



## Concept Paper

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# Proposed Policy-Based Loan and Technical Assistance Grant Sri Lanka: Capital Market Development Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 4 April 2016)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRs1.00	=	\$0.0068
\$1.00	=	SLRs146.25

## ABBREVIATIONS

ADB	–	Asian Development Bank
CSE	–	Colombo Stock Exchange
GDP	–	gross domestic product
SEC	–	Securities and Exchange Commission
IOSCO	–	International Organization of Securities Commissions
TA	–	technical assistance

## NOTE

In this report, "\$" refers to US dollars.

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## I. THE PROGRAM

### A. Rationale

1. The proposed Capital Market Development Program aims to enhance the capacity and size of the capital market in Sri Lanka, grounded on a strong legal and regulatory framework. The program is scheduled to be submitted for Asian Development Bank (ADB) Board consideration in the third quarter of 2016.<sup>1</sup>

2. **Development problems.** Sri Lanka's financial markets are coming under stress, largely on concerns about the strength of the national economy and, in particular, the weak fiscal position. Sri Lanka's gross general government debt burden is estimated to have increased to more than 75% of gross domestic product (GDP) by the end of 2015, up from 71% at the end of 2014. Gross international reserves (excluding gold deposits) were \$5.5 billion as of January 2016 (over two months' coverage of current account payments), compared with an average of \$8.2 billion in 2014 (3.5 months of current account payments). The Colombo Stock Exchange (CSE) has been selling steeply, accumulating losses of about SLRs400 billion from January to March 2016. The sell-off not only reflects concerns about the strength of the economy but also triggered concerns about firms delisting from the main board and listing on the secondary board. A policy framework that strikes the right balance in financial regulation, enhances the stability of Sri Lanka's financial system, and is implemented effectively is required for sustainable capital market growth. This can be done by liberalizing investment decisions, removing distortions, and promoting stronger supervision of the markets.

3. Furthermore, the capital market in Sri Lanka has not been effective in channeling savings to support private sector participation in reducing the large infrastructure deficit—a major constraint to higher and sustainable economic growth. While bank financing accounts for nearly 60% of the country's financial assets, it is unable to finance Sri Lanka's infrastructure investment needs because this would expose banks to credit risks such as maturity-mismatch issues.<sup>2</sup> The corporate bond market remains at a nascent stage, undermining long-term infrastructure financing needs. Total outstanding corporate bonds account for only 2% of GDP, which is significantly less than is the case in other middle-income Asian countries (Table 1). Insurance companies as well as pension funds (particularly Employees' Provident Fund and Employees' Trust Fund) have a limited role in financing government securities, which hampers the formulation of a credible government yield curve and liquid bond market. The CSE is owned and dominated by brokers whose businesses take precedence over the governance of their exchange and overall market development (including critical market infrastructure).

**Table 1: Regional Comparisons of Capital Markets (% of GDP, 2014)**

	Stock Market	Government Bond Market	Corporate Bond Market
Bangladesh	22	11	<1
India	75	31	13
Pakistan	28	34	2
Sri Lanka	30	41	2

GDP = gross domestic product.

Sources: Asian Development Bank. 2014. *Asia Bond Monitor*. Manila; Bangladesh Bank; Central Bank of Sri Lanka; Colombo Stock Exchange; Dhaka Stock Exchange; Ministry of Statistics and Programme Implementation of India; Reserve Bank of India; Securities and Exchange Board of India; and State Bank of Pakistan.

<sup>1</sup> The government requested ADB's support for a capital market development program through confirmation of an aide-mémoire dated 9 March 2016. The South Asia Department subsequently added such a program to the 2016 operational program. Project preparatory technical assistance (TA) is included to identify policy measures to support the development of a robust financial market system in Sri Lanka (Appendix 3).

<sup>2</sup> In addition to licensed banks, nonbank financial institutions (such as licensed finance companies and specialized leasing companies) account for 9%, contractual savings institutions (including Employees' Provident Fund) for 19%, and the Central Bank for 12%.

4. After many years of centralized control over the economy, which kept responsible institutions from carrying out their mandates effectively, the recently elected government is cognizant that if Sri Lanka is to increase its GDP growth, it will have to rectify fundamental deficiencies in the capital market.<sup>3</sup> This can be done by moving toward market-based structural reforms through deregulation of the financial system, which would better support the real economy and promote private sector investment, and in turn help tackle the infrastructure deficit. Correcting the existing legal and regulatory frameworks, continuing improvements to the market infrastructure, and empowering institutions—e.g., the Securities and Exchange Commission (SEC) of Sri Lanka—is crucial to developing a more stable and resilient financial system. An efficient and reliable capital market is a critical prerequisite for Sri Lanka to attract foreign direct investment and portfolio investment, since most foreign investors require a good enabling environment and market depth before they invest.

5. **Proposed focus areas.** The proposed program would combine policy reforms with information and communication technology investments and technical assistance (TA) to support reforms that will strengthen capital markets in Sri Lanka. Consultation with the government identified the potential need for reforms in five areas:

- (i) **Improvements to legal and regulatory structures.** This includes the design and implementation of a new SEC Act, implementation of the CSE's demutualization, and setup and operationalization of a capital market tribunal and securitization act.<sup>4</sup>
- (ii) **Bond market development.** This involves measures to facilitate and expand corporate bonds, improve secondary market trading, and enhance penetration of the mutual funds industry at the retail level.
- (iii) **Development of financial-instrument tax policies.** The policies would remove tax distortions, and promote a more stable and predictable financial market tax regime.
- (iv) **Development of an enabling environment for derivatives.** This includes formulating a regulatory framework for trading in derivatives, and establishing a commodities exchange.
- (v) **Development of the insurance and pension industries.** This means promoting the participation of contractual savings institutions and pension funds (e.g., insurance sector, Employees' Provident Fund, and Employees' Trust Fund) in the capital market.

6. The proposed reforms of standards and procedures will conform to international best practices, including but not limited to those promulgated by the International Organization of Securities Commissions (IOSCO). A key objective of the program would be to ensure promotion of the SEC to the highest-category membership of the IOSCO.<sup>5</sup> The program will also set up the requirements to convert Colombo into an international financial center, which would deepen integration and enhance the standing of Sri Lanka's financial system in the world's financial markets.

7. The reform measures will enable the capital market to better contribute to meeting the increasing financing requirements of a growing economy. Diversifying a predominantly bank-based system of financial intermediation will expand alternative sources of credit and limit systemic impacts of economic shocks. Capital market development will reduce financing costs to borrowers by stimulating healthy competition with the banking sector.

