1.

Table 1. Summary of Key Recommendations

Recommendations	Responsible Departments of MoF	Timeline
Prioritize the key fiscal risks in the 2025 FRS, including the risks related to macroeconomy, debt, SOEs, natural disasters, financial sector, guarantees and on-lending, and PPPs.	FPD taking the lead with contributions from relevant departments of MoF	Near term
Develop a focused and concise FRS with close coordination with other official publications relevant to fiscal risks	FPD taking the lead with contributions from relevant departments of MoF	Near term
Issue a Treasury Circular to delineate the roles and responsibilities related to FRS preparation, specifying tasks, timelines, and reporting protocols to ensure timely data supply and output achievement.	FPD taking the lead with contributions from relevant departments of MoF	Near term
Identify the sources of data/information for the selected fiscal risks, develop databases, and confirm data quality.	Relevant departments of MoF responsible for respective risks	Near term
Prepare an analysis of individual fiscal risk by summarizing existing reports where available, conducting analysis based on related data if no prior analysis exists, or providing a qualitative description of the risks if data is unavailable.	Relevant departments of MoF responsible for respective risks	Near term
Clearly communicate to politicians the benefits of the FRS in supporting timely decision-making and enhancing market confidence, while also informing the public about the actions taken, including mitigation measures	FPD taking the lead with contributions from relevant departments of MoF	Near term
Train staff to enhance their capacity for fiscal risk analysis and management.	FPD taking the lead with contributions from relevant departments of MoF	Near term and medium term
Strengthen the legal framework relevant to fiscal risk management (e.g. PPP Act, financial regulations)	Relevant departments of MoF responsible for respective risks	Medium term
Improve coverage and quality of fiscal risk datasets (e.g. SOEs, PPPs, natural disasters)	Relevant departments of MoF responsible for respective risks	Medium term

Enhance analysis of fiscal risks (e.g. stress testing and sensitivity/ scenario analysis, credit risk assessments for guarantees)	Relevant departments of MoF responsible for respective risks	Medium term
Strengthen mitigation measures (e.g. limiting fiscal exposure to PPPs, insurance and risk transfer, financial stability fund)	Relevant departments of MoF responsible for respective risks	Medium term
Expand the coverage of FRS (e.g. SNGs, legal claims) and deepen its analysis	FPD taking the lead with contributions from relevant departments of MoF	Medium term

Notes: 1. This table focuses on the actions of MoF. Line ministries and other relevant institutions (e.g. CBSL) should be responsible and accountable for identifying, assessing, and monitoring specific fiscal risks that fall within their functions. They are not specified here.
2. The departments responsible for respective risks are discussed in Section VIII
3. The near term is between February and June 2025; and medium term refers to the subsequent 3 years.

I. Introduction

1. Sri Lanka has faced significant fiscal challenges in recent years, exacerbated by inadequate monitoring and management of fiscal risks. In the absence of a focal point for fiscal risk oversight, there is no centralized compilation or analysis of fiscal risk data. As a result, a comprehensive picture of the risks to the fiscal outlook and of the overall state of the public finances is lacking. These weaknesses have contributed to the materialization of substantial fiscal risks over the past few years, particularly in the wake of a series of economic shocks. The COVID-19 pandemic, geopolitical events such as the Russia-Ukraine war in 2022, the global coronavirus outbreak and its prolonged effects in 2020 and 2021, domestic security concerns like the Easter attacks in 2019, oil price increases and tighter financial conditions in 2018, and natural disasters, including the severe drought and floods in 2017, adversely impacted the fiscal position. The realization of fiscal risks, such as those originating from state-owned enterprises (SOEs) and government guarantees, has further intensified fiscal vulnerabilities. These challenges underscore the urgent need for a comprehensive approach to fiscal risk management and economic resilience.

2. The Government of Sri Lanka (GoSL) has initiated measures to strengthen fiscal risk management as part of broader public financial management reforms. For instance, the government has aligned energy pricing with costs and reduced the ceiling on the stock of guarantees to 7.5 percent of GDP, down from the previous limit of 15 percent. The Public Debt Management Act (PDMA), enacted in 2024, mandates the government to undertake credit risk assessments before approving and issuing guarantees or on-lending. It further restricts eligibility to entities that are not in financial distress and requires risk mitigation measures, such as fees and spreads. Additionally, the Public Financial Management Act (PFMA), enacted in 2024, mandates prudent management and mitigation of fiscal risks. It also includes provisions to address specific fiscal risks associated with SOEs and public-private partnerships (PPPs).

3. A key reform effort is the preparation of a Fiscal Risk Statement (FRS) as mandated by the PFMA. The law requires the government to specify the main sources of fiscal risks and estimate their potential fiscal impact in the Fiscal Strategy Statement (FSS). A comprehensive analysis and disclosure of fiscal risks can help ensure that fiscal policy settings are resilient to a range of potential future economic and fiscal shocks. By actively monitoring and managing specific risks, the government can avoid abrupt and disruptive policy changes when risks materialize. The government of Sri Lanka is committed to publishing its first FRS by June 2025.

4. The objective of this report is to identify the key sources of fiscal risk in Sri Lanka and to provide guidance for preparing the FRS. This report outlines the critical actions required to develop and publish the FRS in the near term, while also identifying areas for future improvement in fiscal risk management. The report focuses on risk identification and quantification, which are the near-term priorities for the development and publication of FRS, though it touches on a few specific risk mitigation issues. Section II discusses macroeconomic risks in Sri Lanka, while Sections III – VII respectively delve into specific risks related to public enterprises, guarantees and on-lending, public-private partnerships, the financial sector, and natural disasters. Section VIII concludes with a near-term reform plan. Debt related fiscal risks are not discussed in this report as there is another technical assistance mission from

the IMF and WB to support the authorities on debt management. Policy implementation risks, such as the non-implementation of revenue-raising or expenditure-cutting policies, the implementation of policy measures outside the budget formulation process, are not discussed in this report. However, some of the methodologies discussed in this report can be used to assess these risks. For example, fiscal forecast error analysis.

II. Macroeconomic Shocks

5. Macroeconomic risks are economic factors that may affect medium-term fiscal projections. Macroeconomic risks arise when outturns differ from forecasts for key macroeconomic variables, such as GDP, inflation, interest rates, commodity prices, and exchange rates. A change in any of these factors, even a small one when the fiscal headroom is limited, can disrupt medium-term fiscal projections. A deviation in nominal GDP growth may have implications for government revenues, expenditures, deficits and therefore for public debt. These factors, many of which are influenced by global developments, are beyond the government's control. Assessing macroeconomic risks is necessary to understand what will happen to the medium-term fiscal framework if risks materialize. This will help the government plan ahead to manage these risks.

6. The forthcoming FRS should include the following key elements:

- A short analysis of how previous macroeconomic shocks have materialized and have put fiscal plans off-track. It should be supported by quantitative analysis through a forecast error and volatility analysis.
- Main macroeconomic risks facing the Sri Lanka economy looking forward from 2026 and over the forecast period of the FSS/MTFF
- Mitigation measures, such as, the application of fiscal ceilings/ targets and the fiscal reform momentum, measures taken to improve forecasting of GDP, revenue and expenditure, and the contingency buffers.

A. Current Situation

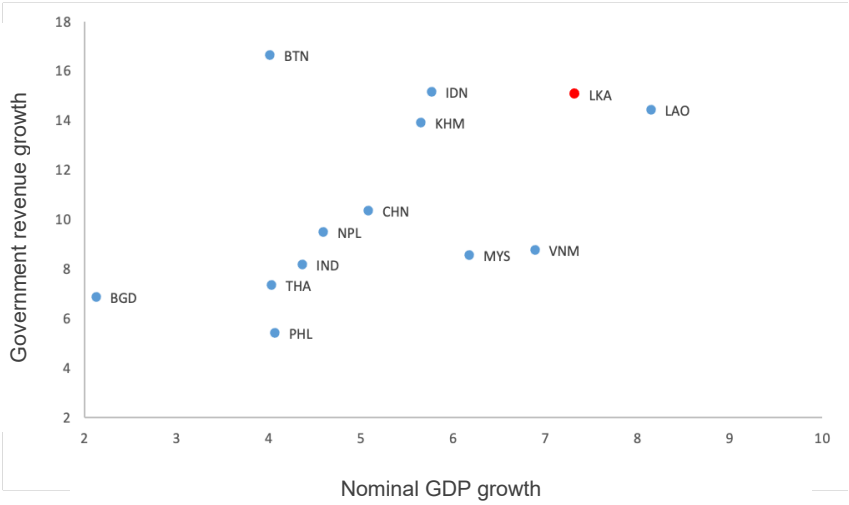
Evidence of high vulnerability

7. There are structural weaknesses that make the country vulnerable to shocks. On the external side, they include a narrow export base, with apparel, textiles, tea and rubber accounting for about 60 percent of merchandise exports; a high dependency on tourism and remittances, which are inherently sensitive to external developments, and oil imports, particularly critical for power generation. Domestically, the weaknesses include an elevated public debt, which limits fiscal space to counteract the impact of major shocks; the country's tropical location on the Indian Ocean, which increases its exposure to extreme weather events; and the lack of a social contract and weak governance, which can make it difficult to sustain policies over time.

8. A volatility analysis points to the vulnerability of the economy and public finances to shocks and the existence of fiscal risks. Using World Economic Outlook (WEO) data, the volatility of growth in total government revenue and expenditure and nominal GDP was derived for Sri Lanka and selected Asian neighbors over the period 2000-2024 (Figures 2.1-2.2). The results show that the variability of revenue growth (15.1 percent) is twice as high as that of GDP (7.3 percent) and total

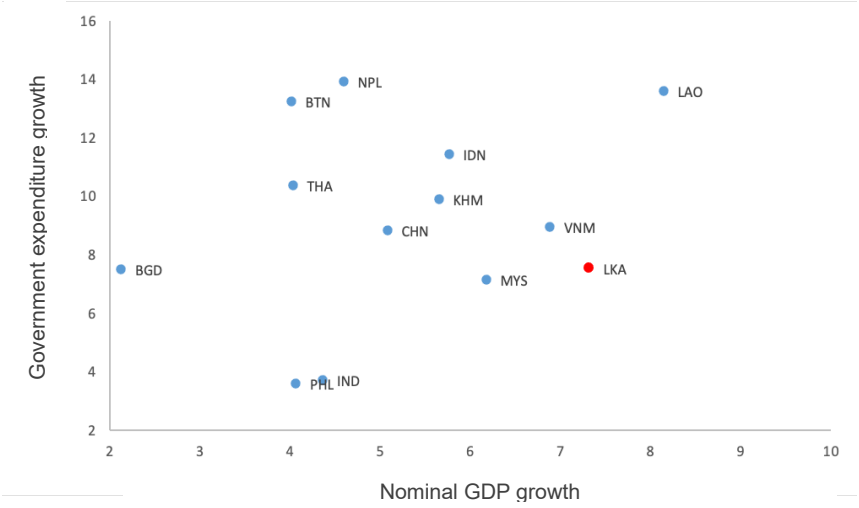
government expenditure (7.6 percent), indicating significant risk to the budget.[5] Moreover, the sensitivities of nominal GDP and revenue appear to be higher than in selected Asian neighbors, reflecting to some extent that the Sri Lankan economy is more vulnerable to shocks in addition to the impact of policy missteps

Figure 2.1. Volatility of Nominal GDP and Revenue Growth in Selected Asian Countries
(In percent; 2000-2024)



Source: World Economic Outlook database Oct 2024.

Figure 2.2. Volatility of Nominal GDP and Expenditure Growth in Selected Asian Countries
(In percent; 2000-2024)



Source: World Economic Outlook database Oct 2024.

[5] The volatility of nominal GDP and revenue growth is slightly reduced if 2020-21 (the COVID-19 pandemic) and then 2022-23 (the economic crisis reflecting partly the impact of policy missteps) are excluded from the period, leaving to the conclusion broadly unchanged.

9. Going forward, public finances remain highly vulnerable to shocks. The combined impact of the COVID-19 pandemic and the recent economic crisis, caused in part by an overvalued exchange rate, has weakened public finances. The public debt ratio is still estimated to be above 100 percent of GDP in 2024 and fiscal space to counter the impact of major shocks is limited. Moreover, public finances could be affected by a number of shocks. These include an intensification of regional conflicts with supply disruptions leading to an increase in commodity prices, a depreciation of the exchange rate and a resurgence of inflation, which could eventually weigh on government spending. A global growth slowdown could affect exports and tourism receipts, jeopardizing the expected economic recovery and government revenue target. Domestically, possible waning reform momentum, SOEs' default and chronic losses and vulnerability to natural disasters pose additional risks. The authorities have confirmed that they consider macroeconomic risks to be among the main fiscal risks.

Key institutional arrangements in place

10. The primary responsibility for the assessment of macroeconomic risks lies with the MFU at FPD. This function fits well with its other responsibilities, which include macro-fiscal forecasting and analysis preparing the FSS and MTFF and monitoring fiscal targets. The principles and methodologies for monitoring fiscal performance and quantifying macroeconomic risks are quite similar. Moreover, continuous fiscal monitoring will enhance staff knowledge of the impact of changes in macroeconomic factors and policies on fiscal aggregates (e.g., transmission channels, magnitude of impact and likelihood of materialization). Staff is familiar with macroeconomic risks and quantification techniques.

11. The MFU has a comprehensive dataset of past macro-fiscal variables, but risk identification and quantification are limited. The MFU has collected and stored main macro-fiscal aggregates from various sources within and outside the MoF. The database covers the four sectors of the economy up to 2024. It also contains forecasts and outcomes for nominal GDP, real GDP growth, government revenue and expenditure and the fiscal balance for ten vintages over the period 2014–2023. While macro-fiscal data are available, the MFU does not have any information on the fiscal impact of past realized shocks. Moreover, the quantification of fiscal risks is confined to an analysis of the historical volatility of tax revenue.

12. The MFU prepares the MTFF but does not yet have a comprehensive macroeconomic framework. An Excel-based Macroeconomic Foundations Tool (MFT), based on the principles of Financial Programming and Policies, is being developed with support from the IMF's Capacity Development Institute. The tool will provide a structure and links for developing baseline macroeconomic forecasts (incorporating key behavioral equations) and scenarios for assessing policy options and risks. The MFT is currently being adapted to the Sri Lankan economy and local data are being integrated. It is expected to be operational by the end of April 2025. MFU staff have been trained in the main aspects of financial programming and the use of the generic tool. Significant CD has also been provided by FAD on macro-fiscal forecasting.[6]

[6] See the most recent TA report: Sri Lanka - Strengthening the Macro-Fiscal Unit (IMF, April 2022).

B. Issues

13. A process for identifying and quantifying macroeconomic risks needs to be put in place for the preparation of the forthcoming and future FRS. As a first step, the identification and evaluation can be based on existing data. The quality of risk quantification can be improved in the medium term once the MFT is operational.

14. A useful starting point for the analysis of macroeconomic risks is the analysis of past forecast errors. Assessing the difference between budget estimates, possibly at different points in time, and actual outcomes gives some indication of the impact of past shocks on macroeconomic variables and can be used as an indicator of future shocks.[7] Average forecast errors can be calculated on the basis of existing macro-fiscal data. Extending the scope of the study to disaggregated fiscal variables (e.g., tax revenue and current and capital expenditure) could help understand the source of the errors.

