ADB

Consultant's Report

Project Number: 49273
May 2016

Sri Lanka Capital Market Assessment

Prepared by Lalith Samarakoon

Capital Market Development Expert

Colombo, Sri Lanka

For Asian Development Bank

Asian Development Bank

TABLE OF CONTENTS

ABBREVIATIONS

ADB	Asian Development Bank
ASPI	All Share Price Index
AWDR	Average Weighted Deposit Rate
BBO	Broker back Office
BSE	Bombay Stock Exchange
BOI	Board of Investment
CBSL	Central Bank of Sri Lanka
CCM	Certificate in Capital Markets
CCP	Central Counter Party
CDS	Central Depository System
CEF	Closed-end Fund
CFTC	Commodities and Futures Trading Commission
CSD	Central Securities Depository
CME	Chicago Mercantile Exchange
CMET	Capital Market Education and Training Division of the SEC
CPD	Continuing Professional Development
CPI	Consumer Price Index
CSBA	Colombo Stock Brokers Association
CSE	Colombo Stock Exchange
DCM	Diploma in Capital Markets
DEX	Debt Securities Trading System
DVP	Delivery vs. Payment
EMI	Emerging Markets Index
EPF	Employees' Provident Fund
ETF	Exchange Traded Fund
ETF	Employees' Trust Fund
FDI	Foreign Direct Investment
FSA	Financial Services Authority
FSCP	Financial Sector Consolidation Plan
GDP	Gross domestic product
IBSL	Insurance Board of Sri Lanka
ICASL	Institute of Chartered Accountants of Sri Lanka
ICSD	International Central Securities Depository
ICT	Information and Communication Technology
IPO	Initial Public Offer
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LPBT	Lanka Primary Dealer Bloomberg Bond Trader
MSCI	Morgan Stanley Capital International
NAMAL	National Asset Management Limited
NAV	Net Asset Value
NBFI	Non-Bank Financial Institution
NSE	National Stock Exchange of India
OECD	Organization for Economic Cooperation and Development
OTC	Over-the-Counter
PDD	Public Debt Department
REIT	Real Estate Investment Trust
RIA	Registered Investment Advisor
Rs.	Sri Lankan rupees

RMS	Risk Management System
RTGS	Real Time Gross Settlement
SAARC	South Asian Association for Regional Cooperation
SBL	Securities Borrowing and Lending
SEC	Securities & Exchange Commission of Sri Lanka
SME	Small and Medium Enterprises
SOE	State-Owned Enterprise
SPV	Special Purpose Vehicle
SSSS	Scriptless Securities Settlement System
UT	Unit Trust
UTMC	Unit Trust Management Company
USD	United States Dollars
WFE	World Federation of Exchanges

EXECUTIVE SUMMARY

1. Sri Lanka is a USD 82 billion economy with a per capita GDP of USD 3,924 and has recorded an average economic growth of 6.3% over the past 10 years. Its capital market primarily consists of government securities, stock, and corporate bond markets which have a combined value of USD 50 billion. The government securities market is the dominant sector with a value of USD 28 billion whereas the stock market capitalization is USD 20 billion. The capital market is about 64% of the economy with government securities and stock markets representing 35% and 26% of the economy respectively.

2. There is a fairly long history of capital markets in Sri Lanka with the modern stock market dating back 31 years. The regulatory, institutional, trading, clearing and settlement infrastructures are fairly well-established. Although many components of the capital market are in place, Sri Lanka needs to undertake substantial and challenging structural and policy reforms in order to establish a well-functioning financial system with more broad-based, efficient and stable capital markets and to fully leverage its potential to achieve long-term economic objectives.

3. Regulatory: On the regulatory side, enacting amendments to the SEC Act is the highest priority in order to strengthen regulatory powers against securities law violations, allow demutualization of the Colombo Stock Exchange and establishing a central counterparty clearing and settlement mechanism, provide for the development of new capital market products, and enhance investor protection. The demutualization of the stock exchange is also a top priority and requires passing both the new SEC Act and the Demutualization legislation.

4. Trading, Clearing and Settlement: There is a critical need to establish a single, transparent secondary market trading system with a market making mechanism for government securities. Establishing and regulating a central counter party system and a clearing house for exchange-listed securities as well as government securities should be considered important priorities. While there are plans underway to establish a separate trading platform for government securities and separate clearing houses for exchange-listed and government securities, serious consideration should be given to establishing a common trading, clearing and settlement infrastructure with appropriate legal and regulatory frameworks for both corporate debt and government securities.

5. The Equity Market: The two major challenges facing the stock market are its smaller size and lower liquidity. Solving this “size and liquidity” puzzle is critical to unlocking the potential of the Sri Lankan stock market and requires very bold and visionary supply and demand side reforms at the level of the Government. On the supply side, public enterprise reforms and listing of key commercial public-enterprises are necessary to increase the size of the stock market to a measurable degree. On the demand side, pension reforms enabling investment of pension assets in broadly diversified portfolios that match subscriber risk and return preferences will generate sustainable demand for investing and trading in securities markets and help enhance market liquidity. Requiring a higher public float for listed companies and establishing a market making mechanism are necessary measures to enhance market liquidity. There are too many intermediaries in the stock market and brokerage industry consolidation is needed to create a financially strong and competitive brokerage industry. Sri Lanka will also benefit from adopting a universal brokerage model where market intermediaries deal in all securities products.
.

6. The Government Securities Market: Establishing a fairly evenly distributed maturity structure for government securities that spans both medium and long-term segments is important to avoid debt bunching and refinancing risks. Developing a reliable benchmark yield curve by issuing relatively more of benchmark securities at key points along the yield curve is fundamental to the development of fixed-income securities markets.

7. Corporate Bonds: While the primary market activity in corporate bonds has been propelled by favorable tax treatment, the secondary market is very inactive and illiquid. It is necessary to establish conditions to make debt financing through the capital market more beneficial to companies than bank-based financing. Policy reforms to increase institutional investor participation in the listed corporate debt market, considering the viability of introducing repurchase agreements on listed corporate debt securities, and introducing a market making mechanism for listed debt securities are important steps for market development.

8. Derivatives and Commodities: Sri Lanka does not have derivatives or commodities exchanges. It is important to assess and ensure that economic and market fundamentals and the necessary regulatory, trading, clearing and settlement infrastructures are in place for introducing derivatives and commodities products. A realistic road map with proper sequencing of initiatives is needed before introducing derivatives and commodities. Stock index futures, Treasury bond forwards and futures, individual stock options, and tea futures have the potential to play an important role in the initial development of derivatives and commodities markets.

9. Unit Trusts: One major challenge for the unit trust industry is the lack of penetration into the savings base and, as a result, the participation in unit trusts by the Sri Lankan population remains very low. Developing a comprehensive plan for educating the saving and investing public about benefits of unit trusts as a saving and investing vehicle and establishing wider distribution channels are necessary steps for industry growth. Pension reforms allowing outsourcing of management of portions of pension assets to unit trusts will also help industry growth. The unit trust industry is highly unconcentrated with too many small funds and needs consolidation to make it more competitive and financially sound.

10. Pension Funds: The two mandatory and state-managed superannuation funds dominate the pensions industry. About 92% of these funds are invested in government securities. It is important to consider creating more broadly diversified portfolios subject to the investment constraints to optimize the risk-reward structure of these portfolios. With pension reforms, offering portfolio choices to subscribers, creating investment portfolios based on subscriber preferences and allowing external fund management of portions of pension portfolios will likely help diversify portfolios and enhance returns to subscribers in the long-term.

11. Education, Training and Licensing: Sri Lanka needs to significantly strengthen capital market knowledge and skills of market participants and investors across all capital market sectors including equity, bonds, unit trusts, derivatives and commodities. The financial market qualification system needs to be expanded to a multi-layered licensing framework to accommodate all asset classes and facilitate capital market development.

12. The most critical step for developing capital markets of Sri Lanka is to formulate a national level capital market development plan with participation and commitment of all key parties such as the Ministry of National Policies and Economic Affairs, Ministry of Finance, Ministry of Public Enterprise Development, Securities and Exchange Commission, Insurance Board of Sri Lanka, Colombo Stock Exchange and the Central Bank of Sri Lanka. Without the highest level buy-in and commitment, the critical pieces of the capital market development puzzle will continue to remain unfinished, and any institutional-level master plans will continue to face implementation challenges.

I. INTRODUCTION

1. The purpose of this report is to provide a comprehensive assessment of Sri Lanka's capital markets. Its main objectives are to (i) identify impediments to the development of Sri Lanka's capital markets, and (ii) suggest initiatives to address these policy, legal, regulatory, supervisory, governance, institutional, and capacity constraints. In order to provide context and background, this report first discusses the importance of capital markets to Sri Lanka, provides a summary overview of the finance sector and capital markets of Sri Lanka, and summarizes the major capital market development policy initiatives undertaken by Sri Lanka over the past 10 years.

2. This report provides an overview, discusses concerns and impediments, and suggests recommendations in respect of key components of the Sri Lankan capital market. These areas of the capital market include regulatory and institutional environment, trading, clearing and settlement systems, the equity market, the government securities market, corporate bond market, derivatives market, commodities market, the unit trust industry, pension funds, and education, training and licensing.

3. The methodology for this assessment comprised of a review of available official and other studies, consultative papers, master plans, presentations, and reports on the Sri Lankan financial sector and capital markets, and interviews and discussions with the government and private sector officials and professionals from key capital market institutions. Key data and statistics relating to the economy, financial sector, and capital markets of Sri Lanka and regional counterparts, obtained from official reports, are also analyzed and presented in this report.

4. A preliminary draft of the report was circulated among the key government and private sector institutions in April 2016. This was followed by an ADB Mission to Colombo from April 25th to 29th for meetings with key government and private sector institutions and players to share the findings of the report and solicit comments and feedback. The Mission team briefed the Secretary to the Treasury, Deputy Governor of the Central Bank, Director General and Chairman of the SEC and the CEO of the Colombo Stock Exchange, among others, and the SEC and CSE provided extensive feedback on the initial draft report. The preliminary report was revised on the basis of findings and feedback from various meetings and interviews conducted during the ADB Mission to Colombo.

5. The ADB Mission team was led by Bruno Carrasco (Director) and included Don Lambert (Senior Finance Specialist), and Takuya Hoshino (Financial Sector Specialist) of the Public Management, Financial Sector and Trade Division of the South Asia Department of the Asian Development Bank, Hasitha Wickremasinghe (Senior Economics Officer), and Thusitha Molligoda (Senior Private Sector Development Officer) of the Sri Lanka Resident Mission of the ADB, and Lalith Samarakoon (Capital Market Development Expert). Sri Widowati, the Country Director of the Sri Lanka Resident Mission, also participated in some key meetings. Syed Shah (Senior Financial Sector Specialist) of the ADB supported the work throughout the assignment.

II. IMPORTANCE OF CAPITAL MARKETS TO SRI LANKA

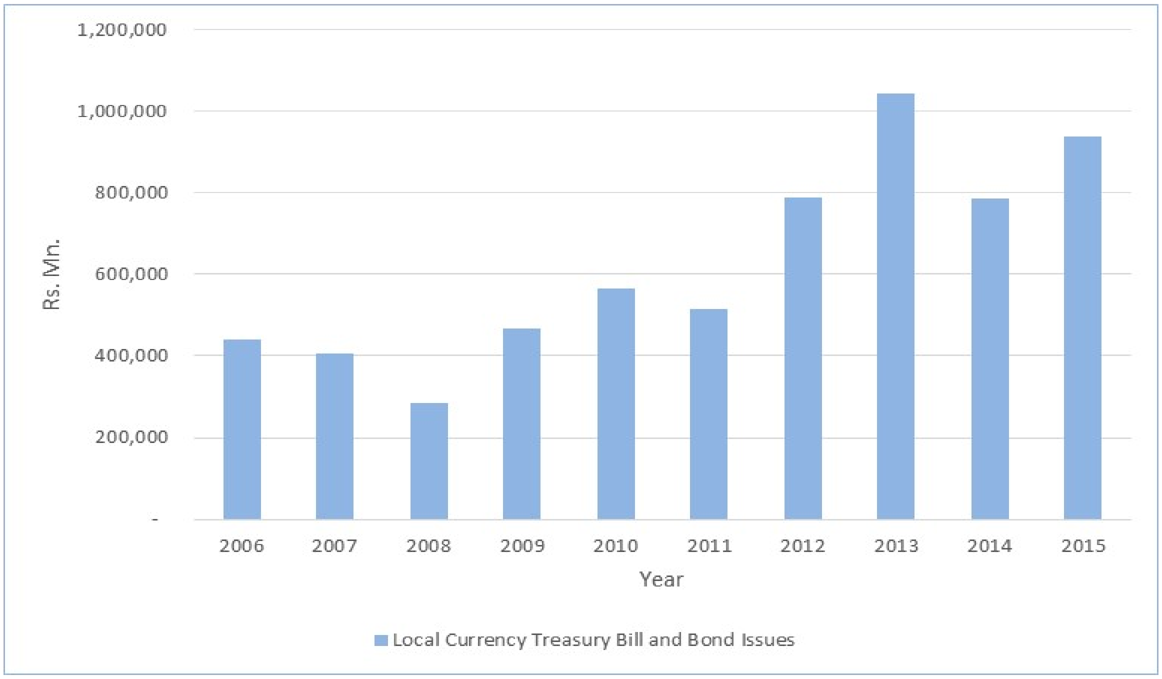
6. **Private sector capital raising:** *Capital markets help corporations raise funds and promote private sector growth.* A vibrant capital market contributes to the growth of the private sector as an important driver of the economy by providing an avenue for raising equity and debt capital. Increased investments by private sector companies lead to more business growth which in turn contributes to increasing the overall economic growth. A deep and liquid capital market helps companies issue equity and debt securities needed to finance their business expansions. Over the past 10 years, companies raised about Rs. 457 billion through equity initial public offerings (IPOs), rights issues, and corporate debt issues (Figure 1).

Figure 1: Capital Raised through the Colombo Stock Exchange (2006-2015)

Source: Colombo Stock Exchange

7. **Government borrowings:** *Capital markets help the Government borrow funds to meet its budgetary requirements.* A well-developed capital market enables the Government to borrow funds needed to finance the Government budget by issuing short-term and long-term government securities to a wide spectrum of local and foreign investors rather than relying on the domestic banking sector. The Sri Lankan Government borrowed about Rs. 6.2 trillion through the issuance of local currency Treasury bills and bonds over the past 10 years (Figure 2).