8. **Government policy support for the program.** To achieve the GDP growth rate targets outlined in President Sirisena's election manifesto and the government's budget speech, the government recognizes the need to strengthen macroeconomic management, deepen policy and

<sup>3</sup> Regulatory functions on capital markets may not effectively be delegated to the SEC. The status of the SEC's independence will be assessed during due diligence.

<sup>4</sup> During due diligence, the status of financial reporting and disclosure will be assessed to determine any need for policy actions.

<sup>5</sup> IOSCO will initiate its Sri Lanka Country Review in May 2016, which will assess the country's implementation of IOSCO objectives and principles of securities regulation. ADB will coordinate closely with IOSCO to address compliance limitations arising from the IOSCO review.

regulatory reform, and improve the incentive structure for encouraging private investment.<sup>6</sup> Policy reforms are therefore envisioned to improve incentives for private investment, including providing long-term financing options through capital market development. A 10-point capital market development agenda was adopted by the previous government in November 2012. While the agenda covered important areas, uncertainty prevails with regard to its implementation. As part of due diligence, the revised implementation schedule of the 10-point agenda will be assessed (para. 15 and Appendix 3).

9. **ADB support for the program.** ADB's finance sector strategy for Sri Lanka, which is part of its country partnership strategy and the country operations business plan, is based on the government's emphasis on private sector development, lessons from ADB's previous finance sector interventions, and coordination with other development partners.<sup>7</sup> Capital and bond market development is in line with the priorities of ADB's Strategy 2020 Midterm Review and Financial Sector Operational Plan, which aim to facilitate private sector development and infrastructure development through the availability of long-term local currency funds for viable financial structures.<sup>8</sup> ADB's intensive engagement with the government since the late 1990s has ensured that it is the lead development partner for capital market development in Sri Lanka. ADB's strength lies in its integrated policy support, which focuses on "how to do it" and covers (i) policy dialogue, (ii) structure and design of tailor-made policy reforms, (iii) policy implementation support, (iv) capacity development through TA to ensure sustainability, and (v) procurement of information technology systems to strengthen operations. ADB's involvement will ensure successful implementation of Sri Lanka's capital market reforms, given the complexities, resources, and expertise required to execute such a multi-faceted program.

10. A policy-based loan is proposed, and justified in this case, since it is targeted at a sector in which the government is committed to reform. The policy-based loan will induce smooth and timely implementation of the reform program by subsidizing significant associated economic, financial, and social costs. It will explore the use of information and communication technology to support the development of market infrastructure in the equities market or to improve the efficiency of the SEC or CSE.

## B. Impact, Outcome, and Outputs

11. The program's impact will be a well-functioning financial system that supports basic capital and investment needs, as well as Sri Lanka's longer-term economic objectives aligned with the Capital Market Development Master Plan.<sup>9</sup> The program's outcome will be greater capacity and size of the capital market. The outputs will be (i) improved legal and regulatory structures, (ii) a developed bond market, (iii) improved financial-instrument tax policies, (iv) an enabling environment for derivatives (including commodities), and (v) developed insurance and pension industries. The preliminary design and monitoring framework is in Appendix 1.

<sup>6</sup> Government of Sri Lanka. 2015. *Manifesto, New Democratic Front, A Stable Country, Maithri, Compassionate* (President Sirisena's election manifesto). Colombo; Government of Sri Lanka, Ministry of Finance. 2015. *Statement by the Minister of Finance on Hundred-Day Revolution* (the revised budget speech). Colombo; Since January 2015, the current government has not prepared its own development strategy to replace the Development Policy Framework for 2010–2016 (Government of Sri Lanka, Department of National Planning, and Ministry of Finance and Planning. 2010. *The Emerging Wonder of Asia: Mahinda Chintana-Vision for the Future*. Colombo.).

<sup>7</sup> ADB. 2011. *Country Partnership Strategy: Sri Lanka, 2012–2016*. Manila; ADB. 2014. *Country Operations Business Plan: Sri Lanka, 2014–2016*. Manila; ADB. 2011. *Completion Report of Sri Lanka Financial Markets Program for Private Sector Development*. Manila. The latter provided a \$65 million program loan to Sri Lanka in 2004 for (i) increased financial products and services available to capital markets, (ii) enhanced corporate governance in the financial markets, and (iii) improved regulations of the insurance industry.

<sup>8</sup> ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila; ADB. 2011. *Financial Sector Operational Plan*. Manila.

<sup>9</sup> The SEC engaged in developing a capital market development master plan with 10 key strategies. The plan was formulated in consultation with all the key capital market stakeholders—comprising senior representatives from the securities industry, CSE, and SEC—to provide policy direction.

### C. Program Costs and Financing

12. The program loan will finance the cost of adjustment arising from the proposed reforms, and is estimated to be \$250 million from ADB's ordinary capital resources, which will be confirmed upon finalization of project preparatory TA findings. The program loan is likely to be released in two equal tranches of \$125 million each. In line with standard program loan readiness filters, all first-tranche policy actions are expected to be complied with by the time the program loan is submitted for Board consideration in September 2016. The first tranche will be disbursed upon loan effectiveness.

**Table 2: Tentative Financing Plan**

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Ordinary capital resources (loan)	250	100
<b>Total</b>	<b>250</b>	<b>100</b>

Note: Amount is indicative.

Source: Asian Development Bank.

### D. Indicative Implementation Arrangements

13. The executing agency will be the Ministry of National Policies and Economic Affairs in close coordination with the Department of Development Finance at the Ministry of Finance. The implementing agency will be the SEC. It is envisaged to place a program management unit at the SEC. A program steering committee will be established to oversee and coordinate program implementation; it will include the secretary of the Ministry of National Policy and Economic Affairs (chair); the director general of ADB's Department of External Resources; the deputy governor of the Central Bank of Sri Lanka; the chief executive of the CSE; and the director general of the SEC. The program will be implemented over 3 years.

## II. TECHNICAL ASSISTANCE

14. Capacity development TA is expected to accompany the program. The objectives and amount of this TA will be determined during implementation of the project preparatory TA. The latter is required to effectively formulate the program, which will support the government's commitment to meaningful capital market reform (Appendix 3).

