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Quantitative Techniques for Public Debt Management

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1 Introduction

"Debt is as old as the world itself."

For several reasons, public debt management is special. Governments tend to borrow to bridge their budget financing gap by issuing various types of government securities. Pricing of these government securities depends on several factors including the risks associated with governments creditworthiness, instruments, markets and the economic conditions. Managing public debt at a sustainable level is important to governments which borrow from domestic or foreign sources as unsustainability will cause severe destresses to its fiscal and monetary stabilities leading to economic, financial, and humanitarian crises. Sri Lanka experienced the consequences of unsustainability of public debt and its management in the recent past.

Hence, this article intends to summarize the types of government securities, pricing, associated risks, the manner debt management could be made and a few quantitative techniques to be used to address risk factors in managing such debt.

2 Preface to public debt instruments

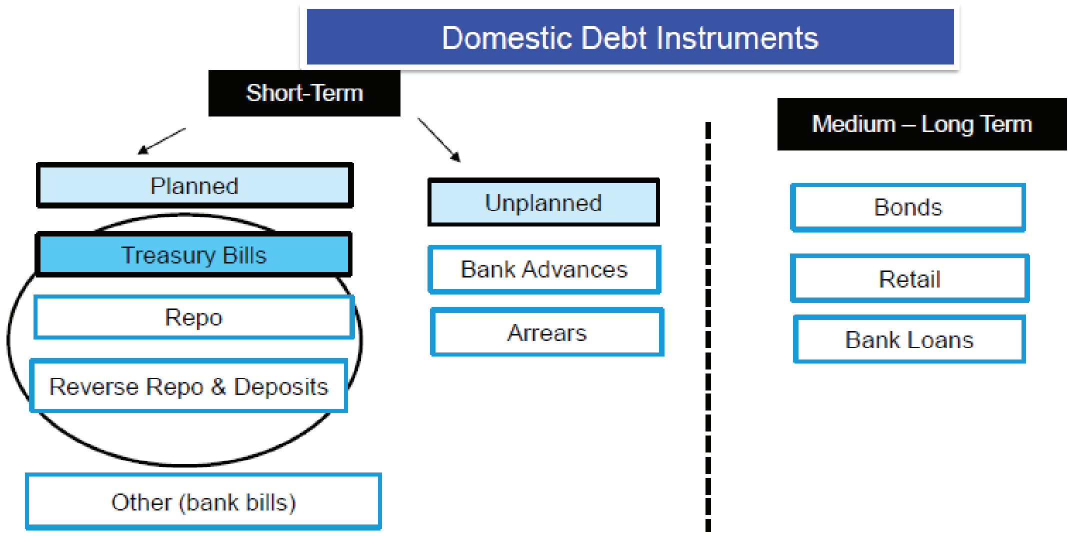
2.1 Governments raise debt by issuing several types of debt instruments, domestically as well as externally. These include Treasury bills (T-bills), Treasury bonds (T-bonds), repurchase and reverse repurchase agreements, and interest rate swaps. Selection of the debt instrument to be used depends on many factors of which some of the key factors are shown in Figure 1, below. Accordingly, tenure plays a key role in deciding which debt instrument is used by a government to raise its debt.

2.2 Brief description of key debt instruments

There are three main types of securities instruments through which governments raise funds.

(i) ***T-bills:*** These are short-term discounted instruments with less than 1 year maturity and issued at a discount with 1 payment at redemption. T-bills are used mainly for

Figure1: Selection of Debt Instruments



the purposes such as government's cash management due to its short-term nature, debt management due to its tradability and attractiveness to banks even at an early stage of market development and for monetary policy implementation and fiscal financing.

(ii) ***T-bonds:*** T-bonds are investment securities where an investor lends money to the government for a set period of time in exchange for regular interest payments. They are referred to as "fixed income" securities, since the investment earns fixed payments over the life of the bond. It does not need to be a constant interest rate, and rather the payment method and frequency is fixed. Their maturity is typically more than one year.

(iii) ***International sovereign bonds (ISBs):*** Governments issue sovereign bonds in a currency that is different from its own currency and in a different jurisdiction to raise money for financing government programs, paying down old debt, paying interest on current debt, and other government spending needs.

Typically, bonds are the main financing instrument for a government due to the following reasons:

(i) Bills are more for cash management needs, bridging periods of cash deficit to periods of cash surplus, their net contribution to financing the budget deficit should be limited.

(ii) Bonds are used for meeting the overall financing needs.

As important as the raising fund through issuing bonds is for a government, investors are interested in bond pricing and the rate of return. The price of a bond is the present value of its expected cash flows and the manner in which the same is calculated is given in Figure 2, below.

Figure 2: Calculation method in brief

$$PV = \frac{C_1}{(1+y)^1} + \frac{C_2}{(1+y)^2} + \cdots + \frac{C_N}{(1+y)^N} + \frac{FV_N}{(1+y)^N}$$

Where:

- PV = present value, or the current price of the bond
- C_i = coupon payment per period
- FV = future value paid at maturity, or the par value of the bond
- Y = yield to maturity
- N = number of periods to maturity

To an investor, yield to maturity (YTM) is the rate of return on his/her investment made in a bond. Several key assumptions are considered when calculating the rate of return of which a summary is given below.

(i) The investor holds the bond to maturity

(ii) The issuer of the bond makes all the coupon and principal payments on time

(iii) The investor is able to reinvest coupon payments at the same yield

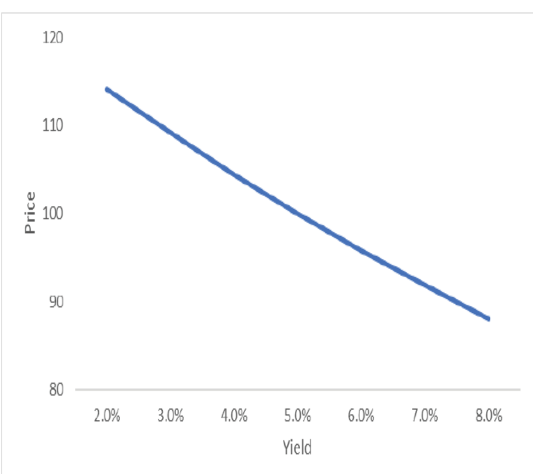
As a summary, the relationship between the bond price and the bond yield is given in Figure 3, below. As per Figure 3, it is observed that the bond price and the bond yield have an inverse relationship. Accordingly, when bond prices increase, their yields decrease, and vice versa. This relationship is primarily driven by interest rate fluctuations.

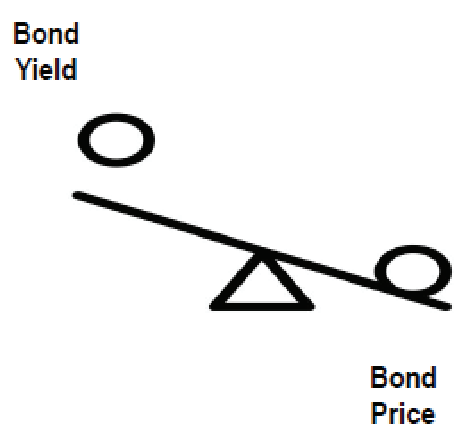
is the basis used to plan and manage their debt, aiming to balance cost and risk over a medium-to-long-term time spam. This would assist countries to preserve sustainable debt levels, develop domestic debt markets, and manage risk exposures. Accordingly, based on the financing composition in the DMS, an annual borrowing plan will be derived specifying each borrowing instrument and its contribution to the financing for the given fiscal year. This is the foundation for the designing of the public debt issuance calendar for a particular financial year.

Amongst many the main types of raising debt are through auctions, syndication, private placements and TAP sales. A brief description of each such method is given below.

Auctions: A bond with specified coupon and maturity structure is issued through an auction

Figure 3: Relationship between the bond price and the bond yield





where investors place bids during a defined period (a few hours) indicating the price they would pay (or yield they require) and the amounts they would like to acquire at this price / yield. There are two types of auctions, i.e., multiple price and uniform (single) price auctions.

3 Methods of borrowing

3.1 Governments raise debt using several methodologies. Usually, considering the debt management objectives of a particular government, they decide a medium-term debt management strategy (DMS). Generally, DMS

Syndication: Bond syndication refers to the process by which a group of financial institutions collaborates to underwrite and distribute a new bond issuance. In this instance, the government (issuer) appoints a lead manager(s) to organise the syndication process and the lead manager(s) helps structure the bond offering, assesses market conditions and provides feedback on the terms (such as coupon rate, maturity, and covenants). They then assemble a syndicate of other banks and financial institutions in order for the government to borrow.

Private Placements: This involves the placement of debt instruments with a small group of selected investors, often non-banking institutional investors such as pension funds. Accordingly, the deals are placed directly with the investor that could be tailored to meet investor requirements, i.e., flexibility in terms negotiated. This method is simple and quicker to structure.

TAP Sales: Borrowing funds over a span of time rather than through a single auction or at a placement is identified as a TAP sale. The issuer announces the availability of the bond for a specified time period at a fixed price and made typically *via* a central bank.

3.2 When selecting a method to raise debt, i.e., an issuance technique, the governments usually consider the factors such as urgency and the size of government funding needs, market and the level of development of the said market of issuance, and the purpose of the issuance.

4 Risks of investing in bonds

Once the securities instruments as discussed above are issued by the government, the investors consider the risks inherent in such instruments prior to making an investment decision. Accordingly, the risks that a fixed income securities investor is exposed to include mainly, the credit risk, market risk, yield curve risk, re-investment risk and liquidity risk, of which a brief description is given below.

Credit risk:

The credit risk of a bond includes the risk that the issuer will default on its obligation (default risk). The risk that the value / price of a bond will decline because either the market requires a higher yield due to perceived increase in the risk of default (credit spread risk) or rating agencies will lower a bond's / issuer's rating (downgrade).

Market (interest rate) risk:

The risk that the price of a bond will fall because of rising yield. This will give rise to realisation of "capital loss" for an investor who has to sell the bond before its maturity. Duration[1] and convexity[2], as measure of interest rate sensitivity, are important to ascertain where longer duration would indicate more exposure to price movements.

Yield curve risk: This is the risk that the price of a bond will fall due to changes in the shape of the yield curve (non-parallel shift of the curve). For example, rising of short-term rates faster than that of the long-term. When the shape of the yield curve changes, the price of each bond issue in the portfolio will also change at varying degrees depending on their maturity.

Reinvestment risk: The variability of returns from reinvestment (particularly of coupons). The interest rate at which interim cash flow

1 Duration identifies how long it takes, in years, for an investor to be repaid a bond's price through its total cash flows. This could also be utilised to calculate how sensitive the price of a bond or fixed-income portfolio is to changes in interest rates.

2 Convexity is the curvature in the relationship between bond prices and interest rates. This would indicate the rate at which the duration of a bond changes as interest rates change.

can be reinvested (interest-on-interest) will depend on the prevailing interest rate at the time. Reinvestment risk is greater for longer holding periods and for high-coupon bonds. Interest rate risk and re-investment risk act in opposite directions as illustrated below.

Interest rate risk	Interest rate will rise and bond price will fall
Reinvestment risk	Interest rate will fall and return on coupons will be lower

Liquidity risk: This refers to the ease with which an investor will be able to sell an investment instrument. In other words, the liquidity risk is the risk an investor might not be able to sell the bonds in his / her portfolio quickly due to a thin market with few buyers and sellers for the bond. A liquid market is characterised by small bid-ask spreads which do not change materially for large transactions. From the perspective of the overall market, the bid-ask spread is the difference between the best bid price (highest price at which an investor is willing to pay) and the best ask price (the lowest offer price and holder of the bond is willing to accept).

5 Sovereign debt management

5.1 Simultaneous to the investors' initiatives to assess the risks associated with debt instruments issued by a government, the governments do concern about their overall sovereign debt levels and the manner in which such debt levels are maintained in a sustainable way. From the government's perspective, sovereign debt includes all securities that have been issued and loans that have been disbursed excluding loans that are committed but has yet to be drawn down, or government securities that have been created to be used as collateral (for purposes of cash management, for example). Hence, it is the responsibility of debt managers for a particular government to manage costs and risks associated with sovereign debt. Accordingly, it is important to raise awareness on potential risks from all sources of debt including contingent liabilities.

5.2 Identifing cost indicators

In order to manage the cost of sovereign debt, it is essential to identify the debt cost indicators, of which a summary is given in Figure 4, below.

5.3 Sovereign debt risks and management tools

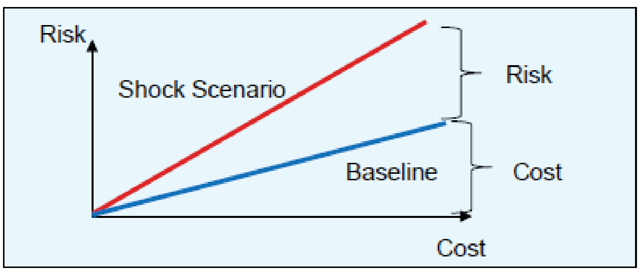
Once the risks and costs associated with sovereign debt is identified it is essential for

Figure 4: Cost indicators

Cost of borrowing: Loans	***Cost of borrowing: Securities*** (T-bills and T-bonds)
Interest rate over the life of the loan	Market determined and influenced by the factors including: • Domestic macro conditions • Market conditions • Global factors • Issuer behavior (e.g. predictability and transparency of auction calendar, debt levels and the debt composition)
Hidden costs (e.g., required collateral, covenants that may include step-up interest rate, acceleration of principal payments)	
Assessment relative to alternative sources (e.g. raising debt through capital markets)	
Comparison of price with peers, if possible	
Terms of loans from multilateral and most bilateral sources are the same (apart from additional policy conditions)	

a government to manage the same in order to inculcate a sustainable debt culture. Risk is associated with the potential for the cost to deviate from its expected outcome on the budget and in the government's balance sheet. The difference from baseline cost against the cost under risk (shock) scenario is considered as the measurement. Hence, the difference can be measured as the absolute maximum, standard deviation, etc., which is indicated in Figure 5, below.

Figure 5: Risk measurement



Increase in debt service produced by unexpected shift in market rates that may impact the budget of the government which can be measured based on the following.

$$Risk_t^{(j)} = f(Exposure_t^{(j)}, Risk\ Factor_t^{(j)})$$

Exposure: Endogenous to debt management (driven by fiscal policy)

Risk factor: Exogenous, except for refinancing risk

It is essential to ascertain country specific refinancing and liquidity risks as well in order to identify suitable measures to be adopted to manage such risks. Unexpected fiscal needs will imply a potential large increase in debt and thus debt burden, with a possibility of higher inflation and higher probability of default. Investors may feel less confident, demand a higher yield on debt, only invest in the short-term debt, or not re-invest at all (not rollover), or disinvest (sell securities). Also, in Less Developed Markets, undiversified investor base and unstable demand can raise uncertainties about refinancing. Political risk, i.e., highly polarized political situation, can also affect government's legal capacity to refinance. In addition, materialisation of unanticipated cash flow obligations needs or difficulty in raising cash at short notice will also be factors to be considered. This can be managed through maintaining sufficient cash buffers, extending maturity profile through issuance of longer dated bonds and by activating liability management operations.

