

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

Major Activities	Expected Completion Date	Major Outputs	Expected Completion Date
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

Item	Total Cost
A. Asian Development Bank Financing^a	
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
Total	500,000

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.

^a 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.

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.

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

² 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.

