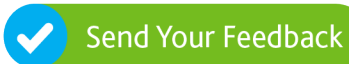


ISSUER COMMENT

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Government of Sri Lanka

Debt-for-nature swaps can provide debt relief, long-term environmental benefits, but could constitute event of default

In a proposal to [Sri Lanka's](#) (Ca stable) government, the United Nations Development Programme (UNDP) has suggested debt-for-nature swaps as part of the sovereign's broader debt restructuring plan. This is in parallel with Sri Lanka's negotiations with the International Monetary Fund and other multilateral development partners for financing support. If effectively implemented, debt-for-nature swaps have the potential to provide long-term credit benefits by offering debt relief while increasing investments that could bolster Sri Lanka's resilience to environmental risks. In the near term, to the extent that they involve a loss for private sector creditors, they could constitute an event of default for Sri Lanka.

Under the UNDP proposal, the debt-for-nature swap would allow a portion of the government's large debt burden to be forgiven in exchange for the implementation of environmental policies or funding of conservation programs. The transaction would be likely to involve bilateral creditors and environment-related nongovernmental organisations as potential partners.

Such a transaction could constitute a default under our definition and would be captured by our ratings based on our assessment of expected losses for private sector creditors. In a case where the transaction only involved public sector creditors and public sector instruments that we do not rate, the sovereign rating may not reflect the loss given default experienced by public sector creditors. This would be similar to our treatment of some sovereigns during the suspension of debt servicing to creditors from Group of 20 leading economies under the Debt Service Suspension Initiative during the pandemic. If private sector creditors were involved, we would consider the extent of losses for them.

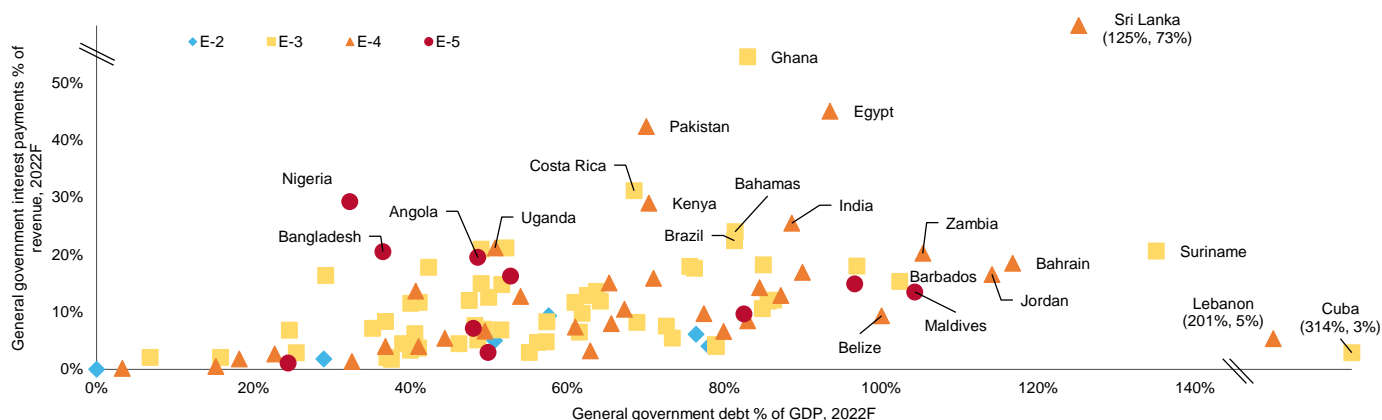
For Sri Lanka, we already assume substantial losses for private sector creditors in line with the global average for defaulting sovereigns after the government's recent decision to suspend the repayment of external public debt. Coupon payments were missed on 18 April and are unlikely to be cured within the 30-day grace period.

Historically, debt-for-nature swaps have been deployed in emerging markets. For example, in 2010, the [US](#) (Aaa stable) and [Brazil](#) (Ba2 stable) struck a deal to write off \$21 million of debt; money which would otherwise have gone to service the debt is being used to conserve Brazil's rainforests and enhance the livelihoods of those who live in them.

Sri Lanka is highly exposed to environmental risks which weigh on its credit profile (see Exhibit 1).

Exhibit 1

Environmental risks weigh on the credit profiles of many developing economies



Source: Moody's Investors Service

We assess Sri Lanka's exposure to environmental risk to be highly negative, as measured by our environmental issuer profile score (IPS). Variations in the seasonal monsoon can have marked effects on rural household incomes and inflation-adjusted real GDP growth. While the agricultural sector comprises only around 7% of the total economy, it employs almost 30% of Sri Lanka's total labour force. Natural disasters including droughts, flash floods and tropical cyclones also disrupt agricultural production, business activity and damage homes. Sri Lanka ranks 30th out of 180 countries in the 2019 Global Climate Risk Index produced by Germanwatch, which measures exposure and vulnerability to extreme weather events.

At the same time, Sri Lanka's fiscal strength is very weak. We estimate that interest payments will absorb around 70% of government revenue in 2022, and government debt will rise to around 125% of GDP by the end of 2022.

Effective use of debt-for-nature swaps may help reduce the government's debt burden and debt servicing requirements, while providing long-term benefits through investments to mitigate environment-related risks.

Examples of where such financing may be deployed include enhancing infrastructure resilience against natural disasters as well as preservation of the country's vast natural capital, ranging from beaches to tropical forests. Sri Lanka already has a long-standing programme of mangrove conservation to preserve its coastline with the help of United Nations Framework Convention on Climate Change and Seacology.

Such investments would not only reduce future disruptions to economic activity and the associated fiscal impact that arise from climate shocks and trends, but also widen the potential for nature-based tourism. Overall, should we assess Sri Lanka's resilience to environmental risks to have increased, this would be reflected in our environmental IPS for the country.

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