Further, the risk of debt service payment increases from changes that may take place in interest rates. For both domestic and foreign currency debt, changes in interest rates affect debt servicing costs mainly on new issuances, when debt (fixed and variable rate) is refinanced. Particularly, on debt raised on variable rates, interest payments are affected as and when the reference rates reset. Hence, both short-term and variable rate debt are usually considered riskier than long-term fixed rate debt. In view of the above, in order to manage the interest rate risk it is essential to minimize short-dated instruments, avoid variable rate instruments such as derivatives (hedging instruments, swaps, options, forwards to lock-in interest rate all with potential counterparty credit risk, and additional cost) and in case of active liability management (ALM), try to use natural hedge where possible.

The risk of debt servicing cost increasing due to depreciation in the local currency is identified as exchange rate risk. For debt denominated in foreign currency, depreciation of the local currency affects debt servicing costs, generally on new issuances, when foreign currency debt (fixed and variable rate) is refinanced, and interest payments (for both fixed and variable rate) are affected as and when the local currency depreciates. This will give rise to potential Balance of Payments implications if international reserves are utilized for debt service and therefore, foreign currency debt should be considered riskier than domestic debt. However, for multilateral loans on concessional terms, the low cost may compensate for the exchange rate risk, and depending on the size of the domestic market, crowding out credit to private sector. The exchange rate risk can be contained by minimizing foreign currency denominated debt (limiting to concessional loans) and using derivatives such as hedging instruments, swaps, options, forwards to lock-in exchange rate (all with potential counterparty credit risk, and additional cost) and in the case of ALM, try to use natural hedge.

Accordingly, when selecting the debt management strategy by a particular government, that is in line with the cost-risk appetite of decision (policy) makers, describing the cost-risk characteristics of existing debt portfolio would help them to express the desired debt portfolio in the future and sovereign's preferences with regard to cost-risk tradeoffs.

5.4 Using yield to maturity as a tool

Yield to maturity (YTM) is a good measure of a return on holding a specific bond with a given maturity and interest rate, which can be utilised as a tool, as well. This is obtained by finding a discount rate that makes the sum of all cash flows zero and that discount rate is the YTM. This can be mathematically expressed as follows:

- Out flow (market price) at time (t=0) = Σ discounted cash in flows
- Market Price = $\frac{Cash\ flow_1}{(1+YTM)^1} + \frac{Cash\ flow_2}{(1+YTM)^2} + \cdots + \frac{Cash\ flow_n}{(1+YTM)^n}$

Calculation of YTM is better in capturing the value of the instrument than other types of yields (current or simple), as it considers time value of money and capital gain. However, it is not sufficient to derive other types of yields or help in pricing calculations. Hence, it is suggested to consider another type of yield called the zero-coupon yield.

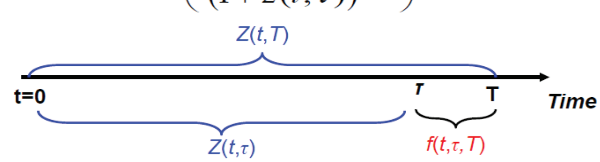
Zero-coupon yield: This measures the relationship a single future value to its present value, as there is no interest payment in between years and such instruments not commonly found in markets. However, it is possible to construct using coupon (interest) bearing bonds, and zero coupon yields and their discount factors are useful in deriving various other yields as well as pricing bonds. Zero-coupon yield is built using coupon paying bonds and built maturity by maturity. The method of calculating yield by yield (from lower maturity to higher maturity) is called bootstrapping and there is a relationship between yields of different maturities, unlike YTM where yields for different maturities can be obtained independently. Additionally, for pricing and calculating par yields the zero coupon discount factors are useful and for forward yields zero coupon yields are useful.

Par yield: This is used to test the market, to compare loan and bond cash flows since both have the same redemption value (face or par value) and to compare swap rates. Par yeild can be mathematically expressed as follows:

$$\frac{(1 - Zero - Coupon\ Discount\ Factor_n)}{\sum_{t=1}^{n} Zero\ Coupon\ Discount\ factors}$$

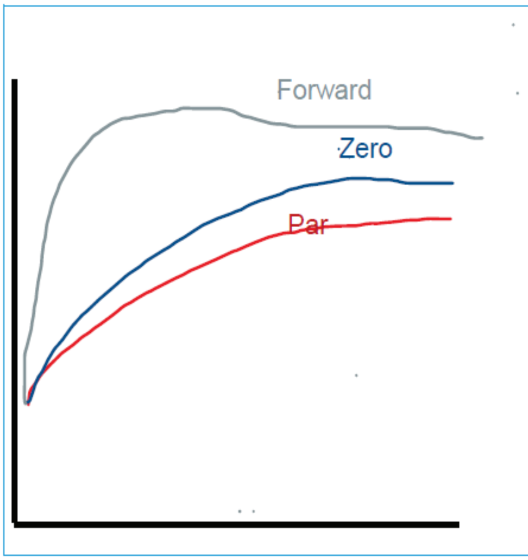
Forward yield: Forward interest rate can be denoted $f(t,\tau,T)$ and can be derived using the following generic formular.

$$f(t,\tau,T) = \left(\frac{(1 + z(t,T))^{T-t}}{(1 + z(t,\tau))^{\tau-t}} \right)^{\frac{1}{T-\tau}} - 1$$



Where:
$Z(t,T)$ = Zero coupon yield rates
t = current time
τ= starting point of the forward contract and
T= maturity of the forward contract

Figure 6: Yeild curves



Type	Description
Yield to maturity (Redemption Yield)	• Commonly encountered in markets • Used in analysis and pricing activity • Assumes constant rate of reinvestment
Par yield	• Par yield = coupon rate • Used in primary market to determine the required coupon for a new bond to be issued at par • Determined from the spot yield curve by iteration
Zero (Spot)	• Liquid zero-coupon (e.g. T-bills) • Rare for longer dated instruments • Can be derived from yield to maturity curve or par yield curve • Term structure of interest rates • No reinvestment risk, therefore ideal to use in relative value analysis • Used in deriving implied forward rates
Forward	• Zero yield is the geometric mean of the forward rates • Plot of forward rates against term to maturity

Yield curve snapshot showing the relationship between yield and maturity (should consist of fixed income securities with the same or similar risk profile) and its general application is given in Figure 6, below.

The yield curve shows the relationship between maturity (on X-Axis) and Yield (Y-axis) and can be drawn for types of yields, yield to maturity (YTM), zero coupon, par and implied forwards. Since yields are not available for all maturities, mathematical approaches are utilized to find the missing data – hence the expression "yield curve fitting". The mathematical methodologies are used to:

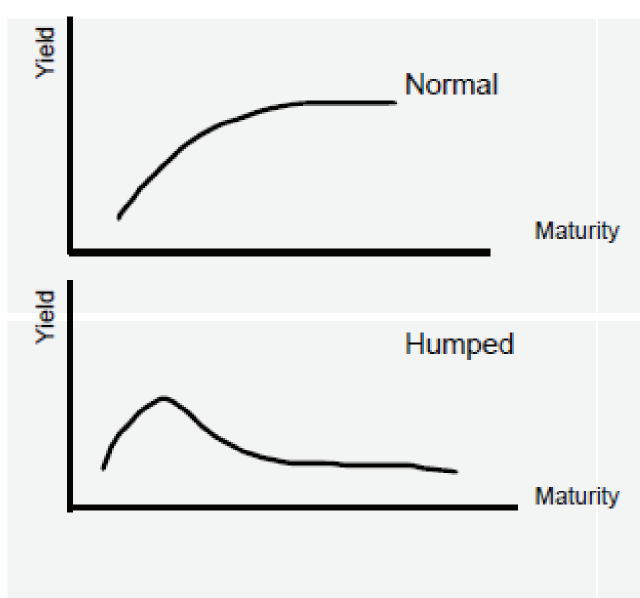
(i) *interpolate* (calculating missing data in between observed yields), and
(ii) *extrapolate* (to find yields beyond that can be observed)

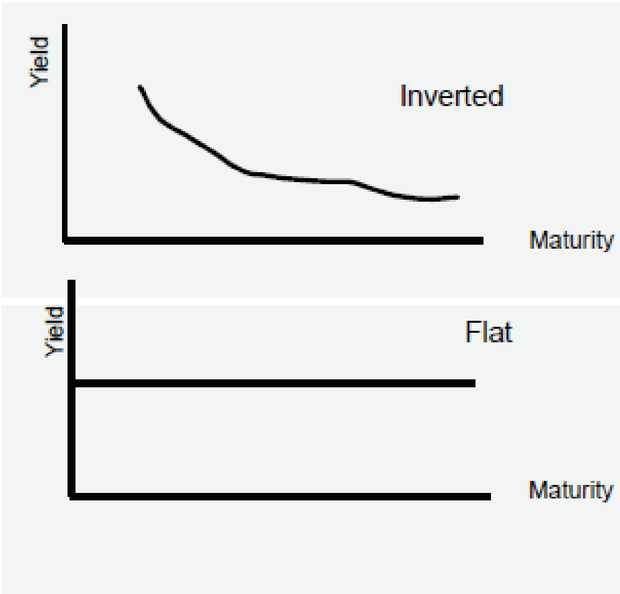
A common (albeit simplistic) approach to yield curve fitting would be to use polynomial functions. The equations for linear, quadratic and cubic are given in Figure 7, below.

Figure 7: Equations

Type	Polynomial and Exponential Equations
Linear	$Y = \beta_0 + \beta_1 X + \epsilon$
Quadratic	$Y = \beta_0 + \beta_1 X + \beta_2 X^2 + \epsilon$
Cubic	$Y = \beta_0 + \beta_1 X + \beta_2 X^2 + \beta_3 X^3 + \epsilon$
Exponential	$Y = A - \beta * e^{-\frac{t}{T}}$

Note: The intercept and coefficients (ββίί) will not be the same.





Mainly:

(i) **Normal yield curve**: gently upward sloping

(ii) **Inverted yield curve**: persistent preceded economic depressions, otherwise, a short-term phenomenon (in some cases structural demand)

(iii) **Humped yield curve**: short and long similar with medium term higher (structural demand)

(iv) **Flat yield curve**: within the two extremes (limited market activity)

Apart from the normal curve, all the other curves show uncertainties and market distortions.

It is useful to construct yield curve regularly (preferably based on zero-coupon) for analyzing the changes in market segment preferences along the curve (short, medium and long), for analyzing factors underpinning significant changes, forecasting purposes on yields and prices and setting the baseline (reference) for other issuers (corporate bonds).

When considering the yield curve, it is essential to assess market data collected from both primary and secondary market, zero coupon by converting interest bearing securities into zero coupon, if zero-coupon is not sufficiently available use other yields, and constructing the yield curve preferably weekly or at least once a month.

6 Liability management operations as a tool

6.1 Originally, liability management has been used as a risk management tool, given it affects the structure of the debt, which in turn affects the risk of the debt. However, as at present, this mechanism is used for a range of additional functions, such as cost savings, or investor diversification. Five main functions of LMOs are to

(i) ***Increase liquidity in government debt markets:*** This supports the creation of benchmark bonds, retire debt with short remaining time to maturity and would assist in enhancing price transparency

(ii) ***Manage risks in the debt portfolio:*** This would help reduce refinancing and interest rate risk and the currency risk.

(iii) ***Reduce the cost of new funding:*** Cost effectiveness will depend on market conditions and buying back or exchanging debt can incur transaction cost, but retiring old debt and issuing new liquid benchmarks can be cost effective depending on market pricing. The balance between the two will determine whether the exercise has cost benefits.

(iv) ***Correct market distortions***

(v) ***Stabilize the market during stressed periods***

6.2 Accordingly, liability management is the process of ‘reprofiling’ the existing debt to using market-based mechanisms that affect the composition of the debt portfolio. This will help manage refinancing and liquidity risks, provided there is no additional funding. The main mechanisms of liability management are:

(i) ***Bond Buybacks:*** Enable issuers to retire an outstanding debt before its maturity against a cash payment

(ii) ***Bond Exchanges:*** Achieve the same result in combination with the issuance of new debt

Advantages and disadvantages of the above mechanisms are given in Figure 8, below, in brief.

- the law governing debt management should include bond buybacks and exchanges among authorized transactions, and
- that indicates all the objectives for which it could be used, ideally as a guideline, at the discretion of the debt manager

(iii) Institutional Set-up is essential where the debt management office should have the authority to decide on the securities to be retired from the market, the appropriate mechanism to do so and the pricing.

Figure 8: Advantages and disadvantages of mechanisms

	Buybacks	Exchanges
Advantages	▪ Simplicity ▪ Wider investor base	▪ Typically cash neutral
Disadvantages	▪ Creates financing need	▪ More complex ▪ Requires a concurrence of needs with the investor

6.3 There are certain pre-conditions to implement liability management operations.

(i) The issuer has to have:

- a debt management strategy to define the desirable adjustments in the debt portfolio
- an issuance strategy to provide a framework for the execution of the transactions, and
- There has to be at least an embryo of activity in the secondary market (SM) to be able to execute the transactions.

(ii) There should be an effective legal framework:

6.4 There are certain risks emanating from implementing liability management operations, as well. Amongst, the risk of market manipulation / collision, market risk (where movement of market prices between buy back and new issuance may vary), reputation risk from an unsuccessful operation, and illiquidity of source stock are important to be considered.

6.5 However, implementation of LMOs would impact the government budget in the following manner.

(i) The net of the annual coupon saved on the old bond and payable on the new bond is a saving on the national budget. Therefore, the buyback of an old bond with a high coupon will narrow the budget deficit (while increasing the amount of the debt.

(ii) If paying a premium for the old bond an additional expense may have to be budgeted (in accrual budgeting) where the usual practice for premium/discount on new bonds that might let the government to capital gain/loss.

7 Conclusion

Countries regularly borrow to fulfil various of its functions. Management of public debt in a sustainable manner is crucial for a country such as Sri Lanka to overcome many fiscal, monetary and financial distresses that stem from its unsustainability. The methodologies as briefly described above, and the quantitative techniques used to monitor debt levels and the associated risks would be some useful procedures to be considered by any public debt management office. Amongst, (a) giving due consideration to calculating risk factors associated with raising and servicing debt such as credit, liquidity, market and refinancing risks using established quantitative techniques, and (b) actively exercising liability management operations to smoothen the debt levels in a sustainable manner, are imperative in raising and managing risks pertaining to sovereign debt. These will eventually support the governments to develop its securities markets and enhance the credibility of an as issuer.

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Monetary and Fiscal Policy Coordination in Sri Lanka

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1 Introduction

Complex and challenging, yet essential relationship between the Central Bank of Sri Lanka[1] (hereinafter referred to as 'the Central Bank') and the Government was recognized at the very inception of the Central Bank. The 'Report on the Establishment of a Central Bank for Ceylon', commonly called 'the Exter Report', provided the basis and rationale for the enactment of the Monetary Law Act No. 58 of 1949 (MLA)[2], under which the Central Bank was established on 28 August 1950.