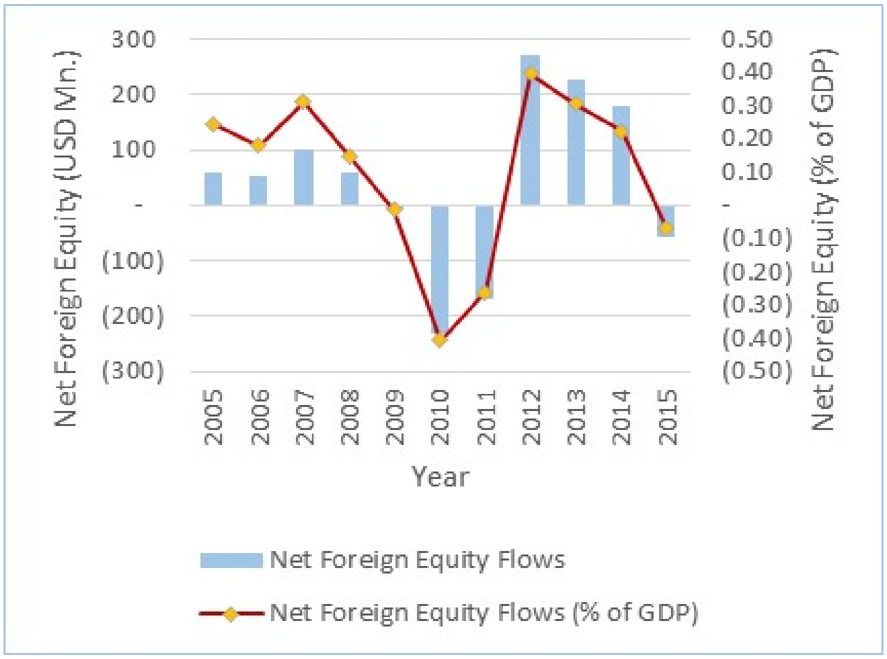
Figure 2: Borrowings of the Sri Lankan Government (2006-2015)



Source: Central Bank of Sri Lanka

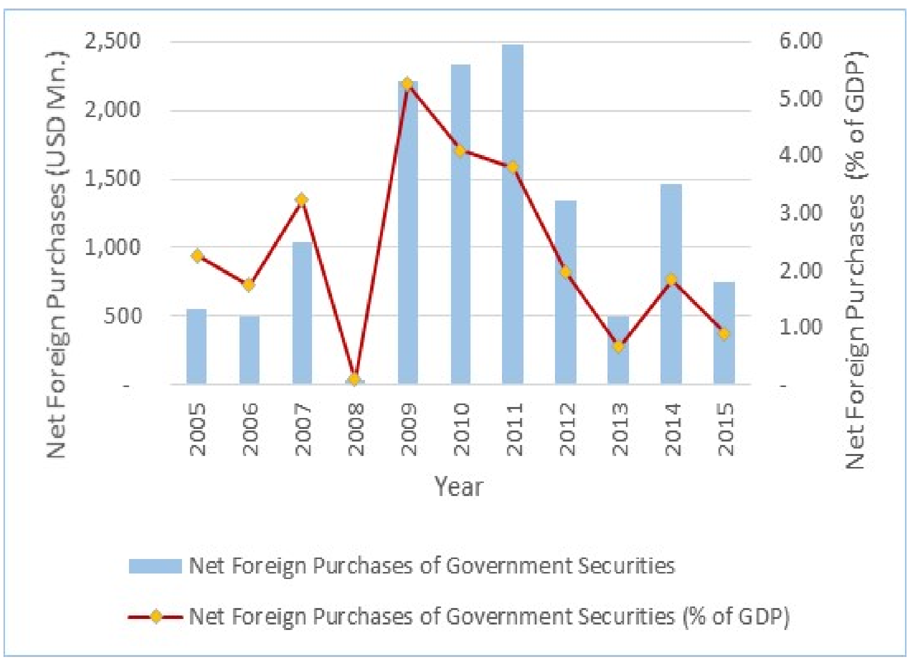
8. **Mobilizing foreign investments:** *Capital markets enable Sri Lanka to mobilize foreign investments.* A vibrant capital market helps attract foreign portfolio investments into the country in terms of equity and debt securities (Figures 3 and 4). A well-functioning capital market is generally regarded as indicative of sound economic and financial policies that create a good environment for making foreign direct investments (FDIs). Therefore, Sri Lanka will be able to attract more foreign direct investments by further developing capital markets. The 2016 Budget stated the significance of FDIs for Sri Lanka's economic growth. It stated that, on average, Sri Lanka received FDIs of USD 919 million per year during the last 10 years which is inadequate due to the shortfall of domestic savings, and that Sri Lanka needs to attract more non-debt foreign investment flows to increase the level of investment required to accelerate economic growth (Figure 5).

Figure 3: Net Foreign Equity Flows (2005-2015)



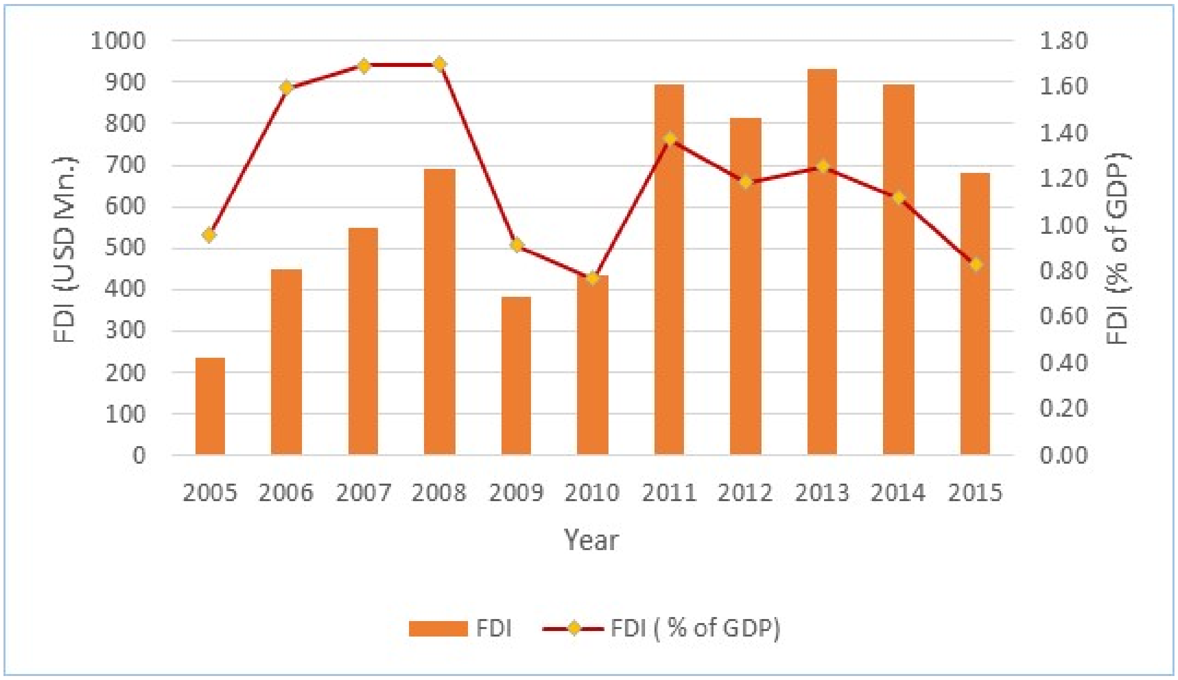
Source: Central Bank of Sri Lanka Annual Reports

Figure 4: Net Foreign Purchases of Government Securities (2005-2015)



Source: Central Bank of Sri Lanka Annual Reports

Figure 5: Foreign Direct Investments (2005-2015)



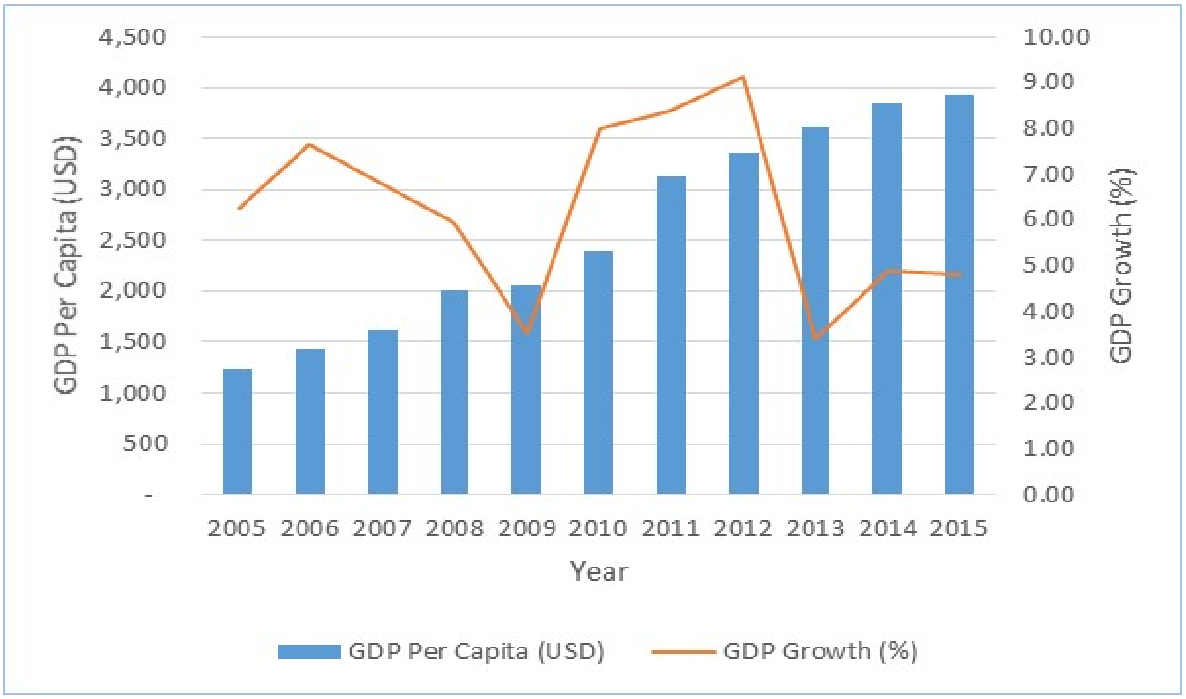
Source: Central Bank of Sri Lanka

9. **Economic growth:** *Capital markets promote economic growth, employment, income and living standards.* It is well known that Sri Lanka needs a large amount of investments for various socio-economic development needs. The Economic Policy Statement made by the Prime Minister in the Sri Lankan Parliament on November 05, 2015 has identified generating one million job opportunities and enhancing income levels as the top two priorities.[1] Achieving both of these objectives requires substantial investments of private and government capital, both domestic and foreign. Developing capital markets will help mobilize funds needed to meet large investment needs required for Sri Lanka. With a strong capital market, both the private sector and the Government will be able to effectively mobilize both domestic savings and foreign capital and channel them to productive investments which raise economic growth, employment, income and living standards with properly formulated and balanced development as well as distributional policies (Figure 6).

10. **Lower cost of capital:** *Capital markets help raise funds at the lowest possible cost*. A well-functioning capital market facilitates both companies and the Government to raise funds at the most competitive rates prevailing in the market place and helps reduce the cost of capital. In the absence of a strong capital market, companies and the Government have to rely on the banking sector to obtain necessary funds and may have to act as price takers. But the ability to source funds from a wider capital market with individual and institutional investors worldwide competing to supply capital enables corporations and the Government to have a wider array of financing options beyond traditional bank financing while obtaining funds at the lowest possible cost.

Figure 6: Sri Lanka's GDP Per Capita and Growth (2005-2015)

[1] Economic Policy Statement of Prime Minister, Mr. Ranil Wickremasinghe, November 05, 2015.



Source: Central Bank of Sri Lanka

11. **Efficient allocation of resources:** *Capital markets promote efficient allocation of resources.* Capital markets are where households, companies and institutions channel their savings to other households, companies, institutions and governments that need funds to finance their investment and consumption needs. Capital markets provide savers and investors with a wide range of instruments and intermediaries including stocks, bonds and mutual funds with varying degrees of risk and return opportunities. A well-developed capital market will ensure that funds are invested and allocated to productive investment opportunities efficiently. Investors will be able to channel their savings according to their own risk and return preferences with a broader spectrum of financial instruments.

12. **Diversification of investments:** *Capital markets provide diversification opportunities for investors*. Traditionally, savers and investors deposit and lend their funds to the banking sector institutions which provide only a limited number of savings and investment products. But with stocks, bonds, mutual funds and other financial instruments, capital markets provide savers and investors a much wider array of options for diversifying their investments across asset classes with varying degrees of risk and returns. One special type of institution that benefits from this diversification opportunity is retirement funds which otherwise invest almost exclusively in government securities. The Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF) and other retirement funds in Sri Lanka, for example, have invested portions of their portfolios, although small, in equity and corporate debt securities. By doing so, they have the opportunity to enhance returns to subscribers in the long-term and provide them with investment options that suit their own investment appetite.

13. **Efficiency of public enterprises:** *Capital markets provide an opportunity for the Government to create efficient state enterprises.* Well-run state-owned enterprises (SOEs) will be able to borrow funds through the issuance of securities in the capital market thus reducing their reliance on the Government for financing needs. Second, the Government can privatize more profitable and financially viable SOEs through listing on the stock market enabling it to raise funds through such divestitures. Listed SOEs will then be able to raise more funds by way of both additional equity and debt offerings to the public and further reduce the budgetary burden of the Government. The market discipline forces the SOEs to have better governance, professional management and sound business models making them more efficient in terms of the use of resources and profitability. Ultimately, well-run listed SOEs will be able to contribute to the Government revenue through payment of dividends and taxes, and the Government will have an exit option in the event it decides to fully divest its ownership in such enterprises.

14. **Liquidity creation:** *Capital markets generate liquidity in the financial system.* A well-developed capital market effectively pools the supply of savings and the demand for funds into a central marketplace that constitutes all capital market institutions, enabling creation of liquidity which is the ability to sell or borrow funds quickly at competitive prices. This enables more trading activity for various financial instruments and channeling of funds for various investment needs. The ability to exit from investments quickly at competitive prices provides more confidence to both savers and borrows to participate in the capital market and take risks. Ultimately, efficient channeling of savings for investments contributes to business and economic growth.

15. **Corporate governance:** *Capital markets promote improved corporate governance.* A well-established capital market is governed by a strong legal and regulatory framework that includes key institutions such as the Securities and Exchange Commission, Stock Exchange and the Central Bank, among others. The regulatory systems require or promote better corporate governance of the entities that issue securities in order to ensure that such entities are effectively and efficiently managed and investor interests are protected.