## III. DUE DILIGENCE REQUIRED

15. As part of due diligence, the revised implementation schedule of the 10-point agenda will be assessed. A McKinsey study commissioned by the CSE to establish a broad framework for market development and an IOSCO assessment of the SEC will also be reviewed. A summary of the 10-point agenda is in Appendix 5. The terms of reference of the project preparatory TA consultants will also ensure that all other due diligence requirements (i.e., economic, financial, poverty, social, safeguards, and governance aspects, and respective risk mitigation measures) of the proposed program are met, such as:

- (i) **Economic and financial.** The economic and financial viability, and the cost of adjustment of the proposed capital market reforms need to be assessed to ensure sustainability and success of these reforms.
- (ii) **Governance.** Anticorruption, policy, and legal capacity, public financial management, and other institutional issues and mechanisms will be assessed.
- (iii) **Safeguards.** Direct or indirect environmental impacts, involuntary resettlement, or impacts on indigenous peoples from policy actions to be supported by the program loan will be evaluated. While the program is not expected to have safeguard impacts, any impacts will be managed with mitigation measures built into the program design.

16. Major risks include (i) political instability; (ii) macrofinancial instability affecting Sri Lanka in the current environment of global financial market volatility; (iii) resistance to reforms from vested

interests; and (iv) lack of willingness to improve fiduciary responsibilities, including the CSE listing requirements and overall market integrity. Broad risk mitigation and management measures would entail strong political will and commitment to pursue capital market reforms. The program will mitigate these risks to build greater investor confidence through the proposed reforms.

#### IV. PROCESSING PLAN

##### A. Risk Categorization

17. The program is categorized as complex since the loan amount exceeds \$50 million.

##### B. Resource Requirements

18. Project preparatory TA is required. It is estimated to cost \$550,000 equivalent, of which \$500,000 equivalent will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-V). The government will provide \$50,000 in counterpart funds in the form of office accommodation, remuneration and per diem of counterpart staff, and other administrative in-kind contributions. A team of 9 international consultants and 8 domestic consultants with expertise in capital market development, and recruited under a firm-based modality, will provide a total of 25 person-months of consulting services (Appendix 3).

##### C. Processing Schedule

**Table 3: Proposed Processing Schedule**

<b>Milestones</b>	<b>Expected Completion Date</b>
Loan reconnaissance mission	May 2016
Loan fact-finding mission	June 2016
Management review meeting	July 2016
Loan negotiations	August 2016
Board consideration	September 2016
Loan signing	October 2016
Loan effectiveness	October 2016

Source: Asian Development Bank estimates.

#### V. KEY ISSUES

19. The key issues include ensuring strong political commitment and government ownership for initiating key policy changes under the proposed program. No major poverty, social, or gender issues are manifest at this early stage. The processing team will consider these aspects while designing the program. The processing team may ask for support from relevant departments once significant issues are identified.

### DESIGN AND MONITORING FRAMEWORK

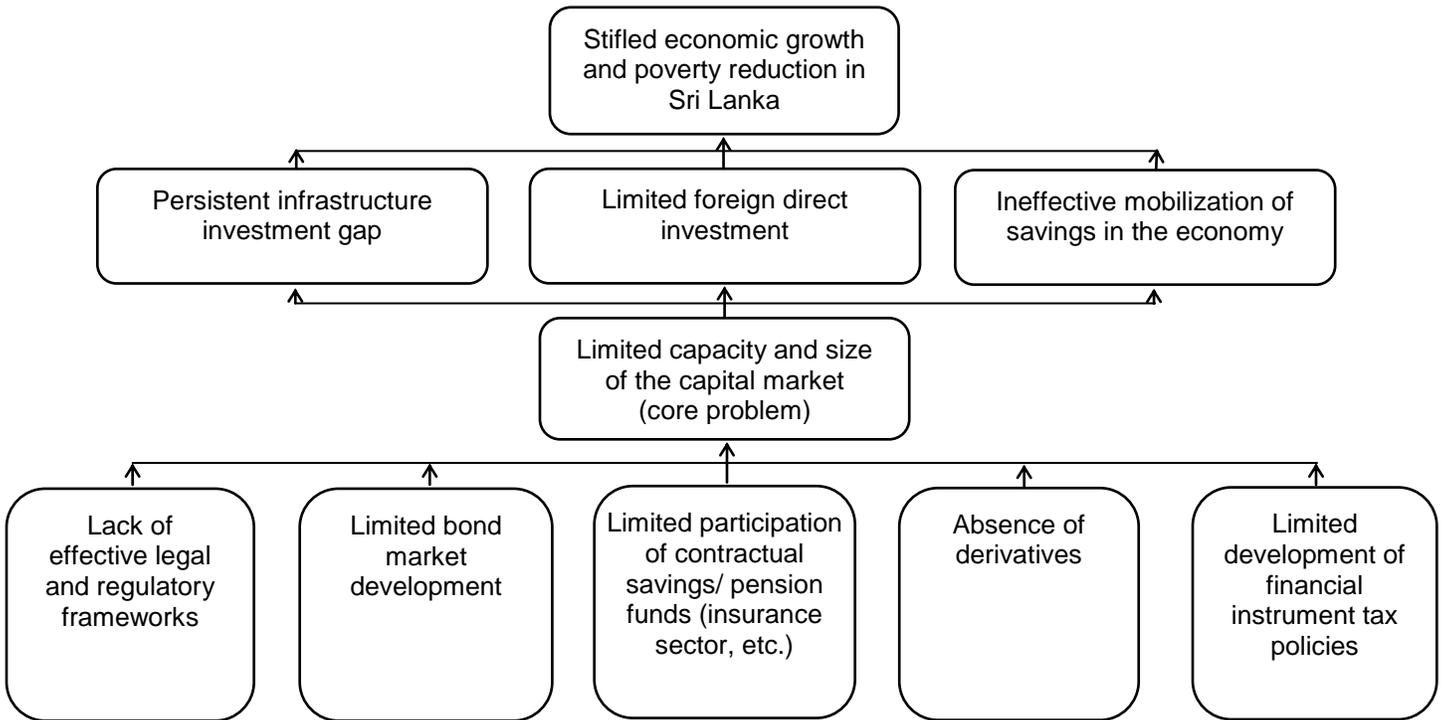
<b>Impact the Program is Aligned with</b>			
A well-functioning financial system that supports basic capital and investment needs, as well as Sri Lanka's longer-term economic objectives (Capital Market Development Master Plan) <sup>1</sup>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting</b>	<b>Risks</b>
<b>Outcome</b> Capacity and size of the capital market enhanced	a. Stock market capitalization increased to XX.X% of GDP by December 2020 (2015 baseline: 26.3%)  b. Enlistment of new companies increased to XXX by December 2020 (2015 baseline: to be determined)  c. Total value of corporate bonds issued through IPO increased to XXX by December 2020 (2014 baseline: Rs54.2 billion)	a. Annual and monthly reports by CSE  b. Annual reports by the SEC  c. CBSL Monthly Bulletin	Macroeconomic downturn
<b>Outputs</b> 1. Improved legal and regulatory structures	1a. SEC Act amendments adopted by December 2016 (2015 baseline: no SEC Act amendments adopted)  1b. CSE demutualization completed by 2017 (2015 baseline: no CSE demutualization completed)  1c. Capital market tribunal established and operationalized by 2018 (2015 baseline: no capital market tribunal established)	a. SEC rules and regulations  b. CSE rules and regulations  c. SEC rules and regulations	Resistance to reforms from vested interests
2. Bond market developed	Policy and institutional measures implemented (2015 baseline: to be determined)	Annual reports by CSE	
3. Financial-instrument tax policies developed	Specific taxation-related distortions between different categories of financial instruments removed by 2018 (Baseline: to be determined)	Executing agency's progress reports	