The following is an excerpt from the explanatory note in the Exter Report on the Constitution of the Monetary Board.[3]

> "… The ideal which is hoped that the proposed law will achieve is one in which there will be continuous and constructive co-operation between the Monetary Board and the Government. The principal instrument for achieving this co-operation should be the Permanent Secretary to the Ministry of Finance whose membership in the Board will ensure at all times that his Minister's views will be made known to the other members of the Board. The effectiveness of this co-operation and co-ordination between the Board and the Government will depend more upon the men occupying the key positions at particular times than upon any legal formula, no matter how carefully or elaborately it might be worked out. A relationship as complex and sometimes as delicate, as this one is certain to be, cannot be established full-blown by a piece of legislation. It must be the result, as in other countries, of years of experience and the slow growth of political conventions…"
>
> (Exter, 1949)

Therefore, it is evident that the importance of monetary and fiscal policy coordination – 'monetary-fiscal coordination' for simplicity – was recognized at the very inception of the Central Bank, more than 7 decades ago.

On the contrary, what can be the repercussions of not having an adequate level of monetary-fiscal coordination? In such a scenario, a weak policy approach in one policy domain can adversely affect the effectiveness of the other policy area. For instance, against its own best interests, a lax fiscal policy may necessitate a stricter monetary policy, even though the latter may not be able to entirely address the fiscal imbalances. So, in the long run, persistent inconsistencies in the overall policy framework could diminish the effectiveness

1 Initially established as the Central Bank of Ceylon and subsequently renamed as the Central Bank of Sri Lanka in 1985

2 The MLA was enacted on 25 November 1949.

3 Refer to Section 8 of the Exter Report

of each policy. Therefore, monetary and fiscal coordination is important for macroeconomic stability and growth, especially during economic shocks (Laurens & Piedra, 1998).

Having recognized the importance of the monetary-fiscal coordination at the inception of the Central Bank, the MLA facilitated it by making the Permanent Secretary to the Ministry of Finance a member of the Monetary Board. The Monetary Board was primarily responsible for the determination of monetary policy as per the MLA. However, the MLA also assigned the responsibility of managing public debt to the Central Bank as the fiscal agent of the Government.[4] This dual role assigned to the Central Bank further heightened the necessity for monetary-fiscal coordination.

Since its enactment in 1949, the MLA was amended several times. For instance, the objectives of the Central Bank were streamlined to secure economic and price stability, and financial system stability. The composition of the Monetary Board was expanded with the inclusion of three members appointed by the President on the recommendation of the Minister of Finance, with the concurrence of the Constitutional Council. Meanwhile, notwithstanding periods of headwinds, the Central Bank continued to discharge its debt management agency function on behalf of the Government.

However, chronic fiscal imbalances that exacerbated with the Covid-19 pandemic pushed the public debt to unsustainable levels by 2022. Meanwhile, sovereign rating downgrades mainly driven by substantive tax cuts and deteriorating fiscal outlook, restricted accessing international capital markets to rollover maturing external debt. Reflecting the weaknesses in the MLA that allowed fiscal dominance, the government resorted to large scale monetary financing to meet fiscal obligations, thereby contributing to an escalation in inflation. The resulting recession and the onset of the socio-economic crisis in 2022 prompted the urgent implementation of long-overdue economic reforms (International Monetary Fund, 2023).

In March 2023, the Government of Sri Lanka entered into an Extended Fund Facility arrangement with the International Monetary Fund (IMF-EFF). Aimed at supporting Sri Lanka's economic policies and reforms, one of its key objectives was restoring Sri Lanka's macroeconomic stability and debt sustainability. In line with this objective and as a part of strengthening the institutional framework of the economy, the requirement of a new Act that would support the Central Bank's operational autonomy was recognized.

This new Act was expected to prevent any form of government representation or participation on the Governing Board or Monetary Policy Board and prohibit the Central Bank from providing monetary financing and from making primary market purchases of treasury securities, except under exceptional circumstances. Having received the Parliamentary approval on 20 July 2023, the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBSL Act) was enacted in September 2023 repealing the MLA. The CBSL Act strengthens the independence of the Central Bank while putting in place several arrangements to ensure the continuation of monetary-fiscal coordination.

Several legislative reforms on the fiscal front were also initiated. Among these, the Public Debt Management Act, No. 33 of 2024 (PDM Act) was passed in Parliament in June 2024. The Public Debt Management Office (PDMO) was established on 02 December 2024 under the PDM Act. The PDMO is expected to be fully operationalized within 18 months from the appointed date of the PDM Act, i.e., 18 November 2024. Once the PDMO is fully operational, the Central Bank is expected to relinquish its debt management agency function. Thus, the country's debt management landscape is currently going through a significant transition.

4 Refer to Section 113 of the MLA

Even though monetary financing has ceased, and the debt management function has been taken away from the Central Bank, the relevant provisions in the CBSL Act and the PDM Act ensure continuous coordination monetary-fiscal coordination. Accordingly, these provisions ensure that no undue pressure is exerted on macro variables such as interest rates, financial system stability is maintained, and the Government is adequately supported during economic shocks.

Against this backdrop, the next section examines the dynamics of monetary-fiscal coordination in relation to the relevant recent legislation, and from the viewpoint of the Central Bank in particular.

2 Monetary-Fiscal Coordination in the period ahead

In this Section, we examine the monetary-fiscal coordination under the CBSL Act and the PDM Act, in the period ahead.

2.1 The CBSL Act

The IMF in March 2023 noted the requirement to strengthen the Central Bank's independence under the broad objective of Restoring Price Stability and Rebuilding External Buffers (International Monetary Fund, 2023). The new CBSL Act, enacted in September 2023, introduced several reforms that would enhance the independence of the Central Bank. Meanwhile, several key measures have been incorporated into the CBSL Act to ensure the continuation of the monetary-fiscal coordination while preserving the Central Bank's independence.

2.1.1 Establishment of a Coordination Council

A Coordination Council (CC) has been established under the provisions available in the CBSL Act.[5] The main objective of the CC is to coordinate the Fiscal, Monetary, and Financial Stability policies. Chaired by the Governor of the Central Bank, the CC consists of the Secretary to the Treasury (ST), and the Secretary to the Ministry of the Minister assigned the subject of Economic Policy, if the subject of Economic Policy is assigned to a Minister other than the Minister of Finance. The CC is required to meet quarterly to share information and exchange views on recent macroeconomic developments, outlook, and risks.

It is noteworthy that the CC does not have any authority to make decisions over the fiscal, monetary, and financial stability policies. Notwithstanding this, the CC is expected to provide a constructive, concise, and formal platform for the monetary and fiscal policy authorities to engage with each other at the highest level. The Chairperson of the CC can call for an emergency meeting to share information and exchange views on matters or circumstances that pose a significant risk to financial stability, or that are expected to have a substantial adverse effect on economic activity. This policy coordination at the highest level would facilitate the authorities to form a collective and swift response on matters of national interest, through ironing out of any differences expeditiously.

As elaborated in the Exter Report and discussed earlier, the intention of including the ST in the Monetary Board was to ensure the coordination between monetary and fiscal policies. Any lacuna in monetary-fiscal coordination that would have otherwise arisen with the removal of any Government representation from the Governing Board established under the CBSL Act, is avoided with the formation of the CC. This is while ensuring that the policy independence of the Central Bank - a key parameter not only in its fight against inflation but also in achieving stable long-term economic growth - is not compromised (Adrian, T, 2024). As such, the CC is expected to act as a cornerstone in monetary-fiscal coordination in line with the broader well-recognized objective of strengthening the independence of the Central Bank, going forward.

5 Refer to Section 83 of the CBSL Act

In addition to the platform provided by the CC, the Central Bank is empowered to exchange views with the Government and any other public authority on policies relating to monetary, foreign exchange operations, financial system stability, crisis prevention and crisis management and fiscal matters[6]. This is while ensuring the autonomy, accountability, and objectives of the Central Bank are not prejudiced. Moreover, the Central Bank and the Minister of Finance shall keep each other fully informed of all matters that affect the functions of the Central Bank and the Ministry of Finance.

2.1.2 Cessation of Monetary Financing

A contentious point in the monetary-fiscal dynamics has been monetary financing, the financing of government via money creation (Agur, Dell'Ariccia, & Sandri, 2022). In the Sri Lankan context, the Government issued Treasury bills to the Central Bank to cover auction shortfalls, if the Treasury could not finance such shortfall through the market issuances. Further, the Government's urgent funding requirements were also accommodated through special issuances of Treasury bills to the Central Bank. These issuances were accommodated through the provision in the MLA, where the Central Bank could make direct tenders for Treasury bills and maintain adequate holdings of short-term securities to conduct open-market operations.[7] Securities such purchased were used for liquidity management purposes through open market operations.

However, during the Covid pandemic and the period leading to the economic crisis, monetary financing reached unprecedented levels. The IMF highlighted that the Central Bank's primary Treasury bill market purchases and special issuances to finance the budget deficit since 2020 reached 14 percent of 2021 GDP as of December 2022. It further noted that the large-scale monetary financing compromised the Central Bank's operational independence and jeopardized its price stability mandate (International Monetary Fund, 2023). As of end of August 2022, the Central Bank's holding of government securities increased to Rs. 2,258.1 billion, recording a substantial increase compared to the end of 2020 holding of Rs. 725.2 billion. In August 2022, well before the enactment of the CBSL Act, the Central Bank began downscaling monetary financing and put in place plans to offload its Treasury bill holdings.

Monetary financing was prohibited under the CBSL Act.[8] Concurrently, the Central Bank agreed with the Government to restructure its Treasury bill holding and the advances it had provided to the Government as a part of the Domestic Debt Optimization (DDO) Programme. Accordingly, on 14 September 2023, Treasury bills held by the Central Bank and Provisional Advances made by the Central Bank to the Government amounting to Rs. 2,492.3 billion were converted into Treasury bonds maturing up to 2038. In addition, Treasury bill maturities amounting to Rs. 220.8 billion were also extended under the DDO programme. Meanwhile, to maintain orderly market conditions under the scenario where the Government could not access monetary financing, the Central Bank facilitated the building up of cash buffers of the Treasury at opportune times to mitigate any unwarranted interest rate pressures in the government securities market.

The CBSL Act provides for the Central Bank to purchase government securities from the secondary market and maintain an adequate stock of such securities.[9] The CBSL Act has also considered a situation where the Government may require substantive funds to manage a critical situation, urgently. Accordingly, notwithstanding the general rule, in the interests of Public Security

6 Refer to Section 84 of the CBSL Act

7 Refer to Sections 90 and 112 of the MLA

8 Refer to Section 86 of the CBSL Act. However, as per Section 86(5) of the CBSL Act, this prohibition does not apply under certain pre-defined exceptional circumstances.

9 Refer to Section 86(4) of the CBSL Act

and the preservation of public order, or a global health emergency that substantially and materially disrupts or constraints access by the Government to market funding, the Central Bank can purchase Treasury bills from the primary market. However, such purchases are subject to several checks and balances and cannot exceed 5 percent of the approved Treasury bill limit applicable for the respective financial year.[10]

Cessation of monetary financing strengthens the Central Bank autonomy and empowers its price stability mandate. It also induces prudent cash flow management at the Treasury. Moreover, the cessation of monetary financing eliminates a hitherto contentious point in monetary-fiscal dynamics. Thus, it may pave the way for a more constructive phase of monetary-fiscal coordination, going forward.

2.2 The PDM Act

The Government obtained extensive technical assistance from the IMF and the World Bank to draft the PDM Act. This was mainly due to the novelty of the concept of a debt office in the Sri Lankan context. The Central Bank contributed to the drafting of the Act by providing input on various aspects related to its debt management functions.

2.2.1 Establishment of the Public Debt Management Office (PDMO)

The PDM Act was passed in the Parliament on 18 June 2024. The 'appointed date'[11] of the PDM Act was required to be within 6 months from the passage of the Act.[12] The Minister, by order published in the gazette, declared 25 November 2024 as the appointed date of the PDM Act, the date on which the provisions of the PDM Act shall come into operation. The PDMO was established under the provisions of the PDM act on 02 December 2024.

10 Refer to Section 86(5) of the CBSL Act

11 The appointed date is the date on which a piece of legislation comes into force

12 Refer to Section 1(4) of the PDM Act

Meanwhile, the Central Bank shall continue to act as the agent of the Government,[13] until such date as the relevant law relating to public debt management agency or office comes into operation.[14] However, the PDM Act provides that the applicability of the above clause of the CBSL Act shall come into operation on such date as the Minister of Finance may by Order published in the Gazette appoint within 18 months from the appointed date. In summary, the PDMO is required to be operational within 18 months from the appointed date of the PDM Act, i.e., 25 November 2024.

Once fully operational, the PDMO is expected to centralize all functions related to debt management which are currently scattered across the Central Bank and various departments within the Ministry of Finance. The Central Bank is expected to relinquish its debt management agency function with the full operationalization of the PDMO and is currently engaged in the process of ensuring a seamless transition its debt management functions to the PDMO. However, the maintenance of the registry of government securities is likely to be continued at the Central Bank.

2.2.2 Public Debt Coordinating Committee

A Public Debt Coordinating Committee (PDCC) has been established under the PDM Act.[15] The PDCC consists of nine members, two of which will be from the Central Bank. It is be chaired by a Deputy Secretary to the Treasury, with Director Generals of the departments of Treasury Operations, Fiscal Policy, External Resources, National Budget and Public Enterprises, and the Director-General of the PDMO making up the Treasury representatives. The two Central Bank officers will be at the rank of Director level or above, as nominated by the Governor. All PDCC members shall be appointed by the Minister.

13 This shall be limited only in respect of the issuance of securities of the Government for the account of the Government and in respect of the management of public debt

14 Refer to Section 132 of the CBSL Act

15 Refer to Sections 8, 9 and 10 of the PDM Act

The PDCC is expected to ensure the consistency of the debt management strategy with macroeconomic policies by reviewing and opining on the debt management strategy and its updates prepared by the PDMO. It is also expected to review and opine on the annual borrowing plan and its performance, review domestic and international market conditions, and provide recommendations on the risks associated with public debt and opportunities in the market and on official development assistance.

2.2.3 Issuance of Government Debt Securities for the Implementation of the Monetary Policy Objectives

The PDM Act provides for the issuance of Government debt securities for the implementation of the monetary policy objectives.[16] Such issuance would take place only if requested by the Central Bank and explicitly for monetary policy implementation purposes. The proceeds of such issuances are kept aside in a separate account at the Central Bank to be repaid at the maturity of securities issued. This ensures that monetary financing does not happen through this operation. The interest cost of such issuances is required to be borne by the Central Bank and these issuances are not considered for the gross borrowing limit of the Government.

