

Transparency International Sri Lanka

Position Paper

Foreign Borrowing of US\$500Million



"The finance of the country is ultimately associated with the liberties of the country." – Gladstone

12th September 2007

1. Introduction

During the past weeks, a serious political debate has evolved in regard to the government's decision to borrow US\$500 Million facilitated by selected private international banks. Since the debate raised several governance issues, including the transparency of borrowing procedures, TISL has decided to issue this Position Paper. This paper is justified for more than one reason, not least of which is that future generations of Sri Lankans will have to settle the borrowed funds with commercial rates interest.

According to a presentation made by the Central Bank, on behalf of the Government, the value of the proposed borrowing is US\$ 500 Million and the interest Rate is LIBOR (London Inter Bank Offered Rate)¹ +100-200basis points² depending on the lenders terms. This could mean that the rate of interest could be up to 2 percentage points above the LIBOR rate. There are discrepancies as to the duration of the loan, a ruling party politician stating that it is 10 years³, where as the Government media indicates that it is 4 years⁴. Also the project costs as disclosed, appears to be conflicting. For instance, according to the Secretary of the Ministry of Power and Energy, as per the statement made at a seminar held on 30th January 2007, the Kerewalapitiya Combined Cycle Power Plant would cost USD 650 million with LNG⁵ being used as a fuel, and USD 323 million with HFO/LFO/LNG⁶ being used. While the Director General, Department of External Resources, Ministry of Finance and Planning, at the Development Forum (2007) estimated USD 210 million for a similar Plant. Taking the smallest figure into consideration, it is a USD 200 million difference.

At this stage in the debate there is much uncertainty and lack of clarity on the applicable terms, tenor, conditions and additional rights of government and bond subscribers (e.g. put options, early payments, recall, links to conditions of governance and changes in sovereign rating). There is even more uncertainty and lack of clarity on the proposed use of the funds raised. The Government position states that the funds realised from the borrowing are to be utilized for infrastructural development projects which have been set out in Annexure 1⁷.

Historically foreign Loans have been sourced by Governments to invest in public infrastructure and associated activities, when Foreign Direct Investments in such areas have not been available. Due to the magnitude of the investments required, it is normally the governments which have to invest in such projects rather than the private sector. It is however a matter of public concern, that in the recent past the government foreign borrowings appear to have been on short term basis and linked to short term interest rate structures and have mostly been to support budget deficits, arising mainly from relatively high revenue spends and capital spends outside investments in physical infrastructure of long term value. It is also a matter of public concern, as to whether medium term

¹ LIBOR, the London Interbank Offered Rate, is the most active interest rate market in the world. It is determined by rates that banks participating in the London money market offer each other for short-term deposits. LIBOR is used in determining the price of many other financial derivatives, including interest rate futures, swaps and Eurodollars. Due to London's importance as a global financial centre, LIBOR applies not only to the Pound Sterling, but also to major currencies such as the US Dollar, Swiss Franc, Japanese Yen and Canadian Dollar.

² A "basis point" is 1/100th of a percentage point.

³ Chief Government Whip

⁴ Daily News 2nd August 2007.

⁵ Liquefied Natural Gas

⁶ Heavy Fuel Oil/Light Fuel Oil/ Liquefied Natural Gas; This refers to the configuration of the cycle plant that comprises of two gas turbines that have the ability to utilize HFO/LFO/LNG

⁷ www.LankaTimes.com quoted as from Daily News

borrowing of 3 – 5 years secured in the past year, with interest rates linked to market movements and reset at lenders option short term have been classified as short term borrowings and not long term borrowings in the debt service computations. Another unclear area is the potential risks and repayment related debt service capacity, of government guaranteed borrowings raised by state banks and state institutions including the Ceylon Electricity Board, and Ceylon Petroleum Corporation.

2. Background

Sri Lanka has a per capita income⁸ of USD 1,355⁹ and a GDP of USD 27.8 Billion¹⁰.