15. An analysis of forecast errors based on MFU data confirms the existence of risks to the budget. Three-year forecast errors have been estimated for nominal GDP, real GDP growth, total nominal government revenue and expenditure, and the fiscal balance for the period 2014–2023 (Figures 2.3–2.6). Average forecast errors were calculated as the difference between budget estimates and actual outcomes. The results show that nominal GDP and revenues have been underestimated (+4.5 percent) and overestimated (-2.2 percentage points of GDP), respectively. The combined effect of lower revenues and a small expenditure adjustment (with an average median forecast error of -0.2 percentage points of GDP) led to an underestimation of the budget deficit (with an average forecast error of -3.2 percentage points of GDP). The pessimistic bias in nominal GDP was due to an underestimation of inflation.

16. A second type of analysis, the results of which can be presented in the forthcoming FRS, is a volatility analysis. High volatility in the past indicates that outcomes are spread over a wide range of values. Thus, the higher the volatility, the less predictable the variable and the more uncertain its evolution. Additional analyses could be extended to a number of macro-fiscal variables, beyond the existing analysis of tax revenue, including nominal GDP growth, inflation, interest rate and exchange rate. Volatilities could be measured either in terms of variance or standard deviation of annual changes. In addition, Sri Lanka's volatility could be compared with that of selected countries using either the FRAT, which contains data up to 2019, or the latest WEO with available data up to 2024.[8]

17. In the medium term, the quality of forecasts could be gradually improved, thereby mitigating the impact of shocks. Sound macroeconomic risk management depends crucially on sound macroeconomic forecasting. It is important for the government to have a reasonably good assessment of what the public finances will look like in the coming years and what the broader macroeconomic context will be. The MFT should lead to improvements in macroeconomic forecasting, and enhance dialogue and discussion on macroeconomic policy within the MoF. The largest forecast errors should be taken into

[7] The forecast errors reflect also the impact of other factors, including the significant technical and political challenges of accurately forecasting macro-fiscal developments.

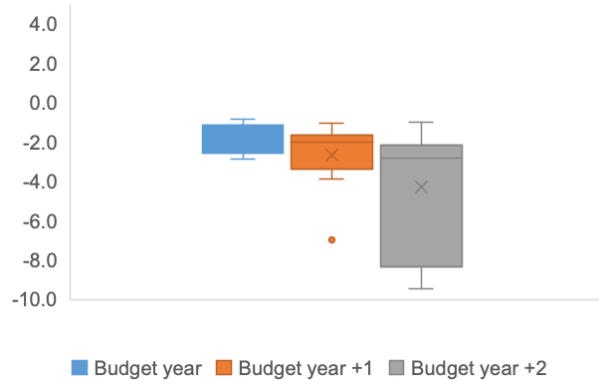
[8] The latest WEO database is available at: https://www.imf.org/en/Publications/WEO/weo-database/2024/October.

account when making forecasts.[9] Learning from these errors can help identify recurring issues and improve the accuracy and robustness of future forecasts.

18. Sensitivity and scenario analyses could be developed. This will help MFU to refine the quantification of risks. The deterministic analysis of shocks to fiscal aggregates can be modelled in different ways. As a first step, the simplest approaches could be considered, namely stress testing and sensitivity analysis. Stress testing typically involves modelling a large, temporary shock, while a sensitivity analysis simulates smaller but persistent medium-term shocks. Simpler shocks are independent, symmetric and linear (e.g., a global oil price surge). An alternative scenario may be developed later. This usually analyses the impact of a severe and prolonged economic downturn or reflects the country's main vulnerabilities. The analysis of forecast errors and volatility and the information contained in the risk register (see paragraph below) can help in the calibration of shocks.

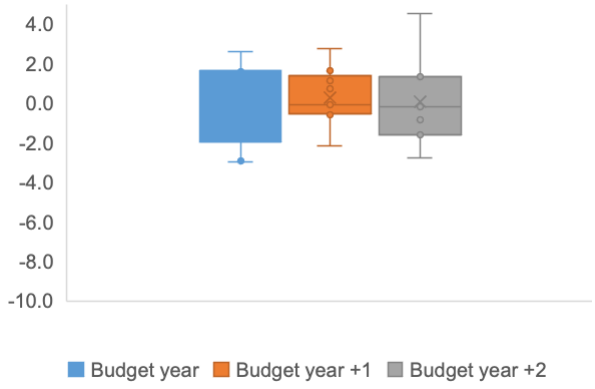
[9] FAD also supports the authorities on revenue forecasting which can also provide inputs for FRS.

Figure 2.3. Historical Forecast Errors for Government Revenues
(In percentage points of GDP; 2014-2023)



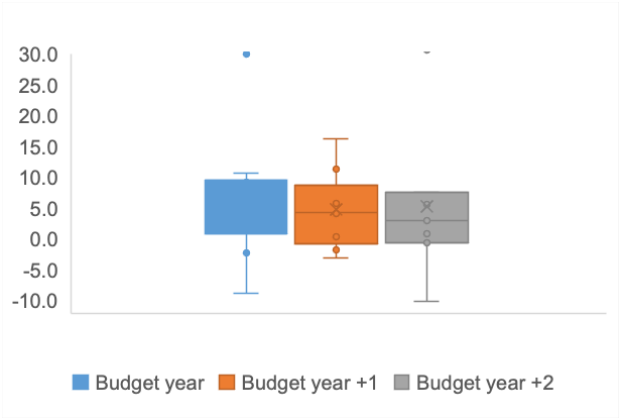
Source: Mission calculations based on MoF data.

Figure 2.4. Historical Forecast Errors for Government Expenditure[1]
(In percentage points of GDP; 2014-2023)



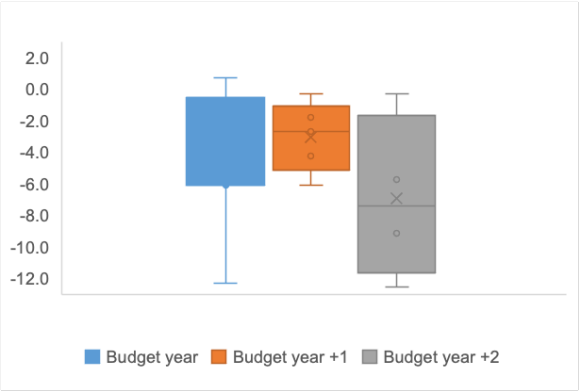
Source: Mission calculations based on MoF data.

Figure 2.5. Historical Forecast Errors for Nominal GDP[1]
(In percent; 2014-2023)



Source: Mission calculations based on MoF data.

Figure 2.6. Historical Forecast Errors for Real GDP Growth[1]
(In percentage points; 2014-2023)



Source: Mission calculations based on MoF data.

[1] A negative value reflects an outturn that was lower than the forecasted value indicating an upward bias in the forecasts.

19. A debt sustainability analysis (DSA) should also be prepared as soon as capacity permits. PDMO should provide data on public and publicly guaranteed debt, and other relevant departments/ institutions should share estimates of contingent liabilities (e.g., bank recapitalization) in the context of the preparation of the FRS. The IMF's Sovereign Risk and Debt Sustainability Analysis tool helps to simulate the evolution of public debt ratios under different scenarios and to assess the vulnerability of debt dynamics to stress. In the near term, the authorities can refer to the DSA conducted in the most recent Article IV or EFF Review of the IMF.

20. The development of a risk register for macroeconomic risks could prove to be a valuable tool in enhancing staff knowledge of the possible impact of risks and the likelihood of

materializing. Risk assessment is the iterative process of identifying and quantifying risks. The register could start with shocks either occurring at the time the register is established or having occurred in the past. The broader the data coverage, the easier it would be to assess the likelihood of risks materializing. To facilitate the identification of past shocks, they could be defined, for example, as episodes in which nominal GDP growth fell by one standard deviation relative to its average. Maintaining information on the nature, recurrence, pattern and impact of past shocks will improve the ability of MFU staff to identify the most common sources of risk and those with the greatest impact and to improve the calibration and modelling of stress tests.

Recommendations

Near Term

2.1 Derive forecast errors in key macro-fiscal variables and calculate historical volatility of key macro-fiscal variables based on existing data for the 2025 FRS.

Medium Term

2.2 Mitigate the impact of shocks and further refine the quality of the risk quantification:

- Incorporate the largest forecast errors in the baseline macroeconomic scenario.
- Conduct stress testing and sensitivity analysis.
- Conduct a DSA. Engage with PDMO and other departments/institutions for data input.
- Build a macroeconomic risk register. Describe each shock in terms of its source, transmission mechanism and fiscal impact, together with a categorization of the impact (low, medium and high).

III. State-owned Enterprises

21. The activities of SOEs can have a significant impact on a country's public finances. SOEs are often major contributors to national GDP, employment and investment, and play an essential role in the provision of goods and services that support key economic and social policy objectives. SOEs are an integral part of public finances, either by generating revenues through dividends and taxes or by requiring budgetary support (e.g., subsidy, capital grant, capital injection, guarantees and on-lending). Thus, poor performing SOEs can have a major impact on government budgets and generate fiscal risks. In addition, SOEs can create contingent liabilities for governments, as their debts are backed by implicit or explicit government guarantees. An IMF analysis has examined the fiscal consequences resulting from state bailouts of failing SOEs and found that these interventions can cost governments an average 3 percent of GDP, reaching up to 15 percent of GDP in extreme cases.[10] Factors contributing to the risks include inefficiencies, weak financial management, quasi-fiscal activities, and excessive resource extraction and borrowing. This section focuses on non-financial SOEs.[11]

- **The forthcoming FRS should include the following key elements:**Overview of the SOE sector and recent developments

- Aggregated financial information, including a reference to SOEs having negative equity and/or large liabilities
- Distribution of credit risk ratings and analysis of financial indicators for high-risk entities
- Transactions with the government: equity injections, transfers, subsidies, dividends and net flows to the government
- Mitigation measures, including those implemented as part of the reform agenda.

A. Current Situation

The fiscal drag of SOEs

22. SOEs have a significant presence in Sri Lanka. There are nearly 400 public corporations. They include commercial corporations (41 entities), government owned companies (158) and statutory boards (198 entities). Commercial corporations and government owned companies are engaged in commercial activities and are considered SOEs (199 entities in total, of which 11 are financial entities). SOEs operate either under their own separate legal status (commercial corporations) or under the Companies Act (government owned companies). They are all fully or almost fully owned by the government. The statutory boards are involved in non-commercial activities , which operate with a balanced budget, are not allowed to borrow independently from central government, and have a good

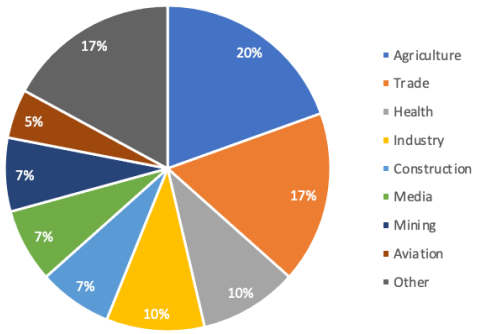
[10] IMF, 2016, "The Fiscal Costs of Contingent Liabilities: A New Dataset," Working Paper. Available at: https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-Fiscal-Costs-of-Contingent-Liabilities-A-New-Dataset-43685.

[11] The analysis of the financial soundness of financial institutions differs from that of non-financial corporations. For example, the role of banks in channeling funds from savers to borrowers and in maturity transformation means that their financial statements take a different form from those of non-financial corporations. Risks in the financial sector are discussed in Section VI of this report.

track record of servicing their on-lent debt to central government. Nevertheless, they are important for fiscal risk management as they remit a substantial amount of levy to the Treasury.

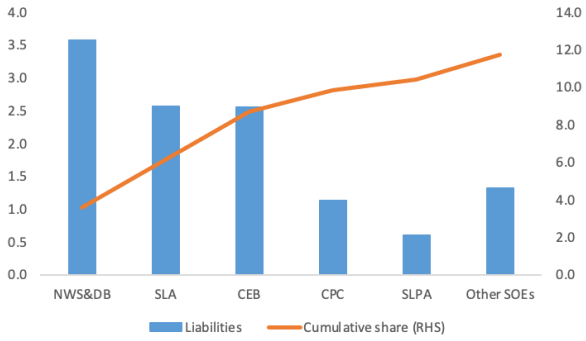
23. Of the 188 non-financial SOEs, 41 are considered strategically important by the authorities. The criteria used to define the strategic importance include the economic sector in which SOEs are present and the size of their liabilities. The 41 SOEs operate in key sectors such as ports, energy, water, retail, basic food production, mining and construction (Figure 3.1). Their total liabilities are estimated at LKR 3.2 trillion at end-December 2023, or 11.7 percent of GDP. Of these 41 SOEs, the five largest are Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), Sri Lankan Airlines (SLA), National Water Supply and Drainage Board (NWS&DB) and Sri Lanka Ports Authorities (SLPA). Their liabilities amounted to LKR 2.9 trillion or about 90 percent of the total liabilities of the 41 strategic SOEs (Figure 3.2).

Figure 3.1. Distribution of SOEs by Sector
(Number of strategically important SOEs)



Sources: PED data and mission calculations.
Note: Agriculture sector includes the plantation activities.

Figure 3.2. Total Liabilities of SOEs
(2023, Percent of GDP)



Source: PED data and mission calculations.

24. The financial performance of Sri Lanka's 41 largest SOEs has been weak, mainly due to losses at CEB, CPC and SLA (Table 3.1). CEB's and CPC's losses were mainly the result of pricing policies that set fuel and electricity prices below cost recovery levels, causing liquidity problems and hampering investment. The poor financial performance of SOEs has weighed on public finances, with net outflows from the government averaging LKR 80 billion per year (0.4 percent of GDP) from 2018 to 2023. The fiscal burden goes beyond the direct budgetary impact, with the provision of debt-for-equity swaps and debt transfers to central government, and the deterioration of public banks' balance sheets.[12] In addition to uncompensated quasi-fiscal activities, other factors have contributed to poor performance, including operational inefficiencies, oil price volatility, currency depreciation, cross-debt, weak governance and weather-related shocks.

25. While there are recent signs of improvements, the financial position of the SOE sector will continue to weigh on public finances and pose fiscal risks.[13] Their performance has improved significantly in 2023, with total profits of LKR 174 billion (0.6 percent of GDP), an LKR 950 billion increase

[12] See Chapter VI of the present report on risks arising from the financial sector for further discussion.

[13] The data for 2023 reflects data extracted from the Management Information System and provided to the mission.

from 2022, largely due to automatic fuel and electricity price adjustments and cost-reflective water tariffs. However, the sector remains fragile, with 11 SOEs incurring losses of LKR 81 billion (0.3 percent of GDP) and six entities having negative equity totaling Rs 525 billion (1.9 percent of GDP). CEB and CPC's outlook remains uncertain despite reforms like introducing competition in petroleum and plans to unbundle the electricity sector. The size of their debt remains to be addressed, and any change in the government's commitment to maintain prices at cost-recovery levels would be detrimental to the companies' financial health. SLA is in a critical state, contributing over 90 percent of losses and negative equity, with US$310 million debt that needs to be restructured.[14]

Table 3.1. Financial information on SOEs
(In LKR billion; otherwise indicated)

	2018	2019	2020	2021	2022	2023
Profit/Loss Before Tax						
41 SOEs	-51.5	-14.8	31.5	-96.8	-774.8	174.0
O/w: main 5 SOEs	-172.4	-138.6	-82.5	-143.1	-1,025.0	132.4
Profit/Loss Before Tax (in percent of GDP)						
41 SOEs	-0.3	-0.1	0.2	-0.5	-3.2	0.6
O/w: main 5 SOEs	-1.1	-0.9	-0.5	-0.8	-4.3	0.5
Net outflows from the government						
41 SOEs	31.4	21.5	57.0	66.5	99.8	206.0
O/w: main 5 SOEs	0.0	24.0	51.3	63.1	109.8	243.5
Net outflows from the government (in percent of GDP)						
41 SOEs	0.2	0.1	0.4	0.4	0.4	0.7
O/w: main 5 SOEs	0.0	0.2	0.3	0.4	0.5	0.9

Sources: Mission team's calculation based on the data from the Annual and Mid-Year Budget Position Reports PED's Management Information System and GDP series from MFU, received during the mission in January 2025.