2.2.4 Appointment of Primary Dealers and Regulation, Supervision, and Monitoring of Primary Dealer Activities

Broadly speaking, the role of Primary Dealers (PDs) is to facilitate the distribution of government securities while contributing to the development of the domestic debt market (Speian, 2022). In the Sri Lankan context, PDs along with the Employees' Provident Fund have been given the exclusive right to directly bid at the primary issuance of government securities. The Central Bank appointed primary dealers (PDs) under the relevant provisions in the Registered Stock and Securities Ordinance No. 7 of 1937 (RSSO) and the Local Treasury Bills Ordinance No. 8 1923 (LTBO), and relevant amendments thereof. Further, the regulation, supervision, or monitoring of PDs concerning their transactions in securities and the performance of their duties as PDs were also carried out by the Central Bank.[17] As of the end of July 2024 there were 10 active PDs consisting, 5 bank affiliated PDs and 5 standalone PDs.

With the operationalization of the PDM Act, the appointment of PDs will be carried out by the Minister, on the recommendation of the Central Bank.[18] The main role of a PD is bidding at primary auctions for government securities. Primary auctions expected to be conducted by the PDMO upon its operationalization. Thus, it may be appropriate for the Minister to be the appointing authority of PDs in such a scenario. Further, the Central Bank is required to inform the Minister of any non-compliance of any legal or regulatory requirements by a PD, which may constitute a ground for cancelation or suspension of its appointment as a PD irrespective of its performance of duties as a PD.

On the other hand, a PD is a financial institution operating in the wider financial market that includes deposit-taking institutions like banks. Moreover, the PDs have access to the Open Market Operations and the Standing Facilities conducted by the Central Bank for liquidity management purposes. As such, existing PDs appointed under the LTBO and RSSO, and any new PDs that may be appointed under the PDM Act will continue to be regulated, supervised, and monitored by the Central Bank. This is in recognition of the responsibility of ensuring the financial system

16 Refer to Section 14 of the PDM Act

17 Refer to Section 21C of the RSSO (incorporating Amendments up to 31 December 2004) and Regulations made by the Minister of Finance under Section 16 of the LTBO (Chapter 420) as last amended by Act No.31 of 1995

18 Refer to Section 31 of the PDM Act

stability that is entrusted with the Central Bank. As such, a practical arrangement built on a coordinated monetary-fiscal approach seems to have been reached in relation to the appointment of PDs and the regulation, supervision, and monitoring of PD activities, going forward.

3 Conclusion

Any lacuna in policy coordination that may have arisen with the removal of the Secretary to the Treasury from the Governing Board post-enactment of the CBSL Act, has been addressed through measures in both the CBSL Act and the PDM Act. The CC established under the CBSL Act provides a platform for engagement between monetary and fiscal authorities at the policy level. The CBSL Act also ensures the maintenance of the envisaged monetary-fiscal coordination without compromising the operational autonomy and objectives of the Central Bank. Meanwhile, once the PDMO is operationalized as envisaged, the PDCC will ensure monetary-fiscal coordination at a more operational level.

When taken together, the mechanisms made available under the CBSL Act and the PDM Act are expected to facilitate a more streamlined, efficient, and robust level of coordination between monetary and fiscal authorities, going forward. This is while preserving the interests of both parties yet not encroaching upon each other's policies. As such, the monetary-fiscal coordination envisaged in the Exter Report at the inception of the Central Bank will continue, albeit within a revamped and streamlined institutional framework that is more compatible with the contemporary economic landscape.

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Structural Features of Green Bonds and its applicability for Pension Funds

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Background

The present capital markets are eternally seeking more avenues to attract funds from investors and the issuance of financial instruments with Green Initiatives plays a prominent role in this regard. The Green Bonds is a subset of Impact Bonds (i.e., green, social, sustainability and sustainability linked). In relation to Debt instruments with an emphasis on maintaining the green initiative, Green Bonds have evolved as an attractive source of investment in many nations.

The total Green Bond issuance was reported around USD 583 billion in 2024. The issuers of Green Bonds have predominantly been the Government and a total of USD 190 bn Green Bonds have been issued by Governments in 2023. The purpose of this article is to provide a brief insight into the Green Bonds and its structural features and to assess its applicability as a source of investments for pension funds.

Introduction to Green Bonds

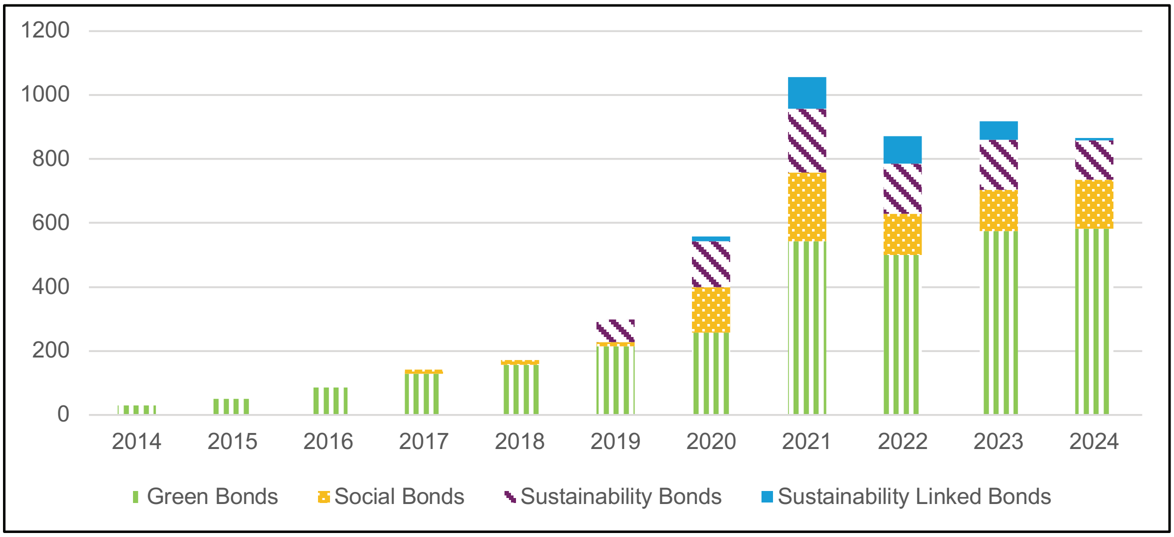
The simple definition for Green Bonds would be, Debt instruments issued for the purpose of financing projects that have a positive environmental impact. These can be issued by Governments, Organizations and Companies and can be used to help funding environmental and sustainable projects related to renewable energy, energy efficiency, sustainable waste management, biodiversity conservation, and clean transportation, among others.

Green Bonds have similar characteristics to other bonds and hence share the pricing mechanism similar to any other bond. These bonds can contribute towards renewable energy (such as wind, hydro and solar), recycling efforts, clean transportation and sustainable forestry. The investors of Green Bonds are not individual investors and Green Bonds are usually sold to institutional investors like pension funds that can buy bonds in bulk.

The first issuance of Green Bonds was recorded in 2007. The slow and steady growth of the Green Bond market was aided by the Global green initiatives such as the Paris Agreement on climate change and the UN Sustainable Development Goals.

Figure 1 depicts the yearly supply of impact bonds, which reflects the fact that the issuance of Green Bonds dominate in the issuance of impact bonds in every year. The Governments function as the main issuer of Green Bonds and Europe has been the main region which has been involved in the issuance of Green Bonds.

Figure 1 : Yearly Supply of Impact Bonds (USD Bn)



In consideration of this novel financial product, Bloomberg has constructed the Global Aggregate Green, Social and Sustainability index (GSS Index) which provides investors with an objective and robust measure of the global market for fixed income securities issued to fund projects with direct environmental/social benefits.

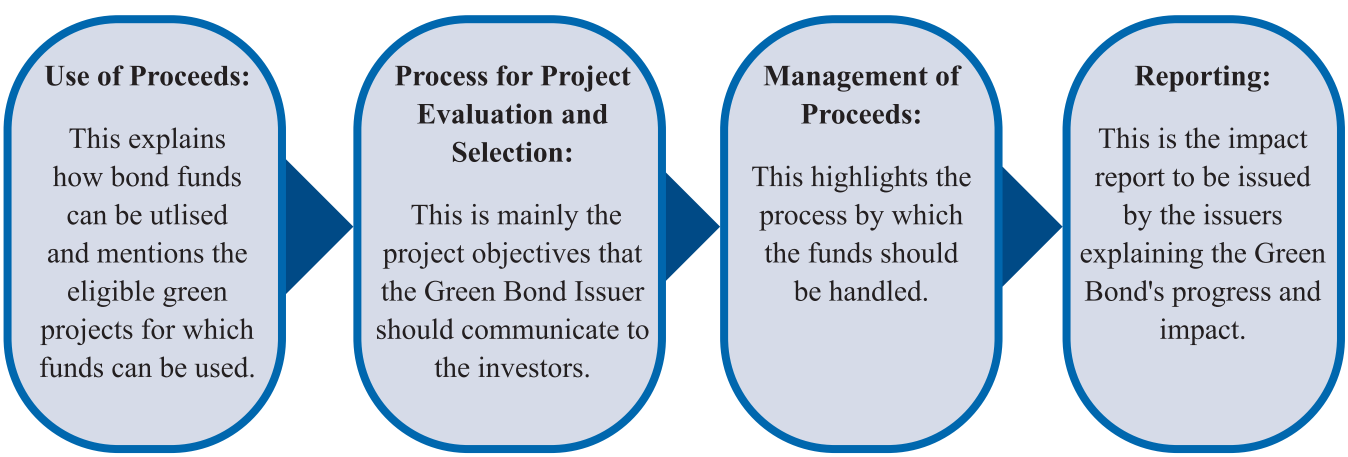
Green Bond Principles

The principles issued by the International Capital Market Association (ICMA) to enable more transparency in the market are as follows;

Globally many corporates have issued Green Bonds with the intention of raising finance for more environmentally friendly projects. Some classic examples of them are as follows;

- Walmart in 2021 issued its first Green Bond worth of USD 2 billion with the green objectives of enhancing energy efficiency, waste recycling and water conservation.
- Apple in 2020 initiated in the provision of Finance for 17 Green Bond projects, which have targeted in preventing the

Figure 2: The Principles issued by ICMA in relation to the issuance of Green Bonds



release carbon emissions. Further to this, this project also intends to finance a solar power development that delivers energy to the grid, and a wind farm near Chicago that facilitates Apple's electricity use in that region.

- ❖ Volkswagen issued a Green Bond in September 2020 with the expectation of funding the manufacture of Electric cars and the establishment of an e -charging station infrastructure.

Greenium

Green Bonds in general offer a slightly lower return compared to other debt instruments. This price difference between Green Bonds and conventional bonds is known as "Greenium". Research has proved that Green Bonds in general offer 0.15-0.20% lower than normal conventional bonds. The main reasons for the low return are that Green Bonds are offered to sustainable investors whose main objective would be to preserve nature and engage in environmental and social benefits and the perceived lower risk of default in Green bonds in comparison with other conventional bonds. However, in the longer term the yields of the Green Bonds are expected to converge to conventional bonds resulting from the growth of the Green Bonds. This is primarily because the increased supply of Green Bonds would reduce the prices thereby exerting an upward pressure on yields.

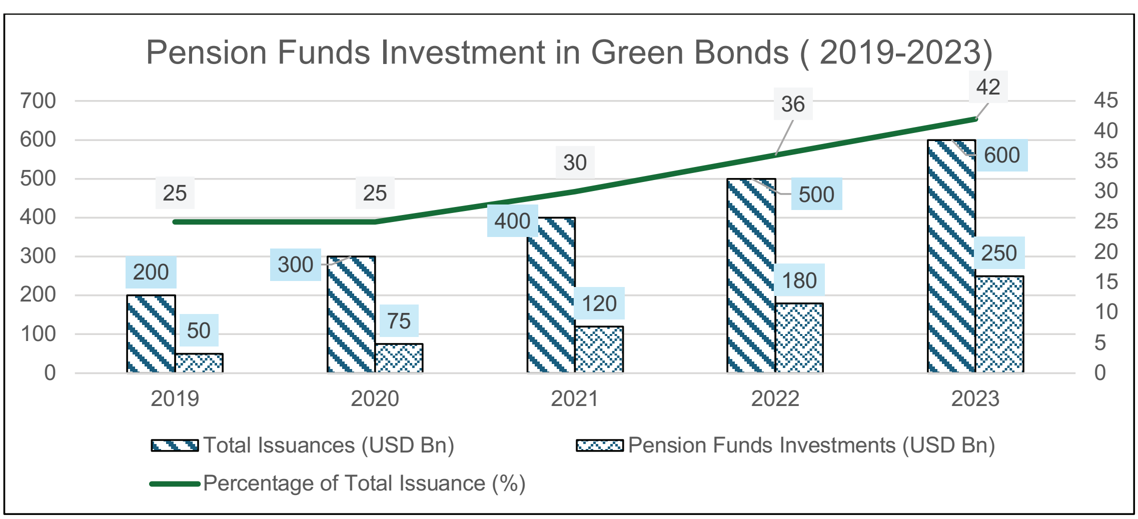
Green Bonds as an alternative asset class for Pension Funds

Investments that Pension Funds have made in Green Bonds have grown from USD 50 bn to USD 250 bn during the past 5 years and as a percentage of the total issuances this has grown from around 25% to 42%. This therefore indicates a steady growth of the pension funds investments in the Green Bond market.

Examples of Pension Funds Investing in Green Bonds

- CalPERS (California Public Employees' Retirement System): Considerable investment has been made by CalPERS in investments in green bonds as part of its sustainable investment strategy.

Figure 3 : Pension Funds participation in the issuance of Green Bonds



Source: Articles written on Green Bonds and Bloomberg

- ABP (Dutch Civil Servants Pension Fund): With the objective of being committed to reduce carbon emissions in its investment portfolio, ABP has invested heavily in green bonds.

- Norway's Government Pension Fund Global (GPFG): GPFG has increased its investment in Green Bonds aligning with its strategy to reduce the carbon footprint of its portfolio.

- California State Teachers' Retirement System (CalSTRS): CalSTRS has substantial portion of new investments directed towards green bonds.

- Canada Pension Plan Investment Board (CPPIB): CPPIB expanded its green bond portfolio, focusing on bonds issued for renewable energy and sustainable infrastructure projects.

- The EPF of Malaysia is currently taking initiatives to invest in Green Bonds to support its target of being 100% compliant with its Environmental, Social and Governance principles (ESG) by 2030 and to be compliant with its objective of achieving carbon neutrality by 2050.

Europe has been one of the main regions that have attracted many pension fund investors to invest in Green Bonds. In the Asian region the Singapore Government continues to issue Green Singapore Government Securities (Greeb SGS) to finance major, long term green infrastructure projects.

If Green Bonds are very much similar in terms of the pricing and return generation, the question arises why a pension fund should draw attention on investing in a Green Bond as an alternative asset class. The reasons being;

- **Opportunity to engage in more responsible investing-** Investments made in Green Bonds facilitate pension funds in being part of Sustainable and Responsible investing (SRI) and to incorporate Environmental, Social and Governance (ESG) criteria in their Investment Decision making process. Application of SRI and ESG guidelines as an investment criterion adds more value in fostering more sustainable investments as pension funds act as the main source of post-retirement wealth.

- **Applicability of the Investment Horizon-** Green Bonds often invest in projects with a long term time horizon, being compatible with the goals of pension Funds.