Sri Lanka's total foreign debt currently stands at USD 12.5 Billion and a Debt Service Ratio of 8.9%, which means that 8.9% of the export income would be utilized for debt service¹¹.

The sources of funding available for the said identified projects are foreign aid, foreign grants, and loans at concessionary interest rates, foreign direct investment, portfolio investment and commercial borrowing¹². The government appears to have chosen the latter option in respect of the proposed borrowing.

Sri Lanka is now rated as a middle income country with a per capita income in excess of USD 1000, and as such may not automatically be eligible for long term concessionary borrowing from traditional sources. Nevertheless, Sri Lanka may be able to secure from Multilateral and Bilateral Donors, Development Partners, International Financial Institutions (including the World Bank, The Asian Development Bank and Japanese Bank for International Co-operation), aid, and bi lateral/multi lateral financial assistance and loans. These include commitments made previously following aid group meetings, peace process related Oslo and Tokyo meetings, post Tsunami reconstruction assistance packages, Millennium Challenge Grant etc. In addition bi lateral concessionary financing packages linked to project or credit lines for imports have been on offer from friendly nations (eg. China, India and Petro-dollar Investment Funds). Some of these funding lines may have conditionality including reform commitments attaching as an inherent term of the facility on offer.

The Legal position of repayment of foreign loans is governed by the Foreign Loans Act, No. 2 of 1957 as amended. Under this Act, the President or any person specially authorized by him in that behalf may, on behalf of the Government, sign: (a) an agreement relating to a foreign loan, (b) a guarantee by the Government relating to a foreign loan to public corporation or public enterprise, and (c) any contract bond, promissory note or other document or guarantee to be executed by the Government¹³. All sums payable by the Government of Sri Lanka under these arrangements are charged on the Consolidated Fund¹⁴, which means that the government automatically pays it without any debate in parliament.

⁸ Per capita income means how much each individual receives, in monetary terms, of the yearly income that is generated in their country through productive activities. That is what each citizen would receive if the yearly income generated by a country from its productive activities were divided equally among everyone.

⁹ Per Capita Gross Domestic Product at Current Market Prices - Annual, Central Bank of Sri Lanka

¹⁰ www.economist.com/Country Briefings on 21st May 2007

¹¹ www.economist.com/Country Briefings on 21st May 2007

¹² The Sunday Times on August 26 2007

¹³ Section 2

¹⁴ Section 3. Article 149 of the 1978 Constitution provides that funds of the Republic not allocated by law to specific purposes will form one Consolidated Fund.

The Fiscal Management (Responsibilities) Act¹⁵, introduced to assure good governance in macro economic management and thus longer term price stability, economic growth and competitiveness of export industries, requires compliance with set national budget outcome targets, disclosure of guarantees and impacts of politically motivated and other decisions having a bearing on the long term economic outlook. Within the spirit of the commitments expected under the Fiscal Management Responsibilities Act, and the good governance expectations from the Monetary Board under the Monetary Law Act¹⁶, may also impact upon the due process to be adopted, disclosure and transparency rules governing the proposed Bond issue.

The current decision to borrow USD 500 million on commercial terms from foreign sources facilitated by international private banks, comes on the heels of a lost opportunity Sri Lanka had under the Millennium Challenge Grant Programme to receive a grant of similar proportions¹⁷. Though there have been prior selective International Bonds issued, this latest borrowing has a far greater pecuniary value than previous loans, such as the USD 100 Million issued on 14th December 2006 at a cost of LIBOR+ 75bp.¹⁸ In addition, the current borrowing is likely to be for a significantly longer tenor than previously obtained. Such a loan could mar Sri Lanka's debt service capability as well as an unblemished record of honouring debt commitment.