Institutional foundations established

26. The PED is responsible for overseeing the financial operations of SOEs. As part of its functions, it reviews their annual budgets and multi-annual corporate plans and monitors their operations to ensure that they meet their performance benchmarks. The PED has a special focus on strategic SOEs. It has a dedicated website that hosts the SOEs' Corporate Governance Guidelines (which details the ownership policy) and Operational Manual, the PED's 2022 Annual Report, and the strategic SOEs' 2017-2023 financial statements. 80 percent of the 2023 posted financial statements have been audited.

27. Under the new PFMA approved in August 2024, SOEs are subject to enhanced reporting requirements. SOEs must submit to the MoF a medium-term strategic plan, an annual budget, an annual action plan and an annual report, which includes the financial statement. Future annual budgets are

[14] The 2025 budget has allocated 20 billion rupees to pay off some of the airline's debt. Sri Lankan Airlines has hired a financial advisor to restructure its international bond. (https://www.imf.org/en/News/Articles/2025/04/30/tr-042925-press-briefing-sla-4th-rev-sri-lankas-reform-program-supported-by-eff-arrangement)

expected to present the risk factors that may affect the expected performance of the enterprise and the strategies to mitigate these risks. SOEs are also required to publish the annual report on their website.[15]

28. The PED has access to the financial data of the most strategic SOEs. In addition to a paper copy of the statements, PED has implemented a Management Information System (MIS) to facilitate the collection of financial information from SOEs. The MIS is a web-based system that allows data to be downloaded in an Excel file. To date, the MIS contains annual data from the strategic SOEs for the last five years. More recently, strategic SOEs have also been asked to enter their data on a monthly basis. The MIS also contains some information for the non-strategic enterprises, but the data coverage remains uneven and requires further training of the SOEs. Within the MoF, NBD has data on the transactions with the government, and DTO (Department of Treasury Operations, and soon PDMO) has data on guaranteed and on-lent debt.

29. The MoF publishes information on the overall performance of SOEs in several reports. These include the Fiscal Position Report (Annual Report), the Fiscal Management Report and the PED 2022 Annual Report. The content of the Fiscal Position Report is the most comprehensive one providing both detailed information on selected companies and aggregated and company-level data on total assets, total revenue, profit before tax, levy/dividend and budget support.

B. Issues

30. The preparation of the forthcoming FRS requires high-quality aggregated SOE financial data, which is the basis for financial analysis. During the mission, an Excel spreadsheet was populated for the first time from the MIS with financial information for 2023 for the 41 non-financial strategic SOEs. The data includes key aggregates of the balance sheet and income statement. An analysis of the data reveals several weaknesses. Some data are inconsistent (e.g., total liabilities are not systematically equal to the sum of current and non-current liabilities), or some tax payments are recorded with a negative or a positive sign. Some data differs from the figures reported in the printed financial statements (e.g., total liabilities for CEB at the company level). Data coverage should be extended to the group and not limited to the enterprise. It will also be important to confirm the data consistency of net government flows and guaranteed and on-lent debt with the relevant MoF departments. Finally, consistency checks should be built into the file to ensure reliability. It is worth noting that there is no legal basis for recording data in the MIS. Data is not systematically entered in a timely manner.

31. Once the dataset has been created for the 41 SOEs and the integrity of the data has been confirmed, financial ratios can be calculated. To do this, the financial data must first be transformed into a format that ensures it is ready for ratio analysis. For example, any non-operating net profit/loss must be included in the calculation of net profit/loss, which in turn is used to derive return on equity. This involves organizing and standardizing the raw data from the financial statements into a structured framework and calculating the key ratios for profitability, liquidity and solvency.

32. To inform fiscal risk analysis, credit risk ratings for the 41 SOEs could then be derived from the financial ratios. The approach is to assess the ability of SOEs to meet their financial

[15] PFMA, Articles 57 and 61.

obligations and assign a rating based on the level of credit risk they pose. The benefits of the analysis are to further segment SOEs and to better identify the sources of fiscal risks. Credit risk calculations can be performed in an Excel file. To develop the scoring model, several decisions must be made, which are key elements of a credit risk analysis methodology. The decisions relate to:

- The set of financial ratios on which the credit risk rating is based. They should cover profitability, liquidity and solvency;
- The benchmarks for assessing the performance of the financial ratios. The SOE Health Check Tool (SOEHCT) User Guide provides benchmarks that are commonly used;[16]
- The weighting of each financial ratio to derive the overall risk rating: applying equal weights to each financial ratio could be considered to facilitate the process;
- The granularity of the rating, i.e., the number of risk categories; and
- The Assignment of the categories, i.e., 1 is very low risk and 5 is very high risk.

33. A preliminary analysis of credit risk shows that one third of SOEs would be classified as high or very high risk (Figure 3.3). Based on the 2023 PED financial data (which, as highlighted above, is subject to confirmation) and the use of the SOEHCT, credit risk ratings have been developed for the 41 strategic SOEs.[17] Fourteen SOEs have been identified as high and very high risk, of which more than a third are in the agriculture and plantation sector. These account for 56 percent of the total liabilities of the SOEs. Eight were operating at a loss, unable to cover their costs. Eight had a poor return on equity of less than 1 percent, further underlining the difficulty of profit generation. Ten SOEs (or 70 percent) had a current ratio of less than one, indicating their inability to meet their short-term obligations.[18] Overall, the results call for a thorough investigation to understand the underlying causes of these risks and to recommend appropriate remedial actions. As CEB, CPC and SLA are not among the 14 companies identified as high and very high risk, this brings the list to 17 companies that may require close monitoring.

34. As a next step, the scope of SOEs' financial oversight should be broadened, while focusing on SOEs that can be considered as market producers. The IMF 2014 *Government Finance Statistics Manual* (GFSM) provides a definition. A market producer is an entity that: (i) engages in market production; (ii) charges economically significant prices; and (ii) makes a profit. As a rule of thumb, one would expect the value of sales (excluding taxes and subsidies on products) to be at least half of the cost of production (including wages, consumption of goods and services, consumption of fixed capital), averaged over a sustained period. An analysis should be carried out to determine which of the 147 companies whose financial performance is not closely monitored are commercially active and to conduct close financial monitoring.

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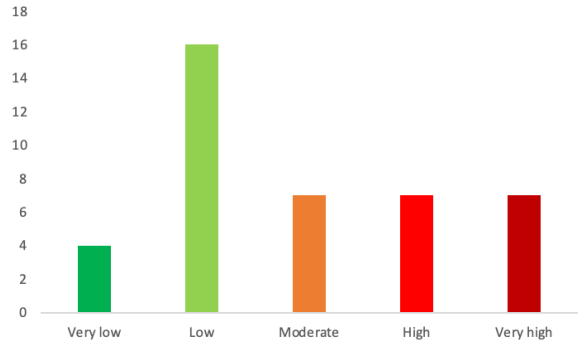
[16] The User Guide is available at: https://www.imf.org/en/Topics/fiscal-policies/Fiscal-Risks/Fiscal-Risks-Toolkit/Fiscal-Risks-Toolkit-SOE-HCT. Benchmarks can be tailored to country circumstances and sector context to better reflect the likelihood of fiscal risks materializing. Sources include third party information (e.g., banks), benchmarking using financial performance of international or local comparator companies or industry norms and expert judgement.

[17] The ratings are based on six financial ratios, namely return on equity, cost recovery, current ratio, interest coverage, debt to assets and debt to equity. The benchmarks used are those presented in the SOEHCT guidelines and equal weighting has been assumed.

[18] Hotel Developers Lanka Ltd, Sri Lanka State Plantations Corporation, and State Engineering Corporation fall into all three categories. The others fall into only one.

Figure 3.3. Distribution of Credit Risk Ratings
(Number of strategically important SOEs)



Sources: PED data and mission calculations.

These may be small companies, but if a number of them are loss-making, the cumulative losses could be significant, and the fiscal risks could be greater than expected. It would therefore be worthwhile to extend the analysis beyond the 41 strategic SOEs, as some of them may generate very small revenues.

35. In addition, the breadth of the future FRS could be gradually improved. Priority should be given to reporting on SOEs' total debt, with data encompassing all financial instruments, ideally categorized by short-term vs. long-term and external vs. domestic debt. Additional aspects to consider in future FRS include: (i) equity injections and transfer of debt to the central government balance sheet; (ii) risk factors that may affect the expected performance of the enterprise and the strategies to mitigate these risks (this is expected to be submitted by the SOEs); (iii) deviations from individual SOE budget projections and forecast budgets and medium-term plans; (iv) the presence of performance contracts and the extent to which annual objectives are met; (v) quasi-fiscal activities and cost estimates; and (vi) forward-looking information that may influence SOE performance (which could also be reflected when deriving risk ratings).

36. The section on risks related to the activities and operations of SOEs should conclude with mitigation measures. Any measures already in place or being implemented as part of the reform agenda should be listed, together with an explanation of how they mitigate the risks.

Recommendations

Near Term

3.1 Require SOE to timely record financial data in the MIS.

3.2 Create a consolidated database of SOE financial data with 2023 data. Review the initial dataset and build consistency checks to ensure data integrity. Engage with NBD/DTO for data input.

3.3 Develop and adopt a credit risk analysis methodology for SOEs.[19]

[19] The credit risk analysis of SOEs will inform the assessment of credit risks associated with guarantees and on-lending to them.

3.4 Derive credit risk ratings in a simple Excel file.

Medium Term

3.5 Prepare a comprehensive register of SOEs that are market producers.

IV. Guarantees and On-lending

37. Government guarantees and on-lending help fostering sectoral investment and economic development, particularly in areas like infrastructure and public services. These instruments can enable beneficiaries, such as SOEs, to access financing that might otherwise be unavailable or prohibitively costly. However, these instruments also expose governments to fiscal risk, specifically credit risk, which arises when beneficiaries of the instruments are unable or unwilling to meet their financial obligations. These risks are further amplified by gaps in capacity and governance arrangements to effectively assess, monitor, and manage the contingent liabilities. Additionally, the financial health of beneficiaries often deteriorates during economic downturns, exacerbating the government's exposure to unanticipated fiscal pressures. Careful management and oversight of guarantees and on-lending are therefore crucial to ensuring they serve their intended purpose without undermining fiscal sustainability.

38. Comprehensive management and reporting of guarantees and on-lending requires a robust framework of legal, governance, and risk management principles. Such a framework defines the policy objectives of guarantees and on-lending, aligns them with fiscal limits, and ensures they are supported by operational guidance and sound institutional arrangements. Effective governance requires clearly assigned responsibilities, formalized processes for information sharing, and mechanisms for accountability and transparency. A strong credit risk management strategy, encompassing risk quantification, mitigation, and continuous monitoring, helps governments proactively manage potential liabilities and reduce fiscal vulnerabilities. These practices support transparent and structured reporting by enabling regular disclosures, integration of risks into fiscal statements, and quantifying risks. Together, they enhance decision-making, accountability, and fiscal sustainability while preserving the developmental benefits of these instruments.

39. The forthcoming FRS should include the following key elements:

- Overview of the outstanding guarantees stock by creditor and beneficiary.
- Overview of guarantees issued in the past financial year by creditor and beneficiary.
- Information on the guarantees called during the past financial year.
- Overview of on-lent loan portfolio by creditor and beneficiary.
- Overview of loans on-lent during the past financial year.
- Information on the servicing of on-lent loans by beneficiaries in the past financial year.

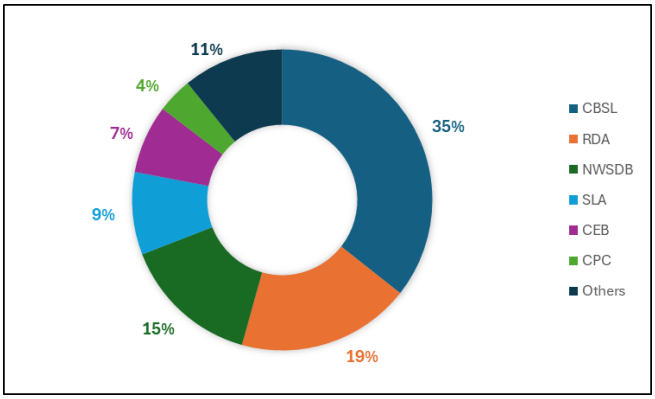
A. Current Situation

40. As of end-September 2024, the outstanding stock of government guarantees and letters of comfort stood at LKR 1,660 billion, equivalent to approximately 5.5 percent of estimated 2024 GDP.[20] Over one-third of this amount was attributed to the currency swap and trade credit provided by the Reserve Bank of India to the CBSL, backed by guarantees from the GoSL (Figure 4.1). Among SOEs, the primary beneficiaries were the Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), Road Development Authority (RDA), Sri Lankan Airlines (SLA), and the National Water Supply and

[20] According to PFMA, the calculation should use 3-year average nominal GDP. In that case, the ratio would be around 6%.

Drainage Board (NWSDB), which collectively accounted for more than half of the outstanding guarantees. The largest domestic creditors for guaranteed SOE loans were three state-owned banks, the Bank of Ceylon (BOC), National Savings Bank (NSB), and People's Bank (PB). This highlights the deep interconnectedness between the GoSL, non-financial SOEs, and state-owned banks, as the financial health of each is closely tied to the others, amplifying fiscal and financial risks.

Figure 4.1. Outstanding guarantees and comfort letters by recipient.
(percent of total)



41. Guarantees and on-lending have been issued without regard to beneficiaries' financial health and creditworthiness. Guarantees have primarily supported key SOEs to sustain service delivery and infrastructure investments, even as these entities operated at a loss. In the absence of clear policies, eligibility criteria, or a credit risk assessment framework, guarantees were provided indiscriminately and without mechanisms to mitigate risks, such as imposing fees. Similarly, the GoSL used on-lending to support SOEs and small and medium-sized enterprises (SMEs), mostly passing original loan terms directly to beneficiaries without accounting for the associated credit risk.

42. Despite inadequate credit risk assessment and monitoring, only a few guarantees have materialized in recent years, as the GoSL frequently stepped in to absorb risks and prevent SOE defaults. Many SOEs have struggled to service their guaranteed debts due to persistently weak financial fundamentals. Rather than allowing guarantees to materialize, the GoSL has intervened by restructuring loans with creditors or providing direct financial support to SOEs. Loans have been on-lent to SOEs with the implicit understanding that the recipients will not be able to repay the debt. On-lent loans have therefore been converted into equity through debt-for-equity swaps on several occasions, most recently in 2019, when outstanding loans were converted to strengthen SOEs' balance sheets. This strategy aimed to reduce the fiscal burden while improving the financial stability of these enterprises.

43. The PDMA, enacted in June 2024, establishes a legal framework for the sound management of guarantees and on-lending, assigning this responsibility to the PDMO. Before the enactment of the PDMA, there were no formal policies governing the issuance of guarantees and on-lending. Line ministries submitted SOE's requests directly to the Cabinet, which then tasked the MoF with analyzing these requests. However, PED analysis was confined to reviewing financial tables and did not include assessments of creditworthiness. Despite negative assessments from the MoF, guarantees and on-lending were often approved and issued. Under the PDMA, the authority to issue guarantees and on-lending rests with the Minister of Finance, while the PDMO is tasked with their management. The PDMA

defines the policy objective of these instruments as promoting economic development. Eligible beneficiaries include SOEs, Provincial Councils, and Local Authorities, with other entities requiring parliamentary approval. The act mandates the PDMO undertake a credit risk assessment before approving and issuing guarantees or on-lending, further restricting eligibility to entities that are not in financial distress, and requires risk mitigation measures, such as fees and spreads.