- **Generation of competitive returns -** The 2023 return for the Green, Social and Sustainability (GSS) index is 9.94%, some 423 bps above that of the Global Aggregate Bond Index, highlighting increased returns for investors with an appetite for sustainability-focused investment. Hence, a competitive return similar to traditional bonds can be made through the investments made in Green Bonds.

- **Tax Incentives -** Green bonds may offer tax incentives in the form of tax exemption and tax credits.

- **Reputational Benefits-** The pension funds who have invested in Green Bonds are perceived to have engaged in Socially Responsible Investing (SRI), and hence would gain a reputational benefit from the investments made.

- **Opportunity to minimize the Risks-** Financial Risks arise due to climate changes. Since, Green Bonds are aimed at investing in environmentally friendly projects it assists in the combat of the risks arising from climate changes.

- **Regulatory Support-** Green Bonds become an attractive source of investment due to increased regulatory and policy support for sustainable financing.

- **Adherence with the Member expectations-** Members of the pension funds would increasingly demand investments to be made in Green Bonds due to their increased popularity.

Governance Framework for Green Bonds under the Sri Lankan Context

The CSE at present has formulated the following listing rules in relation to Sustainable Bonds. These can be considered when assessing the issuer of Sustainable Bonds.

In accordance to that an entity seeking to issue Sustainable Bonds shall, in addition to the requirements stipulated in Rule 2.2.1 of the Section 2 (Please Refer https://cdn.cse.lk/pdf/listing-rules/Section-2-Updated-as-at-Jan-2024.pdf for more details) should satisfy the criteria set out below:

a. Funds raised through the issuance of Sustainable Bonds shall be fully utilized to finance or re-finance new and/or existing eligible Sustainable Projects as per the International Standards on Sustainable Bonds (hereinafter referred to as 'Sustainable Bond Standards') accepted by the Exchange which are stipulated in Rule 2.2.1 (l)(b) below.)

b. The Entity seeking to issue Sustainable Bonds shall adhere to at least one (01) of the following International Sustainable Bond Standards.

   (i) Principles issued by the International Capital Markets Association with regard to Green and blue Bonds (ICMA)

   (ii) The European Green Bond Standard (EUGBS)

   (iii) Climate Bonds Initiative Standards (CBI Standards)

c. The Entity seeking to issue Sustainable Bonds shall appoint an Independent External Verifier (hereinafter referred to as 'External Verifier') to provide an independent Assurance Statement prior to the issuance.

Further Rule 3.2, 3.3, 3.4 and 3.5 of the Section 3 of the Listing Rules (Please refer https://cdn.cse.lk/pdf/listing-rules/Section-3-Updated-as-at-Jan-2024.pdf for more details) and rule 7.6 and 7.13.3A of the Section 7 of the Listing Rules (Please refer https://cdn.cse.lk/pdf/listing-rules/Section-7-Continuing-Listing-Requirements.pdf for more details) also specify certain criteria which need to be adhered to when Listing Green Bonds.

Applicability to the Sri Lankan Context

At present the Employees' Provident Fund(EPF) (Fund Size of Rs 4.3 trillion), as the largest superannuation fund in the country and the Employees Trust Fund (Fund Size of Rs 514.33 bn) are seeking for alternative investment opportunities. With a large part of these funds being invested in Treasury Bonds, Green Bonds would be a viable investment option in consideration of the above-mentioned factors. The following can be considered in exploring the possibility of investing in Green Bonds;

1. Understand the opportunities available in the market for Green Bonds- The currencies in which the issuances are made and the issuers should be eligible for a pension fund to make investments in Green Bonds.

2. Set investment criteria- Define criteria for green bond investments, such as project types, geographic focus, and risk levels.

3. Obtain the support of experts – Work with experts in green investment to identify the green Bonds.

4. Continuous performance monitoring- regular monitoring of the performance of the Green Bonds are needed to ensure that they meet the investment objectives.

Challenges associated with investing in Green Bonds

1. The rating of the Green Bonds will depend on the credit rating of the issuer and hence will carry the same risk profile similar to the issuer. Therefore, although the Green Bond Market is developing at a rapid pace finding a high quality market opportunity can be challenging.

2. The need to ensure that the funds issued by Green Bonds are genuinely utilized for environmental wellbeing, and not for any other purpose. This is to ensure that the "Green" concept is not used merely for marketing purposes.

3. Adherence to strong measurement and reporting - Developing robust metrics to measure the environmental impact of investments and ensure transparency.

Therefore, in consideration of the above-mentioned features of Green Bonds it could be considered as a viable source of an asset class for any pension fund. However, it should be noted that if it is considered as an alternative asset class, a thorough preassessment should be conducted on the credit profile of the issuer similar to any other bond issuance along with properly implemented Risk Management guidelines.

References

International Capital Market Association (ICMA): The ICMA provides data on the issuance of green bonds globally, including trends and analysis.

Climate Bonds Initiative (CBI): CBI is a key source of information on the green bond market, offering reports and statistics on green bond issuance and investments.

OECD Reports on Pension Fund Investments: The Organisation for Economic Co-operation and Development (OECD) publishes reports on pension fund investments, including their involvement in sustainable finance.

Regulatory Bodies and Industry Reports: Various regulatory bodies and industry reports provide insights into the growing trend of sustainable investments by pension funds.

Financial News Outlets: News articles and analyses from reputable financial news outlets like Bloomberg, Financial Times, and Reuters often report on the latest developments in the green bond market.

Enhancing Corporate Governance in the Banking Industry in Sri Lanka

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1. Introduction

The financial system of a country which is comprised of regulatory authorities, financial institutions, markets, instruments, a payment and settlement system, a legal framework and regulations plays an important role in the modern economic world. It enables the financial intermediation process which facilitates the efficient flow of funds between savers and borrowers, thus ensuring the financial resources are allocated efficiently towards promoting economic growth and development. One of the major outcomes of globalization and financial liberalization in the last few decades has been that the size of the financial sector and volume of financial transactions have been increasing rapidly. An increased level of financial integration comes with higher likelihood of risk and shock transmission to all the institutions integrated into the financial system.

Financial system stability means a safe and secure financial system which is able to withstand internal and external shocks. A stable financial system creates a favourable environment for depositors and investors, encourages financial institutions and markets to function effectively and efficiently, and hence, promotes investments and economic growth. Financial instability and its effects on the economy can be very costly due to its contagion or spillover effects to other parts of the economy.

The banking sector in Sri Lanka, which comprises Licensed Commercial Banks and Licensed Specialised Banks, dominates the financial system and accounts for the highest share of the total assets in the financial system. Therefore, the health of Sri Lankan financial system depends to a large extent on the soundness of the Licensed Banks. During the last decade, the banking industry in Sri Lanka has exhibited resilience to foreign and domestic economic shocks while contributing positively to the country's economic progress amidst strong macroeconomic headwinds due to easter attack and COVID-19 pandemic.

2. What is Corporate Governance?

Corporate governance processes and practices shall be deemed to be the management framework that facilitates the conduct of the banking business in a responsible and accountable manner in order to promote the safety and soundness of the individual banks, thereby leading to the stability of the overall banking sector. Enhancing Corporate Governance in Sri Lanka's banking industry is essential to ensure financial stability, protect investors, and increase public confidence in the financial sector. Strong governance frameworks help reduce risk, promote ethical behavior, and ensure accountability in decision making, which is particularly important in the financial sector.

3. Evolution of Corporate Governance regime in Sri Lanka

Even though the term corporate governance was not utilized, the history of corporate governance dates back to the reign of kings in Sri Lanka where the governance structure was based on the caste system and the hierarchy was clearly defined. Further, the labourers belonged to the lowest levels while the land owners belonged to the highest ranks. They had their own rules and regulations to govern them.

The colonial period is also important with related to the development of corporate governance practices of Sri Lanka. Due to the establishment of corporate bodies and introduction of share trading in the country, the development of governance could be observed during the period from 1796 to 1948. This was evident by the following introduced in the said period:

- Civil Law Ordinance No. 05 of 1852 enacted to apply the Law of England on all commercial and maritime matters;
- Joint Stock Companies Ordinance No. 4 of 1861 introduced in relation to share trading;
- In 1896, Share Brokers Association was established which was renamed Colombo Brokers' Association in 1904 (CSE, 2016).
- Companies Ordinance No. 51 of 1938 was introduced and under this Ordinance, the Department of Registrar of Companies was established and its main task was licensing and regulating the corporate bodies.

The above statutes and institutions played a vital role in relation to the proper governance of corporate bodies even though they did not use the term corporate governance during the said period.

Another milestone of the development of the governance framework of Sri Lanka is the implementation of open economic policies in 1977. With that, companies were established for different business purposes and new laws and regulations were introduced including Companies Act No. 17 of 1982 which was enacted to govern the corporate bodies. As mentioned earlier, even though the term corporate governance was not used, many governance practices were incorporated in the said laws, such as disclosure requirements (e.g. disclosure of directors' age, directors' interest in contracts, payments made in connection with transfer of shares); board responsibilities; procedures of conducting shareholders' meetings and audit procedures.

Colombo Securities Exchange (GTE) Ltd was established in 1985 by amalgamating the Colombo Brokers' Association and the Stock Brokers' Association. It was a company limited by a guarantee established in terms of the Companies Act No. 17 of 1982 and licensed by Securities and Exchange Commission of Sri Lanka. Later, this was developed as Colombo Stock Exchange and it plays a prominent role in developing rules applicable to listed companies and which improve the governance structure of such companies.

Securities and Exchange Commission (SEC) was established in pursuance to the Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987. The main objectives of this Act are to create and maintain a good market to trade securities in an orderly and fair manner, to protect the interest of investors, to regulate the securities market and to ensure the professional standards in such a market. When these objectives are analyzed, it is obvious that the rationale of the above is to improve proper governance in the securities market and their participants.

Later on, Securities and Exchange Commission Act was amended by Act No. 26 of 1991, Act No. 18 of 2003 and Act No. 47 of 2009. All these Acts support the improvement of the governance practices in the equity market.

In 1995, Sri Lanka Accounting and Auditing Standard Act No. 15 of 1995 was enacted. This Act is also pivotal in creating the governance culture in Sri Lanka and the main steps taken under this include 1) Empowering the Institute of Chartered Accountants of Sri Lanka (ICASL) to develop Sri Lanka Accounting and Auditing Standards and 2) Establishing Sri Lanka Accounting Standard Monitoring Board.

In December, 1997, the first formal corporate governance code, 'The Code of Best Practices: Matters relating to Financial Aspects of Corporate Governance' was issued by ICASL. It is a land mark of the corporate governance history of Sri Lanka. In line with that report, major corporate governance principles such as the structure and responsibilities of the board of directors, the role of auditors and the rights and responsibilities of shareholders were covered in the local code. This is a voluntary code of corporate governance. Thereafter, in 2001, Institute of Chartered Secretaries and Administrators in Sri Lanka issued 'Hand Book on Corporate Governance: Principles and Guidelines to Best Practice in Sri Lanka'.

In May 2002, ICASL issued 'Best Practice on Audit Committees' which is a voluntary code of corporate governance. The duties and responsibilities of the Audit committees are clearly defined in this Code. In the same year, Central Bank of Sri Lanka (CBSL) also issued 'Code of Corporate Governance for Banks and Other Financial Institutions'. This was drafted based on the local and international initiatives of corporate governance and this code consists of 12 basic principles of corporate governance related to board; namely, the qualification of directors, chairman and CEO, the role of CEO and senior management, company secretary, directors' training/ familiarization, committee structure for board, transparency, risk management systems and prudential regulation and supervision. It is a voluntary Code of corporate governance and all the banks were requested to abide by the same in order to maintain the integrity and stability of the financial system.

In January, 2003, the Department of Public Enterprises of the Ministry of Finance issued 'Code of Best Practices in Corporate Governance for Public Enterprises in Sri Lanka'. This was developed to improve the corporate governance of public enterprises as well as the statutory bodies. In March 2003, ICASL issued the 'Code of Best Practice on Corporate Governance' by replacing their previous code issued in 1997. It appears that this code followed the Hampel Code-1998 of UK since it follows the same principles such as the role of directors, remuneration of directors, and the role of shareholders, audit and accountability which are similar to the Hampel Report.

In May 2004, SEC issued Guidelines for Listed Companies on Audit and Audit Committees. This was issued since ICASL Guide issued in 2002 was not a comprehensive one covering all the aspects of audit in terms of both depth and breadth. However, these guidelines are also not mandatory to listed companies. In March 2007, corporate governance was incorporated into the Listing Rules by Colombo Stock Exchange (CSE) with the support of ICASL and SEC. It was a mandatory set of rules and it was implemented in two stages. At the initial stage, listed companies were required to publish a confirmation in the annual report for the financial year commencing on April 1, 2007 that they comply with the corporate governance requirements set out in the listing rules. If not, they were required to give an explanation for non-compliance based on 'comply or explain' principle. At the second stage, it was mandated to comply with listing rules and required to publish an affirmative statement on compliance in the annual report relevant to the financial year commencing from April 1, 2008. This initiative could be observed as a tough initiative that was taken to improve the corporate governance culture in Sri Lanka.

In December 2007, CBSL issued two sets of Directions on licensed banks. (i.e. one is on licensed commercial banks (LCBs) and the other one is on licensed specialized banks (LSBs)). Direction No. 11 of 2007 was issued on LCBs (CBSL, 2013a) and subsequently this was amended by Direction Nos. 05 of 2008, 07 of 2008 and 03 of 2013. Furthermore, guidelines have been issued from time to time in relation to the clarification on corporate governance principles mentioned in such Directions. Direction No. 12 of 2007 was issued with regard to the corporate governance of LSBs and it was also subsequently amended by Direction Nos. 06 of 2008, 08 of 2008 and 04 of 2013 (CBSL, 2013b).

Furthermore, the enactment of the Companies Act, No. 07 of 2007 was observed as a major initiative in relation to the development of corporate governance. Many areas which promote and develop the corporate governance culture of Sri Lanka are incorporated in to the said Act.

In June 2008, ICASL and SEC jointly issued the 'Code of Best Practices of Corporate Governance'. This is also a voluntary code of corporate governance. The key aspects covered in the code are, collective responsibility of single board for the success of the company, objectivity of directors towards the interest of the company, check and balances, transparency on appointment and remuneration and effective rights of the shareholders. In July 2008, SEC issued separate guidelines for the appointment of auditors of listed companies with the objective of strengthening the effectiveness of audit functions of listed companies while enhancing the transparency, accuracy, reliability and consistency of financial reporting. Further it was expected to enhance the risk management process of listed companies through these guidelines.

In the same year, CBSL issued Finance Companies (Corporate Governance) Direction No. 3 of 2008 which is effective from January 1, 2009 with the intention to improve the corporate governance standard of registered finance companies in Sri Lanka. In 2009, Finance Leasing (Corporate Governance) Direction No. 4 of 2009 was issued by CBSL in terms of the Finance Leasing Act No. 56 of 2000 to improve the corporate governance of finance leasing companies. This Direction came into operation with effect from January 01, 2010.