3. Transparency of Borrowing

Unfortunately there is a lack of information readily available to the public with regard to the proposed Bond issue. The information that is available refers mostly to the political issue rather than a public debate based on macro economic fundamentals, good governance commitments and the long term national economic interests. The presently evoked focus in the public sphere (due to some political parties raising objections) concerns the future non-repayment of the loan under a different government. This political debate appears to have compelled the government to respond to the issues raised but not adequately. However, it is unfortunate that in the process, a political party has announced that it will, when it comes to power, revoke the operating licence of the foreign Bank appointed to support the process of the floatation of the Bond. Such threats are certainly not in the longer term interest of Sri Lanka as they have a negative impact on the credit rating and foreign investment attractiveness of Sri Lanka. Further, calling on the people to surround HSBC, an independent professional service provider, responding to a call for professional services by a legitimate Government, is a totally unacceptable act of coercion, and a total deterrent to foreign investments promotion in Sri Lanka.

There is no/insufficient official information in the public domain as to the following:

- Whether the loan is required from the point of view as a bridging Finance.
- Whether the quantum would be repaid immediately, once the funding for the projects are received or as a bullet payment.
- Why and how three international banks were selected and why others, if any, were rejected, in the selection of lead arrangers or borrowers. The deal process followed in the selection.
- Under which provision of law, the Central Bank has been authorized to raise this foreign loan and the exact role of the Central Bank in the securing of the loan.

¹⁵ Act No. 3 of 2003

¹⁶ 58 of 1949

¹⁷ Financial Times, Sunday Times dated 2nd September 2007
<http://www.sundaytimes.lk/070902/FinancialTimes/ft307.html>

¹⁸ Lanka Business Online on 26th December 2006.

- Why the Government has chosen to seek medium to long term commercial loans instead of long term concessionary loans with grace periods corresponding to project cash flow maturity.
- Justification challenges of the “effectiveness” and “fairness” of the proposed deal.
- The rationale for borrowing from private banks as against concessionary loans.
- The proposed plan to service the debt.
- Whether the borrowing has been in compliance with rules and regulations including Fiscal Management (Responsibility) Act 3 of 2003, with a sign off by Secretary to Treasury.
- An assurance from the government that the foreign loan/borrowed money will be utilized for the disclosed purposes only.
- Risk mitigation strategy

TISL believes that the Government of Sri Lanka should be required to explain to the public the following:

- Sri Lanka has been taking loans from multi-laterals and bi-laterals at a maximum of 1% interest, so why has the government agreed to pay higher interest at the rate of 6.5-7.5%?
- Whether all other options for non commercial borrowing related finance raising have been duly evaluated against the proposed funding structure.
- Generally infrastructural investments do not generate income in the short term; therefore the repayment would have to be done through other sources such as new borrowing and taxes. The government has to explain how it proposes to sustain the repayment without over burdening the public.
- How does the government sustain the repayment due to the depreciation of SLR as against the US\$, especially if a significant fall in the exchange rate were to occur in the interim period up to repayment. This risk is aggravated particularly because the balance of trade is not favourable to Sri Lanka at a time when the international oil prices are rising and the Foreign Remittances from Sri Lankan expatriate workers overseas may be required to settle costs of oil imports.

4. Desirability of Borrowing and Public Interest

With the inflow of USD 500 million into the system the USD/LKR exchange rate would stabilize in the short term. At present, there seems to be a severe drain of foreign reserves due to the fuel bills coming up for payment. Inflow of US\$ by way of sovereign bonds may not be in the interest of the country in the long term, if the exchange rate regime resulting leads to a revaluation of the currency as seen following the Tsunami related aid and fund transfers, and this can lead to a lack of competitiveness of goods exported by Sri Lanka. Also, there does not seem to be any justification in not utilizing the available funding hitherto pledged or secured.