44. The GoSL is currently finalizing the legal instruments needed to implement the PDMA. At present, there are no detailed policy documents to operationalize its provisions or establish a comprehensive framework for managing guarantees and on-lending. To address this gap, the GoSL has finalized the drafting of a regulation for the PDMO, which includes procedures for managing these instruments and is currently undergoing approval through Cabinet and Parliament. Additionally, guidelines are being drafted, which will outline the processes for assessing, mitigating, monitoring, and reporting credit risk. Both the regulation and guidelines are expected to be finalized within the current financial year.

45. The PFMA, enacted in August 2024, further restricts exposure to credit risk from guarantees and on-lending. The PFMA reduces the ceiling on the outstanding stock of guarantees from 15 to 7.5 percent of GDP, calculated as the average of the current and previous two financial years. Although no explicit limit is set for on-lending, it is indirectly constrained by the PFMA's requirement to reduce public debt to sustainable levels.

46. The gross exposure to guarantees has been disclosed in the GoSL's fiscal position reports, financial statements, and the quarterly debt bulletin. Guarantees are recorded in an Excel-based database maintained by the DTO rather than the debt recording and management system.[21] These reports disclose gross exposure to guarantees, along with a breakdown by debtor and creditor, purpose of the guarantee, as well as issuance and maturity dates. The reports do not provide additional details such as the guarantees issued over the past financial year or any risk assessments. Information on on-lent loans has been excluded from the GoSL's reports. The PDMA mandates that the PDMO's quarterly public debt reports include detailed information on outstanding guarantees and on-lent loans, improving transparency and reporting standards.

B. Issues

47. To enable the PDMO to effectively fulfill its responsibilities under the PDMA, implementing legislation and policies must be enacted without delay. The absence of detailed procedures, along with unclear coordination and information-sharing requirements, hampers the PDMO's ability to assess, quantify, and monitor credit risk effectively. Although a circular was issued to facilitate data collection, the process remains cumbersome and time-consuming. Inefficient information sharing also limits the PDMO's ability to provide detailed reporting on outstanding guarantees and on-lending.

48. Finalizing the implementing legislation requires careful consideration of the policy objective and eligibility criteria outlined in the PDMA. Guarantees and on-lending should be restricted to projects that promote economic development as required by the PDMA. To operationalize this

[21] Debt liabilities are currently recorded in the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS). The PDMO, however, confirmed that the migration to the Commonwealth Secretariat's Meridien system is scheduled for 2025.

objective, the PDMO should coordinate with NPD and other relevant departments that undertake analysis whether proposed projects align with national priorities. Similarly, the concept of financial difficulty needs clarification to determine its impact on the financing of currently loss-making SOEs, which remain the largest beneficiaries of guarantees.

49. In the short term, existing reporting on guarantees can be complemented with information on recently issued guarantees and the same information on on-lending. Reporting on the outstanding stock of guarantees by creditor and beneficiary can be supplemented with information on guarantees issued during the past financial year and information on where the GoSL had to absorb risk. The same information should be provided for on-lending, which is currently absent from reporting.

50. Effective risk management will require the PDMO to develop a robust credit risk assessment methodology in collaboration with the PED. While the PDMA mandates credit risk assessments for new guarantees and on-lending, the PDMO was only recently established and is still in the process of developing the capacity to fulfill this role. As a result, credit risk assessments for new requests and the outstanding stock of these instruments have not yet been undertaken, reflecting the time needed to build the necessary systems and expertise. Consequently, the PDMO cannot adequately manage risks or incorporate risk quantification and probabilities of materialization into the forthcoming FRS. The PDMO, in collaboration with the PED, should develop a credit risk assessment methodology (key elements of such methodology are highlighted in paragraph 34 of section III).[22]

51. The implementation of the credit risk assessment methodology would allow the PDMO to base risk mitigation measures on expected losses. The PDMO should link fees for guarantees and spreads for on-lending to the assessed credit risk, ensuring a transparent risk-pricing mechanism. During the mission meetings, the PDMO expressed their consideration of linking risk mitigation to expected losses, which requires the credit risk methodology. The measures to mitigate risk should be outlined in the FRS, including the mitigation strategies applied, the creditworthiness of beneficiaries, and the probabilities of risk materialization.

52. The PDMO faces a significant workload as it develops its capacity to manage credit risk and expands reporting. Given these demands, it would be prudent for the PDMO to create a detailed capacity building roadmap that distinguishes between urgent training required to fulfill its immediate responsibilities and additional capacity development that can be undertaken over the medium-term. Seeking technical assistance from development partners and other stakeholders could support these efforts and ensure a structured approach to building the necessary expertise.

Recommendations

Near Term

4.1 Expedite the finalization of legislation and policies required to implement the PDMA, enabling the PDMO to effectively carry out its responsibilities.

[22] The credit risk analysis of SOEs will inform the assessment of credit risks associated with guarantees and on-lending to them.

4.2 In addition to guarantees, include an overview of the on-lent loan portfolio in the first FRS.

4.3 Include an overview of guarantees and on-lent loans provided during the past financial year and information on materialized risks.

4.4 Identify priority capacity building needs for PDMO staff and develop a structured roadmap for addressing them, prioritizing most critical short-term needs.

Medium Term

4.5 Develop and implement a comprehensive framework for assessing the credit risk from loan guarantees and on-lending.

4.6 Link risk mitigation measures for guarantees and on-lending, i.e., fees and spreads, to the results of the credit risk assessments to ensure consistency and accountability.

4.7 Enhance future FRSs by incorporating risk measures derived from credit risk assessments, including detailed risk quantification, to improve transparency and risk management. [23]

[23] If there is market-sensitive information related to specific SOEs, it could be considered for disclosure in an anonymized or aggregated manner.

V. Public Private Partnerships

53. Public Private Partnerships (PPP) offer opportunities to leverage private sector expertise for developing social and economic infrastructure in a country. Private sector participation can usher efficiency gains through the use of advanced technology, better project management and innovative methods. However, projects may require government support which can be upfront (viability gap funding, subsidies, grant of land etc.) or through government guarantees which create contingent liabilities. The projects also present an array of fiscal risks that must be carefully assessed, managed, and mitigated to ensure long-term financial sustainability for the government.[24]

54. Countries with mature PPP portfolios manage fiscal risks through sound legal and institutional arrangements clearly delineate specific responsibilities and define standardized processes. Typically, contracting authorities are responsible for identifying and procuring projects, PPP agencies for assisting line ministries and ensuring coordination, ministries of finance for assessing fiscal affordability and providing central oversight, and cabinets for approving projects. As part of risk mitigation strategy, several countries have also placed a limit on exposure to PPPs – in terms of stocks or flows or both.

55. Ministries of Finance have also sought to strengthen fiscal transparency by publishing a report on existing risks and the mitigation strategies in place. FRS normally discusses fiscal risks pertaining to PPPs by reporting on the following:

- Size of the PPP portfolio and the sectoral composition;
- Legal, institutional and organizational arrangements for facilitation, management and oversight of PPP projects;
- Nature of fiscal exposure – upfront contribution and explicit contingent liabilities created by government guarantees; and
- Risk mitigation strategy in place for effective risk management.

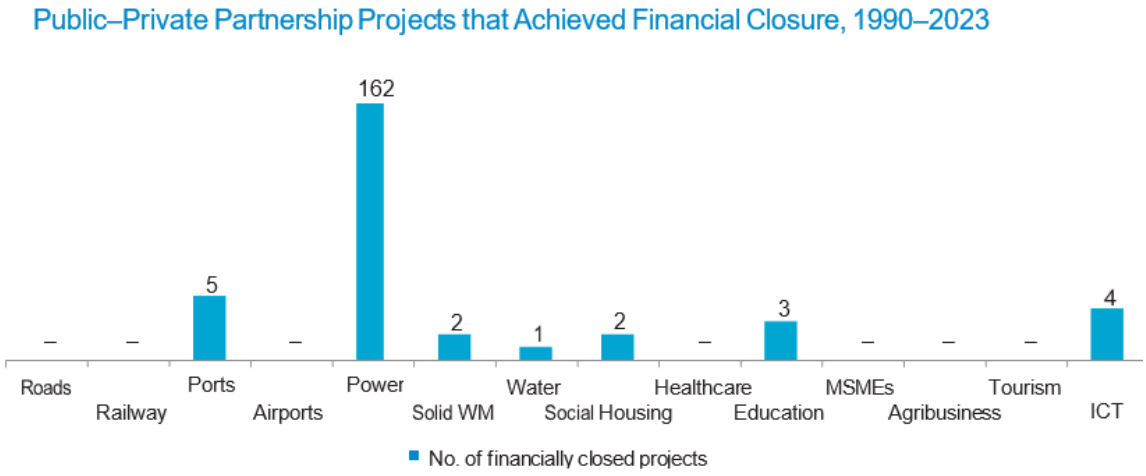
A. Current Situation

56. The PPP portfolio has been growing in Sri Lanka. Over 175 PPP projects have been financially closed during 1990-2023 with most of them in the energy and port sector. These projects are being implemented at an estimated cost of USD 5.3 billion (over 6 percent of GDP). Investment in the port sector is estimated at USD 2.7 billion, followed by the power sector with an investment of USD 2 billion. Investment in other sectors is rather modest. In the entire PPP portfolio, only 13 projects were awarded through competitive bidding, and the rest through unsolicited proposals, direct appointments and licensing schemes. An additional 80 projects are now under consideration in various line ministries with an estimated investment of USD 2 billion. The emphasis on power and port sectors remains unchanged,

[24] Internationally, implementation of PPP projects presents several instances where materialization of fiscal risks resulted in significant fiscal costs for the country e.g. Mexico (1997), Portugal (2012-14), United Kingdom (2001) and South Korea (1997) etc.

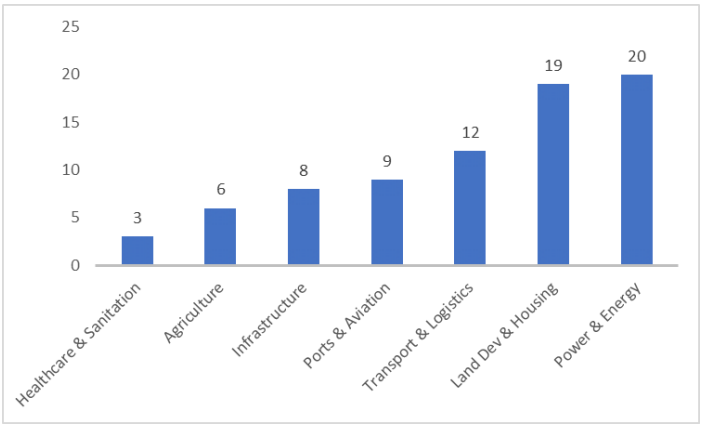
though land development, housing, and transportation and logistics projects are seeing a marked increase.

Figure 5.1. Public–Private Partnership Projects that Achieved Financial Closure, 1990–2023



Source: ADB: Public Private Partnership Monitor Sri Lanka: December 2024.

Figure 5.2. PPP in Pipeline



Source: NAPPP

57. The PPP processes are governed by various Acts, guidelines and circulars. PPP projects are initiated by line ministries and guided by the PF circular 02/2019 and the Guidelines on Government Tender Procedure Part II for Private Sector Infrastructure Projects (1998). Provisions of various other Acts and subordinate legislation are also applicable as relevant. Line ministries initiate the process and obtain cabinet approval to proceed with the project. After following the process outlined in the guidelines, the final proposal and agreed draft agreements are submitted to the cabinet for its approval. The MoF grants a preliminary clearance and is represented in the project committee and Cabinet appointed Negotiations Committee

58. The new PFM Act mandates an integrated public investment framework and requires that risks associated with PPP projects are identified, assessed and reported to Parliament. The Act requires that PPP proposals should be assessed by the Ministry of Finance along with other projects in the PIP during the budget process. Further, the PFMA mandates maintenance of a centralized database of PPP projects by Ministry of Finance and to submit prescribed details of new and ongoing PPP projects to Parliament in the annual budget document. With a view to effectively managing fiscal risks associated with these projects, the Act requires including an estimate of contingent liabilities associated with the PPP project Portfolio in the Fiscal Strategy Statement and a report on the financial impact of PPP projects in the Annual Report submitted to Parliament.

B. Issues

59. Fiscal risk analysis and reporting necessitate a robust legal framework with clearly defined roles and close collaboration among stakeholders. Fragmented organizational responsibilities, lack of a comprehensive database, insufficient awareness of fiscal risks and associated costs, and inadequate capacity and skills for economic and financial analysis of complex PPP projects pose significant challenges. PPP procuring entities need to identify fiscal risks arising from individual projects, assess the likely fiscal costs from these risks, design an effective strategy to manage and record them in a fiscal risk register which is updated on a regular basis. The initial record and subsequent changes should also be shared with NPD, the department in Ministry of Finance responsible for compiling this information from across various entities. NPD could assume the responsibility of contributing to the PPP related section of the FRS, as fiscal risks evolve through different phases of a PPP contract, a robust monitoring mechanism is essential for independent risk assessment.

60. The absence of standardized processes for identifying, screening, appraising, and approving PPP projects undermines the assurance that these projects align with government priorities. Furthermore, existing provisions do not require procuring entities to identify, assess, and manage fiscal risks by developing appropriate risk mitigation strategies, nor do they mandate the Ministry of Finance to independently assess and report on these risks. The current circulars and guidelines also fail to address critical aspects of the PPP process, such as early contract termination and renegotiation, which can impose significant fiscal costs.

61. A comprehensive and consistent legal and regulatory framework is needed for the governance of PPP processes and portfolios. A PPP Act and accompanying regulations or guidelines, aligned with the PFM Act 2024 and reflecting international best practices within the country context, should be finalized promptly. In addition to rules and guidance for various stages of PPP project preparation, award, and implementation, the law and regulations should delineate institutional arrangements and organizational responsibilities for identifying, recording, assessing, reporting, and managing fiscal risks associated with PPPs. These provisions should ensure that the Ministry of Finance maintains a strong gatekeeper function in PPP processes.

62. The current PPP processes do not empower the MoF with a strong "gatekeeper" role. The fiscal affordability of these projects is not assessed comprehensively. International experience suggests that requiring MoF approval at key stages can help eliminate weak projects early. PPP projects are

neither monitored nor evaluated by the MoF, and no department within the Ministry conducts a fiscal risk assessment of the entire PPP portfolio.

63. A fragmented institutional framework is evident in the absence of a centralized and comprehensive database for PPP projects across government. Project details, including size, contract award methods, contract value, fiscal risks, and government support, are scattered across ministries and SOEs, making identification and assessment of fiscal risks challenging. Establishing a comprehensive database will ensure the ready availability of critical data for PPP projects. Ideally, the NPD should establish a centralized database containing individual project details (purpose, start and end date, value, physical and financial progress, government support, etc.). The MoF should issue directives mandating line ministries to provide information in a prescribed format and share details of fiscal risks and their likelihood. A centralized database at the MoF will facilitate meaningful analysis of PPP-related fiscal risks for individual projects, sectoral portfolios, and the entire portfolio and in assessing their likely fiscal impact. The analysis could then inform and refine risk mitigation strategies for effective risk management. This database could also be accessed by NBD when assessing fiscal affordability of PPP projects.