4. Enabling environment for derivatives developed	4a. Commodities market established by 2018 (Baseline: no commodities market established)  4b. Regulatory framework for trading in derivatives issued by 2018 (Baseline: no regulatory framework issued)	a. CSE rules and regulations  b. SEC rules and regulations	
5. Insurance sector and pension sector developed	Level of investment in capital market by insurance companies and pension funds (EPF and ETF) increased to X% by 2018 (2015 baseline: to be determined)	Insurance regulator's and pension regulator's rules and regulations	
<b>Key Activities with Milestones</b>  Not applicable			
<b>Inputs</b>  ADB: \$250 million (program loan from ordinary capital resources) Amount to be determined (TASF-V CDTA)  External Funds: \$ 750,000 (CDTA)			
<b>Assumptions for Partner Financing</b>  Not applicable			

ADB = Asian Development Bank, CBSL = Central Bank of Sri Lanka, CDTA = capacity development technical assistance, CSE = Colombo Stock Exchange, EPF = Employees' Provident Fund, ETF = Employees' Trust Fund, GDP = gross domestic product, IPO = initial public offering, SEC = Securities and Exchange Commission, TASF = Technical Assistance Special Fund.

<sup>1</sup> Government of Sri Lanka, Securities and Exchange Commission. 2012. *Capital Market Development Master Plan*. Colombo. Source: Asian Development Bank.

### PROBLEM TREE



CMDP possible result areas:

- Design and implementation of a new SEC Act
- Implementation of the CSE demutualization
- Establishment and operationalization of capital market tribunal

CMDP possible result areas:

- Extension of the government yield curve
- Corporate bond market development
- Mutual Funds Industry expanded at the retail level.

CMDP possible result areas:

- Formulation of white paper on insurance sector and pension sector
- Enhanced pension and provident fund participation

CMDP possible result areas:

- Establishment of commodity exchange

CMDP possible result areas:

- Introduce tax policy measures to catalyze bond and equity markets

CSE = Colombo Stock Exchange, SEC = Securities and Exchange Commission.

## PROJECT PREPARATORY TECHNICAL ASSISTANCE

### A. Justification

1. Project preparatory technical assistance (TA) is necessary to effectively formulate the Capital Market Development Program, which will support the government's commitment to meaningful capital market reform. The objective of the TA is to identify policy measures to support the development of a robust financial market system in Sri Lanka that is well balanced, sustainable, and resilient; and which is able to effectively intermediate savings so as to finance investment.

### B. Major Outputs and Activities

2. The TA will build upon the 10-point agenda (Appendix 5) that was established by the Securities and Exchange Commission (SEC) of Sri Lanka and the Colombo Stock Exchange (CSE). To develop the bond market, the TA experts will also draw on results of work previously undertaken by the SEC and CSE to assess Sri Lanka's capital market. The TA will engage international and domestic consultants, who will work closely with the government, market participants, and the Asian Development Bank (ADB) in the five areas below:

- (i) **Improvements to legal and regulatory structures.** The TA will assist the government in further developing a legal and financial supervisory policy structure that strikes the right balance in financial regulation and enhances the stability of Sri Lanka's financial system. The TA will help develop measures to remove inherent conflicts of interest, and enhance liquidity and public trust. The TA will focus on options for legal and regulatory reforms and benchmark regulatory efforts against international standards. It will analyze structural and institutional issues, such as the limited autonomy of the SEC and the Insurance Board of Sri Lanka (IBSL), and recommend measures to solve or minimize them. The feasibility of investing in an information and communication technology system to enhance regulatory and enforcement capacities (such as real-time surveillance) at the SEC and IBSL will also be assessed. To complement the enhanced surveillance system, the TA will assess and guide the establishment of a capital market tribunal. It will review legislation related to accounting and auditing standards, and recommend measures to strengthen the Sri Lanka Accounting and Auditing Standards Monitoring Board. The creation and introduction of a Small and Medium-Sized Enterprise (SME) Board on the CSE will also be examined. The CSE listing requirements and registration fees for companies (including for developing the SME Board) will be assessed. The TA will also facilitate the CSE demutualization process by introducing best practices in its governance structure, which would include drafting the required legislative and procedural frameworks.
- (ii) **Bond market development.** The second output will focus on measures that will lead to the extension of the government yield curve and thus to further corporate bond market development. The TA will analyze impediments to the development of a liquid debt market and recommend a strategy that will foster a deep, liquid, and transparent debt market offering a wide range of products. On the supply side, emphasis will be placed on increasing the supply of high-quality corporate paper by building on the benchmark yield curve of Government of Sri Lanka tradable securities and thereby improving the functioning and efficiency of the fixed-income market. The output will also identify measures to enable the repo

market and, in particular, the trading of repos. The development of a market facilitator through a liquidity facility will be examined to reduce the liquidity premium that hinders secondary trading. The TA will review the primary dealer system and focus on developing competitive pricing of primary issuances, including promoting the role of credit rating agencies and the use of credit enhancement products or risk mitigation instruments. The TA will also review the establishment of a bond clearing house for transactions in government securities, which could be extended to other instruments such as corporate debt securities, known as debt exchanges. An assessment of the merits of integrated versus separate e-trading platforms for government and corporate bonds will be undertaken. On the demand side, initiatives to increase the demand for corporate securities will be assessed, e.g., through contractual savings institutions (such as promoting the establishment of pension and provident fund management companies and enhancing their participation in capital markets). On the supply side, initiatives to increase the supply for corporate securities will be assessed (e.g., waiver of any double-taxation measures or nuisance taxes). The output will also examine nontraditional bond markets (e.g., Thai baht, Indian rupee, Chinese yuan) and *sukuks* for sovereign bond issuance purposes. Regional experiences in developing resilient, liquid bond markets will be considered while formulating the strategy. The role of mutual funds (including unit trusts) in promoting capital market development and bond market development will be explored. The introduction of real estate investment trusts (REITs), securitization structures (which include support for drafting the securitization act), covered bonds, municipal bonds, and infrastructure bonds will also be assessed.