In 2013, Code of Best Practice on Corporate Governance was issued jointly by ICASL and SEC (ICASL&SEC, 2013). When comparing this code with the previous code, the major amendments introduced to this edition include reporting of internal controls, risk management and responsibilities of board of directors and audit committees, requirements related to remuneration committee, the role of company secretary in relation to the corporate governance of the company, communication with shareholders and sustainability reporting.

The fifth edition of the Code of Best Practices of Corporate Governance was issued by ICASL in December 2017 (ICASL, 2017). This code was built to strengthen corporate governance in Sri Lanka in line with global developments, emerging contemporary matters of governance and challenges in capital market in Sri Lanka. Accordingly, key changes were introduced to board composition, board meetings, role of the board and audit committee charter along with the new initiatives such as related party transaction committee, requirement for reporting on cyber security and requirement for environment, society and governance under this code.

CBSL, with a view of strengthening the corporate governance processes and practices of the licensed banks, has issued Banking Act Direction No. 05 of 2024 to licensed banks with effect from 01.01.2025 (CBSL, 2024). All these Directions issued to LCBs and LSBs generally cover the principles related to 1). Responsibilities of the board, 2). Composition of the board, 3). Criteria to assess the fitness and propriety of directors, 4). Management functions delegated by the board, 5). The chairman and CEO, 6). Board appointed committees, 7). Related party transactions, and 8). Disclosure requirements.

Given the above are the major developments of the evolution of corporate governance in Sri Lanka.

4. Why is Corporate Governance important in the Banking Sector?

Corporate governance is particularly crucial in the banking sector for several key reasons as given below:

- **Ensuring Financial Stability:** Banks hold a significant portion of the economy's wealth and are integral to the financial system's stability. Effective corporate governance helps ensure that banks operate soundly, avoid risky practices, and maintain financial health, thereby preventing potential financial crises.

- **Risk Management:** Banks are exposed to various risks, including credit risk, market risk, and operational risk. Strong governance helps ensure that banks implement appropriate risk management frameworks, policies, and oversight mechanisms to mitigate these risks.

- **Regulatory Compliance:** Banks are highly regulated institutions. Corporate governance ensures that banks comply with both domestic and international regulations, such as the Basel III framework, Anti-Money Laundering (AML) laws, and other financial industry standards, which helps to protect investors, customers, and the broader economy.

- **Accountability and Transparency:** Corporate governance mechanisms, such as independent board oversight and transparent financial reporting, are essential for maintaining accountability to stakeholders (e.g., shareholders, regulators, and customers). This builds trust in the banking sector and ensures that banks are managed in the best interests of stakeholders.

- **Preventing Mismanagement and Fraud:** With banks managing large amounts of public money, corporate governance is essential to prevent unethical behavior, fraud, and mismanagement. Proper checks and balances in governance structures help detect and prevent such issues.

- **Investor Confidence:** Strong governance practices increase investor confidence by ensuring that banks are well-managed, financially stable, and operate with integrity. This can lead to more attractive investments and the ability to raise capital more efficiently.

- **Long-Term Growth and Sustainability:** Corporate governance focuses on creating a sustainable long-term strategy for the bank, rather than pursuing short-term profits at the expense of stability or customer trust. This contributes to the overall health of the banking sector and the economy.

In summary, corporate governance plays a critical role in ensuring that banks operate efficiently, responsibly, and ethically, protecting stakeholders and the robust financial system.

5. Way forward in strengthening Corporate Governance in banks

This section discusses the recommendations for improving corporate governance in Sri Lanka's banking industry under different aspects, as detailed below:

Strengthening Board Oversight: Banks should have a majority of independent directors on their boards as the independent directors bring impartial perspectives and ensure that management decisions are aligned with the interest of shareholders and other stakeholders. Further, establishing/ strengthening board sub-committees such as audit, risk and renumeration committees ensures transparency and provides specialized oversight. These committees should be led by independent directors and consist of professionals with expertise in relevant disciplines to provide effective guidelines, leadership and strategic decision making. In order to strengthen board oversight, regular training and updates on governance practices, financial regulations, risk management, etc., for board members are essential. Directors should be well-equipped to monitor financial and operational performance of the bank effectively.

Balance of Board Composition: Boards of licensed banks should comprise of balance of skills, knowledge, qualifications and experience in relevant disciplines considering the size, scale and complexity of the bank. Hence, such balance board can take better decisions, effective strategies and effectively oversight the bank's operations. Further, such diverse combination helps in identifying different type of risk exposed to the bank, leading to better problem solving and also sharing of knowledge among each other.

Promoting Transparency and Disclosure: Banks should adhere to the highest standards of financial reporting and ensure that their financial statements provide a true and fair view of their performance and financial position. Regular and transparent disclosures on risk management, financial health, executive compensation and conflicts of interest are vital. Furthermore, transparency in governance practices should be emphasized, including the disclosure of governance structures, board composition and any potential conflicts of interest.

Regulatory and Compliance Framework: CBSL plays a pivotal role in regulating the banking sector. Strengthening the supervisory role of CBSL by increasing capacity for regular audits and oversight will ensure that banks comply with national and international governance standards. Sri Lanka's banking sector should align with global best practices in corporate governance, such as the Basel III framework and recommendations from international organizations. Further, banks should establish clear codes of ethics and conduct for all employees. Regular audits to ensure compliance with ethical standards and regulations will minimize fraudulent activities and conflicts of interest.

Strengthening Risk Management Practices: Banks should implement advanced risk management systems that assess and mitigate financial, operational, credit and market risks. This includes adopting early warning systems to detect potential financial distress. Regular stress testing and scenario analysis should be conducted to understand how banks would perform in adverse economic conditions. This helps in building resilience against economic downturns and systemic shocks. Further, strengthening internal audits and control functions ensures that risks are being managed appropriately. A strong internal audit team provides an additional layer of assurance that operational risks and governance issues are being flagged promptly.

Enhancing Shareholder and Stakeholder Engagement: The consideration of minority shareholders in the decision making process can ensure that such minority shareholders are informed and communicated of the bank's affairs and performance and thereby provide them an equal opportunity to raise their voice in annual general meeting. This improves inclusiveness and transparency. Banks should regularly engage with various stakeholders, including customers, regulators and employees to ensure that their interests are understood and addressed. Proactive communication about business performance, risks and governance improvements, in this regard, is essential.

Promoting Ethical Leadership and Corporate Culture: The leadership of banks must set the tone at the top for ethical conduct. A culture of integrity, transparency and responsibility should be embedded throughout the organization. Encouraging employees and other stakeholders to report unethical behavior or governance issues without fear of retaliation is essential. Establishing strong whistleblower mechanisms can help uncover fraud, corruption and poor governance practices. Further, executive compensation packages should be structured to incentivize long-term performance and alignment with shareholder interest, rather than rewarding short-term gains that may pose risks to the bank's financial health.

Strengthening the Role of Auditors: Ensuring that external auditors are independent and free from conflicts of interest is crucial. There should be regular rotation of external auditors to ensure unbiased assessments. Moreover, strengthening the audit function within banks by ensuring external auditors are of high quality and provide comprehensive and accurate assessments of the bank's operations. In addition, effective and timely communication with external auditors can help the bank in taking actions with respect to any risk/ issues exits within the bank.

Leveraging Technology and Innovation: Implementing advanced technology for governance, such as digital platforms for board meetings, reporting and shareholder communication can streamline governance processes and make them more transparent. As financial services become more digitized, banks must ensure robust cybersecurity frameworks are in place. Failure to protect customer data and financial transactions can severely undermine governance and public trust.

Promoting Corporate Social Responsibility (CSR): Banks should focus on integrating sustainable business practices and responsible lending policies. A commitment to CSR enhances the public image, reputation, trust of banks and demonstrates their dedication to broader societal well-being. Further, aligning bank policies with Environmental, Social and Governance criteria is increasingly important. This will not only meet regulatory requirements but also respond to stakeholder expectations regarding sustainable business practices.

Monitoring and Enforcement: Effective monitoring by regulatory bodies like the CBSL ensures compliance with governance standards and addresses potential lapses. Stricter penalties for non-compliance with governance practices can serve as a deterrent to banks that may otherwise neglect their responsibilities. However, it is pertinent to note that the board of directors of the bank has ultimate responsibility to ensure that effective and strong governance culture exists within the bank.

In view of the above, having a sound Corporate Governance structure is mandatory to banking institutions. Therefore, in order to promote a sound corporate culture, the Boards should take the lead in establishing the "tone at the top" as discussed in this article. The bank's code of conduct/ ethics, or a comparable policy, should explain acceptable and unacceptable behaviours. It should explicitly disallow behaviour that could lead to any reputation risks or improper/illegal activity, such as financial misreporting, money laundering, fraud, anticompetitive practices, bribery and corruption, or the violation of consumer rights. Also, it should make clear that employees of the bank are expected to conduct themselves ethically in addition to complying with laws, regulations and bank policies.

Conclusion

In conclusion, strengthening corporate governance in Sri Lanka's banking industry will require collaboration between regulators, banks, and other stakeholders., Sri Lanka can enhance the stability and resilience of its banking sector by prioritizing transparency, accountability, integrity, robust risk management, ethical leadership, and regulatory compliance and thereby contributing to the overall health of the economy. These measures will help instill public confidence, attract foreign investment, and reduce systemic risk, ensuring that the banking sector operates efficiently and responsibly.

The Regulatory Framework of Corporate Governance for Banking Sector

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Introduction

Corporate governance can be best defined as the rules, practices and processes by which a company is directed and controlled. (Banda & Mwange, 2023). This definition gives a relatively narrow explanation for corporate governance as it emphasizes the need for good management and good control within a company. However, certain researchers provide broader definitions for corporate governance expanding its scope to external stakeholders of a company. For example, the Organization for Economic Co-oporation and Development (OECD) defined corporate governance as "A set of relationships between a company's management, it's board, its shareholders and other stakeholders… Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring." (Organisation for Economic Co-operation and Development, 2004) Accordingly, this definition focuses on managing and controlling the relationship between executive management and shareholders with a view to mitigating the negative impact of the agency conflict. The recent corporate failures and scandals in the international arena have underpinned the significance of sound corporate governance framework for the financial institutions in order to safeguard the interest of depositors and the stability of the entire financial system.

Evolution of Corporate Governance Regulations

Agency theory suggests that shareholders and managers are likely to have a conflict of interest when attempting to maximise their own objectives at the expense of the other party's interest. This is known as "agency conflict" and corporate governance is considered as an effective mechanism of reducing the costs of agency conflict. (Biswas, 2008). While the concept of "corporate governance" has existed for many centuries, it came into forefront in 1970's, with the Securities and Exchange Commission (SEC) of United States bringing a stance on official corporate governance reforms. While agency conflict is known to be the primary reason for establishment of corporate governance principles, increased size and complexity of firms, growth of capital markets, increased frauds and bankruptcy cases and enhanced awareness of corporate governance impact on firms' performance are the subsequent factors that drove the evolution of corporate governance.

The Sarbanes-Oxley Act (SOX), which entails requirements on corporate governance, risk management, auditing and financial reporting for public companies, was passed in 2002 in response to a series of large scale corporate scandals including Enron and WorldCom. The global financial crisis of 2007-2008, which is often termed as the most serious financial crisis after the Great Depression of 1930's, revealed several aspects of failures in financial institutions, out of which corporate governance was considered to be one of the main causes of the crisis. Lehman Brothers, a large investment bank filed for bankruptcy in 2008 mainly due to excessive risk taking, lack of transparency in financial disclosures and leadership failures. Collapse of Lehman Brothers is considered as one of the main triggering events of the global financial crisis. Northern Rock, a UK-based mortgage lender was the first British bank in 150 years to fail due to a bank run, in the wake of the global financial crisis. The British Government nationalized Northern Rock in 2008 to prevent the bank from insolvency, by incurring a substantial cost of £37 billion in funds. Heavy reliance on risky funding sources causing liquidity issues, failure in governance and risk management framework and poor internal controls were the primary reasons for failure in Northern Rock.

The financial crisis of 2007-2008, to a greater extent, can be attributed to failures and weaknesses in corporate governance arrangements. When they were put to test, corporate governance routines did not serve the purpose to safeguard against excessive risk taking in a number of financial companies. (Kirkpatrick, 2009) As such, it is evident that the rules and practices that govern the financial sector were inadequate particularly due to undermining the fiduciary duty towards depositors by focusing on maximizing shareholder value.

Drawing on the lessons learnt during the crisis, the regulators and standard setters across the world strived to strengthen the existing corporate governance frameworks in the financial sector, particularly the banking sector. In October 2010, the Basel committee on Banking Supervision (BCBS) issued a set of principles for enhancing sound corporate governance at banking institutions to address the fundamental deficiencies in banking sector corporate governance which became apparent during the global financial crisis. These principles were further updated in 2015 and serve as a guidance to assist the banking supervisors and provide a reference point for promoting sound corporate governance practices. Basel Core Principles (BCPs), a set of minimum prudential standards for effective functioning of the banking business, by its principle 14, require the supervisors to determine that the banks have robust corporate governance policies and processes covering corporate culture and values, strategic direction and oversight, group and organizational structure, suitability assessments, responsibilities of directors and senior management and compensation practices. (Basel Committee on Banking Supervision, 2024)

Significance of Corporate Governance in Banking Business and the Evolution of Corporate Governance Regulations for Licensed Banks in Sri Lanka

Banks are considered as the backbone of any financial system as they undertake the role of financial intermediation while safeguarding the depositors' interest. Maturity mismatches in assets and liabilities and the high levels of leverage make these institutions vulnerable to significant risks. Several inherent features of the banking industry can make it more susceptible to greater moral hazard such as availability of financial safety nets, viz., government guarantees and deposit insurance schemes, government intervention to prevent banking crises, securitization, interconnectedness, etc. As a consequence of the relatively higher extent of moral hazard, the banking institutions are generally incentivized to engage in riskier activities with a view to maximizing shareholder value, knowing that there will be safeguards even in the event of a crisis. However, this unique nature of banking business may largely undermine its fiduciary duty to safeguard the funds held by the depositors. Therefore, stringent governance structures are crucial for the banking industry in order to ensure duty of care[1] and duty of loyalty[2] of bank directors and senior management towards depositors and other stakeholders.

As stated in **John Exter's Report** on the Monetary Law Act, "Banking is an economic activity which affects the public welfare to an unusual degree. Sound banking is essential to healthy and vigorous economic development. Supervision of banks helps to protect the public against mismanagement, bank failures and loss of confidence in the banking system". The banking sector of Sri Lanka plays an integral role as the financial intermediary of the country by dominating the financial system with 61.5 per cent of total assets of the financial system as at end 2023. Deposits are the main source of funding for the banking sector, representing 81.5 per cent of the total funding structure of the banking sector. Therefore, the Board and senior management, i.e., CEO and key management personnel (KMP) of banks are predominantly entrusted with the duty of safeguarding the interest of depositors.