64. Contingent liabilities are not comprehensively recorded. While the DTO maintains details of loan guarantees, it does not record payment or revenue guarantees. For example, under the Power Purchase Agreement (PPA) model, the CEB agrees to purchase power from private partners (independent power producers), and the government grants payment guarantees to ensure CEB's obligations if CEB cannot fulfill them. However, these are not recorded as contingent liabilities in government accounts. Such liabilities could lead to unplanned public expenditure, exerting pressure on the national budget. It is essential to record all guarantees given to PPPs, not just debt guarantees, and present them in the FRS.

65. There is a lack of centralized oversight and monitoring mechanisms for PPPs. A centralized oversight and monitoring mechanism is necessary to monitor fiscal risks throughout the life of PPP contracts. The Project Management and Monitoring Department (PMMD), tasked with overseeing large projects, could also assume responsibility for monitoring PPP projects. Since PPPs involve long-term financial commitments (20-30 years) and fiscal risks change as projects progress through stages, a centralized monitoring and oversight mechanism is essential to track these risks and periodically revise fiscal cost assessments. In this task, they could be assisted by a designated team in MoF, comprising officers of NPD, NBD and PMMD, to independently assess the estimated fiscal costs from these fiscal risks – information which would be useful for NPD, NBD and PMMD.

66. There are no fiscal limits on PPP commitments despite associated fiscal risks. Given that PPP-related risks could impact the country's fiscal situation, setting limits on government PPP commitments could be considered. Several advanced and developing countries (e.g., UK, Hungary, Peru, Brazil, Indonesia, Turkey) have sought to limit their exposure to PPPs, either in terms of stock (size of the PPP portfolio), flows (annual fiscal commitments for PPPs), or both, to ensure that fiscal costs from these risks remain manageable.

67. Capacity development across procuring entities, the PPP agency, and the Ministry of Finance should also be prioritized. Limited awareness of fiscal risks necessitates capacity development across government. The National Agency for Public-Private Partnerships (NAPPP) should be well-resourced to act as a center of excellence, assisting line ministries at various stages of the project

development and implementation to ensure proper structuring of the project, preparation of contracts and managing them thereafter. To build sufficient capacity, NAPPP should also train officials of procuring entities as well structured and managed projects will promote effective fiscal risk management. Officers in relevant departments in the Ministry of Finance should also be equipped to screen, appraise, and assess the fiscal affordability of PPP projects within an integrated public investment management framework (Part IX of the PFM Act) and monitor project performance. Efforts should also be made to leverage the Financial Management Information System (FMIS) and available tools (e.g., PFRAM) for fiscal risk assessment.

68. The 2025 FRS could provide a high-level discussion on PPP-related fiscal risks based on information available, with the aim to deepen the analysis in the future. The NPD should obtain relevant information (project size, purpose, procurement nature, investment, financial and physical progress, government guarantees, risk mitigation strategy, and expected worst-case fiscal cost) from line ministries and provide the FPD with a brief discussion on the PPP portfolio's size, sectoral exposure, associated fiscal risks, and mitigation strategies in place. Future FRS should present an in-depth analysis of the PPP portfolio and associated risks. International best practices suggest quantifying risks when possible and detailing measures undertaken during the year for superior risk management. The expected annual receipts and expenditures over the life of PPP contracts should be clearly stated.

Recommendations

Near Term

5.1 in the 2025 FRS, provide a qualitative discussion on the PPP related fiscal risks mentioning the PPP portfolio, fiscal risks identified in PPP projects, and the steps being taken or being contemplated by government to manage these risks.

Medium Term

5.2 Develop a comprehensive legal and regulatory framework for managing PPP processes and portfolio, aligned with the PFM Act 2024.

5.3 Strengthen institutional arrangements by clarifying the roles and responsibilities of PPP procuring entities and relevant departments in the MoF, and by empowering the MoF to stop projects in each step of the project cycle. Institute a centralized oversight and monitoring mechanism for PPP contracts assisted by a designated team in MoF, comprising officers of NPD, NBD and PMMD.

5.4 Establish a comprehensive PPP database within MOF.

5.5

5.6 Strengthen capacity development across all stakeholders i.e. procuring entities and relevant departments in the Ministry of Finance.

5.7 Deepen the analysis of PPP portfolio and associated risks in the future FRS by progressively adopting a quantitative approach.

VI. Financial Sector

69. Fiscal risks can arise from the need to safeguard financial stability, protect customers, address market failures or pursue social and economic development objectives through the financial system. Financial crises are high profile examples of such risks materializing, with wider macroeconomic consequences, but full-blown crises tend to occur relatively infrequently with multi-layered systems of oversight and regulation employed to avoid them. More frequently, the fiscal position can be impacted through financial channels when regular economic shocks and business cycles affect the performance of financial institutions, through lower revenues or higher payments to underperforming state-owned enterprises, or the presence of (unfunded) quasi-fiscal activities.

70. A relatively advanced level of practice in reporting on financial sector fiscal risks could be achieved in the first FRS by focusing on the following elements. CBSL publishes annually a detailed Financial Stability Review (FSR) together with quarterly updates of a narrower set of Financial Soundness Indicators (FSI). The FSR and quarterly FSIs provide ample material which could be summarized or cross-referenced in the Fiscal Risk Statement to convey an overall assessment of financial system health and recent trends.

- Presenting summary indicators of the overall health of the financial sector and analyzing trends and any risks that are explicitly covered by the government (e.g. deposit insurance),
- Analyzing the performance of state-owned financial institutions and associated net budgetary flows, and
- Explaining how regulatory, coordination and policy frameworks that promote institutional soundness and systemic stability are being strengthened, including extraordinary powers for crisis management and resolution.

In due course, adopting a more advanced practice of publishing the results of financial sector stress testing would be an important enhancement.

A. Current Situation

Overall health of the financial sector

71. Sri Lanka's financial system has faced significant challenges but with the success of various policy interventions has remained relatively stable. Significant interventions have been required by GoSL and CBSL through the recent economic crisis to provide financial support to the sector, reduce exposures to the government and SOEs, and ensure it is well placed to grow and support an economic recovery. Overall risks remain elevated but continue to subside. Outstanding credit contracted for a period but has resumed growing. Banking sector profitability was impacted by the need to provision against declining credit quality which has been improving slowly. The market share of private sector financial institutions has also been affected. More favorable financial conditions have followed the macroeconomic policy responses, progress with debt restructuring and the recapitalization of state banks.

Performance of state-owned financial institutions

72. The impact of recent events on the performance of state-owned banks and insurance companies has had significant fiscal implications. With the temporary retreat of private sector capital, the state-owned banks and insurers now account for a larger share of financial sector revenues.

- State-owned institutions have remained profitable, in aggregate, but their share of profits has not increased in line with their increase in market share.
- A higher profit share has been retained to satisfy rising regulatory provisions and underpin future growth in credit and underwritten risk, meaning a reduction in dividends and levies payable to GoSL (less than 0.1 percent of GDP in 2023, down from around 0.2 to 0.3 percent of GDP in 2016 and 2017).
- Budgetary support to the sector via subsidies and capital injections also had a significant bearing on the fiscal position. This has included the LKR 122 billion (0.4 percent of GDP) subsidy paid to two state banks in 2024 and budgetary support to Sri Lanka Insurance Corporation and Bank of Ceylon of around 0.1 percent of GDP each over 2017 and 2018.

73. Sri Lanka's state-owned banks have become less profitable over recent years compared to the rest of the banking sector. This suggests potential inefficiencies or competitive disadvantages within their operations, including exposures to loss-making SOEs, operation of larger branch networks and different employment policies than private sector counterparts. There are examples of quasi-fiscal activities, including provision of high interest savings accounts to senior citizens, low interest housing loans for low and middle-income families. No detailed account can be provided of whether these activities are adequately compensated through direct budgetary support.

74. Policy steps are being taken to ensure that state-owned financial institutions are subject to the same regulatory and prudential standards as apply to private sector financial institutions. More specifically, limits on large exposures will be phased in over 2026 to 2029 which will ultimately reduce the risks faced through troubled SOEs or private sector corporate groups. Private sector governance standards and practices are gradually being applied to state-owned financial institutions.

Oversight arrangements for financial sector stability

75. Institutional responsibilities for financial sector oversight are established in Sri Lanka and have been strengthened recently. CBSL is responsible, among other things, for overall financial stability and prudential supervision of bank and non-bank lending. IRC supervises life and general insurers. PED monitors the financial performance of state-owned financial institutions. Regulatory coordination and crisis management are handled through the recently established Financial Sector Oversight Committee (FSOC) and Financial Sector Crisis Management Committee (FSCMC).

Financial sector stress testing

76. CBSL undertakes financial sector stress testing, but the analysis is only for internal purposes and does not form part of its FSR. A summary of the results from financial sector stress testing could usefully be included in future versions of the FSR which could be cross-referenced in the FRS.

B. Issues

77. As a topic requiring expert input from various external agencies, it would be advisable to establish a working-level technical group to support preparation of the financial sector section of the FRS. The working group should comprise FPD (lead coordinator), PED, DFD, CBSL and IRC. In coordinating this section of the FRS, FPD should not be drawn into detailed work on compiling available data or preparing inputs. Contributing areas should be reminded that the FRS will be a strategic document that conveys the big picture (assessing the overall performance and risks emanating from the sector in terms of the potential impact on the economy and budget).

78. It should be relatively straightforward to provide an account of overall financial sector conditions and recent regulatory enhancements. A key sensitivity to manage is to respect the independence of the CBSL and IRC as sectoral regulators, while ensuring they contribute their expertise and remain comfortable with the main content and messages of the FRS as a government document.

- A set of FSIs can be selected to provide an account of the overall health and performance of the sector, covering the past 5 years (Annex 1 provides an example, with the selection of indicators).
- Recent regulatory responses and improvements to the overall risk management framework for the financial sector, as summarized in the FSR, will be important to emphasize in the FRS.

79. MoF Annual Reports summarize the sectoral and individual performance of state-owned banks and insurers, but do not evaluate performance from a fiscal risk perspective. Such a perspective would seek to evaluate the underlying drivers of any changes in performance over time, and the direct budgetary impacts created by the sector and/or individual institutions. Nonetheless, using existing information, it would be relatively straightforward to present analysis of the state-owned financial institutions covering the past 5-10 years, as follows:

- An assessment of the aggregate performance of state-owned financial institutions (e.g. market share, profitability, solvency and liquidity) of the seven SOBs and four SOIs.
- Selecting a small set of FSIs to enable comparison of the state-owned institutions (collectively or individually) to the relevant sector-wide values.
- Reporting explicit financial flows from the sector to the government (e.g. dividends, levies, taxes).
- Reporting explicit financial flows from the government to the sector (e.g. subsidies, grants, capital injections).
- Discussing any material examples where state-owned financial institutions perform quasi-fiscal activities (e.g. subsidized loan or insurance programs where the provider is not fully compensated).
- Discussing other examples where material risk exposures may arise (e.g. the provision of reinsurance by NITF for natural disaster risks creates underlying exposures for government, including implicit risks if the private insurance market is found to be unable to cope with extreme events).
- If there is market-sensitive information related to specific financial insitutions, it could be considered for disclosure in an anonymized or aggregated manner.

80. DFD could contribute advice on the various financial sector schemes. This could include high-interest savings, subsidized loan and insurance schemes) that might create material risks, including whether the providers are appropriately compensated or undertake quasi-fiscal activities.

81. It would be a good idea to systematically examine risk management and transfer practices within the financial system under the direction and guidance of the FSOC. This could include the adequacy of budgetary provisions or standing appropriations for financial sector crisis management arrangements, and the relative sharing of risks between the government, creditors, shareholders and customers.

Recommendations

Near Term

6.1 Establish a working-level technical group to compile the information and analysis supporting the financial sector section of the 2025 Fiscal Risk Statement.

- FPD would compile the inputs from other areas and establish agreed processes and timelines for compiling and summarizing the necessary information for future statements.
- CBSL and IRC could contribute material on the overall health of the financial sector and relevant market and policy developments for banks and insurers. An analysis of the adequacy and capitalization of deposit insurance arrangements should be included.
- PED would contribute its analysis of and expertise on the state-owned banks and insurers.

DFD could contribute advice on the various financial sector schemes.

6.2 Summarize existing CBSL material on financial sector soundness and recent policy responses.

Medium Term

6.3 A more advanced level of practice in the financial sector fiscal risk reporting should be developed in future versions of the FRSs:

- Summarizing the key findings of any stress testing / alternative macroeconomic and financial scenarios in FSR.
- Discussing the ongoing development of Sri Lanka's financial sector crisis management framework, including new legal powers and size of the financial stability fund.
- Providing further details about the work program and/or special topics of focus of the FSOC and FSCMC.

VII. Natural Disasters and Climate Change

82. Fiscal costs from natural disasters arise from relief and recovery arrangements, and the reconstruction or rehabilitation of damaged assets. Other significant indirect costs include risk management and mitigation, including insurance and building resilient infrastructure. Economic impacts on the capital base, production and incomes and loss of revenue following a major disaster can also be significant. Contingent liabilities could be triggered (e.g. via SOEs or PPPs). Fiscal risks can crystallize when provisions and contingencies (within the budget) and other fiscal buffers, risk transfer and financing strategies (beyond the budget) are insufficient to cope with major events. Climate change is increasing the frequency and impact of natural disasters, calling for establishing stronger risk management and mitigation practices. The more adverse climate change scenarios resulting from higher temperatures could have profound impacts on productivity, reducing potential economic growth and requiring a sharper focus on the implications for fiscal sustainability.

83. The following elements of reporting on the fiscal risks of natural disasters should be included in the first FRS:

- Providing an historical account of the incidence of natural disasters, to illustrate the main types of hazards and exploring the main economic and fiscal implications, at least in qualitative terms.
- Reporting quantitative estimates of the economic loss and fiscal costs over time to establish the potential range of aggregate economic and fiscal impacts that may need to be managed.
- Examining the adequacy of budgetary provisions, contingencies and other strategies to ensure there is a sound plan for managing the fiscal costs of natural disasters of varying degrees of severity.

More advanced practices, to be developed over time, would include presenting any results of modelling or stress testing of the economic and fiscal impacts of a range of potential disaster and climate change scenarios.[25]

A. Current Situation

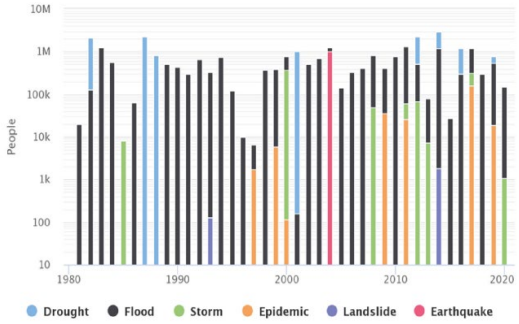
Incidence and costs of natural disasters

84. Sri Lanka is exposed to a range of natural disaster hazards, with floods, landslides, cyclones, drought among the most significant regularly occurring events (Figure 7.1). The scale and significance of individual events varies quite significantly, not just due to the random severity of events but also the extent to which they affect more densely populated areas or according to the resilience of infrastructure in place. Among the low-frequency, more costly natural hazards, the 2004 Indian Ocean Tsunami was the single largest loss event (over 2 percent of GDP in 2023 terms) with catastrophic impacts felt in large parts of the country and resulted in extensive human casualties and loss

[25] Quantitative Climate Risk Assessment Fiscal Tool (Q-CRAFT) helps governments assess the fiscal risks posed by climate change. It allows governments to conduct quantitative, long-term analysis of the impact of climate change on key macroeconomic and fiscal indicators, including government debt, under different climate scenarios. Annex 2 presents this tool. Q-CRAFT is not covered in this mission.

