

# Sri Lanka: restructuring with biodiversity-links?

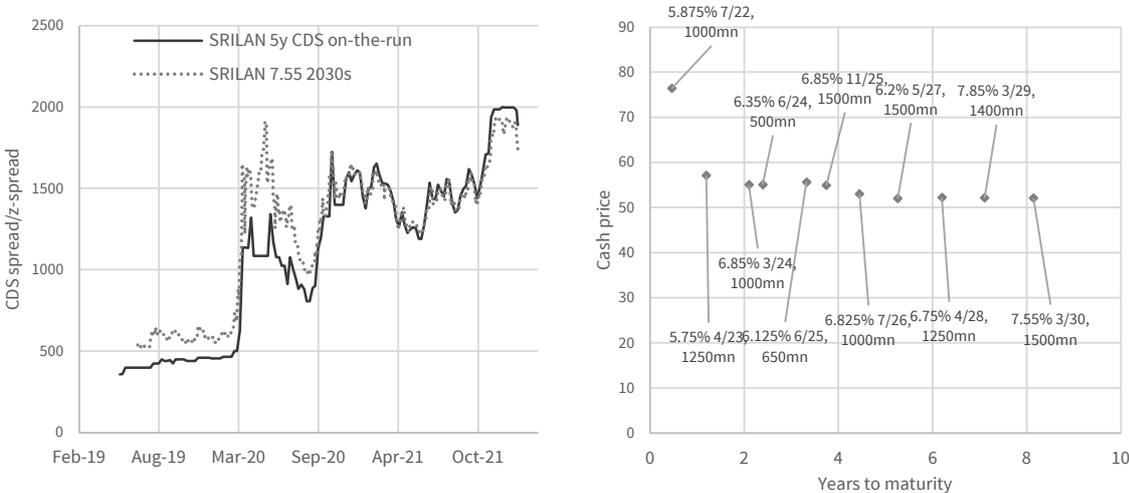
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Sri Lanka government bonds (15bn of USD denominated bonds outstanding) are currently trading at distressed levels implying a market expectation of a default and/or restructuring in the near time. Combining the fact that Sri Lanka has explored various ways to tap into green funding in 2021, the country’s climate change vulnerability as well as the high demand for positive impact assets in the international investor community, it seems natural to involve some sustainability criteria in a potential restructuring of the USD bonds.

Various new initiatives during COP26 discussed different ways to provide credit enhancement for EM assets: we opine that this is a situation where the rubber should hit the road. Ideally, we would see a credit enhanced structure allowing investment grade investors to participate in an investment meeting both their rating/size criteria as well as having robust sustainability links. We suggest focusing on biodiversity factors such stopping deforestation, general marine protection and specific whale habitat protection measures.

The Financial Times reports on the situation in “[Sri Lanka on brink of sovereign bond default, warn investors](#)”, 7 Feb 2022. As illustrated in Figure 1, Sri Lanka has not been able to recover from the Covid-induced volatility that hit all asset classes at the on-set of covid in 2020. Bonds are trading at what appears to be a recovery value of ca. 50-60 cents on the dollar. A key liquidity test for Sri Lanka will be the repayment at maturity of the 5.875% bond maturing in July this year (ISIN USY2029SAH77 REGS) . Annual coupon payments at the current USD debt stock sit at USD840mn per annum (avg coupon 6.71%).

Figure 1. Sri Lanka CDS and long-end bonds (left); Sri Lanka USD bonds in cash price terms, central government only, with amount outstanding in USDmn. Source: AFII, Bloomberg.



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# Biodiversity link considerations

Given expectations for a restructuring, and the fact that Sri Lanka is a biodiversity hotspot<sup>1</sup>, we believe investors should be exploring interesting ways to invest in Sri Lanka risk in a post-restructuring scenario that includes sustainability/biodiversity links, analogous to the Belize restructuring in 2022 which featured a USD364mn Blue Bond (BZBLUE 1.6 10/40; ISIN USG71351AA14).<sup>2</sup> With Sri Lanka being a considerably bigger credit, there are a multitude of options to look at in terms of how to (and if) provide credit enhancement to draw in more investors. For example, we note that capacity is ramping up with credit enhancement options provided by special guarantor facilities in the UK explicitly targeting EM/sustainability.<sup>3</sup>

Sri Lanka exhibits exceptional levels of terrestrial and marine biodiversity whilst having an economy highly dependent on nature and its services (for sectors such as fisheries, agriculture and tourism). A 2021 World Bank report stressed Sri Lanka as being highly vulnerable to climate change,<sup>5</sup> and is a signatory of the Convention on Biological Diversity from 1992. As Sri Lanka is moving towards the end of its *2016-2022 National Biodiversity Strategic Action Plan*,<sup>6</sup> investors could have an important role in terms of supporting renew and strengthened plans.