The Central Bank of Sri Lanka (CBSL), underpinning the responsibilities set out in John Exter Report, included the provisions on assessment of fitness and propriety of Directors, CEO and KMP in the Banking Act, No. 30 of 1988, which is the key legislation pertaining to licensing, regulations and controlling of persons carrying out banking business. In 2007, CBSL issued Directions on Corporate Governance for Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs), hereinafter referred to as 'licensed banks', in 2007 under Section 46(1) of the Banking Act, No. 30 of 1988, as amended. These Directions were aimed at enhancing the overall banking sector stability which is central to the financial system stability. It is pertinent to note that these Directions were issued by CBSL even prior to the issuance of corporate governance principles by the Basel committee. The Directions included a comprehensive set of principles and rules with regard to responsibilities and composition of the Board, criteria to assess fitness and propriety of directors, responsibilities of chairman and CEO, Board appointed committees, related party transactions and disclosures.

However, the Sri Lankan banking sector has since evolved and has become increasingly complex driven by advanced technology and global trends. Contactless payment technology, integration of e-commerce, exposure to global markets, digital banking, usage of artificial intelligence (AI) and data analytics are some of the key milestones in the banking sector evolution of Sri Lanka which resulted in greater efficiency and economies of scale in banking business. However, this rapid transformation made the sector highly vulnerable to emerging risks including cyber security risks, fraud and governance failures. Additionally, the recent developments in ownership structures, independence of Board members and related party transactions have raised concerns on adequacy of existing banking sector governance and risk management frameworks.

1 The duty of a director of a bank to act and take decisions with skill, care, prudence and due diligence in the performance of his duties of the respective bank

2 The duty of a director of a bank to act in good faith in the interest of the bank.

Change in Regulatory Landscape of Sri Lankan Banking Sector in year 2024

Taking into consideration the banking sector developments and international best practices, CBSL implemented necessary measures to enact the amendments to the existing Banking Act, with a view to strengthening the legal and regulatory framework. The Banking (Amendment) Act of 2024 came into operation on 15.06.2024 and include several key areas *inter-alia* corporate governance. Provisions were introduced to address inconsistencies in the Statutes of state-owned banks (SOBs) and the Banking Act, broaden the responsibilities of the Board, strengthen the requirements on accommodation granted to related parties and to ensure directors, CEO and KMP have relevant and adequate qualifications and experience.

CBSL, with a view to implementing the new amendments of the Banking Act and maintaining the resilience of the banking sector amidst the latest developments and emerging risks, issued the Banking Act Direction No. 05 of 2024 on Corporate Governance for Licensed Banks on 30.09.2024, revising the existing Directions on Corporate Governance issued in 2007. These Directions took into consideration the international best practices including the latest BCPs on Effective Banking Supervision issued in 2024, the revised Rules on Corporate Governance issued by the Colombo Stock Exchange (CSE) for listed entities in 2023 and the recommendations made in the Sri Lanka Governance Diagnostic Assessment Report – September 2023 issued by the International Monetary Fund (IMF). CBSL issued these Directions after a comprehensive consultation process with the banking industry and other relevant internal departments.

The newly issued Directions came into effect on 01.01.2025, except for certain requirements for which extended compliance timelines are available in the Direction.

Salient Features of the newly issued Regulations on Corporate Governance

The Directions issued by CBSL to licensed banks on corporate governance in 2024 are predominantly aimed at enhancing the Board responsibilities and composition, strengthening functions of Board sub-committees, reinforcing risk governance culture with strong internal controls, improving transparency and accountability of the Board decision-making process and emphasizing the Board oversight of senior management members.

Strengthening Board Oversight and Independence

The overall responsibility of the Board was further strengthened particularly in relation to active monitoring of the bank's affairs, approving and overseeing key policies, maintaining a robust finance function, overseeing whistleblowing policies and having a sound procedure to select senior management members.

The minimum independent component of the Board was improved by the new Directions for the purpose of enhancing the objectivity and transparency of the Board decision-making process. The previous requirement for the Board to have at least three or one third of the Board as independent directors, whichever is higher, was revised as at least half of the Board to be independent. Further, the existing criteria of independence was further strengthened by factoring business relationships, material transactions and provision of consultancy/advisory services, etc.

The new Directions emphasize the importance of collective suitability of the Board, where it is necessary for the Board to ensure an effective combination of knowledge, expertise and skills in relevant fields to promote a variety of perspectives in Board deliberations.

The composition and independence of the Board sub-committees were further strengthened in order to foster objectivity and transparency of the functions undertaken by each committee. Committees such as Board Audit Committee (BAC) and the Board Integrated Risk Management Committee (BIRMC) require the members to possess collective expertise in the relevant fields.

Suitability, Functions and Responsibilities of Chairperson, CEO and KMP

The Chairperson of the Board shall be independent in terms of the new regulations to ensure greater element of accountability and objectivity of the Chairperson. A transition period of three years has been allowed to the licensed banks that are currently chaired by non-independent directors to comply with this requirement.

A formal and a transparent procedure should be in place for the Board to select suitable persons to the CEO and KMP positions, and to hold such persons accountable for their actions. The Board shall ensure the mix of knowledge and skills of the senior management remains appropriate given the size, scale and underlying risks of the bank.

Enhanced Risk Governance Framework

The new Directions require the Board to establish a strong risk governance framework that reinforces the responsibilities of "three lines of defence" thus emphasizing the critical role played by risk management, compliance and internal audit functions. BAC and BIRMC are responsible for establishing strong and sound risk, control and oversight functions under the leadership of suitable key management members with appropriate expertise in the respective fields.

Licensed banks are also required to clearly define the risk appetite framework and ensure that all material risk-taking activities are aligned with the institution's strategic goals and risk tolerance.

Related Party Transactions

As per the new Directions, the Board shall form a Board Related Party Transactions Review Committee with a view to mitigating any conflicts of interest that will result from the related party transactions of the bank and any preferential treatment to related parties. The definition of related parties has been further expanded in line with the latest amendments to the Banking Act.

Ethical Conduct and Management of Conflict of Interest

The new Directions also require the Board members to promote a sound corporate culture that is established on appropriate norms and principles of professional and ethical behaviour across all layers of the institution. The requirements to formulate sound policies on managing conflict of interests and whistleblowing mechanisms are also expected to compliment the corporate culture.

Further, the enhanced disclosure requirements shall be met by licensed banks with regard to functions of Board-sub committees, related party transactions and terminal benefits provided to directors, CEO and KMP, ensuring greater levels of transparency.

The new Directions also require the Board to promote sustainability aspects through suitable ESG considerations in the bank's business strategies and promote assistance to businesses that are greener, climate-friendly and socially inclusive.

Conclusion

Banks play a pivotal role in the financial system by conducting the financial intermediation function while safeguarding the interest of depositors. Due to its unique nature, banking business is highly vulnerable to significant risks. Therefore, strong and sound corporate governance requirements are of paramount importance for the banking institutions to remain strong and resilient amidst underlying risks and constant challenges. Stronger governance structures that focus on transparency, accountability, and sound risk management contribute to enhance banks' performance and reduction in systemic risks. (Eshan & Niaizi, 2020).

The Sri Lankan banking sector underwent a rapid transformation due to influence of advanced technology and global trends resulting in increased complexity and exposure to emerging risks, frauds and failures. CBSL, in consideration of the recent banking sector developments and international best practices, implemented necessary measures to enact the amendments to the Banking Act in several aspects including corporate governance.

To implement the amendments made to the Banking Act, revised Banking Act Directions on Corporate Governance were issued in September 2024 by CBSL in line with updated BCPs and other international regulations. These Directions are aimed at strengthening the risk management and governance frameworks of licensed banks, enhancing the independence and effectiveness of the Board decision making process and improving the conduct of directors, CEO and KMP. These Directions are also expected to inculcate a sound corporate culture within the banking institutions that emphasize the fiduciary duty towards depositors and other stakeholders. The goal is to foster a more sustainable, transparent, and accountable banking sector that can better withstand future economic shocks, safeguard the interest of depositors, enhance investor confidence, and contribute to the overall stability of the Sri Lankan economy.

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FOREIGN EXCHANGE INTERVENTION BY THE CENTRAL BANK OF SRI LANKA AND ITS EFFECTIVENESS

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Disclaimer : *The views expressed in this article are the views of the authors and do not necessarily reflect the views or policies of the Central Bank of Sri Lanka, or the governments.*

1. Introduction

Central banks, especially those in emerging countries, intervene in the foreign exchange (FX) market in order to build international reserves or to provide FX to banks when required and the objective is often to stabilize the undue volatility of the exchange rate. Emerging markets often face significant currency fluctuations due to commodity price volatility, and domestic and global economic conditions.

In countries with flexible exchange rates, interest rates are usually used to achieve an inflation objective. In these situations, exchange rates are free to fluctuate in order to strike a balance between imports and exports and also other FX flows. In order to accomplish particular monetary policy goals, central banks in certain instances actively intervene to dampen exchange rate volatility, and fostering an atmosphere that is conducive for investment and trade. In response to excessive appreciation of the domestic currency, central banks have generally accumulated their foreign reserves, in an effort to lessen the detrimental effects of stronger currencies on competitiveness due to the Dutch disease[1].

The core objective of the Central Bank of Sri Lanka (CBSL) is to achieve and maintain domestic price stability. In recent years, Sri Lanka has encountered a series of significant challenges, including the Easter Sunday attack, Covid-19 pandemic, political instability, and a profound economic crisis. These circumstances have underscored the necessity for proactive and timely FX interventions by the

1 Dutch Disease is an economic term for the negative consequences that can arise from a spike in the value of a nation's currency. It is primarily associated with the new discovery or exploitation of a valuable natural resource and the unexpected repercussions that such a discovery can have on the overall economy.

CBSL as well as the need to maintain adequate FX buffers. Such interventions were essential not only to mitigate undue volatility in the exchange rate but also to ensure the continuous provision of essential goods and to restore confidence in the economy.

2. Motives of Intervention in the FX Market

The term "intervention" refers to the buying and selling of foreign currency with the intention of correcting misalignment and reducing exchange rate fluctuations, building up FX reserves to bolster macroeconomic stability and meeting the inflation objective.

Accumulation of International Reserves

Since the 1997 Asian financial crisis, intervention by the central banks to accumulate reserves has gained prominence, especially in emerging market countries, mainly with the intention of facing any unexpected external shocks. Most importantly, investors may be less likely to withdraw if they have confidence that the central bank can intervene and stabilize excessive volatility conditions in the FX market if a sudden stop in capital inflows takes place. With adequate international reserves, the central bank can reduce the possibility of adverse conditions materializing in the first place. Vulnerability is usually indicated by low international reserves, especially in economies with tightly controlled exchange rates. However, due to robust macroeconomic frameworks and significant levels of reserves, the severe depreciations that were seen in some Latin American countries following the global financial crisis did not result in disruptive contractions or high inflation as they had in the past.

Reducing Financial Instability

A "benign neglect" attitude toward the exchange rate is common in advanced economies with floating exchange rate regimes. A lengthy history of exchange rate fluctuations, occasionally quite large, without having a negative impact on financial stability lends credence to this. However, worries about financial stability are far more prevalent among central banks in emerging markets. Generally speaking, abrupt changes in the exchange rate are not preferred, especially when there is a significant depreciation.

One of the main causes of financial instability is currency mismatches on corporate and financial balance sheets. When there are currency mismatches, abrupt changes in the exchange rate have the potential of making a borrower, including the government, insolvent. It is also easy for the shock to acquire a systemic character if there are mismatches in the financial sector. These discrepancies have decreased over time as a result of stricter financial oversight and regulation, as well as increased borrower awareness of the risks.

Fear of Inflation Pass- through

Another motive for intervention, is the fear of pass-through to inflation. A large depreciation may adversely affect confidence whilst disturbing the price-setting mechanism in both tradable and non-tradable sectors. It is important to understand that, if there are permanent and persistent shocks to the exchange rate, there should not be intervention by the monetary authorities and the economy will have to adjust itself. However, if the shock to the exchange rate is perceived to be temporary, then there could be a case for using FX intervention to counter such overshooting and to limit its impact on inflation. Provided that the intervention is carried out to the extent that it is consistent with the monetary policy objective, which is to achieve the inflation target and is driven by the response to a perceived temporary shock to the FX markets, such intervention could be justified. However, it was highlighted by Chamon (2019), that inflation-targeting countries need to credibly highlight that FX intervention is subordinated to interest rate policy to avoid misperceptions and potential confusion about the central bank's objective. Further, there are concerns with respect to nonlinear effects where inflation pass-through becomes stronger after a large depreciation, with some threshold level of depreciation, after which the pass-through increases.

3. Effectiveness of Intervention on Exchange Rate Volatility

In practice, authorities are more likely to be worried about sharp movements in the exchange rate and hence the objective of FX intervention is to limit the excessive volatility of the exchange rate. Interventions have been proven to be successful in a few recent studies that employ deviations from equilibrium as a volatility measure. For instance, Adler and Tovar (2014) estimate the impact of interventions on the rate of exchange rate appreciation following global shocks in a study encompassing 15 countries, including several in Latin America. They conclude that interventions are successful in slowing the exchange rate movements and, consequently, in limiting deviation from the equilibrium exchange rate. Fry-McKibbin and Wanaguru (2013), using official currency intervention data from the CBSL found that currency interventions were effective, although in different ways. The results highlighted that the CBSL was successful in achieving its short-term and medium-term objectives of containing exchange rate volatility and accumulating reserves.

Absorptions (Purchases) verses Injections (Sales)

The effect of sales and purchases may be asymmetric if flows are more sensitive to circumstances or returns during periods of pressure on appreciation, or vice versa. Conversely, for instance, capital flow may be more susceptible to the impact of intervention during "risk-on" times than during "risk-off" times. Central banks usually step in heavily during times of volatile markets with depreciation pressure, with the expressed goal of influencing market rates. Compared to a central bank that is progressively building up foreign reserves in the face of appreciation pressures, such an intervention pattern is likely to have a greater impact on the market, notably through signaling effects.

Since foreign currency is a finite resource, selling foreign reserves costs the central bank more than purchasing reserves, hence FX sales may also send a stronger signal to the market. One could contend that, if there are sufficient reserves, FX sales give markets a clear indication that authorities disapprove the prevailing exchange rate. However, a central bank that wants to curtail appreciation pressure by purchasing FX might do so continuously, which is quite credible and might also be interpreted as a powerful signal. Fry-McKibbin and Wanaguru (2013) found that specifically, during period of low volatility, pre-GFC period foreign currency purchases were effective relative to foreign currency sales.

4. Intervention by the CBSL in Recent History

In response to changes in the balance of payments and the CBSL's assessment of the exchange rate's trajectory, the level of CBSL intervention in the FX market changed throughout time. From 1950 to 1977 Sri Lanka's monetary policy framework was principally based on maintaining a fixed exchange rate regime in line with the Bretton Woods agreement. This system succeeded as long as there was sufficient FX to meet expenditure on imports. The exchange rate was allowed to float in 1977 with the opening up of the economy. Since early 1980s, although monetary aggregate targeting continued to serve as the foundation for Sri Lankan monetary policy, the exchange rate regime gradually changed. The managed floating exchange rate system largely remained a crawling band arrangement and resulted in increased pressure on international reserves. As a result of revisiting the exchange rate policy, the CBSL on 23 January 2001 allowed the determination of the exchange rate based on supply and demand for FX in the domestic FX market. Even under this floating exchange rate regime, the CBSL intervened in the FX market to curtail the depreciation, at times of excessive domestic demand created through expansionary fiscal policies.