5. Risks

TISL feels that the following are cause for concern:

- Fluctuation of the Interest Rate with the LIBOR movement as the rate of interest would vary in the International Market with the World Economy.
- Depreciation of the SLR against the USD. Due to the Sri Lankan Rupee depreciating at a faster pace to the USD, the Government would have to repay a higher quantum of Rupees as against the initial borrowing. During 2006 the Sri Lankan Rupee has depreciated by around 5% against the US Dollar. This could be mitigated by having a Foreign Exchange Hedge which will have an associated cost for the option.
- There are no guarantees whether the funds raised would be utilised for infrastructure projects as presently indicated. There is a possibility that it may even go towards funding consumption or to fund the war related costs or financing the budget deficit.
- Political instability created by the pronouncements made by main opposition party not to honour the debt on coming to power. There could be a legal argument to contradict the stated pronouncement, as sovereign debts are paid virtually automatically as long as the Foreign Loan Act is in operation.
- At the end of 2006 the total Foreign Borrowing was Rs 1,131,074 million (US\$ 10,501 million¹⁹) of which Rs 1,045,112 million (US\$ 9,703 million) was concessional borrowing. This amounts to 92.4% of foreign borrowing. By adding the International Bond, the Commercial borrowing would go up from Rs 85,962 million to Rs 635,962 million. This would bring the concessional borrowing from 92.4% to 62.2%.
- Previous international commercial borrowing data in the public domain appears to indicate the highest interest rate applicable as LIBOR+140 borrowed at the beginning of 2006. This was arrived at by going through data available to the public. Due to the quantum of the loan exceeding previous borrowings and due to higher risk factor, the cost of the loan would fluctuate between LIBOR +100-200bp.
- An up front disclosure that adequate cash flow based returns are available to service the debt in due course. The repayment capacity of the government should be seriously examined.
- There appears to be an over reliance on normal export earnings and worker remittances to meet all future foreign debt obligations.
- It is commonly believed that the previous borrowings in foreign currency, especially those taken in the last year, have lacked the above risk mitigation action. Though taken for a longer tenor, these borrowings were rated short term, with rate renewals short term, need to be classified as short term borrowings for debt service computations. Equally important are risk mitigation strategies that need to be in place in the event that the rates of interest are upward revised, due to country situation/rating, or market environment. The disclosed purposes for which these funds were used and the specific resultant debt service capacity have not been placed in the public domain.

¹⁹ At the end of 2006 the Exchange Rate was 107.71SLR/USD, Source Central Bank

6. Expected Frame Work of Governance

Transparency International Sri Lanka recommends that a governance accountability framework be in place and in effective practice, prior to the proposed national foreign debt being committed, and seeks the following:

- Clarity of information available in the public domain
- Transparency within the deal process
- Full details of the terms, tenor and applicable conditions and options
- Justification challenges of 'effectiveness' and 'fairness' of the deal
- Confirmation that all available alternative options have been assessed and the best option selected
- Compliance certification with acts and regulations, including Fiscal Responsibilities Act
- A due process compliance sign off from the Secretary to Treasury, Monetary Board, Auditor General, Attorney General and Finance Commission or equivalent
- Indication of the specific purpose of borrowing
- An assurance that adequate cash flow based returns are available to service the debt
- Details of duration based asset liability and cash flow mismatches, effective risk management processes and mitigation action plans
- Continuous half yearly disclosure of information for public review and assessment of the status quo

7. Conclusions and Recommendations

TISL strongly recommends that the above framework be followed and further states that the public should be informed of the process of all financial commitments including severing loans in order to ensure that the finances would not be abused by those who manage them.

The need to have a Freedom of Information Act²⁰ with sufficient safeguards to guarantee, among others, the disclosure of financial information of the State at all levels including foreign borrowings is reiterated.

The desirability of having a totally independent Central Bank, independent of direct or indirect control of the Finance Ministry or the Executive becomes evident in this case.

There must be an effective Finance Committee of Parliament that is capable of examining the foreign loans and ensuring that the sovereign loans are used for intended purpose. All measures must be taken to prevent any attempt to use the money for utilization purposes.

Transparent and tangible risk management processes should be in place for foreign loans. The need for continuous, half yearly pro active disclosure of information for public review and assessment of the status quo is reiterated.

