



## Fitch Downgrades Sri Lanka's Long-Term Local-Currency IDR to 'C'

Fitch Ratings - Hong Kong - 05 Jul 2023: Fitch Ratings has downgraded Sri Lanka's Long-Term Local-Currency (LTLC) Issuer Default Rating (IDR) to 'C' from 'CC'. The issue ratings on local-currency bonds have also been downgraded to 'C' from 'CC'. The Long-Term Foreign-Currency (LTFC) IDR has been affirmed at 'RD' (Restricted Default) and the Country Ceiling at 'B-'.

A full list of rating actions is detailed below.

Fitch typically does not assign Outlooks to ratings of 'CCC+' or below.

### KEY RATING DRIVERS

**Domestic Debt Restructuring Proposal Announced:** The downgrade of Sri Lanka's LTLC IDR reflects Fitch's view that a sovereign local-currency debt restructuring process has begun, as parliament approved the government's domestic debt restructuring plan on 1 July. On 4 July, the authorities launched a formal exchange offer to bondholders for those bonds that are eligible for the restructuring.

**Restructuring Plan Outlined:** The debt restructuring announcement outlines a domestic debt optimisation (DDO) strategy, which includes treatment of Sri Lanka's domestic debt as well as domestically issued foreign-currency debt. The key elements of the DDO include: conversion of CBSL's T-bills and provisional advances to the government into treasury bonds (T-bonds); exchange of superannuation funds' T-bonds into longer maturity T-bonds; exchange of outstanding Sri Lanka development bonds (SLDBs), which are US-dollar denominated but governed by local law, into new US dollar or Sri Lankan rupee instruments; and, restructuring of local-law foreign-currency denominated bank loans of the government.

The debt restructuring excludes banks' holdings of Sri Lankan rupee-denominated treasury securities, but bank holdings of SLDBs will be affected.

**DDO Qualifies as DDE:** In Fitch's view, the proposed DDO will qualify as a distressed debt exchange (DDE) under our criteria, as it entails a material reduction in terms and is needed to avoid a traditional payment default. We will downgrade the LTLC IDR to 'RD' upon closing of the exchange offer and following confirmation that the exchange will be executed. The government plans to complete the exchange within July.

**Foreign Currency IDR in Default:** The sovereign remains in default on foreign-currency obligations and has initiated a debt restructuring arrangement with official and private external creditors. The Ministry of Finance had issued a statement on 12 April 2022 that it had suspended normal debt servicing of several categories of external debt, including bonds issued in international capital markets, foreign currency-denominated loan agreements and credit facilities with commercial banks and institutional lenders.

**ESG - Governance:** Sri Lanka has an ESG Relevance Score of '5' for Political Stability and Rights as well as for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Sri Lanka has a medium WBGI ranking in the 45th percentile, reflecting a recent record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

**ESG - Creditor Rights:** Sri Lanka has an ESG Relevance Score of '5' for Creditor Rights, as willingness to service and repay debt is highly relevant to the rating and is a key rating driver with a high weight. The affirmation of Sri Lanka's LTFC IDR at 'RD' reflects a default event.

## **RATING SENSITIVITIES**

### **Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade**

The LTLC IDR will be further downgraded once the government executes its domestic debt restructuring.

### **Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade**

Following completion of the DDE, the sovereign LTLC IDR will likely be lifted out of 'RD' to a rating that appropriately reflects its prospects.

For the LTFC IDR, completion of the foreign-currency commercial debt restructuring that Fitch judges to have normalised relationship with private-sector creditors may result in an upgrade.

## **SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)**

In accordance with the rating criteria for ratings in the 'CCC' range and below, Fitch's sovereign rating committee has not used the SRM and QO to explain the ratings, which are instead guided by the rating definitions.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LTFC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the LTFC IDR, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories

ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

## **ESG CONSIDERATIONS**

Sri Lanka has an ESG Relevance Score of '5' for Political Stability and Rights as WBI have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight. As Sri Lanka has a percentile rank below 50, for the respective governance indicator, this has a negative impact on the credit profile.

Sri Lanka has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Sri Lanka has a percentile rank below 50 for the respective governance indicators, this has a negative impact on the credit profile.

Sri Lanka has an ESG Relevance Score of '4' for Human Rights and Political Freedoms, as the Voice and Accountability pillar of the WBI is relevant to the rating and a rating driver. As Sri Lanka has a percentile rank below 50 for the respective governance indicator, this has a negative impact on the credit profile.

Sri Lanka has an ESG Relevance Score of '5' for Creditor Rights as willingness to service and repay debt is highly relevant to the rating and is a key rating driver with a high weight. Sri Lanka's LTFC IDR is 'RD' as the sovereign is in default on its foreign-currency debt obligations.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
<input type="text"/>	<input type="text"/>	<input type="text"/>
Sri Lanka	LT IDR RD Affirmed	RD
	ST IDR C Affirmed	C
	LC LT IDR C Downgrade	CC
	LC ST IDR C Affirmed	C
	Country Ceiling B- Affirmed	B-
senior unsecured	LT C Downgrade	CC
senior unsecured	LT D Affirmed	D

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[VIEW ADDITIONAL RATING DETAILS](#)

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

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### APPLICABLE CRITERIA

- [Country Ceilings Criteria \(pub. 01 Jul 2020\)](#)
- [Sovereign Rating Criteria \(pub. 06 Apr 2023\) \(including rating assumption sensitivity\)](#)

## APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

- Country Ceiling Model, v1.7.3 ([1](#))
- Macro-Prudential Indicator Model, v1.5.0 ([1](#))
- Sovereign Rating Model, v3.13.3 ([1](#))

## ADDITIONAL DISCLOSURES

- [Dodd-Frank Rating Information Disclosure Form](#)
- [Solicitation Status](#)
- [Endorsement Policy](#)

## ENDORSEMENT STATUS

Sri Lanka EU Endorsed, UK Endorsed

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