FX Supply by the CBSL to Facilitate Essential Imports during the Crisis

More recently, the depreciation pressures on the Sri Lanka rupee (LKR) against the US dollar (USD), exacerbated by the COVID-19 pandemic, persisted into 2021. Moreover, the CBSL's capacity to intervene in the market to alleviate pressure on the exchange rate was significantly hindered by the critically low levels of FX reserves and the Government's FX debt obligations. During 2021 and in early 2022, the USD/LKR exchange rate was maintained at stable levels before being allowed a measured adjustment in early March 2022. However, the outcome of this adjustment fell short of expectations due to the large overshooting of the exchange rate. Despite the relatively low level of FX reserves during this period, the CBSL took proactive measures to facilitate the critical economic activities, by injecting FX liquidity into the market. Such intervention aimed at financing essential import bills related to fuel, food and medicine. Further, in order to build the country's FX reserves through non-borrowed sources, the CBSL mandated banks to sell a specified portion of converted inward workers' remittances, as well as the mandatory conversion of export proceeds, to the CBSL.

Daily Guidance on Exchange Rate to Manage the Excessive Volatility during the Crisis

By early May 2022, the value of the US dollar had risen to approximately Rs. 365.00, signaling increasing pressure on the rupee to depreciate further. In response to this rapid and sustained depreciation, on 13 May 2022, the CBSL provided guidance by daily publication of the Middle USD/LKR spot exchange rate applicable for interbank transactions, along with a prescribed variation margin, to all LCBs. As a result, the exchange rate began to show signs of stabilization toward the end of May 2022.

Allowing Greater Flexibility for the Exchange Rate

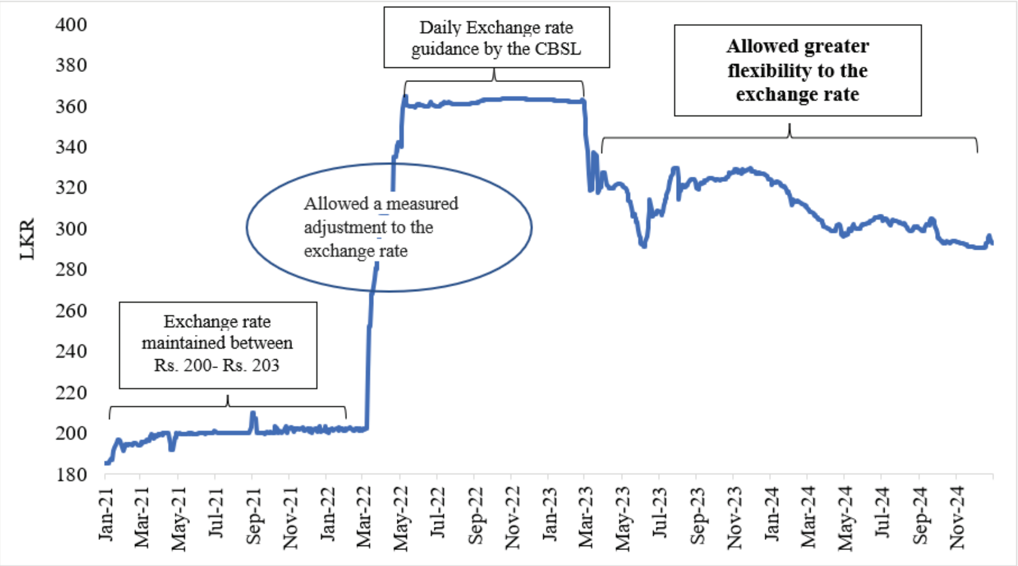
In an effort to revive a market-driven economy and stimulate activity in the domestic FX market, the CBSL began gradually relaxing the daily fluctuation band while easing the mandatory sales requirement in order to establish a flexible exchange rate in line with the Flexible Inflation Targeting (FIT) framework. The daily market guidance was discontinued by early March 2023, and the policies pertaining to FX conversions that had been put in place since 2022 such as the requirement that licensed banks sell FX weekly to the CBSL out of worker remittances converted, export receipts from the service sector, and the remaining value of converted export proceeds of goods were repealed in March 2023. Consequently, the liquidity conditions in the domestic FX market gradually improved.

The enactment of the CBSL Act No.16 of 2023 (CBA) in September 2023 reiterated the importance of a flexible exchange rate regime to complement the FIT framework. According to the CBA, the CBSL is charged with the implementation of a flexible exchange rate regime in line with the FIT framework in order to achieve and maintain domestic price stability. A flexible exchange rate regime is also expected to foster a deeper and more liquid FX market. The USD/LKR exchange rate, which hovered around Rs. 363.00 per US dollar at the beginning of 2023, started to appreciate following the CBSL's policy decision to allow the exchange rate to be determined based on market forces since 07 March 2023. This was further driven by exporters accelerating the conversion of foreign earnings, absence of significant FX outflows due to lower import demand and import restrictions, confidence built upon the receipt of the first tranche of IMF EFF and FX inflows to the Government securities market. The exchange rate reached Rs. 290 levels during early-June 2023. Figure 1 shows the movement of the exchange rate during 2021 – 2024.

with LCBs, the volatility of the exchange rate was stabilized. Market confidence significantly increased with the implementation of the flexible exchange rate policy, leading to sizable net inflows into the domestic FX market. As a result, the LKR appreciated by 12.1% in 2023.

The year 2024 commenced with an optimistic outlook, driven by favorable developments in the domestic FX market. The USD/LKR

Figure 1 : Movement of USD/LKR Indicative Exchange Rate (January 2021- December 2024)

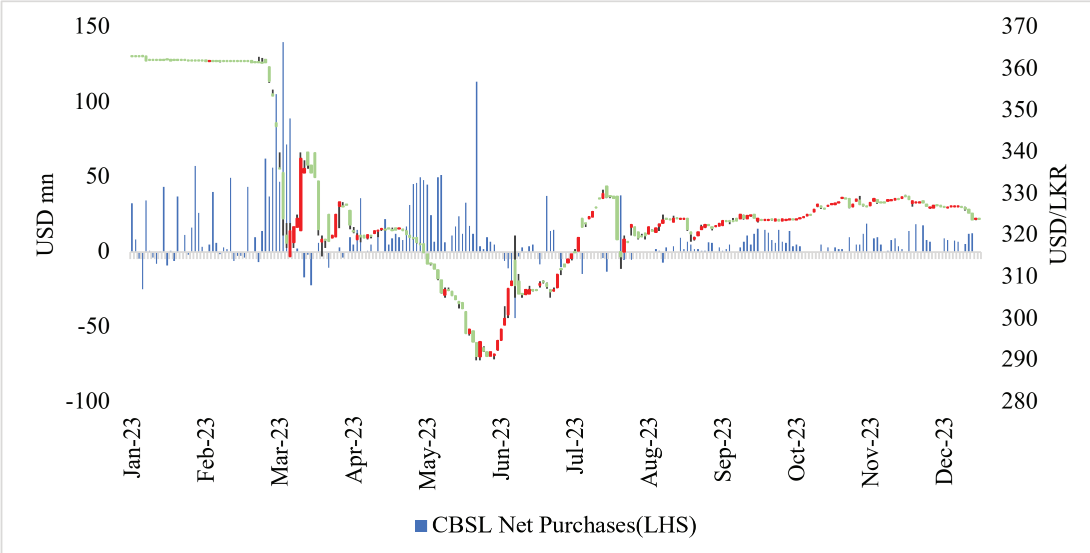


FX Purchases by the CBSL Curtailing Sharp Appreciation of the LKR post crisis

The CBSL intervened aggressively in the market to curtail intraday volatility as well as to decelerate the sharp appreciation of the LKR and to build the FX reserve positions. During the second half of 2023 the LKR experienced depreciation pressures with the announcement of the Domestic Debt Optimisation (DDO) programme on 30 June 2023 and geo-political tensions in the Middle Eastern region. Figure 2 shows the USD/LKR intraday movement vs net interventions during January-December 2023 period. The CBSL's prompt intervention through provision of FX liquidity to the market, along with effective communications

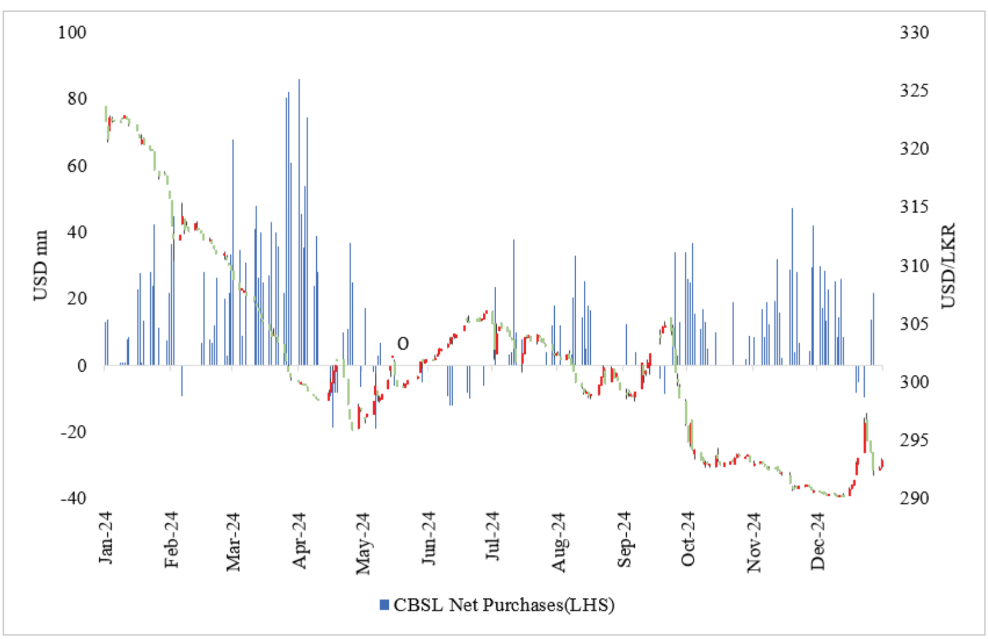
exchange rate, which remained relatively stable at approximately Rs.324 level, experienced a notable appreciation, reaching Rs. 306 by the end of June. The CBSL actively intervened in the domestic FX market as a net purchaser in order to mitigate the volatility induced by the pronounced appreciation of the exchange rate. This appreciation was primarily attributable to several factors, including a less demand for FX from importers, exporters' anticipation of further exchange rate gains leading them to convert export proceeds in forward tenors, and increased workers' remittances. Despite its position as a net purchaser, the CBSL also periodically supplied liquidity to the market, aiming to alleviate depreciation pressures caused

Figure 2: USD/LKR intraday movement vs net interventions (January- December 2023)



by a seasonal reduction in workers' remittances and escalating geopolitical tensions in the Middle East. During the second half of 2024, the CBSL intervened in both directions in a timely and appropriate manner to curtail the intraday volatility of the exchange rate. With steady and continuous purchases of FX, the CBSL over-achieved the end year reserve targets under the IMF-EFF program in August 2024, and this was continued further with net FX purchases surpassing US dollar 2.8 bn end of 2024 marking the all-time highest net FX purchases recorded within a year. FX intervention by the CBSL against the intra-day volatility of the exchange rate in 2024 is shown in Figure 3.

Figure 3 : USD/LKR intraday movement vs net interventions (January - December 2024)



5. Conclusion

FX intervention by the CBSL was highly effective in addressing the shortage of FX reserves and the sharp appreciation of the LKR since the exchange rate flexibility was allowed in March 2023. Prompt and adequate intervention contributed to provide stability and confidence to the market. The exchange rate volatility could result in exporters from emerging markets having to scale back their trading activities and temporarily halt international trade or cut back on their investments until exchange rate volatility subsides. Therefore, in extreme cases, severe exchange rate volatility might lead exporters completely halting doing business internationally and concentrate on serving home markets. Conversely, through provision of FX liquidity to the market at times of liquidity shortage, the volatility of the exchange rate was curtailed and the depreciation of the LKR was decelerated. Despite encountering challenges, through consistent acquisition of FX during 2023 and 2024 without unduly influencing the market, the CBSL was able to achieve the reserve targets set under the IMF-EFF program and re-building the Gross Official Reserves position to a level exceeding USD 6 bn by end 2024. Despite such large absorptions by the CBSL from the market, the Sri Lanka rupee appreciated significantly both in 2023 and 2024 and this clearly explain the effectiveness and importance of the CBSL's intervention in the FX market.

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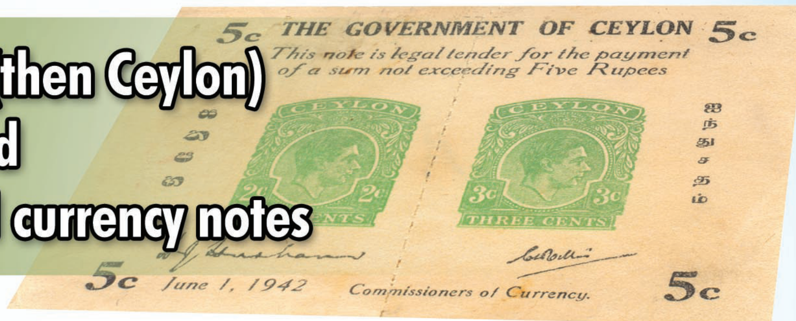

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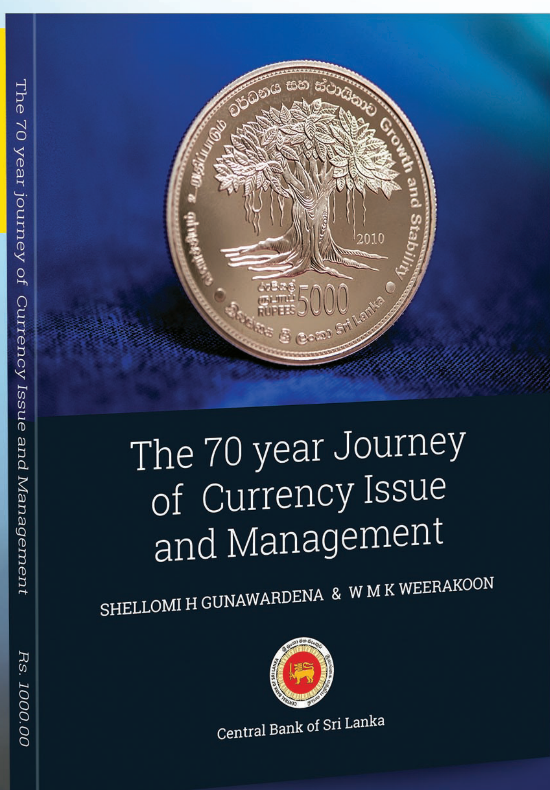

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