- (iii) **Development of financial-instrument tax policies.** The third output will focus on a systematic analysis of the tax structure for financial instruments. It will recommend measures that are compatible with financial market development—and that also do not violate tax principles—to remove distortions between different types of financial assets, such as elimination of the share transaction levy. Tax incentives to attract foreign companies to be listed on the CSE will also be examined. The potential impacts of a tax-neutral structure will be assessed, and the likely benefits of such a structure will be weighed against the likely costs. This will be substantiated by an analysis of successful financial-instrument tax policies elsewhere in the region. A sequenced action plan will be developed that is compatible with financial market development.
- (iv) **Enabling environment for derivatives (including commodities).** The fourth output will focus on establishing a commodities exchange (i.e., a feasibility study to assess and guide its establishment, including implementation, rules and regulations, and legislation needed) as well as developing a regulatory framework for trading in derivatives. In addition to building critical market infrastructure, the output will also focus on developing bond futures, interest rate derivatives, exchange rate derivatives, and equity derivatives.
- (v) **Development of insurance and pension industries.** The fifth output will focus on measures to strengthen the insurance and pension industries. These will be sequenced with actions to ensure active investment and participation of these industries in the capital market.

3. The major outputs and activities are summarized in Table A1.1.

**Table A1.1: Summary of Major Outputs and Activities**

<b>Major Activities</b>	<b>Expected Completion Date</b>	<b>Major Outputs</b>	<b>Expected Completion Date</b>
Sector assessment, situational assessment, and comprehensive analysis to address the prevailing weaknesses	April 2016	Legal and regulatory structures	August 2016
Mapping of activities related to specific outputs	May 2016	CSE demutualization	August 2016
Development of and agreement on a sequenced action plan	August 2016	Bond market	August 2016
		Taxation	August 2016
		Commodities exchange	August 2016
		Insurance and pension	August 2016

Source: Asian Development Bank estimates.

### C. Cost Estimate and Proposed Financing Arrangement

4. The TA is estimated to cost \$550,000 equivalent, of which \$500,000 equivalent will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-V). The government will provide \$50,000 in counterpart funds in the form of office accommodation, remuneration and per diem of counterpart staff, and other administrative in-kind contributions. The detailed cost estimate is in Table A1.2. The government has been informed that approval of the TA does not commit ADB to finance any ensuing program.

**Table A1.2: Cost Estimates and Financing Plan**

<b>Item</b>	<b>Total Cost</b>
<b>A. Asian Development Bank Financing<sup>a</sup></b>	
1. Consultants	
a. Remuneration and per diem	
i. International consultants (15 person-months)	345,000
ii. National consultants (10 person-months)	40,000
b. International and local travel	36,000
c. Reports and communications	2,000
2. Seminars and conferences	30,000
3. Miscellaneous administration and support costs	5,000
4. Contingencies	42,000
<b>Total</b>	<b>500,000</b>

Note: The technical assistance (TA) is estimated to cost \$550,000, of which contributions from the Asian Development Bank (ADB) are presented in the table above. The Government of Sri Lanka will provide counterpart support in the form of office accommodation, remuneration and per diem of counterpart staff, and other administrative in-kind contribution. The value of government contribution is estimated to account for 10% of the total TA cost.

<sup>a</sup> Financed by the Technical Assistance Special Fund (TASF-V) of the Asian Development Bank.

Source: Asian Development Bank estimates.

### D. Consulting Services

5. The TA will be implemented over 6 months, from April 2016 to September 2016. A team of 9 international consultants and 8 domestic consultants will provide a total of 25 person-

months of consulting services. Consultants will be recruited using the quality- and cost-based selection method with a standard quality–cost ratio of 90:10 because of the highly specialized expertise needed. ADB will engage a consulting firm in accordance with the Guidelines on the Use of Consultants (2013, as amended from time to time). The selection of the consulting firm will be based on the submission of a simplified technical proposal and effected by the quality- and cost-based selection process.

**Table A1:3 Summary of Required Consulting Services**

International		National	
Name of Position	Person-months	Name of Position	Person-months
Capital market development expert	4.0		
Capital market legal and regulatory expert	1.5	Capital market legal and regulatory expert	1.0
Demutualization expert	1.5	Demutualization expert	1.0
Capital market products risk management expert	1.0	Capital market products risk management expert	1.0
Derivatives expert	1.5	Derivatives expert	1.0
Taxation expert	1.5	Taxation expert	1.5
Capital market institutional expert	1.0	Capital market institutional expert	1.0
Auditing expert	1.0	Auditing expert	1.5
Insurance and pension expert	2.0	Insurance expert	2.0

Source: Asian Development Bank estimates.

6. The outline terms of references for the TA consultants are described in paras. 7–15.

7. **Capital market development expert and team leader** (international, 4 person-months). The team leader is expected to have significant recent expertise (a minimum of 15 years) in capital market development. Experience in the Asia and Pacific region is preferable. The team leader will be responsible for preparing a comprehensive and systematic master plan for the Sri Lanka capital market, which will embrace all relevant dimensions (including equity market, bond market, derivative market [including commodities], money market, capital market tribunal, and qualification framework for securities industry professionals) and facilitate agreement on new initiatives to tackle policy, legal, regulatory, supervisory, institutional, and capacity constraints. In coordination with the legal and regulatory experts, risk management experts, taxation experts, institutional experts, insurance experts, and auditing expert, the team leader will (i) conduct a sector analysis, (ii) identify remaining impediments to development of the Sri Lanka capital market based on background research prepared by the SEC, and (iii) draft a sequenced implementation plan over the next 5 years with performance Indicators for each measure. The team leader will also be responsible for elaborating on the requirements to convert Colombo into an international financial center, which would deepen the integration of Sri Lanka’s financial system with the world’s financial markets and enhance the standing of Sri Lanka in global financial markets.