16. **Sound economic policies:** *Capital markets reward sound economic policies.* Capital markets will enable governments with sound fiscal and monetary policies to borrow funds at the lowest possible costs on its bond issues. Furthermore, the ability of the Government to attract foreign investor demand for its issuances of sovereign bonds and other foreign-currency denominated securities will be greatly enhanced by having a a more efficient capital market with sound regulatory, trading, clearing and settlement systems.

17. **Monetary policy:** *Capital markets augment instruments of monetary policy.* Capital markets provide an array of options and instruments and flexibility for the Central Bank to implement its monetary policy. For instance, a deep and liquid market for government securities greatly facilitates open market operations of the Central Bank. Since the 2008 financial crises, central banks have increasing relied on both government and corporate debt instruments in implementing monetary policy innovations such as quantitative easing. Robust capital markets greatly enhance the Central Bank's flexibility to deal with liquidity and financial crises.

III. THE FINANCE SECTOR AND CAPITAL MARKETS OF SRI LANKA

A. Finance Sector

18. The Sri Lankan finance sector consists of the Central Bank, deposit taking financial institutions (commercial banks, specialized banks, finance companies, co-operative rural banks, and thrift and credit societies), specialized financial institutions (leasing firms, primary dealers, stock brokers, unit trusts, underwriters, investment managers, margin providers and venture capital companies), insurance companies, and superannuation funds.

Table 1: The Size and Composition of the Finance Sector of Sri Lanka in 2015

FINANCE SECTOR	Finance Sector Assets			
	Rs. Bn.	USD Bn.	% of Total Sector	% of GDP
Central Bank	**1,426**	**9.9**	**10.4**	**12.8**
Deposit Taking Financial Institutions	**9,119**	**63.3**	**66.7**	**81.5**
Licensed Commercial Banks	6,974	48.4	51.0	62.4
Licensed Specialized Banks	1,103	7.7	8.1	9.9
Licensed Finance Companies	915	6.4	6.7	8.2
Co-operative Rural Banks	116	0.8	0.8	1.0
Thrift and Credit Co-operative Societies	11	0.1	0.1	0.1
Specialized Financial Institutions	**544**	**3.8**	**4.0**	**4.9**
Specialized Leasing Companies	81	0.6	0.6	0.7
Primary Dealers	283	2.0	2.1	2.5
Stock Brokers	10	0.1	0.1	0.1
Unit Trusts	130	0.9	1.0	1.2
Market Intermediaries	32	0.2	0.2	0.3
Venture Capital Companies	8	0.1	0.1	0.1
Insurance Companies	**454**	**3.2**	**3.3**	**4.1**
Superannuation Funds	**2,119**	**14.7**	**15.5**	**18.9**
Employees' Provident Fund	1,665	11.6	12.2	14.9
Employees' Trust Fund	223	1.5	1.6	2.0
Approved Pension and Provident Funds	185	1.3	1.4	1.7
Public Service Provident Fund	46	0.3	0.3	0.4
Total Finance Sector	**13,662**	**94.8**	**100.0**	**122.2**
Memorandum Items				
GDP (at current market prices)	11,183	82.3		
Exchange Rate (Rs. per USD Annual Average)	135.94			
Exchange Rate (Rs. per USD Year-End)	144.06			

Source: Central Bank of Sri Lanka Annual Report 2015

19. At the end of 2015, total size of Sri Lanka's finance sector amounted to Rs. 13.7 trillion (USD 95 billion). The finance sector assets are 122% of the GDP of Rs. 11.2 trillion (USD 82 billion). Table 1 and Figure 7 show data relating to the finance sector composition. The largest segment of the finance sector is deposit taking financial

institutions accounting for 67% of the finance sector assets. The second largest sector is superannuation funds, which include the two largest provident funds - EPF and EFT - among others, amounting to 16% of the finance sector assets. Specialized financial institutions account for 4% while the insurance sector is 3.3% of finance sector assets. The value of unit trusts, which are part the specialized financial institutions, was about Rs. 130 billion (USD 1 billion) representing just about 1% of the finance sector.

20. The assets of the deposit taking financial institutions represent 82% of the Sri Lankan economy while the superannuation funds are 19% of the economy. The most dominant sub-sector within the deposit taking financial institutions is the licensed commercial banks which account for 51% of the finance sector assets and 62% of the GDP. The largest provident fund, EPF, represents 12% of the finance sector assets and 15% of the economy.

B. Capital Markets

21. The key components of the capital markets of Sri Lanka include government securities, stocks and corporate bonds. As at the end of 2015, total size of the capital market was Rs. 7.1 trillion (USD 50 billion). Government securities markets dominate with a share of 56%. The second largest asset class is the stock market which has a 41% share of the capital market. The listed corporate debt market is very small accounting for just 3% (Table 2 & Figure 8).

22. Treasury bills and bonds account for 17% and 83% of government securities and 9% and 46% of of the entire value of the capital market respectively. In term of the importance in the economy, total size of the capital market is about 64% of the Sri Lankan economy. The size of the government securities and stock markets are 35% and 26% of the economy respectively.

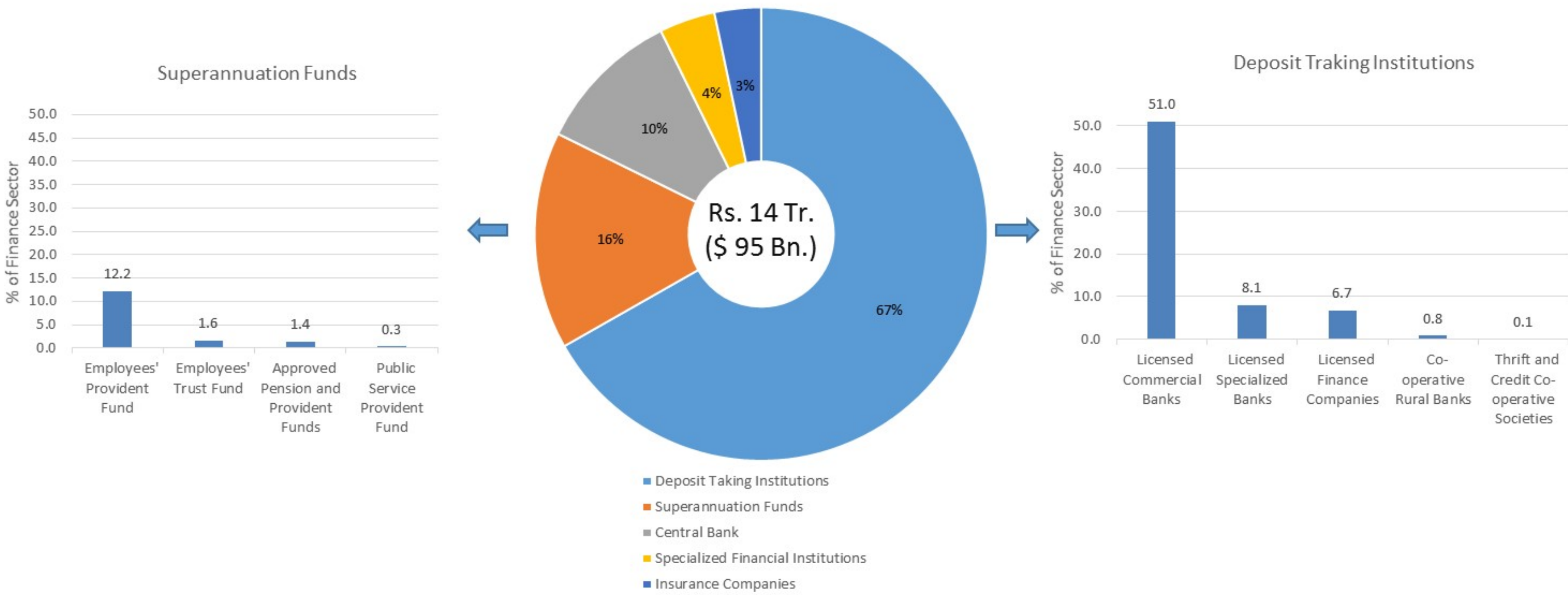
.

Table 2: The Size and Composition of Capital Markets of Sri Lanka in 2015

Capital Markets	Value of Capital Market Asset Classes			
	Rs. Bn.	USD Bn.	% of Total Capital Market	% of GDP
Government Securities (1)	**3,963**	**27.5**	**55.5**	**35.4**
Treasury Bills	658	4.6	9.2	5.9
Treasury Bonds	3,305	22.9	46.3	29.6
Stock Market Capitalization	**2,938**	**20.4**	**41.1**	**26.3**
Corporate Debt Market Capitalization	**239**	**1.7**	**3.3**	**2.1**
Total	**7,140**	**49.6**	**100.0**	**63.8**

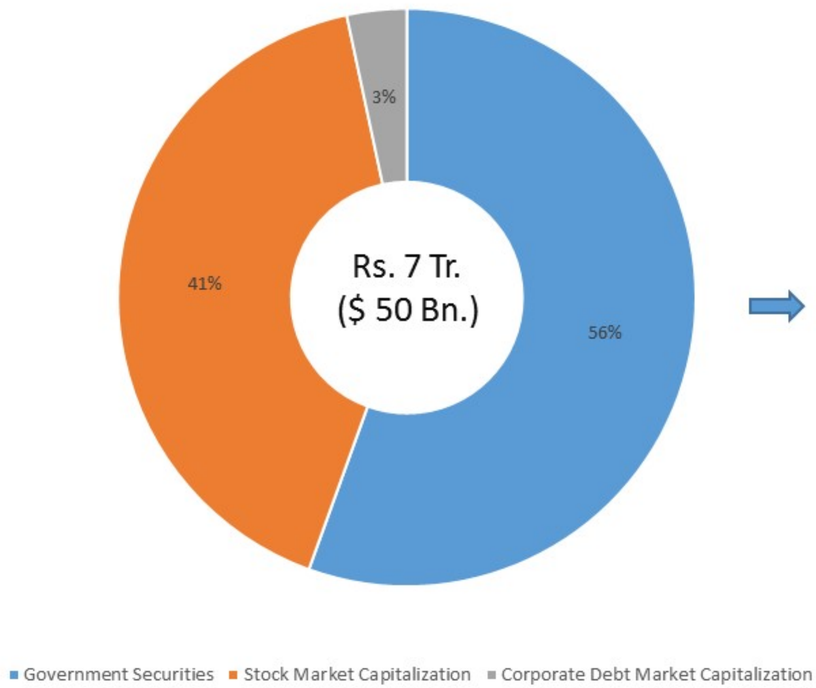
(1) Face value of outstanding government securities.
Source: Central Bank of Sri Lanka Annual Report 2015, Colombo Stock Exchange.

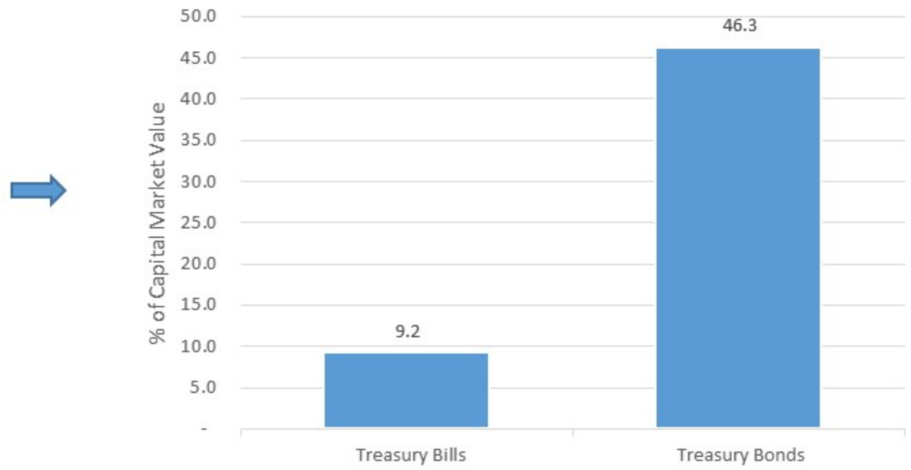
Figure 7: The Size and Composition of the Sri Lankan Finance Sector in 2015



Source: Central Bank of Sri Lanka Annual Report 2015

Figure 8: The Size and Composition of the Sri Lankan Capital Markets in 2015





Sources: Central Bank of Sri Lanka Annual Report 2015, Colombo Stock Exchange

IV. SRI LANKA CAPITAL MARKET POLICY DEVELOPMENTS

23. Capital market development within an integrated national economic and finance sector development framework is a critical precondition for achieving significant success in developing deep and liquid capital markets. Sri Lanka has had a number of capital market development plans in the past. They include, among others, the Securities and Exchange Commission (SEC) Capital Market Master Plan (2006), the Colombo Stock Exchange (CSE) Mackenzie Plan (2012), the SEC Capital Market Development Road Map (2012), and the SEC 20/20 Vision (2014). The contents of these plans provide insights into various objectives the capital market policy makers intended to achieve through implementation of various initiatives.

A. The SEC Capital Market Master Plan (2006)

24. In 2006, the Sri Lankan SEC drafted a 10-year (2006-2015) Capital Market Master Plan with consulting assistance from E&Y Malaysia and funded by the ADB. The Master Plan envisaged four phases of market development and included 44 recommendations. Some of the key recommendation for each phase of development are listed in Table 3.

Table 3: The SEC 2006 Capital Market Master Plan (2006-2015):
Phases and Recommendations

Phase	Major Objective	Key Recommendations
Phase 1: 2006	Building the SEC and capacity and confidence in the capital market	• Strengthen the SEC structure and capabilities • Establish the SEC Capital Market Institute • Develop a program to develop a vibrant debt market • Education programs for issuers and retail investors • Encourage greater participation of pension funds (EPF, ETF)
Phase 2: 2007	Building vibrant equity and debt markets	• Conduct annual dialog with industry • Expand the SEC regulatory coverage to other capital market products and intermediaries • List one SOE • List 10-20 large corporates[2] • List asset-backed securities • Establish a counter for listing infrastructure project companies • Establish a benchmark yield curve • Convert investor accounts to Central Depository System • Establish National Equity Corporation • Encourage EPF and ETF to outsource fund management • Encourage SOE's to increase investment portfolios • Outsource fund management by insurance companies • Reinstate Sri Lanka on the MSCI index • Mandate Corporate Governance Code • Strengthen capital adequacy requirements of stock brokers • Widen capital market services of stock brokers

[2] Although there were no listings in 2007, 77 companies were listed on the CSE during 2008-2015 by way of IPOs while there were 24 delistings.