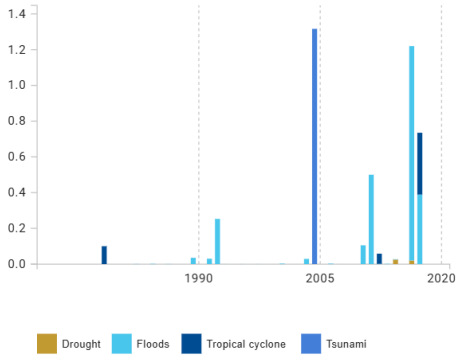
livelihoods. In recent years, extensive flooding and landslides have presented significant challenges (the combined economic loss from floods in 2016 and 2017 was close to 3 percent of GDP in 2023 terms). Droughts have had serious and sustained impacts on agricultural production and incomes. Significant dengue fever outbreaks have occurred with a moderate frequency.

Figure 7.1. Sri Lanka Number of Affected Persons, by Hazard (persons, log scale)



Source: Sri Lanka Nationally Determined Contributions Implementation Plan 2021-2030.

Figure 7.2. Sri Lanka estimated damages, by hazard (USD, billion)



Source: UN ESCAP Risk and Resilience Portal, Sri Lanka country profile.

Availability of estimates of economic loss and fiscal costs

85. There are significant gaps for the historical economic loss and fiscal costs of natural disasters in Sri Lanka. Estimates of economic loss are not systematically recorded although relevant information can be drawn from post-disaster needs assessments following major events. Data on economic loss associated with major events has not been recorded in the EM-DAT database after 2017 (Figure 7.2). The DesInventar database contains a field but no data entries on economic loss. Data on the number of injuries, deaths and houses damaged or destroyed are included, but do not always align with the final situation reports meaning the impacts may be underreported.

86. There are no centrally coordinated estimates of the fiscal costs associated with major events nor a consolidated account of total natural disaster-related spending by year. Fiscal data on coordination costs, compensation of affected individuals, payment of insurance and reinsurance premiums, and landslide mitigation projects are relatively complete. Key gaps include fiscal data on reconstruction and rehabilitation costs and reallocation of appropriations to Ministries, subnational governments and districts to deal with post-disaster response and recovery.

87. In 2016, the World Bank and Global Facility for Disaster Reduction and Recovery prepared quantitative estimates of the potential costs associated with natural disasters in Sri Lanka.[26] This work estimated the annual average economic loss from natural disasters to be around 1.5 per cent of GDP, leaving aside the catastrophic impact of the 2004 Indian Ocean Tsunami, a single event that had an

[26] World Bank and GFDRR (2016), Fiscal Disaster Risk Assessment and Risk Financing Options.

estimated loss of over 6 per cent of GDP. The study used a range of assumptions about the associated fiscal costs of disasters, with a middle scenario estimating the annual fiscal costs associated with coordination, relief and recovery costs associated with housing and roads to be around 0.5 per cent of GDP. These estimates were for the annual average costs, whereas in the context of financial preparedness it is also clearly important to consider the potential range of impacts associated with lower-frequency, higher impact events.

88. More recent estimates of the average economic losses from natural disasters by UN ESCAP find an estimated annual loss of around 2.5 per cent of GDP.[27] If the assumptions from the World Bank/GFDRR middle scenario assumption discussed above were applied, this would translate into expected annual fiscal costs in the order of 0.9 per cent of GDP.

Adequacy of budgetary provisions and risk management

89. It is not possible to gauge from the information available the overall adequacy of Sri Lanka's financial preparedness for natural disasters. To prepare the FRS, historical tables and projections of the budgetary allocations to disaster coordination, relief, reconstruction and rehabilitation costs, risk management and transfer and resilience and adaptation initiatives will be required. The use of within-year budgetary flexibility – virements and use of the budget reserve – will also be important to consider as there are clearly instances where such arrangements have supported natural disaster responses (e.g. the 2016 and 2017 Annual Reports noted but did not quantify substantial reallocations). It will also be valuable to consider the breadth of other financial risk transfer and management mechanisms – including whether to revisit the natural disaster fund (which could accumulate unspent provisions), the implications of the recent closure of the Natural Disaster Insurance Scheme and availability and pricing of insurance more generally, and the new requirements of the PFM Act which govern use of the budget reserve and supplementary budgets.

90. In relation to climate change, there are a number of parallel considerations regarding risk transfer and management. The FRS could review the adequacy of the framework for Sri Lanka relating to adaptation investment, risk retention (including contingencies and budgetary reallocation mechanisms) and catastrophe risk insurance or risk ceding arrangements.

Climate scenario analysis and stress testing

91. Under alternative climate change scenarios, Sri Lanka's projected annual economic losses from natural disasters increase from 2.5 to 2.8–3.0 per cent of GDP. Adopting the same WB/GFDRR assumption as above, the mission estimated that the expected fiscal cost from natural disasters rises to around 1.1 per cent of GDP. Sri Lanka faces annual adaptation costs of around USD 430 million or 0.5 per cent of GDP per annum.[28]

[27] UN ESCAP, Risk and Resilience Portal, Sri Lanka Country Profile.

[28] UN ESCAP, Risk and Resilience Portal, Sri Lanka Country Profile

B. Issues

92. As a potentially complex topic involving external inputs, it would be advisable to establish a working-level technical group to support preparation of the natural disaster section of the FRS. The group should comprise FPD (lead/coordinator), DMC, NBD, NPD, MoE. To ensure the analysis and inputs are fit-for-purpose, our proposed approach is for FPD to coordinate preparation of this section of the FRS. FPD should not be drawn into the detailed work on compiling available data or preparing inputs. Contributing areas (DMC, MoE, NBD, NPD) should be reminded that the FRS will be a strategic document that conveys the big picture (overall risks to the economy and budget) and cannot be concerned with excessive details. This should serve to focus efforts.

93. From a practical standpoint, the first FRS in 2025 will need to be based upon readily available information, with a modest investment in improving what is available. An immediate priority should be to establish more complete and reliable estimates of the direct fiscal costs from natural disasters. The goal should be to present information for the past 10 years on the relevant categories of fiscal costs (see Annex 1). If gaps remain, the objective should be to close them quickly.

94. Sri Lanka's Nationally Determined Contributions (NDCs) make explicit mention of the need to establish better information on natural disaster risks and estimates of loss and damage. This includes various commitments to analyze and address gaps and participate in global initiatives to improve measurement of loss and damage such as the Warsaw International Mechanism. The work required to prepare a natural disaster section of the FRS should be complementary to these efforts, which are already being led by MoE and DMC.

95. The National Natural Disaster Management Plan (NDMP) 2023–2030 was updated and approved by Cabinet in 2023 and tabled in the Parliament. In relation to financial preparedness, the NDMP contains several recommendations that need to be considered by NBD and NPD. For example, recommendation 3.1 NDMP proposes contingency reserves equal to 2 per cent of the total budget of each Ministry and allowing reallocation of budgetary provisions from any newly approved projects for post-disaster reconstruction purposes. Recommendation 3.2 flags an expansion of post-disaster compensation in the medium-term and introducing new tax expenditures in the short-term. These issues need to be considered from an overall PFM perspective and the clear limitations on fiscal space.

Recommendations

Near Term

7.1 Establish a working-level technical group to compile available information and analysis supporting the natural disaster and climate change section of the 2025 Fiscal Risk Statement.

- FPD would compile the inputs from contributing areas and establish agreed processes, timelines and information needs for this and future statements.
- DMC, NBD and NPD would work from February to May 2025 to establish a more complete dataset on the fiscal costs of natural disasters from the past 10 years.

7.2 Summarize the historical incidence of natural disasters and present available quantitative estimates of the annual expected economic losses and fiscal costs in the 2025 FRS.

- This should cover the past 10 years.
- The FRS can summarize estimates prepared by other partners on the costs of natural disasters and the potential impacts of climate change.
- It should also contain a high-level discussion of the adequacy of budgetary provisions and risk management practices (regarding both natural disasters and climate change), foreshadowing an intent to review these more closely in future and report on the findings in subsequent statements.

Medium Term

7.3 Expand the depth of analysis and bring more of a focus to the implications of climate change in future FRSs.

- It would be desirable to find permanent solutions to facilitate better tracking of natural disaster-related spending, including exploring the option of a marker in the chart of accounts/ITMIS.
- Hazard risk profiles should be updated at least every 5 years, in line with the planning cycle, and might be used to generate aggregate multi-hazard loss exceedance estimates.
- Ensuring the main databases are accurate and complete will support better estimation of future impacts.
- Integrating climate scenarios with the macroeconomic framework will allow the potential impacts (on revenue, productivity etc) to be explored in terms of fiscal aggregate projections and DSA.

VIII. Reform Strategy

96. Preparing the first FRS is a complex process that requires careful planning and strategic decision-making. Establishing a clear governance framework is essential, as it clarifies institutional roles and responsibilities and fosters inter-agency coordination. Equally important are robust data management practices and the development of solid, practical analytical frameworks. An effective communication strategy is necessary to prevent misunderstandings while ensuring fiscal transparency. Additionally, strengthening capacity is crucial for the successful preparation of the FRS.

A. Establishing Institutional Arrangements

97. The near-term priority is to clearly allocate roles and responsibilities among ministries, departments, agencies, and SOEs. As discussed in the previous sections, there is no central compilation and analysis of data on fiscal risks, although various departments of MOF play certain roles in monitoring respective fiscal risks. In the absence of a focal point, the management of MOF is unable to access reliable data on fiscal risks in a timely and regular manner, and the data on aggregate exposure is probably unknown. Consequently, a holistic picture of risks to the fiscal outlook and of the overall state of public finances is not produced either for internal decision-making or for the purposes of deliberation by the legislature or public information.

- Information on fiscal risks needs to be centralized within government because of interactions between risks from different sources.
- It is important, however, that individual government entities are clearly responsible for managing the risks from their own activities. A carefully designed mix of centralized and decentralized roles and responsibilities is therefore required.
- Senior managers in all government entities need to promote a culture of information sharing, risk awareness, and proactive management.

98. The FPD (MFU) is well positioned to lead and coordinate the FRS preparation given the close linkage between fiscal risk analysis and FPD's mandate on macroeconomic and fiscal assessment and policy analysis. As discussed in the previous sections, there are various institutional arrangements for different types of fiscal risks. Thus, the accountability of respective divisions/departments/agencies in terms of managing certain fiscal risks would be different depending on the institutional arrangements and availability of information. Figure 8.1 provides an overview of the suggested institutional arrangements.

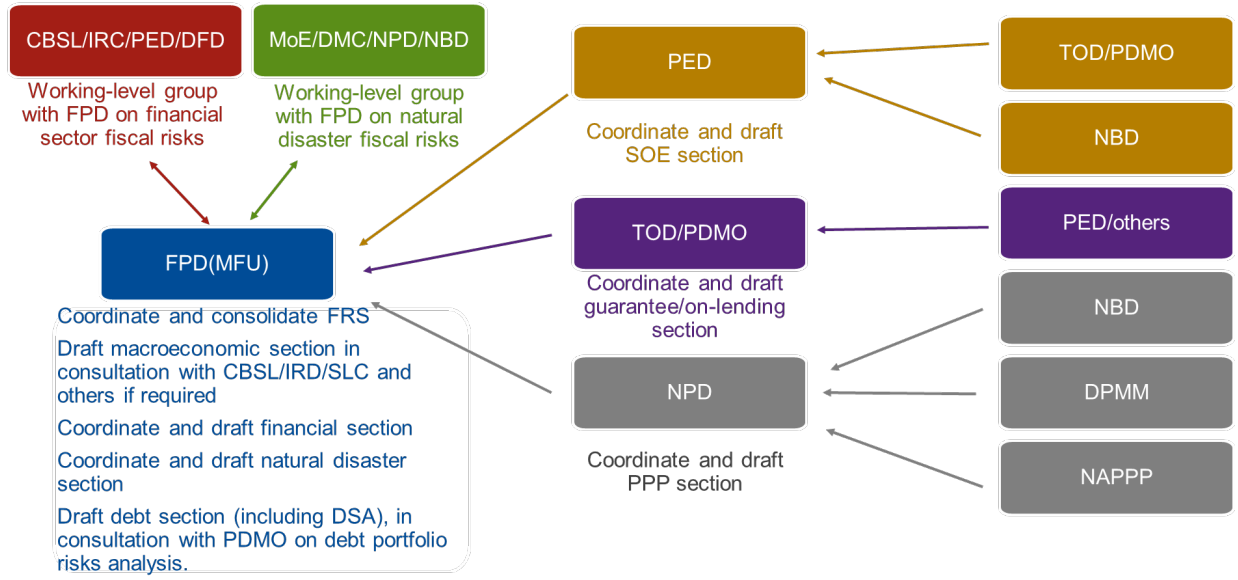
- Macroeconomic risks. The FPD should analyze the macroeconomic risks and draft macroeconomic section in consultation with CBSL/IRD/SLC and others if required. (Section II)
- SOE risks. The PED is already collecting the financial statements of SOEs and is involved in the decision-making of providing fiscal support to PEs. PED should coordinate with DTO/PDMO and NBD and draft the SOE section for FRS. The analysis of SOE risks should be enhanced. (Section III)
- Guarantee/on-lending risks. PDMO is in the transition period of taking over the function of guarantee/on-lending issuance and database maintenance from DTO. Other relevant departments of MoF, e.g. NPD, PED, etc. also play a role in guarantee/on-lending proposal assessments. PDMO

together with DTO should coordinate with relevant departments to analyze guarantees and draft the guarantee/on-lending section of FRS. (Section IV)

- PPP risks. NPD should coordinate with NAPPP and relevant departments of MOF to develop a comprehensive PPPs database, which should include, among other information, fiscal commitments, contingent liabilities, and government revenues. (Section V)
- Financial sector risks. A working-level technical group should be established comprising FPD (lead coordinator), PED, CBSL and IRC to compile available information and analysis supporting the financial sector section of FRS (Section VI)
- Natural disaster risks. The DMC and MoE coordinate natural disaster risk management, NBD and NPD take the lead in disaster risk financing, and FPD also plays a role in the analysis of disaster risk financing. A working-level technical group comprising FPD (lead/coordinator), DMC, NBD, NPD, and MoE should be established to compile available information and analysis supporting the natural disaster and climate change section of FRS (Section VII)

99. A Treasury Circular should be issued to allocate roles and responsibilities among ministries, departments, agencies, and SOEs. The circular should clearly specify the responsibilities of each task and the associated timelines. Reporting protocols will need to be established in the circular under which data are regularly supplied in specified templates and with specified frequency and lags.

Figure 8.1. Suggested Institutional Arrangements for FRS Preparation



Source: mission team

B. Improving Data Management

100. Identifying the data sources for various fiscal risks is a priority. Despite gaps in some fiscal risk data, there is existing data that can be leveraged, although much of it is dispersed across various MDAs. As discussed in the previous sections, some data, such as financial sector information found in FSRs, is publicly available, while others, like data on PPPs in pipelines and fiscal costs of past natural

disasters would need to be identified and collected. The respective departments of MoF responsible for specific fiscal risks should collaborate with relevant MDAs to pinpoint the necessary data sources.

101. A fiscal risk register could be considered to support the effort of building fiscal risk databases. A fiscal risk register, an internal management tool that comprehensively lists and categorizes all known and potential fiscal risks, can help MOF in tracking, monitoring, and updating risks over time. The information will feed into the fiscal risk statement which supports public risk communication. Annex 3 provides an example of such a register, highlighting data sources and the responsible institutional units ("owners") for each fiscal risk. If available, information on the fiscal impact, likelihood of risks, and mitigation strategies should be included in the register. Such information is important for the FRS. A centralized approach is advised, with FPD taking the lead. This overarching fiscal risk register should be complemented by detailed registers for specific risks, such as guarantees, SOEs, and PPPs. The responsible departments of MOF should manage these detailed registers. A future goal could be to develop a bottom-up fiscal risk register from line ministries to enhance the high-level register maintained by the MOF. As data availability within the MOF expands, the FPD could consider utilizing the Fiscal Risk Assessment Tool (FRAT) to support its high-level fiscal risk analysis.