8. **Capital market legal and regulatory experts** (one international, 1.5 person-months; one national, 1 person-month). These experts should have significant experience (a minimum of 10 years) in capital market regulation in developed and developing markets, and a working knowledge of the implementation of the best-practice principles and objectives of the International Organization of Securities Commissions in securities regulation. Experience in the Asia and Pacific region is preferable. The principal aim of this assignment will be to strengthen the regulatory framework governing Sri Lanka’s capital market. This will focus on setting suitable supervisory policies, rationalizing institutional responsibilities across different products

and sectors (such as introduction of REITs), identifying any legal implications, defining any regulatory areas to be strengthened with a new information and communication technology platform, and establishing a capital market tribunal.

9. **Demutualization experts** (one international, 1.5 person-months; one national, 1 person-month). The consultants must have extensive experience (a minimum of 10 years) in the process of implementing demutualization in stock exchanges. The expert will help the team leader identify measures for facilitating the demutualization process of the CSE by introducing international best practice in the governance structure, especially in the areas of (i) appropriate governance structures in the CSE, and (ii) the required legislative and procedural framework.

10. **Capital market products risk management experts** (one international, 1 person-month; one national, 1 person-month). The consultants will be risk management experts with extensive experience (a minimum of 10 years) in developing and trading in risk management and derivative products. The experts will help the team leader identify measures for (i) developing the corporate bond market as a competitive source of financing; (ii) improving liquidity and market efficiency for secondary trading of securities (including development of a market facilitator through a liquidity facility to reduce the liquidity premium that hinders secondary trading); and (iii) introducing a wide range of capital market products, including commodities, which entails a feasibility study to assess and guide the establishment of a commodity exchange. For developing the bond market, the experts will also draw on the results of the work previously undertaken by the SEC to assess Sri Lanka's capital market.

11. **Derivatives experts** (one international, 1.5 person-months; one national, 1 person-month). The consultants must have extensive experience (minimum of 10 years) in derivatives, and have developed regulatory frameworks for derivatives. The main aims of the assignment will be to develop an appropriate legal and regulatory framework for financial derivatives based on international best practice (including trading in derivatives).

12. **Taxation experts** (one international, 1.5 person-months; one national, 1.5 person-months). The experts should have an extensive background in finance sector tax and legal matters, and should be experienced in the implications of taxing financial instruments for finance sector development (a minimum of 10 years). The taxation experts should coordinate with the team leader as well as the other consultants to address finance sector tax issues. The experts will help develop a liquid and integrated capital market by identifying a tax system that meets the needs of different market participants and encourages savings and investments. The experts will develop a well-defined tax implementation framework that will help determine the impact of the recommended tax reforms and introduce equal treatment across products and institutions. The experts will recommend how to make tax treatment consistent with international accounting standards.

13. **Capital market institutional experts** (one international, 1 person-month; one national, 1 person-month). The experts will have first-rate experience and credentials in boosting knowledge and understanding of capital market principles and operations. In coordination with the team leader and the other team members, the experts will (i) focus on building and understanding financial markets, financial regulations, and trends in financial integration; (ii) enhance participants' conceptual understanding and practical skills in capital market development (includes stock-take of the SEC's financial literacy work, i.e., identification of current gaps and recommendations to bridge them); and discuss conceptual and practical policy issues concerning capital market development, particularly the bond market; and (iii) share best practices and information that would be beneficial to developing and managing the capital

market in Sri Lanka, the analytical framework for capital market development, institutional and legal settings, infrastructure issues, and strategies and policy recommendations.

14. **Auditing experts** (one international, 1 person-month; one national, 1.5 person-months). The experts will have a strong background in International Standards on Auditing and International Financial Reporting Standards, and be familiar with capital market operations. The experts should be fully familiar with International Accounting Standards and best practices in the disclosure of financial information. The experts will build on the impending enactment of the Financial Reporting Act to recommend policy measures that will strengthen accounting and auditing standards at the insurance regulator and the SEC, thereby raising market confidence. The experts will (i) review the capacities of regulators to assess the quality of audits, and (ii) help the insurance regulator to design procedures for an independent review of audit practices adopted by auditors of insurance companies; their work process and systems, which includes developing relevant databases; format of reporting; internal quality assurance system; and enforcement.

15. **Insurance and pension experts** (one international, 2 person-months; one national, 2 person-months). The experts will have 10 years or more of international professional experience in insurance and pension supervision. They will build on existing white-paper road maps for the insurance and pension industries developed under a government initiative, if any, by providing detailed analysis and policy recommendations for the (i) improved governance and regulation of the insurance industry and the pension industry in conformance with international best practices to facilitate achievement of the industry's potential, as well as (ii) enhanced participation of the insurance and pension industries in Sri Lanka's equity and bond markets.

## **E. Implementation Arrangements**

16. The executing agency will be the Ministry of National Policies and Economic Affairs in close coordination with the Department of Development Finance at the Ministry of Finance. The SEC will be the implementing agency. To support the TA activities, the government will provide (i) furnished office space for the consultants, and access to a conference room; (ii) secretarial support; and (iii) local communication facilities for the consultants in Colombo. The government will provide counterpart staff, available on a part-time basis, as necessary. A TA inter-agency working group—chaired by the secretary of the Ministry of National Policy and Economic Affairs and including the director general, Department of External Resources; deputy governor, CBSL; chief executive officer, CSE; and director general, SEC—will provide comments, suggestions, and guidance at different stages of TA implementation. All disbursement under the TA will be made in accordance with ADB's Technical Assistance Disbursement Handbook (2015, as amended from time to time).

17. The consultants will submit an inception report to the government, ADB, and the TA working group within 2 weeks of the start of work; an interim report midway through the engagement to report on the progress of the work; and a draft final report 2 weeks before the end of the engagement. A capital market development workshop will be held in the early part of the engagement to discuss with the stakeholders in the public and private sectors their major concerns, to ensure that these are identified early and given sufficient attention under the proposed TA and follow-on program loan. At the end of the engagement, a national conference involving stakeholders, various donors, the private sector, and the government will be held to discuss the findings of the report, which will be used as the basis for the proposed program. The interim report and the finalization of the draft final report will be discussed at tripartite meetings between the government (including the TA inter-agency working group), the consultants, and

ADB. The final report will incorporate results from the workshop, national conference, and tripartite meetings, and be made available 2 weeks before the consultants' engagement ends.