Phase	Major Objective	Key Recommendations
		• Review tax regimes to encourage investment in unit trusts • Enhance corporation among regulatory bodies (SEC, CBSL, IBSL)
Phase 3: 2008-2010	Building capacity of intermediaries and grooming several regional champions	• 10-20 large corporates to issue private debt securities • Establish a counter for listing high-tech companies • Establish a National Mortgage Loan Corporation • Demutualize and list the CSE • Strategic alliance with regional stock exchanges for the CSE • Develop the private pension fund industry • Establish Minority Shareholder Watchdog • Reassess the need and timing for venture capital industry • Liberalize stock brokering commission rates • Encourage development of financial planners
Phase 4: 2011-2016	Increasing participation of foreign investors and intermediaries	• Encourage foreign companies to list on the CSE • Reassess the need and timing for derivatives products

Source: Capital Market Master Plan, Securities and Exchange Commission of Sri Lanka, August 01, 2006.

B. McKinsey Capital Market Master Plan (2012)

25. The CSE engaged McKinsey & Company to prepare a capital market master plan for Sri Lanka. The McKinsey Report of 2012 identified 12 initiatives for developing the Sri Lankan capital market (Table 4).

Table 4: McKinsey Capital Market Master Plan: Phases and Initiatives

Phase	Objective	Initiatives
Phase 1: 12-18 months	Build robust platforms and capabilities	• Transform the brokerage industry • Strengthen business media • Robust risk infrastructure within the CSE • Create globally acceptable stock index • Improve talent and capabilities
Phase 2: 18-30 months	Improve stakeholder confidence and expand participation	• Attract large companies to list on local markets • Facilitate development of corporate debt market • Increase retail participation in capital markets through unit trusts • Attract global and regional foreign institutional investors • Strengthen the investment banking landscape • Demutualize stock exchange
Phase 3: Ongoing	Leverage strengths to innovate	• Launch complementary trading products

Source: McKinsey Capital Market Master Plan, Colombo Stock Exchange, February, 2012.

C. The SEC Capital Market Development Road Map (2012)

26. In November 2012, the SEC developed a Capital Market Development Road Map which identified 10 key strategies as priorities for capital market development in the medium-term over a 3-year period period from 2013 to 2015 (Box 1). This road map was supported by findings of the CSE-initiated McKinsey Report of 2012.

27. The plan targeted achieving market capitalization ratio of 50% of the GDP assuming a USD 100 billion economy, a fully demutualized exchange, a fully-fledged clearing corporation, enhanced risk management, and a USD 10 billion bond market by 2016.

Box 1
The SEC 10 Key Strategies (2013-2015)

1. Demutualization of the CSE
2. SEC Act amendments
3. Implementation of Risk Management System (RMS), Delivery vs Payment (DVP) & Central Counter Party (CCP)
4. Development of corporate bond market
5. Development of new products
6. Development of unit trust industry
7. Education and awareness
8. New listings (public and private sector)
9. Attracting new funds (local and foreign)
10. Develop infrastructure – Broker Back Office Systems (BBO)

Source: Capital Market of Sri Lanka Opportunities and Challenges, The Securities and Exchange Commission of Sri Lanka, February 2013

D. The SEC 20/20 Vision (2014)

28. The SEC introduced a capital market development master plan called "the SEC 20/20 Vision" in 2014. Accordingly, the vision was to create "a capital market global in scale possessing a multi-asset class, multi-product base, equipped with sophisticated risk management systems on par with most advanced markets and comfortably placed within the emerging market sphere."

29. The plan envisaged the equity market capitalization to increase from USD 24 billion in 2014 (32% of GDP) to USD 100 billion (66% of GDP) by 2020. It assumed that the increase in the market cap will come from organic growth of the existing listings (USD 31 billion), new listings (USD 30 billion), structured products (USD 10 billion), and cross border listings (USD 5 billion). The 20/20 Vision also projected a corporate debt market capitalization of USD 20 billion, average daily market turnover to market cap of 15% and market participation by 33% of the working population by 2020.[3]

[3] Also see, Dr. Godahewa shares 2020 vision for Sri Lanka's capital market, Daily FT, January 06, 2015. http://www.ft.lk/2015/01/06/dr-godahewa-shares-2020-vision-for-sri-lankas-capital-market/

Box 2
The SEC 2020 Vision (2015-2020)
Migrating from Frontier Market in 2014 to Emerging Market by 2020

2015

1. Amending the SEC Act of 1987
2. Demutualization of the CSE
3. Risk management - Central Counter Party (CCP) & Delivery vs Payment (DVP)

2017-2020

4. Strategic partner for the CSE
5. Commodities exchange
6. Structural products (REITS, ABS, MBS, ETFs)
7. Derivatives (options and futures)
8. Cross border listing (SAARC countries and SAFTA mechanism)
9. Short selling

Source: 20/20 Outlook, The Securities and Exchange Commission of Sri Lanka, 2014

E. Overall Assessment of Capital Market Development Plans

30. The goals set out in past capital market development plans were excellent and well-intended. However, most goals were highly ambitious and not supported by detailed implementation strategies. In most cases, the goals and the time lines could have been better grounded on a more realistic assessment of necessary regulatory, economic, market and infrastructural preconditions and the time it takes to develop various components of the market with proper sequencing of reforms, Such plans were almost always crafted without a cohesive, national-level finance sector development strategy and high-level commitment. At times, there were national level financial sector reform committees. But they were not effectively integrated into an overall economic and finance sector development strategy and, in almost all cases, government changes led to implementation bottlenecks, slowdowns, and abandoning of some old plans and creating new ones with essentially similar broader goals and initiatives.

31. The most important step for developing capital markets of Sri Lanka is to formulate a national level capital market development program with participation and commitment of all key parties such as the Ministry of National Policies and Economic Affairs, Ministry of Finance, Ministry of Public Enterprise Development, Securities and Exchange Commission, Insurance Board of Sri Lanka, Colombo Stock Exchange and the Central Bank of Sri Lanka. Without the highest level buy-in and commitment, the critical pieces of the capital market development puzzle will continue to remain unfinished, and any institutional-level master plan will continue to face implementation challenges.

V. REGULATORY AND INSTITUTIONAL

A. The Securities and Exchange Commission Act

32. The major law regulating Sri Lanka's securities markets is the Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987. It has been amended by the Securities Council Amendments Act No. 26 of 1991, the Securities and Exchange Commission of Sri Lanka (Amendment) Act No. 18 of 2003, and the Securities and Exchange Commission of Sri Lanka (Amendment) Act No. 47 of 2009.

33. *The functioning and investor confidence of the Sri Lankan securities markets have been undermined by weak regulations in some critical areas.* The SEC's regulatory powers are weak in certain critical areas such as enforcement of securities laws while necessary laws and regulations are lacking in other areas such as demutualization of the exchange, central counterparty clearing and settlement, and derivatives and commodities markets. Amendments to the SEC Act are needed to address existing regulatory gaps and to make provisions enabling future capital market developments.

34. *The SEC has been working on amendments to the SEC Act of 1987 since 2012.* Previous capital market development plans, at least since 2012, have stated amending the SEC Act as an important priority. The 2016 Budget Speech also stated that the Government is committed to creating an enabling environment in which the stock market can operate efficiently and effectively and proposed that the SEC Act be revised to address such regulatory deficiencies. Thus, the importance of amending the SEC Act has been clearly recognized by both the SEC and the Government.

35. The current status is that the SEC has set up a committee to further review the work that has been already done and then to redraft the Act. The SEC expects the new Act to be presented to the parliament for approval in the latter part of 2016.

36. The new Act is expected to contain a number of provisions to strengthen the regulatory scope and powers and to develop new securities products. The key new provisions expect to include the following:
    i. Provision for and regulation of demutualized exchanges
    ii. Regulation of central counter party system and clearing houses
    iii. provisions for civil sanctions against securities law violations such as market manipulation and insider trading
    iv. Providing for restitution to investors
    v. Licensing and regulation of derivative and commodities exchanges and introduction of new products including derivatives
    vi. Incorporating legal duties on auditors in respect of capital market offences
    vii. Enhancing of measures for investor protection

37. *The SEC needs to complete the drafting of the new SEC Act addressing regulatory deficiencies and enact it into law expeditiously*. The new provisions are expected to significantly mitigate the existing regulatory deficiencies in the areas of securities law enforcement, create an enabling environment for developing the capital market, and enhance investor confidence and protection.[4]

[4] The IOSCO is carrying out a country review to develop a road map to upgrade the regulatory framework.

B. Demutualization of the Colombo Stock Exchange

38. Demutualization is the process by which an existing member-owned, mutually operated, non-for-profit stock exchange is converted into a shareholder-owned, commercially operated, for-profit corporate entity. It segregates ownership and management from trading rights of the members of an exchange. Ultimately, the demutualized stock exchange itself may be listed, and its shares are traded on the stock exchange.

39. *The CSE is the only major exchange in South Asia that remains un-demutualized.* Demutualization of exchanges has been a key global trend in the securities exchange architecture. Thirteen of the 23 markets in the MSCI Emerging Market Index (EMI) have been demutualized. Of the 8 Asian stock markets in the EMI, 6 are demutualized exchanges with the only 2 non-mutualized exchanges being China and Indonesia. As far as the South Asian region, Bombay, Dhaka, and Islamabad exchanges have already been demutualized (Table 4).

Table 4: List of Demutualized Stock Exchanges in Asia

Exchange	Year Demutualized	Year Listed
Taiwan Stock Exchange	1961	-
Singapore Stock Exchange	1999	2000
Hong Kong Stock Exchange	2000	2000
Philippine Stock Exchange	2001	2003
Bursa Malaysia	2004	2005
Bombay Stock Exchange	2005	-
Korea Stock Exchange	2005	-
Stock Exchange of Thailand	2007	2008
Islamabad Stock Exchange	2012	2012
Dhaka Stock Exchange	2013	-

Source: Individual Stock Exchanges

40. *Demutualization of the CSE has been a top priority for the SEC and the CSE*. All recent capital market development plans have identified demutualization as one of the key objectives. The Government has also pointed out the importance of demutualization in its 2016 Budget. It states that "the Colombo Stock Exchange is still a member-owned entity and a not-for-profit entity. If one looks at stock exchanges of the world that have performed well, they are demutualized. Demutualization ensures that the exchange actually looks into the issues of the market participants rather than satisfying financial intermediaries. This will also ensure greater transparency, better use of technology to ensure transparency and lower trading costs. As such, since the Government is dedicated to creating a fair and efficient environment that benefits its participants, it is proposed to conclude the demutualization process of the CSE during 2016."

41. By being a mutually-owned entity, the CSE has to manage the interests of the not-for-profit closed member-based organization with a central focus on providing services for the benefit of primarily of the members/brokers. The current member-owned structure gives the brokers more leverage in determining the strategic and operational policies of the CSE. Demutualization will allow the CSE broaden its ability and flexibility to better serve interests of all market stakeholders.

42. *Lack of regulatory provisions enabling demutualization of the exchange is the critical stumbling block for moving forward with the demutualization process.* There are two regulatory requirements to proceed with demutualization. First, the SEC Act has to be amended to include provisions enabling demutualization. Second, a demutualization act has to be enacted in order to lay the legal foundations enabling transition of the CSE to a demutualized entity. Thus, the passage of both the new SEC Act and the Demutualization Act are necessary pre-conditions before Sri Lanka can proceed with the actual execution of a demutualization plan.

43. According to the SEC, the Demutualization Bill has passed through the legal draftsman stage, and the Cabinet has given its approval. The SEC is in the process of finalizing the Bill with the intention of forwarding it to the Sri Lankan Parliament for enactment, along with the new SEC Act, in the latter part of 2016. The new SEC Act is expected to contain provisions enabling demutualization of the stock exchange. If all goes as planned, demutualization of the CSE might be possible in 2017 the earliest.

44. In anticipation of the passage of the new SEC Act and the Demutualization Act, the SEC and the CSE have begun preparatory work on the modalities of demutualization including regulatory, governance, and shareholding structure, and allocation of shares of the demutualized stock exchange among the stakeholders including existing member firms and the Government or a capital market development fund. The CSE has also completed a consultation report through Ernest and Young in regard to demutualization which has provided recommendations and guidelines.

45. *Share allocation is likely to be one of the biggest contentious issues of demutualization.* There is likely to be tension between stock broker members on the one hand and the SEC and Government on the other hand as to the formula for allocation of shares and ownership rights.

46. *A key concern is the feasibility of running the demutualized exchange as a profitable and financially strong entity.* The demutualized CSE will have to operate as a for-profit company to meet the return expectations of its investors. This becomes particularly paramount once the exchange has been listed since trading and changes in share ownership could potentially create a broader investor base.

47. *It is not clear if Sri Lanka has developed a comprehensive demutualization plan encompassing all aspects of demutualization of the CSE*. The key areas of such a framework will include, among others,

   i. Shareholding structure of the demutualized exchange.
   ii. Methods for allocating the share capital of the exchange among the identified shareholders.

iii. Management structure of the exchange including corporate governance guidelines.
iv. Voting rights/restrictions of shareholders.
v. Listing of shares of the demutualized exchange and related matters.
vi. Framework for regulating the demutualized exchange.

48. *The SEC should draft and enact the Demutualization Act expeditiously*. As previously stated, the SEC is in the process of drafting a demutualization act which is expected to be presented to the Parliament of Sri Lanka for enactment, along with the new SEC Act, in 2016. The new SEC Act is expected to contain provisions enabling the demutualization of the stock exchange. The passage of these two laws needs to be completed within the target timeframe.

49. *The CSE needs to create a viable business plan for the demutualized exchange*. The demutualized CSE will have to be run as a for-profit company, and its ability to generate revenue becomes more important. At present, the CSE primarily depends on its portion of trading commission on stock market transactions, and it is important to assess how such income will be impacted after demutualization. As will be discussed later, existing transaction costs are high and any future reduction of them will have revenue implications for the exchange. Increasing the size and liquidity of the market as well as having a diversified mix of capital market products will become very important for profitability and financial stability of the CSE. Strategies will need to be formulated in order to reduce the CSE's dependence on trading income and to increase non-trading sources of revenue.

C. Takeovers and Mergers Regulation

50. The Takeovers and Mergers Code of 1995 as amended in 2003 (Code) provides for rules relating to takeovers and mergers where the offeree is a listed public company. The Code aims to ensure equal treatment of all shareholders of the same class in the company sought to be taken over and dissemination of sufficient information and advice with adequate time to the shareholders of the target company in order for them to arrive at an informed decision relating to the takeover. The Code provides for the SEC to approve market announcements, offer documents, and independent valuation reports in the takeover process of public listed companies.

51. In December 2014, the SEC released a consultative paper on a new Takeovers and Mergers Code to amend the Code. According to the SEC, the new Code is designed to afford enhanced protection to shareholders of listed companies in takeover or merger situations ensuring that they are treated fairly and are not denied an opportunity to exit from a listed company after deciding on the merits of a takeover or merger. The new Code also enhances the discretion and flexibility vested with the SEC to dispense with mandatory offers under certain circumstances. It also provides for the establishment of a Takeover Panel to decide on complicated issues that may arise in relation to takeovers and mergers in the future and recognizes compliance auditors that will primarily ensure that parties to a takeover will comply with the regulation.