102. Validating data quality is crucial for effective fiscal risk analysis. High-quality data forms the foundation of accurate risk assessment and decision-making. Discrepancies in data should be diligently identified and rectified through a structured validation process. This process involves cross-verifying data against multiple sources, conducting consistency checks, and implementing feedback mechanisms to continuously improve data accuracy and reliability. In the future, establishing protocols for regular data audits and updates can further ensure that the data remains current and accurate, thereby enhancing the overall integrity of fiscal risk analyses.

C. Strengthening Fiscal Risks Analysis

103. When comprehensive analyses are available in existing reports, it is efficient to incorporate brief summaries of these reports into the FRS. For example, FSR comprehensively analyzes financial sector risks. This approach ensures that stakeholders are informed of critical insights without redundant efforts in re-analyzing well-documented risks. Summarizing these reports provides a concise reference that can help in understanding the overarching risk landscape and supports cohesive policymaking. Additionally, it allows resources to be focused on areas where analysis is lacking or where deeper dives are necessary.

104. In cases where analyses have not yet been conducted but related data is accessible, new analyses should be initiated. The depth of these analyses should be tailored to the complexity and importance of the issues at hand. For example, as discussed in the previous sections, scenario analyses and stress testing can be conducted for macroeconomic risks to understand potential impacts on fiscal stability; financial performance, governance structures, and fiscal linkages of SOEs can be analyzed to identify their vulnerabilities and potential fiscal risks.

105. Where data is not available, it is important to develop qualitative descriptions of the risks. Expert judgment and historical context can be applied to outline possible risk scenarios. FRS can also provide insights into how these risks could affect fiscal sustainability and economic stability, and what

mitigation strategies have been put in place, even in the absence of quantitative data. Qualitative descriptions offer valuable insights and help maintain awareness of fiscal risks, ensuring they are not overlooked in policy discussions and strategic planning. This approach also highlights the need for improved data collection and management to enable more quantitative analyses in the future.

D. Developing a Communication Plan

106. Engaging with politicians at an early stage is critical. While fiscal risk management reform can yield significant benefits, it may also encounter political challenges. Some politicians may believe that disclosing fiscal risks could undermine public trust. It is essential to ensure that politicians understand that comprehensive reporting of fiscal risks, based on robust analysis, can help governments ensure that fiscal policy settings respond effectively to a range of potential future economic and fiscal shocks. This includes actively monitoring and managing specific risks to avoid abrupt and disruptive policy changes when risks materialize. A better understanding of fiscal risks, along with greater transparency and effective risk management practices, can mitigate negative effects on fiscal balances and the economy, thereby enhancing credibility in the government's management of public finances and boosting market confidence.

107. Collaboration within government is also essential. Given the wide range of information sources related to fiscal risks, line ministries, SOEs, and various departments of the MoF all play a role in this reform. Perspectives on the benefits of this reform may differ among these stakeholders. At the technical level, the FPD needs to ensure sufficient engagement with stakeholders through both bilateral and multilateral discussions, emphasizing the advantages of this reform, particularly the benefits to them, such as improved preparation for the risks they are responsible for and reduced disruptions to their own financial management. Providing clear technical guidance and user-friendly tools (e.g., spreadsheet templates for collecting fiscal risk information) can also help alleviate unnecessary burdens on these stakeholders.

108. Communication with the public should be carefully planned. While public disclosure of fiscal risk information is crucial for enhancing transparency, it is equally important to clearly explain the meaning of fiscal risks, as public understanding may vary. Including the government's current and upcoming measures for risk mitigation in the FRS is essential. The FRS is not only about disclosing the government's risk exposure; it also facilitates the development and communication of the government's risk management strategies, which can help build public confidence in how risks are managed, including credibility in financial markets. The FRS should synthesize information from the fiscal risk register and present fiscal risk information in a manner conducive to effective public communication. While the MoF should aim to disclose all explicit fiscal risks, it may choose not to disclose certain implicit risks, such as the potential for a bailout of large financial institutions, as such disclosures could lead to moral hazard.

E. Improving Staff Capacity

109. Given the limited awareness of fiscal risks, it is crucial to build the analytical capacity of staff involved in fiscal risk analysis and management. Training can be provided to educate staff on different types of fiscal risks, focusing on the priority areas initially. Hands-on training in using analytical tools and methodologies, such as stress testing, scenario analysis, and risk modeling, can help staff to

evaluate and manage relevant fiscal risks. In addition to internal training, collaborations with international organizations, such as the IMF or World Bank, can gain access to global expertise and good practices in fiscal risk management.

Recommendations

Near Term

8.1 Issue a Treasury Circular to clearly allocate roles and responsibilities among ministries, departments, agencies, and SOEs—specifying who is accountable for each task and the associated timelines.

8.2 Identify the sources of data/information for the selected fiscal risks, develop databases, and confirm data quality.

8.3 Prepare analysis of the fiscal risks:

- If comprehensive analysis is available in other reports, e.g. FSR on financial sector risks, a brief summary of those reports would suffice
- If analysis hasn't been conducted, but related data is available, e.g. macroeconomic risks, SOEs, guarantees, analysis can be performed (analysis depth may vary depending on the issues)
- If data are not available, a qualitative description of the risks can be prepared

8.4 Clearly communicate with politicians about the benefits of the FRS in supporting timely decision-making and enhancing market confidence, while also informing the public about the actions taken to effectively manage fiscal risks to avoid potential misunderstandings.

8.5 Train staff to enhance their capacity on fiscal risk analysis and management. Seek technical assistance if needed.

Annex 1. Outline for the 2025 Fiscal Risk Statement

Introduction and overview

Explain the policy motivation and legal requirements for preparing the FRS and how the breath of coverage of risks and depth of analysis and risk management practices will build over time. Fiscal risk assessment needs to be dynamic, and so the constellation of risks and their relative significance in the Sri Lankan context would be expected to evolve.

Consider including the Fiscal Risk Heatmap from the FRAT, which can neatly summarize the scope of coverage of each year's FRS and the broad conclusions drawn for each risk.

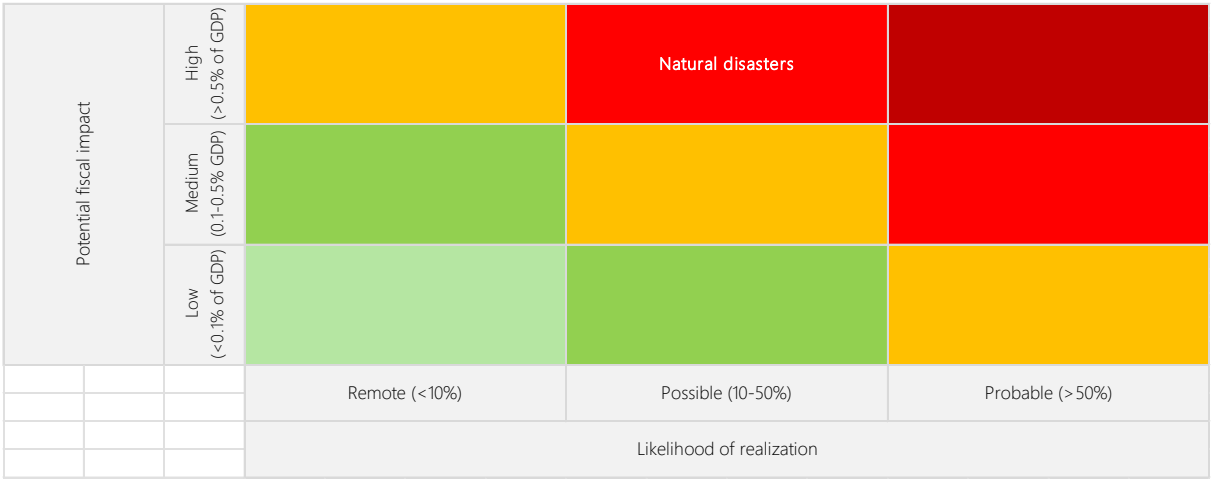
Note that even if quantification has not been possible, a judgment-based or qualitative assessment of relevant risks is quite acceptable, particularly in the early years.

It will be necessary to determine the thresholds to distinguish between each category. Some initial thresholds have been suggested in the table below.

For example, previous studies have estimated that the average annual fiscal cost of natural disasters is around 1 per cent of GDP. This suggests unexpected fiscal costs (beyond what is already provisioned) might exceed 0.5 per cent of GDP with medium likelihood (say on average once every 5 years. Events with more significant impacts will occur but with a lower probability (so no need to distinguish these).

The heatmap can be completed for each risk that is included in the 2025 FRS. Risks that are not assessed can be excluded for now but added in future years.

Example: Summary of 2025 Fiscal Risk Assessment for Sri Lanka



Macroeconomic Risks

Describe what macroeconomic risks are and how such risks can impact upon the fiscal aggregates and achievement of the medium-term fiscal strategy [1 paragraph].

Economic uncertainty and forecast errors

Discuss the volatility observed in key macroeconomic aggregates in Sri Lanka, focusing on nominal GDP and its components of real GDP and the GDP deflator. Discuss how estimates of volatility are particularly affected by real and external shocks and some recent examples of such events.

Use the calculated estimates of volatility to present a fan chart for the nominal GDP and revenue projections presented in the FSS, to illustrate the inherent uncertainty around the projections (e.g. the central case projection +/- one standard deviation).

Present an analysis of historical forecast/projection errors for selected series – e.g. nominal GDP, total revenue, primary balance, overall balance, public debt. Discuss briefly the main drivers of these errors.

Discuss how errors have been addressed through the recalibration of forecasts under the IMF EFF, new MTFF and through the regular evaluation of forecast performance under the FSS.

Main sources of macroeconomic risks

Include a qualitative discussion of the top 3-5 areas of macroeconomic risk that could impact on the MTFF fiscal projections both in the short term and over the 5-year projection horizon. Summarize these in a table, as per the example below.

Major macroeconomic risk	Likely impact if realized
GDP growth is slower than expected	Lower exports leading to currency depreciation; lower revenue; [etc.]
Commodity prices higher than expected	Higher expenditure, lower SOE profits [etc.]
Exchange rate depreciation	Inflationary impacts as import prices rise; higher repayments on foreign currency denominated debt [etc.]
[Continue]	[Continue]

Risk mitigation

Describe the arrangements that will allow GoSL to better manage macroeconomic risks. Brief reference can be made to the new Fiscal Responsibility Framework; the fiscal strategy objectives of revenue mobilization, controlling expenditure growth and rebuilding fiscal buffers; and broader structural reforms to support development of a more diversified economy. Specific mention should be made of recent and future steps to address any systematic biases in the forecasting of GDP, revenues and expenditures.

Public Debt

Debt Sustainability Analysis

Under the new PFM Act, the Finance Minister is required to prepare and publish DSA on an annual basis, as a first step in establishing or updating the MTFF. This could be done in advance of the June publication of the FSS/FRS, or if not covered off in the FSS itself.

The DSA will present an updated central case projection for the debt reduction path that is implied by recent fiscal performance and the latest set of fiscal aggregate projection vintages.

The FRS could present any sensitivity analysis or alternative scenarios prepared as part of the DSA.

In early years, it may be necessary to use the IMF's DSA from the most recent Article IV or EFF Review. Recent versions of the IMF DSA have included a natural disaster scenario.

At a later stage, when capacity permits, FPD could conduct its own DSA.

Debt Portfolio Analysis

This section could include some summary information and a short discussion of the composition of Sri Lanka's public debt portfolio, and relevant targets or metrics under the Medium-Term Debt Strategy (MTDS).

It should avoid duplicating what will be done through the quarterly Debt Bulletin or other reporting against the MTDS.

A small set of tables and charts could be used to illustrate the term structure of Sri Lanka's debt, domestic vs FX exposures, fixed vs floating interest rate exposures and projections of debt servicing costs. Discuss the main risk factors and how they may affect the budget (e.g. refinancing risk, interest rate risk and exchange rate risk).

Supplement with information on the latest credit risk assessments and ratings published by the main rating agencies.

Mitigation measures

Describe the measures that are taken to mitigate debt-related risks.

These could include the implementation of a prudent debt management policy (i.e., with a reference to the adopted debt management strategy), ongoing monitoring of the portfolio against relevant targets and publication of the quarterly Debt Bulletin.

State-owned Enterprises

Describe the main types of fiscal risks that may arise from SOEs operations and activities and how they may impact upon the fiscal aggregates. [One paragraph].

Provide a brief overview of Sri Lanka's SOE sector. Which entities are included in the SOE fiscal risk analysis (i.e., the 41 most strategic companies; 11 others considered separately under the financial sector)? In which sectors do they operate? [One paragraph].

Financial performance

Prepare a summary table presenting the aggregate performance (e.g. revenue, profitability) of the 41 strategically important non-financial SOEs over the past 3-5 years. Which entities drove the results?

Include an explanation of how many of the 41 entities were profit-making and how many were loss-making in 2024. Identify any of the 41 entities that recorded negative equity as at the end of 2024.

Include a chart (see main Report) identifying the SOEs with the largest liabilities and their contribution to the total liabilities of the sector.

SoE risk assessment

Briefly explain that a methodology has been developed to allow MoF to undertake a credit risk assessment of individual SOEs (which may have used 2023 data) using financial ratio analysis.

Present an overview of the risk ratings in a table that lists the number of entities in each risk category (e.g. very high, high, medium, low and very Low risk). Identify the entities that have been classified as very high or high risk and briefly identify the areas of concern.

Budgetary impacts

Present a table or chart, covering the past 5-10 years, on the aggregate financial flows from SoEs to the government (e.g. dividends, taxes, levies) and aggregate financial flows from the government to SoEs (e.g. subsidies, grants, capital injections). Calculate the net flows each year and present the net flows as a percentage of GDP for each year (see also examples in the financial sector risks section).

Mitigation measures

Discuss any specific policy reform measures to mitigate the risks that will be implemented as part of the GoSL reform agenda. Measures targeted at high-risk SOEs should be emphasized.

The policy discussion could also focus on SOE governance frameworks and more general steps being taken to improve the financial performance of the sector and/or reduce the risks that government faces.

Guarantees and On-Lending

Portfolio analysis

Provide a breakdown of loan guarantees and on-lending.

Newly issued guarantees and on-lending

Provide a breakdown of newly issued instruments, their purpose, and alignment with policies.

Risk materialization

Discuss historical risk materialization and highlight the past financial year.

Risk management strategy

Discuss the policy framework (mitigation and monitoring), what is being developed, and discuss provisioning in the budget.

Financial Sector

Overall health of the financial system

Provide a summary account and present a small set of financial soundness indicators addressing the overall health – profitability, solvency, liquidity and asset quality – of the financial system. This can be done in consultation with CBSL and IRC to select a suitable set of indicators for banking, non-bank lending and insurance. Include preliminary FSIs for December 2024 (available from quarterly updates).