## INITIAL POVERTY AND SOCIAL ANALYSIS

Country:	Sri Lanka	Project Title:	Capital Market Development Program
Lending/Financing Modality:	Policy-based loan	Department/ Division:	South Asia Department/ Public Management, Financial Sector and Trade Division

### I. POVERTY IMPACT AND SOCIAL DIMENSIONS

#### A. Links to the National Poverty Reduction Strategy and Country Partnership Strategy

The program supports the poverty reduction development goals of the Government of Sri Lanka, and the Asian Development Bank (ADB) for Sri Lanka. Thanks to strong economic growth after the civil war, poverty has dropped significantly. The latest household income and expenditure survey (2012/2013) showed that poverty had dropped from 22.7% in 2002 to 6.7% in 2012/13. Sri Lanka is on track to meet most of the key targets of the Millennium Development Goals.

The government is strongly committed to capital market development as a critical element in achieving sustainable and robust growth. In 2006, the Securities and Exchange Commission (SEC) of Sri Lanka established the Capital Market Master Plan (2006-2015) with support from ADB. Building on it, the SEC and the Colombo Stock Exchange (CSE) formulated the Capital Market Development Road Map in 2012, and have been implementing it to make the regulatory system more proactive, in line with international standards.<sup>1</sup> The current government also recognizes the need to shift from overreliance on public-sector-funded infrastructure projects toward stimulating domestic consumption and promoting public-private partnership investments.

The proposed program is consistent with the goals of ADB's interim country partnership strategy, 2015-2016 for Sri Lanka (to catalyze private investment and promote inclusive growth), is built on Strategy 2020, and supports the focus of ADB assistance on private sector development, including projects that accelerate the pace of private sector participation and promote financial sector development.<sup>2</sup>

#### B. Poverty Targeting

General Intervention  Individual or Household (TI-H)  Geographic (TI-G)  Non-Income MDGs (TI-M1, M2, etc.)

The program is targeted to tackle the country's finance sector issues and the constraints in the development of a capital market. The intervention will have a broad and nationwide direct impact on inclusive growth, and an indirect impact on poverty reduction.

#### C. Poverty and Social Analysis

1. **Key issues and potential beneficiaries.** The potential primary beneficiaries include (i) the government because the outcome of the program will contribute to national economic growth; (ii) market participants, i.e., public and private corporations, financial institutions, and individuals; and (iii) regulatory agencies. The poor and the socially excluded will benefit from the program indirectly.

2. **Impact channels and expected systemic changes.** These would include (i) finance sector stability, (ii) long-term funding source, and (iii) diversified and efficient investment channels.

3. **Focus of (and resources allocated in) the PPTA or due diligence.** The focus of (and resources allocated to) the project preparatory technical assistance (TA) and due diligence is to identify policy measures to support the development of a robust financial market system in Sri Lanka. Targeted are five areas: (i) improvements to legal and regulatory structures, (ii) bond market development, (iii) development of financial-instrument tax policies, (iv) an enabling environment for derivatives (including commodities), and (v) development of the insurance and pension industries. The TA's due diligence will be carried out by the project processing team of the Public Management, Financial Sector and Trade Division of ADB's South Asia Department.

4. **Specific analysis for policy-based lending.** The program will benefit all citizens, including the poor, through the development of an efficient capital market that will ensure an optimal allocation of capital. By enhancing the availability of capital and optimizing its cost, it is expected that private sector investment will increase and help finance infrastructure, spur economic growth, and create jobs. Stronger governance of Sri Lanka's financial and capital markets will help attract foreign investments, including foreign direct investment, which generates jobs for skilled and unskilled labor. The intervention will have a broad and nationwide direct impact on inclusive growth, and an indirect impact on poverty reduction.

### II. GENDER AND DEVELOPMENT

1. What are the key gender issues in the sector/subsector that are likely to be relevant to this project or program?  
There is no key gender issue in this program because the development of a capital market empowers all individuals'