52. The current status of the new Code is that the SEC has completed final consultations and is now reviewing public comments. *The SEC needs to expeditiously proceed with*

the enactment of the new Code. This enhanced regulation of the market for takeovers and mergers is very important to ensure fair and efficient capital markets.

D. Securitization Regulation

53. *Sri Lanka has long considered the possibility of facilitating the introduction of structured products such as mortgage backed securities (MBS) and asset-backed securities (ABS) by establishing a regulatory framework through a securitization act.* Securitization regulations are needed in order to provide the legal framework for the establishment of special purpose vehicles (SPVs) for securitization, transferring assets to SPVs, issuance of asset backed securities by SPVs, and regulation of persons involved in securitization transactions such as originators and trustees. According the SEC, a securitization law was approved and sent to the Parliament in June 2009. However, this legislation was not taken up at the Parliament because the sessions had been prorogued. There has not been any progress on this legislation since then.

54. There have been issuances of asset-back securities in Sri Lanka. Specialized leasing companies have traditionally originated quasi-securitization transactions. These securitizations involve borrowing against assets such as leasing and hire purchase receivables. The pledged assets are not transferred to a SPV and remain on the borrower's balance sheet. In essence, these are "collateralized borrowing" rather than securitization of assets since there is no creation of asset-backed securities. Some of the securitization issues were rated as well. There is no publicly available data on the overall amount of such transactions.[5]

55. *The Sri Lankan financial sector regulators need to provide a comprehensive legal and regulatory foundation for securitizations in Sri Lanka.* Regulation of securitization markets including origination, trading and intermediation are very important, particularly in the context of the experience in developed markets such as the United States where MBS and ABS contributed to the 2008 financial crises and the subsequent Great Recession. Since financial institutions come under the regulatory purview of the Central Bank of Sri Lanka (CBSL), it is important for both the SEC and the CBSL to spearhead regulations necessary to provide the legal foundation for developing the securitization industry. Any new initiative to proceed with this work will most likely require revising the Act that was drafted in 2009 and should take into account mitigation of systemic risks associated with securitized products given the experience of the role of securitized products in the 2008 global financial crisis.

E. Insurance Industry Regulation

56. The Regulation of Insurance Industry Act, No. 43 of 2000 provides the relevant legal framework for the regulation and supervision of insurance companies, insurance brokering companies, insurance agents and loss adjusters. This Act has been amended by the Regulation of Insurance Industry (Amendment) Acts, No. 27 of 2007 and No. 03

[5] For example. The People's Leasing Company (PLC), the largest specialized leasing firm in Sri Lanka, had Rs. 9.5 billion of asset-backed securities on its balance sheet as of March 31, 2015. Lanka Orix Leasing Company (LOLC), which is the largest specialized leasing company listed on the CSE, had Rs. 2.3 billion of securitized borrowings as of March 31, 2014.

of 2011. The Insurance Board of Sri Lanka (IBSL) is the regulator for the insurance industry. The current regulatory issues that have capital market implications include segregation of composite insurance companies and risk-based capital rules.

57. The Regulation of Insurance Industry (Amendment) Act, No. 3 of 2011 requires that composite insurance companies segregate the long-term (life) and non-life insurance businesses into two separate entities and obtain a listing on or before February 2015. Sri Lanka's 9 of the 12 composite insurers have so far completed their segregation requirements, and 3 are still pending.[6] In terms of listing of segregated firms, People's Insurance has been listed and others have three years to seek a listing. Once all such insurance companies are listed, the CSE will have a higher number of insurance companies.

58. A Risk-Based Capital (RBC) framework has been introduced with effect from January 2016 under the RBC rules, also known as Solvency Margin Rules, gazetted in December 2015. Accordingly, every insurer is required to maintain a Capital Adequacy Ratio (CAR) of a minimum of 120%, and a Total Available Capital (TAC) of Rs. 500 million. These rules specify guidelines for admissible assets, asset limits, valuation of assets and liabilities, and determination of risk capital factors for each class of assets. Under the asset limit rules, the maximum limits relating to capital market instruments include government securities issued by the CBSL (100%), listed ordinary shares (30% for general insurers and 40% for life insurers), corporate debt issued by a commercial bank or a licensed specialized bank (60% for general insurers and 50% for life insurers), listed corporate debt (10%), and asset-backed securities (10%). These investment limits for asset classes provide for more room for insurance companies to participate in the capital market particularly in equity and corporate bond instruments.

F. Financial Sector Consolidation

59. The CBSL proposed a Financial Sector Consolidation Plan (FSCP) in 2014. The main purpose of this plan is to create a strong and dynamic financial sector by consolidating within the banking and non-bank financial institutions through mergers and acquisitions. The ultimate goal is to have a smaller number of large and financially strong banks and non-bank financial institutions. The rationale for consolidation also includes financial issues, and alleged mismanagement and fraud in finance companies. Many of the finance companies are believed to be financially unviable.

60. The FSCP was halted following the Presidential election and the formation of a new government in January 2015. Subsequently, the Government appointed a committee to revisit the FSCP and make recommendations, and a report was submitted to the Government in May 2015. This report is not publicly available.

61. *This plan has enormous implications for the capital markets. Consolidation is necessary for finance sector soundness and stability and to mitigate against any systemic risks given that bank and non-bank institutions play a very significant role in the Sri Lankan finance sector and the economy*. Financial institutions also have a larger share in the CSE in terms of the number of listed companies, market capitalization, trading and

[6] The composite insurers pending segregation are Sri Lanka Insurance Corporation, MBSL Insurance, and Sanasa Insurance. The latter two require recapitalization.

capital raising including debenture issues. As such, industry consolidation will affect a larger number of firms directly or indirectly through the changes in the industry competitiveness and profitability.

62. *The financial sector regulators need to consider industry consolidation as an important objective in financial sector development.* The FSCP needs to be revisited, appropriately revised and implemented with a realistic and proper strategic approach and sequencing.

G. Unified Regulatory Mechanism

63. *Regulatory, supervisory and enforcement powers in respect of securities markets are vested with multiple governmental agencies contributing to significant regulatory and market development bottlenecks and inefficiencies*. The SEC is the primary regulator for listed securities markets that currently include equity and debt securities. As such, the only listing exchange, the CSE, is regulated by the SEC. The Insurance Board of Sri Lanka (IBSL) is the regulatory body for the insurance industry of Sri Lanka, and a number of insurance companies are listed on the CSE. The Central Bank of Sri Lanka has the regulatory and supervisory powers over the banking and non-banking financial institutions. As the issuer of government securities, the CBSL also has the regulatory and supervisory powers over the primary dealers who participate in both primary auctions and the OTC secondary market as brokers and dealers. Further, the CSE has its own scope of supervisory authority in regard to the operation of the primary and secondary market for equities and listed debt securities. There have been some trading of government bonds on the CSE and some of the primary dealers have become debt trading members of the CSE as well.

64. As the securities industry grows in terms of size and complexity of products and the number, types, and scope of market intermediaries expand, a fragmented regulatory system could pose significant regulatory challenges and systemic risk. Establishing a single regulator covering all securities market institutions and products including all fund management firms will greatly foster capital market development.

65. *Consistent with global trends, Sri Lanka should consider creating a unified or single regulatory and supervisory mechanism*.[7] If the establishment of a single regulator is deemed infeasible for various institutional and policy reasons, further rationalization and consolidation of securities market regulations are pivotal to measurable success in future financial sector and capital market development initiatives.

H. The SEC Governance and Capacity

66. *With the expansion of the securities industry, the organizational and governance structure must be able to facilitate a highly efficient and effective regulation of the*

---

[7] Sri Lanka considered establishing a single regulator in 2001. The Government in fact appointed a committee comprising of representatives from the Ceylon Chamber of Commerce, the Central Bank, the National Development Bank, the Securities and Exchange Commission, the Sri Lanka Accounting and Auditing Standards Monitoring Board and the Registrar of Companies to look into the feasibility of establishing a financial services authority. No information is available on the progress of this initiative. See "Single Regulator for Financial Sector," The Island, Feb 23, 2001.

securities industry. With the deepening of Sri Lanka's securities industry, the role of the regulator becomes even more important. A review of existing organizational and governance structure of the SEC with benchmarking to International Organization of Securities Commissions (IOSCO) standards and comparable SEC's in a sample of countries should be undertaken to assess the areas for developing organizational capacity and strengthening the internal and external governance of the SEC.

67. *The ability for the SEC to serve as a highly competent securities market regulator requires building up technical competencies of its own staff.* It cannot continually depend on external technical expertise extensively for most of its activities. The SEC has a critical need for technical capacity building across all of its divisions and areas of activities including legal and enforcement, corporate affairs, supervision, surveillance, external relations, capital market development, capital market education, training and research, and finance and administration.

68. The tasks needed for technical capacity building for the SEC may include the following:
    i. Carry out a comprehensive review of the organizational structure of the SEC, properly benchmarked to other SEC's in developed and advanced emerging markets to identify gaps in the existing structure that will need to be addressed and make recommendations.
    ii. Identify specific technical capacity building needs across the SEC including information and communications technology (ICT) needs.
    iii. Identify modalities for technical capacity building, both in house and through outside institutions, local and abroad.
    iv. Prepare a detailed plan for technical capacity building that will ensure sustainability of technical expertise within the SEC to effectively regulate the market and contribute to the continued capital market development.
    v. Liaise with local and foreign institutions to facilitate the implementation of the proposed capacity building plan and provide any necessary advice to the SEC in this regard.

I. Corporate Governance

69. Sri Lanka has a voluntary corporate governance code. This was originally developed by the Institute of Chartered Accountants of Sri Lanka (ICASL) in 1997. In 2008 and most recently in 2013, this corporate governance code was revised as a joint initiative of the ICASL and the SEC. The code covers best practices of corporate governance relating to directors, directors' remuneration, shareholder relations, accountability and audit, all types of institutional investors, other investors, and sustainability reporting.

70. The IOSCO has recommended that its members foster good corporate governance based on the "G20/OECD Principles of Corporate Governance." The most updated version of these principles have been published in 2015. The IOSCO notes that policy makers and regulators need to adapt more robust corporate governance frameworks to address challenges faced by rapid changes in both corporate and financial climate such as the increasing complexity of the investment chain, the changing role of stock exchanges, and the emergence of new investors, investment strategies and trading practices.

71. *Sri Lanka should consider comprehensive corporate governance reforms*. Given many developments and changes anticipated in the Sri Lankan securities markets, an initiative to align the Sri Lankan Code of Governance with the latest international principles such as the ones contained in the G20/OECD Principles of Corporate Governance should be considered important.

VI. TRADING, CLEARING AND SETTLEMENT SYSTEMS

A. Trading Systems

1. Automated Trading System (ATS)

72. The CSE uses an Automated Trading System (ATS) for both equity and debt securities. The ATS was put in place in 1997 for equity securities only. A separate debt trading system, called the Debt Securities Trading System (DEX), was introduced in 2004 for trading corporate and government debt securities. The CSE upgraded the ATS in 2012 integrating both equity and debt trading into a uniform trading platform. The ATS was further upgraded in 2014. The existing ATS is very robust and scalable and has the capacity to handle secondary market trading of listed equity, listed closed-end funds, listed corporate debt and beneficial interests in government securities. However, secondary market trading of corporate debt and government securities on the CSE is very inactive.

2. Lanka Primary Dealer Bloomberg Bond Trader (LPBT)

73. The secondary market trading in government securities takes place through the primary dealer system. Primary dealers use the e-bond trading platform known as Lanka Primary Dealer Bloomberg Bond Trader, which was introduced in 2003. The LPBT is a system for providing anonymous bid and ask quotes, electronic trading of securities, and trade recording and reporting. Primary dealers are required to provide two-way quotes for government securities.

74. *A majority of secondary market transactions, however, are done outside of the LPBT system through money brokers approved by the CBSL.* In the broker-driven market, money brokers act as intermediaries between primary dealers, licensed commercial banks, provident, insurance and mutual funds etc. Money brokers provide two-way quotes as well and are very active in the wholesale market for government securities. Prices and yields for such transactions do not necessarily reflect the quoted prices and yields on the LPBT. Thus, there is lack of price transparency in the over-the-counter (OTC) market for government securities resulting in an inefficient price discovery process.

3. Integrated Trading System for Debt Securities

75. Capital markets of a vast majority of countries have evolved into separate trading platforms for government and corporate debt securities. Corporate debt securities are traded on OTC markets or stock exchange trading platforms while government securities are primarily traded through an inter-bank or OTC trading platform. This is generally the case in Sri Lanka as well. Corporate debt comes under the purview of the CSE, and the automated trading system of the CSE is the trading platform for listed corporate debt.

Government debt securities are also allowed to be traded via ATS since 2004. However, trading in government securities on the CSE became very inactive, and there has not been any trading of government securities on the CSE since July 2012. Almost exclusively, government securities are traded through the OTC primary dealer system facilitated by the Blomberg Bond Trader System. So, effectively, Sri Lanka has one trading system for corporate debt securities and another for government securities.

76. Separate trading platforms for corporate and government debt securities have a number of key disadvantages relative an integrated or a common platform.
   a. Setting up and periodic upgrades of a trading system require significant capital investments. Having multiple systems will further increase costs, which may ultimate make trading expensive as well.
   b. Separate systems may also result in having different technologies increasing the amount of resources needed for monitoring and supervision of the systems for potential technological and systemic failures.

77. There are significant advantages to having an integrated system for corporate and government debt securities, particularly for a relatively smaller market such as Sri Lanka.
   a. It enables increased trading volume and liquidity since all the orders are routed through one system.
   b. It enables more efficient price discovery across markets thus setting a single two-way quote at a given point of time than having multiple quotes in separate markets.
   c. It facilitates portfolio management and strategy since fund managers can easily discover prices and execute their portfolio strategies across both corporate and government debt securities more efficiently in one trading platform.
   d. It facilitates unified regulation and monitoring for systemic risk to ensure financial system stability.