As the full control over public finance is vested with the Parliament²¹, details of such a borrowing of this nature, needs to be informed to the Parliament. The best practice of governance demands, in the absence of a Finance Committee, full facts be placed before Parliament and approved. Proceeds

²⁰ Guaranteeing the rights of individuals to seek and receive information as protected under article 19 ICCPR. The right to information has been recognised by Sri Lanka's Supreme Court as being implied in the existing constitutional provisions. Determination on Broadcasting Authority Bill & Fernando vs. SLBC

²¹ Article 148 Constitution

of the loan need to be exclusively used for the purpose agreed with the Bank. However, funds could be used to cover temporary deficits in consumption.

There is no specific mention in the Constitution in regard to borrowings, but expenditure out of it definitely should have the approval of the Parliament.

It is patently apparent that the current situation has arisen mainly due to the scant respect paid by those in key positions of governance to the importance in good governance of transparency, accountability, adherence to due processes, and public debate prior to commitment on key macro strategies and actions having long term implications.

TISL looks forward to this position paper crystallising a public debate even at this stage and believes that if it so generates interest and debate, TISL has realized a key objective of good governance, transparency and accountability.

- END -

Annexure 1

Infrastructure Development Projects

Power Plants

Norachcholai Coal Power Plant; USD 455 mn loan by the Chinese Govt, approximately 3.5 % p.a with a 15 to 20 yr repayment period including a grace period of 5 yrs.

Kerawalapitiya Combined Cycle Plant; USD 210, 323 or 650 million loan; by the Japanese Government. 30% by the SL Govt. as equity, 70% raised through debt.

Trincomalee Coal Power Plant (Sampoor); USD 450 or 1,150 million loan; by the Indian (National Thermal Power Cooperation) – interest not known

Air Ports

Weerawila Airport; USD 175 Mn loan; Foreign Assistance - Saudi Fund

BIA phase II; USD 200 million loan; Japan

Water Supply & Sanitation Projects

Water & Sanitation Sector Development; a USD 90 mn project; with funding of USD 113 Mn being supplied by Japan.

Secondary Towns Water Supply - phase 11; a USD 175.2Mn project; with USD 60.3 Mn funding being supplied by ADB. The loan will be composed of a \$46.5 mn loan from ADB's concessional Asian Development Fund (ADF), and \$13.5 mn from its ordinary capital resources (OCR). The remainder of the project will be funded by the SL Govt; USD 51.8 Mn +local community USD 3 Mn

Harbours

Hambanthota Harbour; USD 310 Mn - Chinese Government

Colombo South Harbour Project; USD 300Mn loan from ADB's ordinary capital resources and be provided under the conditions of the London interbank offered rate-based lending facility. The loan will have a 25-year term and include a 5-year grace period.

Galle Port Development; USD 140 mn project funded by Japan

Highways

Southern Highway; USD 300 Mn project with funding by ADB USD 90 Mn, Repayable 32 Years, grace 8 Years, during grace period 1%p.a.and thereafter 1.5%.p.a, JBIC USD 120 Mn, Nordic Development Fund USD 6.7 Mn, and SIDA USD 1 Mn.

Greater Colombo Urban Transport Project (Outer Circular Highway) Phase 1; a USD 186 Mn project; with USD 186 Mn funding by Japan.

Greater Colombo Urban Transport Project Phase 11; US\$ 150 mn; a project funded by Japan.

Road Network Improvement Project; a US\$ 150 mn project with USD 100 mn funding by the World Bank.

Road Network Improvement; USD 98 mn; funding from ADB and Japan

Proposed Northern Highway to Jaffna; US \$ 250 mn project- it is questionable whether it can be carried out

Railways

Improvement of Colombo – Matara Railway line US \$ 100 mn-170mn project funded by India

Irrigation Projects

Moragahakanda; USD380 Mn project; funding - Negotiation with German Government (through Dorsch Group of Germany)