There are a number of potential high impact target areas linked to biodiversity that could be considered in a sustainability linked bond and would be attractive for investors looking to participate and access the sustainable debt markets. Below we suggest a few general ideas that we believe should be leveraged in a potential sustainability-linked restructured format,<sup>8</sup> with a particular focus on biodiversity, as Sri Lanka's fossil energy phase-out already is ambitious.<sup>9</sup> These (non-exhaustive) suggestions for direction of travel have the advantage of being fairly straightforward to communicate and measure and thus easier to incorporate in investors' biodiversity strategies, as well as encouraging and strengthening actual work that already is ongoing or being considered in Sri Lanka:

- **Deforestation:**

Deforestation is one of the main drivers of negative change to terrestrial biodiversity in Sri Lanka. The country lost approximately 10% of its forest cover since 1990 with forestry being the dominant driver according to Global Forest Watch.<sup>11</sup> Although the forest loss rate has considerably slowed

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<sup>1</sup> "[Hotspots: Earth's Biologically Richest and Most Endangered Terrestrial Ecoregions](#)", Mittermeier, Myers and Goettsch Mittermeier, 1999.

<sup>2</sup> It should be noted that the Belize restructuring was led by Credit Suisse as sole structurer and arranger of the Blue Bond linked to The Nature Conservancy (TNC)'s Blue Bond Conservation Program. See for example "[Capital Markets Weekly: Belize agrees to innovative debt restructuring involving new marine-focused debt](#)", IHS Markit, 1 Oct 2021, or "[Belize offers ocean 'blue' print with debt-for-reef swap](#)", Reuters, 5 Nov 2021.

<sup>3</sup> The Green Guarantee Company, a UK COP26-inspired initiative is seemingly quite suitable for this type of transactions, cf. "[Deutsche Bank & The Development Guarantee Group sign Memorandum of Understanding to tackle climate financing gap for developing countries](#)", DB press release, 31 Jan 2022.

<sup>5</sup> "[Climate Risk Country Profile – Sri Lanka](#)", World Bank, 2021.

<sup>6</sup> "[National Biodiversity Strategic Action Plan 2016 – 2022](#)", Biodiversity Secretariat, Ministry of Mahaweli Development and Environment (MoMD&E), May 2016.

<sup>8</sup> For a discussion on sustainability-linked sovereign bonds, see "[Striking the Right Note: Key Performance Indicators for Sovereign Sustainability-Linked Bonds](#)", World Bank, Nov 2021.

<sup>9</sup> "[No new coal-power plants to be set up in Sri Lanka](#)", AFP, 27 Oct 2021.

<sup>11</sup> "[Global Forest Watch – Sri Lanka dashboard](#)", accessed in Feb 2022. "Forestry": Temporary loss from plantation and natural forest harvesting, with some deforestation of primary forests.

down, thanks to implemented conservation measures and an increase in protected areas,<sup>12</sup> the country's growing population continues to increase land use pressures.

■ **General marine biodiversity protections:**

In line with Aichi Biodiversity Target 11,<sup>13</sup> the country had committed in its biodiversity action plan to have 10 percent of its coastal and marine areas protected by 2020. According to IBAT, only 0.07% of Sri Lanka's marine areas are protected as of 2021. Tourism accounted for 4.9% of the country's GDP<sup>14</sup> pre-covid with coastal tourism being highly dependent on a rich marine biodiversity. Furthermore, according to the World Bank, "*Fish make up about 50% of Sri Lankans' animal protein intake, a ratio three times higher than the global average.*" Thus, a sustainable management of Sri Lanka marine life is essential for continued food security and providing jobs opportunities.

■ **Whale habitat protection:**

One of the busiest global shipping routes passes close to the southern tip of Sri Lanka, which is also the habitat of a unique sub-species of blue whales. A minor shift of the route could substantially reduce any impacts to the whale populations inhabiting Sri Lanka's southern coastline, see "['Giant obstacle course': call to reroute major shipping lanes to protect blue whales](#)", The Guardian, 7 Feb 2022. Whale populations have indeed been brought to the forefront in terms of climate- and environmental actions as of late, cf. "[Shell-shocked: a whale trade in corporate bonds](#)", AFII, 1 Dec 2021. We believe that whale protection conditionalities could provide a fillip for asset-managers and asset-owners representing environmentally conscious stakeholders, as the specificity of the target carries powerful messaging potential for end-investors.

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<sup>12</sup> As of 2021, 43.69% of terrestrial Key Biodiversity Areas were protected compared to 32.38% in 1990 according to [IBAT Alliance](#)

<sup>13</sup> *The Aichi Biodiversity Targets were included in the Strategic Plan for Biodiversity for the 2011-2020 period adopted by the 10th meeting of the Conference of the Parties of the Convention on Biological Diversity* (see <https://www.cbd.int/aichi-targets/target/11>)

<sup>14</sup> "[Annual statistics report 2018](#)", Sri Lanka Tourism Development Authority

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