78. There are a number of practical realities with respect to trading of corporate and government securities in Sri Lanka.
   a. Corporate debt trading has generally been not very active in exchanges across emerging and some developed markets. One reason is that corporate debt generally does not lend itself to trading by individual investors. Rather, corporate debt is typically traded by institutional investors such as banks, primary dealers, pension and insurance funds, and mutual funds. The same is true for government securities. This is a major reason as to why secondary market trading in corporate and government debt securities has not succeeded on the CSE.
   b. There is some segmentation between corporate and government debt securities markets in Sri Lanka. Investors in corporate bonds tend to be more buy-and-hold types whereas there is some institutional investor interest in trading in government bonds.
   c. Leverage is higher in government securities trading since government securities can be easily used as collateral whereas only a few would accept corporate bonds as security.
   d. Trading in government debt is also helped by the existence of a yield curve between short-term and long-term government securities, although the yield curve itself is not very efficiently determined. At least, there is some volatility in yields across the yield curve that triggers some trading. A reliable corporate yield curve, on the other hand, is lacking due to the lack of listed corporate debt across different maturities and the lack of secondary market activity.

79. *There is a clear need for reforms in the trading systems for corporate and government debt securities markets in Sri Lanka.* Corporate debt and government securities trading are segmented between the exchange and the OTC market. The Bloomberg Bond Trader System does not operate as an efficient price discovery mechanism since most trades take place through money brokers outside of the Bloomberg system.

80. *Developing deep and liquid bond markets in Sri Lanka can be greatly facilitated by having an integrated, common trading platform for both corporate and government debt securities.* This new common trading platform will need to ensure that all transactions in debt securities take place through one trading platform in order to ensure efficient price discovery unlike the current broker-driven government securities trading. This would mean merging both corporate debt and government securities into a common platform. In addition to efficient price discovery, a common platform will enable more effective regulation, supervision and monitoring of these securities markets, lead to increased trading and liquidity, and provide enhanced tools for investors and other market participants to engage in trading and portfolio management strategies. More secondary market trading based on transparent pricing will also produce more reliable corporate and government securities yield curves. Thus, such an integrated system will greatly benefit the overall financial sector development.

B. Clearing and Settlement Systems

1. Central Depository System (CDS) of the CSE

81. The clearance and settlement system for securities listed on the CSE, which include equity, corporate debt and beneficial interests in government securities, is the Central Depository System (CDS). The CDS is an automated system and commenced in 1991. It was upgraded to a new system in 2015. The CDS functions as a clearing and settlement system as well as a depository for securities listed on the CSE.

2. LankaSecure

82. The clearance and settlement system for primary and secondary market trading of government securities is LankaSecure. This consists of the Scripless Securities Settlement System (SSSS) which is a computer-based settlement system for primary and secondary market transactions of scripless government securities in local currency and a Central Depository System (CDS) which records trading and ownership of government securities. The corresponding funds transfer takes place through the Real Time Gross Settlement System (RTGS). SSSS operates on a delivery versus payment (DVP I) mechanism in collaboration with RTGS. The participants of LankaSecure are primary dealers and licensed commercial banks and any other institution permitted by the Monetary Board. The Employees' Provident Fund (EPF) and the Central Depository System (CDS) of the CSE are two approved participants.

3. Central Counterparty (CCP) Clearing

83. *Developing complete capital markets also requires the establishment a robust clearing corporation encompassing all the securities products including stock, bonds and derivatives*. Sri Lanka does not have a central counterparty clearing system for any of

the securities. In 2014, recognizing this need, the Central Bank of Sri Lanka, the Securities and Exchange Commission of Sri Lanka, the Colombo Stock Exchange, and LankaClear (Pvt) Ltd (LCPL) undertook a project for establishing a Central Counterparty for ensuring efficient clearing and settlement of all transactions in the domestic financial markets. In 2015, a consulting firm was commissioned to design the business specifications for proposed CCP, recommend a structure for the clearing house taking into account the requirements of all stakeholders, i.e. ownership, capital structure and governance, draft rules, regulations and by-laws that are necessary for the functioning of proposed CCP, draft Request for proposals (RFPs) for the selection of a suitable vendor for supply of necessary systems, processes and hardware for the proposed CCP, manage the project until the successful implementation of CCP and the clearing and settlement system, and running the project office and coordination with all stakeholders.[8] The corporate bond transactions have been already brought under the delivery vs. payment (DVP) system. The CSE expects to introduce the DVP for other securities as part of the CCP mechanism.

84. However, in 2015 the Central Bank of Sri Lanka decided that it would set-up its own clearing house for government securities. The 2016 Budget included a proposal to setup a bond clearing house by the Central Bank primarily for transactions in government securities which could be extended to other instruments including corporate debt securities. The Government has proposed that this bond clearing house be governed by an independent board of directors. The budget also proposed to allocate Rs. 500 million from the Consolidated Fund to establish the trading platform under the supervision of the Central Bank.

85. This proposal by the CBSL to setup its own bond clearing house will give the CBSL the sole regulatory authority on clearing and settlement system relating to government securities. As a result of the CBSL's decision, the scope of the consulting assignment for developing a CCP mechanism has been modified to exclude government securities. The CCP project, commissioned jointly by the SEC and the CSE, is expected to be completed by the end of 2016.

86. In February 2016, the CSE called for Request for Information from eligible suppliers to provide implementation and post live maintenance and support of a system or outsourced services for a Central Counterparty Organization operating in the Sri Lankan Capital market. The CSEClear Pvt Ltd. will be established as a wholly-owned subsidiary of the CSE, located in Colombo. The procurement of CCP Systems or CCP Service Provision will be financed by CSEClear. The proposed CCP system will include risk management, clearing, and collateral management and valuation components. This clearing house will need to be appropriately capitalized by equity participation of the SEC and the CSE and as such will require capital funding.

87. *Sri Lanka's capital markets do not have the scale to support multiple CCPs and multiple depositories.* Segregation of clearing and settlement systems for corporate and government debt securities will potentially create access barriers to the Sri Lankan capital market whilst also raising costs for any domestic or international investors

---

[8] Sri Lanka to setup clearing house for capital market transactions, March 23, 2015, Economynext. http://www.economynext.com/Sri_Lanka_to_set_up_clearing_house_for_capital_markets_transactions-3-1360-.html

seeking to access Sri Lankan securities. Serious consideration should be given to establishing a single clearing and settlement infrastructure with appropriate legal and regulatory framework.

4. International Settlement Systems

88. It is also important that Sri Lanka consider having links to international settlement systems, such as Euroclear or Clearstream, that provide settlement, safe-keeping and servicing of domestic and cross-border securities from bonds, equities and derivatives to investment funds. In addition to its role as an International Central Securities Depositories (ICSD), they also act as the Central Securities Depositories (CSD) delivering fast, efficient and low risk acceptance, issuance and distribution of securities with direct access to the broadest range of investors across multiple jurisdictions in multiple currencies.

89. In addition to clearing and settlement, a key advantage of systems such as Euroclear and Clearstream is their collateral management service. Securities held in safekeeping with them become eligible as collateral for securitized transactions. The ability to use securities as collateral will contribute to the development of the repo market which is a very important component of the financial system.

90. For emerging markets such as Sri Lanka, these international settlement systems have the potential to help attract foreign investors for the issuances of bonds abroad, both government and corporate. They make the markets more accessible to foreign investors and facilitate more efficient price discovery. They also enhance liquidity thus attracting more foreign investor interest in the securities listed.

91. An excellent example is Russia which integrated with the Euroclear platform for government securities in 2013 and extended it to include municipal and corporate securities in 2014.[9] According to Euroclear, after integration there has been a large increase in Russian government bond transactions settled at Euroclear Bank. Foreign investor participation has increased from 3% to 21% since Euroclear Bank's service was first announced. Further, in the first quarter of 2013, fixed-income trading on the Moscow Stock Exchange doubled, clearly demonstrating the very positive impact on liquidity. In 2015, Euroclear began to expand its network outside of Europe, opening an account with the Central Money Markets Unit of Hong Kong's Central Securities Depository to provide Euroclear Bank clients with access to China-domiciled funds, as well as Hong Kong-domiciled funds. Both Hong Kong Monetary Authority and Bank Negara Malaysia have established links to Euroclear to settle cross-border transactions in debt securities. Euroclear also established a partnership with the China Construction Bank to further support offshore Renminbi capital markets. Working closely with the China Construction Bank, the Euroclear group supported the launch of the first ever RMB-denominated money market international ETF, listed in London. The Reserve Bank of India is working

[9] Euroclear Bank and NSD launch cross-border services for Russian corporate and municipal bonds, January 22, 2014, https://www.euroclear.com/en/news-views/news/press-releases/2014/2014-MR-02.html

to integrate their system with Euroclear in 2016/2017 in order to include Indian government bonds on the Euroclear platform.[10]

92. *Sri Lanka will benefit from having a link to Euroclear or Clearstream*. Some of the key advantages include:

a. Providing better, standardized access to foreign investors already connected to these ICSDs to participate in foreign bond issuances by both the Government of Sri Lanka and corporates.
b. Providing a more simple process overcoming many operational issues associated with domestic clearance and settlement platforms for foreign investors relating to foreign bonds.
c. Having securities settled on an internationally recognized platform makes such securities eligible for many global investors, including pension and sovereign wealth funds, that have rules prohibiting securities that are not settled on platforms such as Euroclear. Hence, having Euroclear platform has the potential to increase the demand for and liquidity of such securities.
d. Ease of market access and liquidity will help the Government and corporates secure funding from international markets at more competitive rates.
e. Helping Sri Lankan Government securities to be eventually included in emerging market bond indices.

93. Currently the CBSL is reportedly exploring the options for establishing its own CCP system for government securities, and the CSE is in the process of developing a CCP system (CSEClear) for securities listed on the CSE. This provides an excellent opportunity for financial market policy makers in Sri Lanka to further develop its securities markets by linking the domestic clearing, settlement and depository systems that include the CDS and LankaSecure, with international platforms such as Euroclear or Clearstream so as to enhance market access for foreign investors and thereby increase the ability for the Sri Lankan Government and corporates to secure foreign funding at more competitive rates and integrate the Sri Lankan securities markets with the global financial markets. The link will provide the cross border liquidity.

94. However, the current plans to have separate depository and clearing systems for the stock exchange and the CBSL will mean that eventually both systems will need to be integrated with international settlement systems.

C. Broker Risk Management and Back Office Systems

95. The CSE provided guidelines and recommendations for developing and installing appropriate broker risk management and back office systems and ultimately approved four vendors. The current status is that stock brokers are now in the process of installing a new broker front and back office system for improved order management to ensure more trade efficacy and accuracy. The CSE has already met the ICT requirements for the risk management and the broker back office system.

[10] Euroclear presses ahead with India government bonds. Financial Times, December 07, 2015. http://www.ft.com/intl/cms/s/0/faa00286-9ca3-11e5-bfed-a24713ecdd4f.html#axzz43keizH1c

VII. THE EQUITY MARKET

A. Overview of the Sri Lankan Stock Market

96. Share trading in Sri Lanka dates back 110 years when the Share Brokers' Association was established in 1896 as a secondary market for share transactions. The market went through numerous transformations and periods of growth and decline due to economic and political changes over its long history. The modern stock market, however, dates back 31 years to 1985 when the Colombo Securities Exchange was established which was later renamed as the Colombo Stock Exchange (CSE) in 1990. The Securities and Exchange Commission was established in 1987 under the Securities Council Act No. 36 of 1987.

97. The stock market has its own Central Depository System (CDS). Trading has been fully automated under the Automatic Trading System since 1997. The main securities traded on the CSE include ordinary and preference shares, corporate debentures and government securities.[11] In 2015, the CSE had 294 listed companies with a total market capitalization of about Rs. 3 trillion and an annual turnover of Rs. 253 billion (Table 5).

Table 5: Turnover, Listed Firms and Market Capitalization of the CSE (2006-2015)

Year	Annual Equity Turnover (Rs. Mn.)	Number of Companies Listed	Market Capitalization (Rs. Bn.)	Market Cap as a % of GDP	Turnover as a % of Market Cap	Turnover as a % of GDP
2006	105,154	237	835	28	12.6	3.6
2007	104,985	235	821	23	12.8	2.9
2008	110,454	235	489	11	22.6	2.5
2009	142,463	231	1,092	23	13.0	2.9
2010	570,327	241	2,210	34	25.8	8.9
2011	546,256	272	2,214	31	24.7	7.6
2012	213,827	287	2,168	25	9.9	2.4
2013	200,468	289	2,460	26	8.1	2.1
2014	340,917	294	3,105	30	11.0	3.3
2015	253,251	294	2,938	26	8.6	2.3

Source: Colombo Stock Exchange

98. Over the past 10 years from 2005 to 2015, the Sri Lankan stock market recorded an average annual return of 24.3% in local currency terms and 21.2% in USD terms. During the same period, the MSCI Emerging Market Index produced an average return of 9.6%. Thus, the Colombo stock market outperformed emerging markets by 11.6%. In fact, the CSE did better than emerging markets in eight of the past 10 years (Figure 9). The volatility of the Sri Lanka stock market, as measured by the annual standard deviation, was about 53% in contrast to 36% for emerging markets suggesting higher risk in the Sri Lankan market. The correlation of returns between the Sri Lankan stock market and the

[11] Government securities have not been traded on the CSE since July 2012.

emerging markets over the same period has been 72% indicating a higher degree of co-movements, which is also evident in Figure 9.

Figure 9: Performance of the CSE vs. the Emerging Market Index (2006-2015)

Sources: Morgan Stanley Capital International, Colombo Stock Exchange

99. The brokerage industry has 36 intermediaries comprising of 15 stock brokering firms who are members of the CSE, 13 trading members, and 8 debt trading members. Both stock brokering firms and trading members act as brokers in listed equities and debt securities while debt trading members act as brokers in listed debt securities only. There are no market makers or liquidity providers, and stock brokers and trading members act only as intermediaries to transactions. As such, the CSE is a price-driven auction market. Some brokers and dealers also trade on their own account. Short selling of securities is not permitted presently.[12] Margin trading is allowed.