Example: Selected Financial Soundness Indicators for Banking Sector

	2020	2021	2022	2023	2024 (Sep)
Profitability					
Return on assets (before tax)	1.4	1.6	0.9	1.5	*1.8*
Return on equity (after tax)	11.4	14.5	10.4	11.5	*13.5*
Solvency					
Tier 1 capital adequacy ratio	13.6	13.2	13.2	15.2	*14.7*
Total capital adequacy ratio	17.1	16.5	16.2	18.4	*18.5*
Liquidity					
High-quality liquid assets ratio	24	22.5	18.5	32.2	*#.#*
Credit quality					
Impaired loans (Stage III) ratio			11.3	12.8	*12.4*

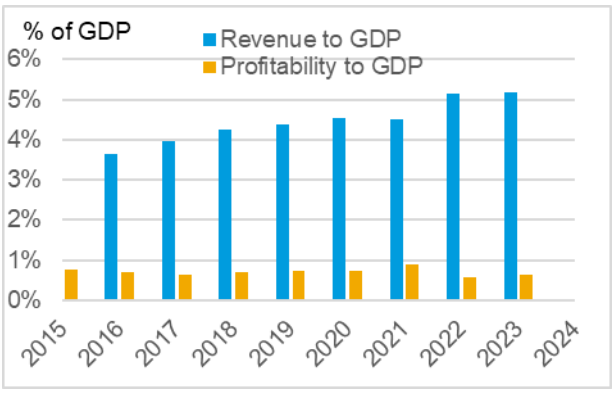
Source: Central Bank of Sri Lanka Financial Stability Review 2024 and Q3 2024 Financial Soundness Indicators.

Performance of state-owned financial institutions

Provide a summary narrative and accompanying analysis of trends in performance of state-owned financial institutions. Consider their overall performance – profitability, solvency, liquidity, asset quality etc – and compare the results to sector-wide averages.

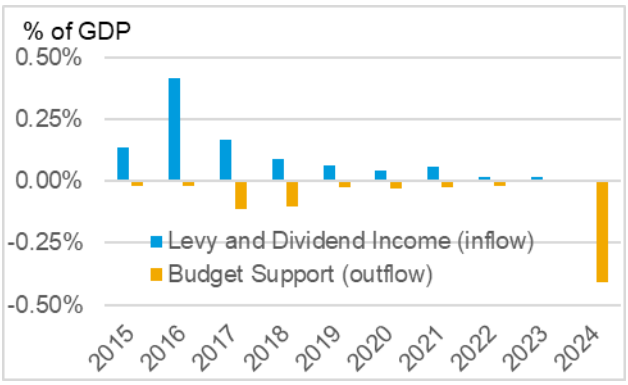
Present a table or charts on the flows from the sector to government (dividends, taxes, levies) and from the government to the sector (subsidies, budget and capital support) over a 10-year horizon (see examples below). Discuss the results and evolution of flows over time.

Example. State-owned banks and insurers – revenue and profitability



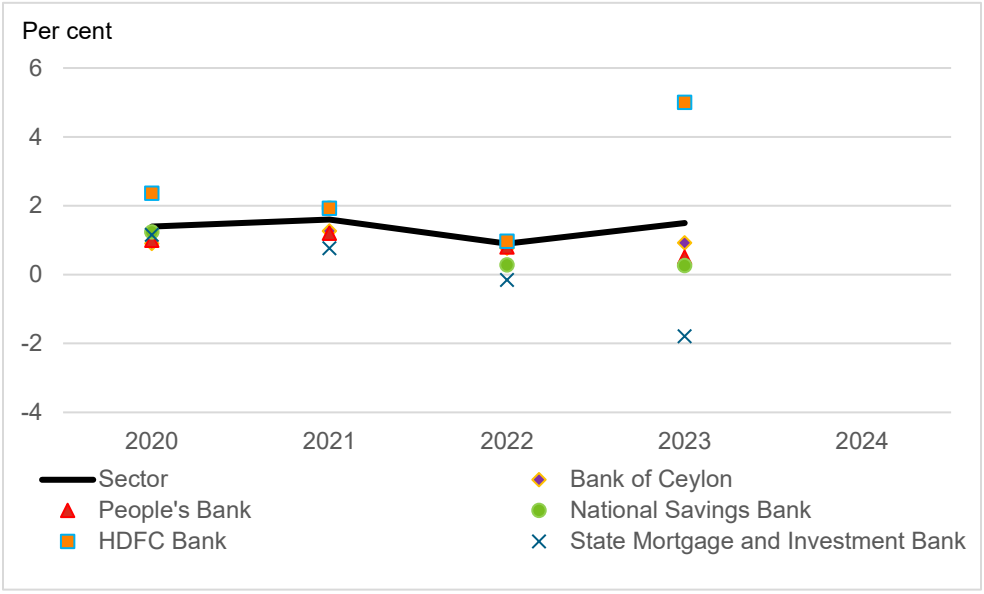
Source: GoSL Annual Reports, various years.

Example. State-owned banks and insurers – net budgetary flows



Source: GoSL Annual Reports, various years.

Example – Major state-owned banks – return on assets



Risk management and oversight arrangements

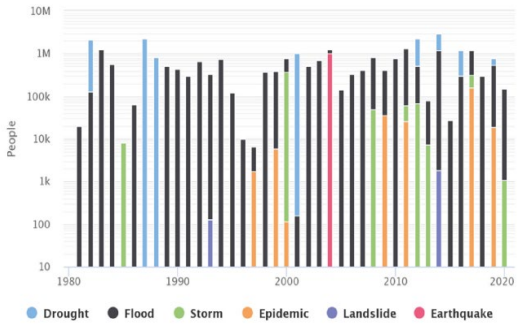
Drawing on recent CBSL FSRs, prepare a high-level discussion of recent policy measures and future steps envisaged to support financial system stability, including establishment of the financial stability fund. The objective is to provide a clear account of coordination arrangements and how systemic risks are being monitored and managed.

Natural Disasters and Climate Change

Incidence of natural disasters

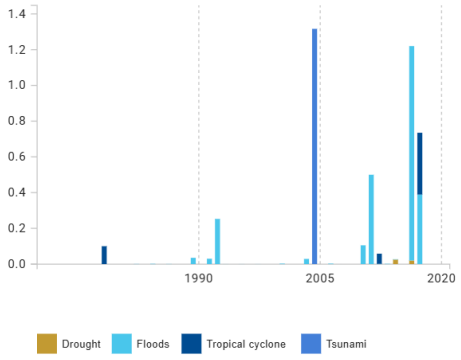
Report on the incidence of natural disasters in Sri Lanka over at least the past 10 years. This could focus on the number of persons affected by the main types of events as an indicator of their significance, or presenting available data on damages (or economic loss). For example:

Example: Sri Lanka number of affected persons, by hazard (persons, log scale)



Source: Sri Lanka Nationally Determined Contributions Implementation Plan 2021-2030.

Example: Sri Lanka estimated damages, by hazard (USD, billion)



Source: UN ESCAP Risk and Resilience Portal, Sri Lanka country profile.

Estimates of fiscal costs

Summarize estimates of the fiscal costs associated with natural disasters over the past 10 years. This can draw on previous World Bank/GFDRR and UN ESCAP work.

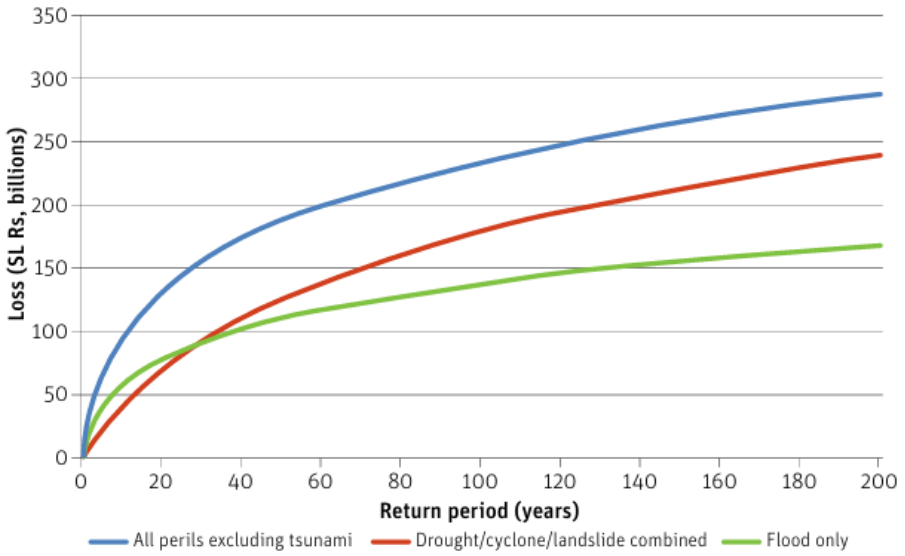
Present a table on the estimated fiscal costs from natural disasters with the following categories.

Example: Sri Lanka - Estimated Fiscal Costs of Natural Disasters, by year
(percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Avg
Direct costs	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**
Coordination	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	
Relief	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	
Reconstruction	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	
Transfers	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	
Indirect costs	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**	**#.#**
Insurance	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	
Adaptation/Mitigation	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	
Revenue losses	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	#.#	

Consider including probabilistic estimates of fiscal costs that illustrate how costs are difficult to predict with accuracy and can vary quite significantly depending on the scale and frequency of disasters. Discuss how the costs of events that may occur with a frequency of say 1 in 10 or 1 in 50 years can be many multiples of the average annual cost. The following chart is taken from the World Bank/GFDRR report.

Example: World Bank/GFDRR Probabilistic Loss Exceedance Curves, Fiscal Costs (LKR, billion)



Source: World Bank DRFI Program, based on data from the DesInventar database of the United Nations Office for Disaster Risk Reduction (UNISDR) and United Nations Development Programme (UNDP) (http://www.desinventar.lk:8081/DesInventar/main.jsp), the Disaster Management Center of Sri Lanka, and other sources compiled for this overall report.

Financial preparedness and risk management

Explain the various layers of financial preparedness, including:

- Appropriations to Ministries responsible for natural disasters (coordination, relief and compensation arrangements, infrastructure) – how do these compare to the observed historical costs
- Virements, the annual budget reserve, constitutional contingency fund and escape clause under the new Fiscal Responsibility Framework – are these sufficient?
- Natural Disaster Fund
- Insurance and other risk transfer arrangements
- Agreements/Contingent Finance Arrangements with Development Partners
- Fiscal buffers – including maintaining a margin for error in terms of fiscal targets (PBT and PEC), reducing debt levels to allow a response to future disasters

Climate change

Summarize material from Sri Lanka's NDCs and other sources to explain projections about the impacts of climate change in terms of future frequency and impact of natural disasters. Briefly discuss Sri Lanka's mitigation and adaptation priorities and associated costs.

Public Private Partnerships

Provide a high-level discussion on PPP related fiscal risks in the 2025 FRS.

Portfolio analysis

If data is not readily available, use the information available in public domain (e.g. ADB Public Private Partnership Monitor 2019 and 2023) for this section. Include a chart to depict the growth of the PPP portfolio during this period (number of projects which have seen financial close and value of investment) and changes in sectoral composition during the period (e.g. use stacked columns). Then briefly mention the number and sectoral composition of PPP projects in the pipeline (NAPPP has the details).

Nature of Government Support

Briefly discuss the nature of government support provided to PPP projects in Sri Lanka.

Fiscal Risk identification, assessment and materialization

Provide an overview of the various types of risks identified and an assessment of their likely fiscal impact. If sufficient data is not available, mention that as the database grows, this analysis will be further refined to perform detailed assessments. Finally, if details are readily available, make a brief mention of historical risk materialization i.e. payments made by Government where a contract was renegotiated, or a guarantee called etc. (e.g. Port City Project – renegotiation etc.).

Risk management strategy

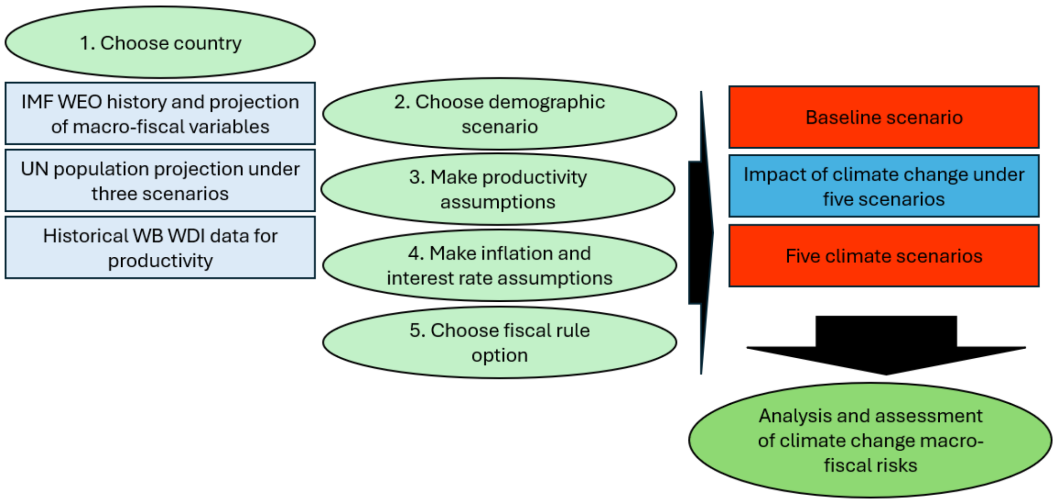
Discuss the policy framework being designed for mitigation and monitoring of fiscal risks. Mention the planned enactment of a comprehensive PPP Law and associated regulations and guidelines, planned institutional arrangements, recording of contingent liabilities, provisioning in the budget and limiting exposure to PPPs, depending on the measures being considered for 2026.

Annex 2. Quantitative Climate Risk Assessment Fiscal Tool (Q-CRAFT)

Q-CRAFT is a tool designed to generate long-term fiscal projections under different climate change scenarios, utilizing publicly available data in a structured approach. It projects stylized macroeconomic and fiscal prospects for 171 economies under different climate change scenarios through 2099. Q-CRAFT projects a baseline macro-fiscal scenario for GDP and key fiscal indicators that is grounded in a simple production function and standard debt dynamic equation, using available budgetary, economic, and demographic data, and some assumptions that can all be easily modified by users. Subsequently, cross-country empirical estimates using the Kahn (2021) methodology, of temperature impacts on GDP per capita under different climate scenarios are applied to the baseline to project to 2099 key fiscal indicators, such as the debt-to-GDP ratio, under different climate scenarios. [29]

Q-CRAFT requires the user to select the country and key assumptions for demography, productivity, inflation, and interest rates. After that, long-term projections for key fiscal aggregates under the baseline and alternative climate change scenarios are automatically generated. The figure below illustrates Q-CRAFT's operative structure.

Figure: Visual Representation of Q-CRAFT's Operations



The tool and its user guide are available https://www.imf.org/en/Topics/fiscal-policies/Fiscal-Risks/Fiscal-Risks-Toolkit/Fiscal-Risks-Toolkit-Q-Craft.

Source: Tjeerd Tim and Jyoti Rahman, 2024, User Guide for the Quantitative Climate Risk Assessment Fiscal Tool (Q-CRAFT)

[29] Kahn M.E., Mohaddes K., Ng R.N.C., Pesaran M.H., Raissi M., and Yang J-C, 2019, Long-Term Macroeconomic Effects of Climate Change: A Cross-country Analysis, Energy Economics, 104, pp. 105624/1–13.

Annex 3. Illustrative Fiscal Risk Register

Risk category	Source	Est. fiscal impact (L/M/H)	Comments on fiscal impact (including direction of impact and time horizon)	Likelihood of risk materializing (L/M/H)	Comments on likelihood	Risk 'owner'	Mitigation measures in place, and what more can be done	Sources of information and data
Macro risk	*e.g. Changes to GDP growth*							
Macro risk	*e.g. Change in import prices*							
Specific fiscal risk	Public enterprises							
Specific fiscal risk	Subnational Governments							
Specific fiscal risk	Natural disasters							
Specific fiscal risk	PPPs							

Notes: 1. L, M, and H stand for low, medium, and high respectively.

2. Risk 'owner' is the institution responsible for managing related fiscal risks.