<p>equal rights to access to the market, financial resources, and opportunities. It does not minimize the benefits to women. The processing team will further consider these issues while designing the program.</p>
<p>2. Does the proposed project or program have the potential to make a contribution to the promotion of gender equity and/or empowerment of women by providing women's access to and use of opportunities, services, resources, assets, and participation in decision making?  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p>3. Could the proposed project have an adverse impact on women and/or girls or widen gender inequality?  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p>4. Indicate the intended gender mainstreaming category:  <input type="checkbox"/> GEN (gender equity theme) <input type="checkbox"/> EGM (effective gender mainstreaming)  <input type="checkbox"/> SGE (some gender elements) <input checked="" type="checkbox"/> NGE (no gender elements)</p>
<p><b>III. PARTICIPATION AND EMPOWERMENT</b></p>
<p>1. Who are the main stakeholders of the project, including beneficiaries and negatively affected people? Identify how they will participate in the project design. – The potential initial stakeholders will be (i) government agencies, i.e., Ministry of Finance, Central Bank of Sri Lanka (CBSL), and Securities and Exchange Commission (SEC); (ii) market participants such as financial institutions, as well as public and private corporations. The preparation of a Consultation and Participation (C&amp;P) plan and stakeholder analysis will be done during project design.</p>
<p>2. How can the project contribute (in a systemic way) to engaging and empowering stakeholders and beneficiaries, particularly the poor, vulnerable, and excluded groups? What issues in the project design require participation of the poor and excluded? – Preparation of the C&amp;P plan and stakeholder analysis will be done during project design.</p>
<p>3. What are the key, active, and relevant civil society organizations in the project area? What is the level of civil society organization participation in the project design?  <input type="checkbox"/> Information generation and sharing <input checked="" type="checkbox"/> Consultation <input type="checkbox"/> Collaboration <input type="checkbox"/> Partnership</p>
<p>4. Are there issues during project design for which participation of the poor and excluded is important? What are they and how shall they be addressed? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p><b>IV. SOCIAL SAFEGUARDS</b></p>
<p><b>A. Involuntary Resettlement Category</b> <input type="checkbox"/> A <input type="checkbox"/> B <input checked="" type="checkbox"/> C <input type="checkbox"/> FI</p>
<p>1. Does the project have the potential to involve involuntary land acquisition resulting in physical and economic displacement? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p>2. What action plan is required to address involuntary resettlement as part of the TA or due diligence process?  <input type="checkbox"/> Resettlement plan <input type="checkbox"/> Resettlement framework <input type="checkbox"/> Social impact matrix  <input type="checkbox"/> Environmental and social management system arrangement <input checked="" type="checkbox"/> None</p> <p>Since the program is about budgetary support for capital market development, it will not engender the need for involuntary resettlement.</p>
<p><b>B. Indigenous Peoples Category</b> <input type="checkbox"/> A <input type="checkbox"/> B <input checked="" type="checkbox"/> C <input type="checkbox"/> FI</p>
<p>1. Does the proposed project have the potential to directly or indirectly affect the dignity, human rights, livelihood systems, or culture of indigenous peoples? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p>2. Does it affect the territories or natural and cultural resources indigenous peoples own, use, occupy, or claim, as their ancestral domain? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p>3. Will the project require broad community support of affected indigenous communities? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p>
<p>4. What action plan is required to address risks to indigenous peoples as part of the TA or due diligence process?  <input type="checkbox"/> Indigenous peoples plan <input type="checkbox"/> Indigenous peoples planning framework <input type="checkbox"/> Social Impact matrix  <input type="checkbox"/> Environmental and social management system arrangement <input checked="" type="checkbox"/> None</p> <p>Since the program is about budgetary support for capital market development, it will not engender any issue with regard to indigenous peoples.</p>
<p><b>V. OTHER SOCIAL ISSUES AND RISKS</b></p>
<p>1. What other social issues and risks should be considered in the project design? – Not applicable  <input type="checkbox"/> Creating decent jobs and employment <input type="checkbox"/> Adhering to core labor standards <input type="checkbox"/> Labor retrenchment  <input type="checkbox"/> Spread of communicable diseases, including HIV/AIDS <input type="checkbox"/> Increase in human trafficking <input type="checkbox"/> Affordability  <input type="checkbox"/> Increase in unplanned migration <input type="checkbox"/> Increase in vulnerability to natural disasters <input type="checkbox"/> Creating political instability  <input type="checkbox"/> Creating internal social conflicts <input type="checkbox"/> Others, please specify _____</p>
<p>2. How are these additional social issues and risks going to be addressed in the project design? – Not applicable.</p>
<p><b>VI. PPTA OR DUE DILIGENCE RESOURCE REQUIREMENT</b></p>
<p>1. Do the terms of reference for the TA (or other due diligence) contain key information needed to be gathered during</p>

the TA or due diligence process to better analyze (i) poverty and social impact; (ii) gender impact, (iii) participation dimensions; (iv) social safeguards; and (v) other social risks. Are the relevant specialists identified?

Yes       No

No key poverty, social, or gender issues are manifest at this early stage. The processing team will consider these aspects while designing the program.

2. What resources (e.g., consultants, survey budget, and workshop) are allocated for conducting poverty, social and/or gender analysis, and participation plan during the TA or due diligence?

Preparation of the C&P plan will be part of the consultants' assignment, while poverty, social and/or gender analyses will be carried out by the processing team.

<sup>1</sup> Government of Sri Lanka, Securities and Exchange Commission. Capital Market Development Road Map 2012. [http://www.sec.gov.lk/?page\\_id=5495](http://www.sec.gov.lk/?page_id=5495) (accessed 25 April 2016).

<sup>2</sup> ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka 2015-2016*. Manila; ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008-2020*. Manila.

**TEN-POINT CAPITAL MARKET DEVELOPMENT AGENDA  
(COLOMBO STOCK EXCHANGE, SECURITIES AND EXCHANGE COMMISSION)**

1. In November 2012, the Securities and Exchange Commission (SEC), together with the Colombo Stock Exchange (CSE) and key industry stakeholders, unveiled a 10-point plan to revitalize the capital market.

2. The 10 points are: (i) expedite SEC Act amendments to be in line with International Organization of Securities Commissions (IOSCO) standards; (ii) encourage more listings (public and private) to increase liquidity and market capitalization; (iii) attract new funds (foreign and local) to broaden the market base; (iv) develop infrastructure (trading, back-office systems) to improve efficiency; (v) develop the corporate debt market; (vi) intensify education and awareness to gain an educated investor base and enhance investor confidence; (vii) develop a unit trust industry to mobilize savings of less-sophisticated small investors; (viii) strengthen risk management systems (e.g., central counterparty, delivery versus payment system, risk-based capital/supervision, broker back office); (ix) develop new products (derivatives, exchange-traded funds, commodities) to broaden the product range; and (x) demutualize the CSE from a member-owned company to one owned by shareholders in line with international standards.

3. These points can be broadly summarized under four categories:

**A. Market Liquidity**

4. The first area is to improve the liquidity of the market. This starts with increasing the participation rate of foreigners, educating retail participants about investing, and communicating well with the media. The next step is to increase the market capitalization of the CSE. Sri Lanka has many successful companies in both the private and public sectors; currently only 5% of these companies are listed. Tax incentives and the growing need for financing are the likely catalysts to encourage these companies to list. Finally, to create market depth, grow the unit trust market, where funds will be managed professionally, and also create growth in the fund management industry.

**B. Market Infrastructure**

5. The second area is to improve market infrastructure. Given the docile markets over the past 20 years, trading systems are now outdated. To meet the needs of market participants, an upgrade to the system's technology is required for it to be of a global standard. This would include strengthening the risk management processes, enabling centralized clearing for counterparties, and instituting a delivery versus payment settlement solution for securities.

**C. Enablers of Capital Market Development**

6. The third area is to enable the capital market to develop, particularly the corporate debt market. Traditionally, companies prefer to use bank financing for their operations. Although the government securities market is 1.6 times bigger than the equity market, the corporate debt market is only 5% of the equity market. Development of the corporate debt market along with allowing other products (e.g., derivatives and commodities) to develop, and demutualizing the CSE to foster a commercial agenda will help sustain market interest.

**D. Market Integrity**

7. The final category is in the area of market integrity. A significant constraint is the time taken for enforcement actions to occur. This is due to a lack of provisions for civil and administrative sanctions in the current SEC Act. Addressing this concern is a key component of

the 10-point plan, which requires amending the SEC Act—specifically, to prevent market abuse and malpractices by capital market participants through introduction of civil and administrative sanctions that will complement the existing route of using criminal action against offenders. Widening the choices will enable enforcements to occur in a more calibrated manner, consistent with the degree of the offence.