B. Concerns and Impediments

1. Market Size

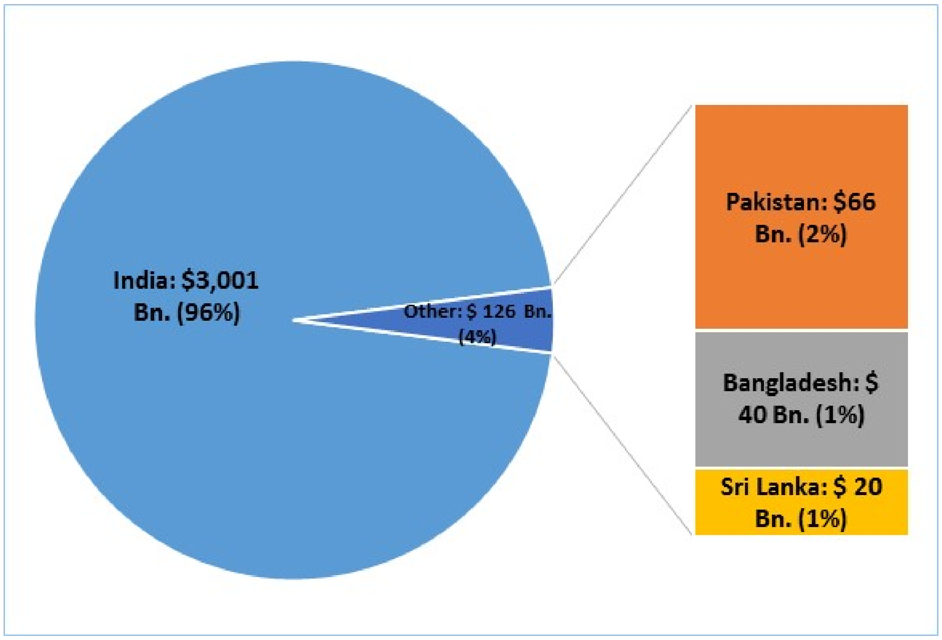
100. One of the most important characteristics of an equity market is its size in terms of the market capitalization. A larger market provides more investable stocks and better opportunities for diversification. Market size has an important influence on the ability to attract institutional investors, particularly foreign investors, and their asset allocations across markets. Table 5 shows important measures of market size.

101. *The relatively smaller size makes the Sri Lankan equity market less attractive in the region*. The market capitalization of the CSE was USD 20 billion as of the end of 2015 (Figure 10). It is the smallest of the four main stock markets in South Asia that include Bangladesh, India, Pakistan and Sri Lanka. The Bangladesh stock market is about twice,

[12] Stock Borrowing and Lending (SBL) was allowed in 2001 and was suspended later.

Pakistan is about three times, and India is about 143 times the Sri Lankan market. Overall, the Sri Lankan market represents just about 1% of the South Asian regional capitalization whereas Bangladesh constitutes just over 1%, Pakistan 2% and India 96%. It is apparent that the Sri Lankan stock market is small in size in both absolute and relative terms.

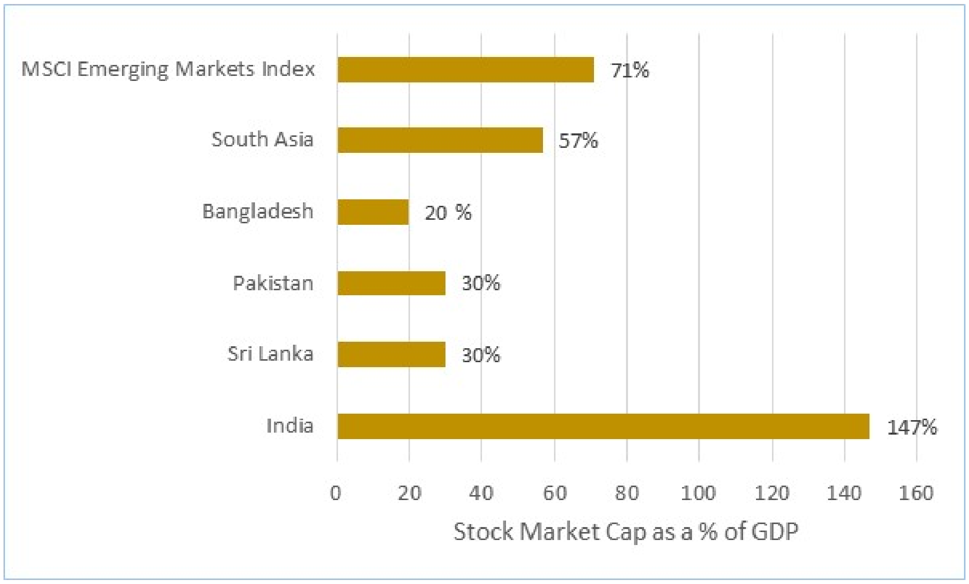
Figure 10: Market Capitalization of South Asian Stock Markets in 2015



Notes: Country: Market Cap in USD Bn. (% of South Asian Market Cap)
Sources: Sources: World Federation of Stock Exchanges, National Stock Exchanges, World Bank, IMF

102. Market size relative to the GDP indicates the significance of the stock market in the economy (Figure 11). The market capitalization of the CSE as a percent of Sri Lanka's GDP grew from 23% in 2005 to 34% in 2010 and then declined to 26% in 2015. Although the Sri Lankan stock market is the smallest in the region in absolute terms, it is at par with Pakistan and ahead of Bangladesh in terms of the market size relative to the economy. In 2014, the stock markets that comprise the Morgan Stanley Capital International (MSCI) Emerging Markets Index (EMI) have an average market size relative the economy of 71% which is more than double the relative size of the Sri Lankan stock market. India is the only South Asian country included in the EMI, and its size relative to the economy is 147% due to the combined size of the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) of India.

Figure 11: Market Capitalization as a Percent of the GDP in 2014



Sources: Sources: World Federation of Stock Exchanges, National Stock Exchanges, World Bank, IMF

103. In 2013, the CBSL projected that Sri Lanka will achieve a GDP of USD 100 billion by 2016, and the SEC set a goal of achieving a market cap for the CSE of USD 50 billion representing a 50% of the GDP by 2016. With only a USD 20 billion stock market capitalization representing 26% of the GDP in 2015, Sri Lanka is a long way away from achieving those target capitalizations. Overall, the CSE has to grow significantly to become a significant player in the region and attract more foreign portfolio investors both in terms of its absolute market capitalization and its size relative to the economy.

2. Liquidity

104. Liquidity is also a very important aspect of a vibrant stock market. Turnover (value of shares traded), turnover ratio (turnover as a percent of market capitalization), and turnover to GDP ratio are three key indicators of liquidity and depth of a market overall. Table 6 provides data relating to these key aspects of market liquidity in the CSE.

105. In terms of 2015 data, Sri Lanka has the lowest turnover with just over USD 2 billion, and turnover is much larger in other South Asian markets. A more important measure of liquidity, however, is the turnover ratio. The average turnover ratio for South Asia is 27%. With a 9% turnover ratio, the Sri Lankan stock market is the least liquid in the South Asian region. All the South Asian markets are less liquid compared with the average turnover ratio of 80% for the emerging markets. The CSE's turnover ratio has to triple to reach the regional average and increase almost nine-fold to be at par with the emerging markets.

106. Turnover as a percent of the GDP provides a useful gauge of the significance of stock market trading activity in the economy. Based on the latest available 2015 GDP data, turnover in the CSE represents only 2% of the Sri Lankan economy whereas it is 37% in

India and 9% in both Bangladesh and Pakistan. On this measure also Sri Lanka ranks as the least liquid stock market in the region.

107. *These statistics quite clearly demonstrate that the CSE significantly lags behind its regional competitors and emerging markets in terms of market liquidity*. As discussed later, smaller pubic float of listed firms, lack of market making, lack of a large number of active individual investors, and lack of an active fund management industry are some of the key reasons for relative illiquidity of the Sri Lankan stock market. This has been a significant weakness in the Sri Lankan stock market inhibiting participation of large institutional investors and foreign investors. Regional and emerging market comparisons point to the need for material increases in liquidity of securities to be competitive in the regional and emerging markets space.

Table 6: Measure of Liquidity of South Asian Stock Markets in 2015

Market	Turnover (USD Mn.)	Turnover Ratio (%)	Turnover as a % of GDP
India	797,400	27	37
Pakistan	26,978	41	9
Bangladesh	13,139	33	9
Sri Lanka	1,758	9	2
South Asia Average		27	14
MSCI Emerging Markets' Average		80	53

Sources: World Federation of Stock Exchanges, National Stock Exchanges, World Bank, IMF

108. *Many listed firms have a smaller free-float impeding active trading.* Before the new listing rules were enacted in 2014, the CSE required, as a condition for initial listing, that a company should have a minimum public float of 25% to be listed on the Main Board and a 10% minimum public holding for companies to be listed on the Diri Savi Board (the Second Board) irrespective of the sector or the market capitalization. This requirement, however, was not imposed as a continuous listing requirement. As a result, many companies have lower public float than what was required at the time of listing.

109. *The lack of market making severely limits liquidity*. The brokers and trading members play a brokering role only. Market makers are specialized institutions that quote bid and ask prices and stand ready to become a counterparty to buy and sell transaction. As a result, when there are no ready counterparty to a buy or sell trade, market makers step into complete the trade providing continuous liquidity to the market. The lack of market making inhibits trading activity and liquidity in the Colombo stock market. The regional markets such as India, Bangladesh and Pakistan have all introduced market makers in order to improve stock market liquidity.

3. Other Concerns and Impediments

110. *Transaction costs on stock trades in Sri Lanka are the highest in South Asia*. Transaction costs in the CSE are 0.82% for transactions up to Rs. 50 million whereas it is 0.02% in the National Stock Exchange of India. Although it is negotiable for transactions above Rs. 50 million, the minimum cost of 0.20% is still higher than the regional counterparts except for the Bombay Stock Exchange (Table 7). Higher transactions costs make the CSE less competitive regionally. It is alleged that although the minimum transaction cost for trades above Rs. 50 million is 0.20%, some stock brokers compete for clients, particularly high net worth investors, by giving rebates thus undermining the level playing field. It seems that there is no mechanism to detect such practices either.

Table 7: Transactions Costs of South Asian Stock Markets (March 2016)

Market	Transaction Costs of Equity
India - NSE	0.02%
India - BSE	0.275%
Pakistan	Negotiable
Bangladesh	0.03%
Sri Lanka	Transactions up to Rs. 50 Mn: 0.82% Transactions above Rs. 50 Mn: Negotiable with a minimum being 0.20%

Sources: Respective stock exchanges

111. *There are too many intermediaries in the Sri Lankan stock market*. As stated previously, there are 28 market intermediaries acting as brokers to stock and debt transactions and there are 8 debt trading members acting as brokers to debt transactions only. The secondary market for corporate debt is highly inactive and there is no trading in exchange-listed government securities. Hence, effectively there are brokers for equity trades with very little differentiation among them in terms of services provided. The 2016 Budget also emphasized the importance of consolidation in the brokerage industry. It stated that volatility in the stock market has resulted in many of the stock brokers facing significant issues, and that the sustainability of stock brokers themselves is important in ensuring the long term development of the capital markets. Consolidation of the existing 38 intermediaries through mergers and acquisitions will create a more healthy and competitive intermediation industry
.

112. *There is no minimum capital requirements for the brokerage industry*. This leaves the industry exposed to possible undercapitalization relative to the capital at risk, and any financial distress or failures in the brokerage industry will undermine the investor confidence and require the regulators and the Government to potentially rescue them. The fact some brokers maintain their own portfolios and some investors engage in margin trading make it even more important that a prudential capital requirement regime is introduced.

C. Recommendations

1. Increasing Market Size

113. *The key to increasing the market size is to have more companies listed on the CSE.* The main sources for new listings include privately-owned enterprises and state-owned enterprise (SOEs). Recent deliberations in this regard at the level of the CSE and the Government have also included encouraging small and medium scale enterprises (SMEs), companies operating under the Board of Investment (BOI) regulations, and foreign firms to list on the CSE. Leveraging the stock and bond markets as an avenue for funding infrastructure development through appropriately formed corporate structures is another potential source for market growth.

114. **Listing privately-owned enterprises:** *A mechanism to encourage and bring large private companies to list is very important for market growth.* Any impediments for privately-owned companies to list on the exchange such as reluctance to dilute ownership and inability to comply with listing rules and disclosure requirements need be examined. In addition to any regulatory and economic incentives such as tax incentives, enhancing the capacity and attractiveness of the stock exchange as the most desired avenue for capital raising for corporate growth is fundamental to a strategy to bring more private companies to the stock market.

115. **Listing state-owned enterprises:** The 2006 SEC Capital Market Master Plan anticipated listing large state-owned enterprises as a key strategy to increase the market size. The Government owns or has significant ownership interests in some of the most important economic entities in the country including banking, insurance, savings, home mortgages, energy, aviation, pharmaceuticals, and plantations, among others. However, 10 years later, not a single new SOE has been listed on the CSE. This underscores the importance of developing capital market development plans within a broader national policy framework in order to get the high-level political and policy commitment to such initiatives.

116. **Public enterprise reforms:** The 2015 Prime Minister’s Economic Policy Statement as well as the 2016 Budget spelled out the Government’s broader policy framework on SOE reforms. The proposals relating to SOEs include the following:
    a. Rather than privatizing SOEs simply as a means to increase revenue, a more strategic approach will be followed where the SOEs will be strengthened and made independent.
    b. All SOEs will be brought under a government-owned State Holding Corporation and shares of these enterprises will be passed onto a Public Wealth Trust, where the Secretary to the Treasury and the Governor of the Central Bank will be the custodians. This Trust will be managed by a Board comprising of members from civil societies, trade chambers, and trade unions, who will be nominated by the Constitutional Council. The Public Wealth Trust is answerable to the Parliament. A new Public Enterprise Act will be enacted to provide the necessary legal framework to this effort.
    c. The boards of SOEs will be strengthened with the appointment of professionals. Key SOEs will be allowed to operate and be evaluated based on key performance indicators. Key SOEs will also be encouraged to adopt a rating mechanism which will also facilitate the entities to access the domestic and foreign capital markets through various instruments for their capital requirements.

d. The Government will exit partially or fully from non-strategic investments in Lanka Hospitals, Hotel Developers PLC (Colombo Hilton), Hyatt Residencies, Waters Edge, Grand Oriental Hotel, Ceylinco Hospital, and Mobitel by listing such investments in the Colombo Stock Exchange during 2016. The monies generated through such listings will be used to retire high cost debt.
e. Restructure regional plantation companies into small manageable units so that they could seek listing in the Colombo Stock Exchange.

More recently in April 2016, the Minister of Finance indicated that the Government will privatize non-strategic SOEs as a means to cut public debt and list them on the CSE.[13]

117. *Listing of minority stakes of key commercial public-enterprises will help increase the market capitalization and promote a market-based framework for the management of these enterprises*. The large commercial enterprises owned by the Government that have the potential to increase market size significantly include the Bank of Ceylon, People's Bank, National Savings Bank, State Mortgage and Investment Bank, Sri Lanka Insurance Corporation, Sri Lankan Airlines, and Ceylon Petroleum Corporation, among others.

118. *While listing of large SEOs is one of the best methods for market growth, this needs to be carried out in a gradual process within a framework for public enterprise reforms.* Some of the SOEs are making losses and some have large amounts of debt on their books. Therefore, public enterprises will need to be restructured and reformed to make them financially strong before they can become viable candidates for listing on the stock market. Therefore, public enterprise reforms are an essential first step to lay the foundation for possible listing of viable enterprises on the stock exchange. It is also important to establish a national policy framework on public enterprises that is linked to the capital market development policy. This requires identification of SOEs that can be potentially rehabilitated, restructured and listed, an economically sound and politically feasible public enterprise reforms strategy, and a realistic timeline to make them professionally managed and financially sound.

