

# World Bank supports crisis-hit Sri Lanka's efforts to reduce interest rate risk on its loans

During the unprecedented economic crisis in Sri Lanka, the World Bank Treasury helped to manage interest rate exposure on outstanding IBRD/IDA loans of USD 712 million. Leveraging World Bank's market expertise, Sri Lanka was able to convert interest rates from floating to fixed at competitive terms on 11 loans for present value savings of approximately USD 38 million on estimated future interest payments.

## How did the World Bank Treasury support Sri Lanka?

- **Providing training** on financial risk management instruments and preparation for London Interbank Offered Rate (LIBOR) transition.
- **Analysing and sharing market projections** for interest rates to support the Ministry of Finance (MoF) in their internal discussions.
- **Providing alternative risk management tools** such as (i) full interest rate conversion; partial interest rate conversion, short vs. long term maturity, (cap and collar options to limit interest rate variability).<sup>1</sup>
- **Converting 11 loans** with a total of USD 712 million from variable reference rates to fixed reference rates at competitive financing terms.
- **Ensuring the conversion was administratively cost-effective** as an embedded feature of the loan agreement.
- **Executing interest rate swaps** with market counterparties to match the fixing of the reference rate with Sri Lanka and hedge IBRD's interest rate risk exposure.

## Sri Lanka's crisis:

Sri Lanka has been mired in economic turmoil and declared an external debt suspension in April 2022. The Government's unsustainable policy decisions and significant balance of payments challenges led to a deterioration of welfare and food security. Inflation soared as the Central Bank printed money to cover the



March 21, 2022, Colombo, Western Province, Sri Lanka: People stand in a long queue to buy kerosene oil to use in their homes, at a fuel station in Colombo. The island has been severely hit by the lack of foreign exchange, resulting in severe shortages in food, fuel and imported goods. Photo Credit: Pradeep Dambarage/ZUMA Press Wire

fiscal deficit, and the Sri Lankan Rupee devalued by almost 80 percent. Sri Lanka's tourism revenues collapsed amid the COVID-19 pandemic. The Russia-Ukraine War and associated sanctions, which sent commodity prices skyrocketing, exerted further pressure on the external sector.

Sri Lankans suffered shortages of fuel, electricity, and even some essential food items. Import of goods was hampered because of the critically low level of foreign reserves. This caused dramatic price increases and ignited mass public protests, resulting in the appointment of a new President in July.

Against this backdrop, the Ministry of Finance (MoF) consulted with the World Bank Treasury about ways to protect public finances against the impact of increasing international interest rates.

<sup>1</sup> Caps set an upper limit on the variable interest rate of the loan. Collars set an upper limit (a cap) and a lower limit (a floor) on the interest rate of the loan.

## World Bank rate conversions removed uncertainty

### Understanding financial risks

The World Bank Treasury provides advisory services to mitigate financial risks such as interest rate and refinancing risks and build capacity for clients.

Sri Lankan MoF staff received training from the World Bank on the mitigation of interest rate risks due to the impending transition of the [London Interbank Offered Rate \(LIBOR\)](#) to new reference rates. They also received a second training on comprehensive financial risk and liquidity management.

As all the financial market indicators were projecting a surge in interest rates for the year ahead, Sri Lankan MoF wanted to protect the budget against interest rate volatility. They wanted to be able to plan for future cash flows.

During 2022, MoF constantly monitored the cost and risk of fixing the interest rate of their World Bank loans. World Bank Treasury provided quotes on different conversion options such as (i) full interest rate conversion; partial interest rate conversion, short vs. long term maturity, (cap and collar options to limit interest rate variability).

### Potentially saved millions

In June 2022, Sri Lanka finally fixed the interest rate of 11 of its disbursed and closed loans for a total amount

of USD 712 million and a remaining weighted average repayment maturity of 12 years. This generated a potential present value savings of approximately USD 38 million on the estimated future interest payments (as of end of December 2022).<sup>2</sup> But more importantly, amid economic, political, and social unrest, the MoF resolutely focused on understanding and managing financial market risks and protected the budget.

**The World Bank Treasury helps clients manage interest rate and currency risks in their debt portfolios by sharing over 70 years of capital markets experience, using the flexibility of the IBRD loans, and executing hedges on non-IBRD exposures.**



### 11 LOANS CONVERTED

For a total amount of USD 712 million



### POTENTIAL SAVING USD 38 MM

Potential net present value savings on future interest payments of approximately USD 38 MM<sup>2</sup> (details in footnote)



### CAPACITY BUILDING

on the mitigation of financial risks to Sri Lanka's public Debt Management Office



### ADVISORY

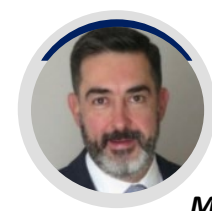
Preparations for the LIBOR transition and analysis of market trends for interest rates

*"The example of Sri Lanka has once more proven the significance of managing financial risks. Governments must understand financial risks and mitigate them to avoid potential impacts on the economy and society. I am pleased that, with World Bank Treasury's support, Sri Lankan Debt Management Office strengthened its capacity and protected a portion of its budget."*

*"Amid economic, political, and social unrest, the Sri Lankan Ministry of Finance remained focused on its goal to reduce interest rate risk and improve fiscal stability. We supported their efforts by providing targeted training advisory and transactions execution."*



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<sup>2</sup> The potential savings are based on the estimated interest to be paid over the life of the loans (based on Bloomberg forward rates as of December 30<sup>th</sup>, 2022). The actual savings at final maturity may be higher or lower depending on the reference rate trajectory.