119. **Infrastructure Development Corporations:** Another strategy to be considered is the establishment of a market-based infrastructure development model. Equity and bond markets can be effectively leveraged to raise much needed capital expenditures for infrastructure development projects such as toll roads, railways, ports, and regional airports. Some of the policy proposals outlined in the 2015 Economic Policy Statement stated that the Government will create a special purpose vehicle for the purposes of attending to infrastructure development initiatives and take meaningful steps to incorporate private sector style efficiency measures that will ensure that the state entrepreneurial ventures are run efficiently and to encourage local and global investors to participate. Some of the key proposals in the 2016 Budget in regard to infrastructure development include the following:

a. Establishing a Special Purpose Vehicle (SPV) for the Southern Expressway and the Katunayake Expressway where private investors will be invited to invest into the SPV for which the Government will guarantee a minimum return. The funds generated from the investments in the SPV will be utilized to pay debt.

[13] Govt looking at privatizing non-strategic investments to cut debt, Daily Mirror, 03/15/2016. http://www.dailymirror.lk/106881/Govt-looking-at-privatising-non-strategic-investments-to-cut-debt

b. Establishing a SPV for the Norochcholai coal-fired power plant to be securitized. The ownership structure of power plant will not change but the Ceylon Electricity Board's liquidity position will improve and thus enable its expansion activities.
c. The Ceylon Petroleum Corporation will collaborate with investors to form a company that will manage the oil tank farm in Trincomalee which is presently under-utilized. This facility will be operated as a bonding warehouse.
d. Improving the domestic air transportation by establishing three new domestic airports at Digana, Badulla, and Puttlam through a PPP arrangement.

120. **SME Board:** *One option being considered is the establishment of small and medium scale enterprises (SMEs) board for listing SMEs.* The 2016 Budget also stated that the ability of SMEs to have access to long-term relatively cheap finance is hampered by the difficulty to list them in the stock exchange because of their inability to comply with the CSE's stringent regulatory requirements. In order to expand the options available for SMEs' access to finance, the Budget proposed to create a new SME Board on the CSE with less stringent compliance requirements for SME listings. The Budget further stated that listing of SMEs will also provide an exit strategy for venture capital firms that have invested in SMEs. The CSE has identified this as a strategic goal for 2016. It has already drafted necessary rules and is awaiting regulatory approval.

121. *While providing SMEs the accessibility to market-based financing is a very good idea in theory, this could be challenging in practice.* It is not known, however, if a study or survey has been conducted to ascertain how many SMEs will be interested in listing and how many of those interested will have strong enough profitability and financial conditions to become good candidates for listing. If it turns out that only a few SMEs will be listed, then such a Board will likely to be less attractive and dormant. If listed SMEs are small in size and have a small free-float of shares for trading, then their shares risk of being inactive or illiquid further reducing their attractiveness to investors. Ultimately, the CSE could end up with more listed companies which are less liquid. A detailed study and analysis could provide better information on the feasibility of an SME Board before moving forward.

122. **BOI Board:** *Another strategic goal of the CSE for 2016 is to set up of a BOI Board for listing companies established under the Board of Investment (BOI) of Sri Lanka Act.* The BOI is charged with facilitating the setting up of companies with foreign investments in various industries in export processing zones and industrial parks or outside of such zones. The concerns stated in respect of the proposed SME Board are equally applicable to a potential BOI Board as well. It is important to carry out a detailed feasibility study on setting up of a BOI Board.

123. *While the addition of SMEs and BOI companies will increase the market size, it is important to assess the economic and practical feasibility of such initiatives.* The size, profitability, financial stability, growth prospects, and free-float available for trading are some of the key features that will decide their attractiveness to investors at the IPO stage and in secondary market trading.

124. **Dollar Board:** *Under its strategic goals for 2016, the CSE is also considering a proposal to establish a dollar board for listing of foreign and domestic companies which would be permitted to issue dollar-denominated securities.* The 2016 Budget also stated the need to encourage foreign companies to list in the CSE. There has been some progress on this initiative. The CSE is exploring the feasibility for Maldivian companies to raise U.S.

dollar-denominated equity which will be initially open for subscription to foreign investors only. The CBSL has approved this proposal and the CSE planned to conduct a road show in March 2016. The economic rationale, practical feasibility, willingness on the part of borrowing firms to raise capital on the CSE by issuing foreign-currency denominated bonds, readiness of CSE in terms of regulatory, trading, clearing and settlement infrastructure, and the issues relating to secondary market trading and liquidity need to carefully evaluated.

2. Increasing Market Liquidity

125. **Higher free-float:** *The CSE has taken several initiatives to increase market liquidity.* In 2014, rules on minimum public float as a continuous listing requirement were implemented in order to increase market liquidity.[14] These new rules require any entity listed on the Main Board to have a minimum public holding of 20% of its ordinary voting shares in the hands of a minimum of 750 public shareholders or a market capitalization of Rs. 5 billion in the hands of a minimum 500 public shareholders while maintaining a minimum public holding of 10% of its ordinary voting shares. Further, any entity listed on the Diri Savi Board is required to maintain a minimum public holding of 10% of its ordinary voting shares in the hands of a minimum of 200 public shareholders. The rules also suggest the methods to be followed by companies that fall below the threshold. They include issuance of new shares to the public through a prospectus, offer for sale of shares held by the non-public shareholders to public through a prospectus or any other lawful modality determined by the listed entity. The rules provide for transitional provisions, appeal to the SEC and requesting waivers from the SEC as well as the possibility for companies to obtain two extensions for a total period excessing 12 months to fully comply with the rules. However, when a company fails to comply after all the extensions, then the company will be transferred to the Default Board of the CSE and then may be liable to one or more of the sanctions that include publication of a notice of malfeasance, suspension of trading and mandatory delisting. All listed companies are expected to be fully compliant with these public float rules by 31st December 2016.

126. *However, the CSE has faced obstacles to the enforcement of these free-float rules.* Minority shareholders of certain listed companies have reportedly challenged the rules and apparently threatened to delist their companies from the CSE. An option for companies not meeting the 20% free-float rule is to be transferred to the second board called the “Diri Savi Board.” However, companies do not like this option because of the fear that it will damage their reputation as a listed company from being delegated to a less reputable second board. As such, the implementation of the free-float rule has been slow and will continue to be a challenging issue.

127. *Increasing public float is an important step to enhance liquidity of listed shares. It helps more trading and in turn better price discovery which is one of the important functions of stock market.* The assurance that prices are efficient in reflecting publicly available information is critically important to attract more investors to participate in the market. Therefore, implementation of minimum public float rules must be considered a necessary step for creating a liquid and more transparent stock market. Moreover, the public float requirements will need to be increased beyond 20% over time.

[14] The Rule 7.13 of the Continuing Listing Requirements of CSE Listing Rules.

128. **Market making Mechanism:** *The Sri Lankan stock market needs to establish a market making mechanism to ensure a continuously liquid market for listed stocks.* This is one of the necessary conditions to create a liquid market since market makers will mandatorily act as liquidity providers by being ready to be a counterparty to trades. Having an acceptable level of public float will be an important pre-condition to establish a feasible market making system. At the start, it might not be possible to require market making in all listed stocks due to persistent illiquidity. But a market making system needs be set up at least for a segment of the market that satisfies a minimum public float and trading activity thresholds. Market making can be expanded to cover more stocks as the market develops in size and liquidity over time. Sri Lanka needs to study the best practices and experiences in establishing market making mechanisms in other developed as well as similar emerging markets and develop a plan for introducing market making without delay.[15]

129. **Lower Transaction Costs:** *The CSE needs consider reforming the transaction cost structure with the objective of lowering them to an appropriate level*.[16] Transaction cost reforms should also consider merits of moving to a more market-based, negotiable brokerage with appropriate conditions for balancing the objectives of ensuring industry competitiveness, profitability and revenue to the the SEC and the CSE. Negotiable brokerage will make the industry more competitive and also eliminate the current alleged practice of brokers giving illegal commission rebates to selected clients creating an unfair playing field. The improved operating efficiencies from demutualization coupled with brokerage industry reforms will help Sri Lanka to lower transactions costs and become a more competitive securities market.

3. Brokerage Industry Reforms

130. **Brokerage Industry consolidation:** *Sri Lanka should design and implement a brokerage industry consolidation plan*. The 2016 Budget has recognized the importance of brokerage industry consolidation. It states that the volatility of the stock market has resulted in many stock brokers facing significant issues and that sustainability of stock brokers is important to long term capital market development. The Budget encourages stock brokers to merge in order to strengthen their capacities and capabilities. The planned introduction of minimum capital requirements for brokers and the stock exchange demutualization will provide an opportunity to provide the necessary regulatory framework for industry consolidation. The goal should be to have an optimal number of brokers to create a financially strong and competitive intermediation industry.

131. **Universal Brokerage:** *Sri Lanka will benefit greatly from adopting a universal brokerage model where market intermediaries deal in all capital market products such as equity, corporate and government debt securities, unit trusts, derivatives etc*. For a smaller market such as Sri Lanka, having specialized brokers for different capital market products might not be economically viable. The expected consolidation might pave way for universal brokerage. In addition to increasing investor access and penetration,

[15] Other options to enhance liquidity include reducing the bid-ask spread through changes in the tick size and introduction of individual stock and equity index derivatives that will have the effect of increasing trading of underlying securities.

[16] The 2016 Budget removed 0.3% share transaction levy to encourage trading activity in the share market effective January 01, 2016. Further, the Budget also removed the stamp duty on share certificates.

universal brokerage will help diversify revenue sources of the industry making it more resilient to different market conditions. Currently, there is no plan to introduce such a model.

132. *The main barrier to a universal brokerage model is that the regulatory powers for different capital market segments are segregated.* The SEC has the regulatory authority on listed equity, corporate debt and unit trusts whereas the CBSL has the regulatory authority on government securities markets. A single regulator model or rationalization of securities regulation are important to provide a robust regulatory framework for universal brokerage. However, within the existing framework, the SEC should be able to establish a universal brokerage model for equity, listed debt securities and unit trusts.

133. **Minimum capital requirements:** *Sri Lanka needs to introduce minimum capital requirements for market intermediaries in the CSE*. The CSE and the SEC are working on a risk-based capital adequacy model.

134. **Enhancing technical capacity of brokers:** *The SEC needs to revise, upgrade and expand the existing financial industry qualification framework to include multiple capital market instruments*. In order for brokers to deal in multiple products such as stocks, bonds, unit trusts and derivatives, they need be technically competent. Presently, many brokering firms are equipped to deal with stock trading only and lack adequate technical skills necessary to trade and provide investor advice on other instruments. Enhancing technical knowledge and skills calls for a robust financial industry training and licensing system. Ultimately, a better trained and educated industry professionals will prepare them for universal brokerage.

VIII. THE GOVERNMENT SECURITIES MARKETS

A. Overview of the Government Securities Markets

135. As per the Monetary Law Act No. 58 of 1949, the Public Debt Department (PDD) of the CBSL is in charge of the issuance of government securities and public debt management on behalf of the Government Treasury. Government securities in Sri Lanka include Rupee-denominated securities and foreign currency denominated securities. The main types of rupee-denominated securities include Treasury bills and Treasury bonds whereas foreign currency denominated securities include Sri Lanka Development Bonds, which are Treasury bonds denominated in foreign currency, and Sri Lanka sovereign bonds.

136. Treasury bills are zero-coupon short-term securities with three, six and twelve-month maturities. Treasury bonds have been issued with 2, 3, 4, 5, 6, 8, 10, 15, 20, and 30-year maturities and carry a fixed rate of interest. Sri Lanka Development Bonds have been issued with short-term maturities such as three, five, and twelve months and with longer term maturities of two years with both fixed and floating interest rates. Treasury Bills are issued weekly while Treasury bond auctions are held depending on the Government's cash flow needs.

137. **Primary market:** Government securities are sold by the PDD through multiple-price competitive auctions. The participants to the primary auction are approved primary dealers, and currently there are 15 primary dealers consisting of 8 bank primary dealers

and 7 non-bank primary dealers. Each primary dealer is required to bid for at least 10% of the value of securities offered at the primary auction. Sri Lanka has relied primarily on short-term funds for financing the the Government's cash flow requirements (Table 8). Over the past 10 years, except for 2015, the percentage of funds obtained through the issuance of Treasury bills has ranged from 81% to 95% with an average of 91% of the total amount of bills and bonds. This trend changed significantly in 2015 when the Government obtained Rs. 710 billion through Treasury bonds representing 41% of total issuances. The issuances in 2015, both bills and bonds, were the largest in the past 10 years totaling Rs. 1.7 trillion.

Table 8: Primary Market Issues of Government Securities (2006-2015)

Year	Treasury Bills (Rs. Mn.)	Treasury Bonds (Rs. Mn.)	Total (Rs. Mn.)	% Bills	% Bonds
2006	398,233	42,848	441,081	90	10
2007	388,458	18,513	406,971	95	5
2008	252,596	32,808	285,404	89	11
2009	416,157	52,231	468,388	89	11
2010	520,146	46,098	566,244	92	8
2011	489,073	26,107	515,180	95	5
2012	728,341	59,326	787,667	92	8
2013	842,527	201,199	1,043,726	81	19
2014	759,240	27,750	786,990	96	4
2015	1,027,979	709,832	1,737,811	59	41

Source: Central Bank of Sri Lanka

138. **Sovereign bonds:** Since 2007, Sri Lanka has made eight international sovereign bond issues with maturity periods of 5 and 10 years for a total of USD 7,650 million (Table 9). Six of these issues amounting to USD 6,550 million are still outstanding. The Sri Lankan Government also has announced its intention to make another sovereign bond issue for USD 3 billion in 2016 denominated in U.S. dollars and Chinese Renminbi. Sri Lanka's credit is rated B+ by both S&P and Fitch.[17] Fitch downgraded Sri Lanka's credit rating from BB- (speculative) to B+ (highly speculative) in February 2016.

Table 9: Sovereign Bond Issues by Sri Lanka

Issue No.	Issue Date	Amount (USD Mn.)	Maturity (yrs)	Maturity Date	Issue Yield %
1	10/18/2007	500	5	2012	8.250
2	10/1/2009	500	5.25	2015	7.400
3	9/27/2010	1,000	10	10/4/2020	6.250
4	7/27/2011	1,000	10	7/27/2021	6.250
5	7/25/2012	1,000	10	7/25/2022	5.875
6	1/6/2014	1,000	5	1/14/2019	6.000
7	4/11/2014	500	5	4/11/2019	5.125

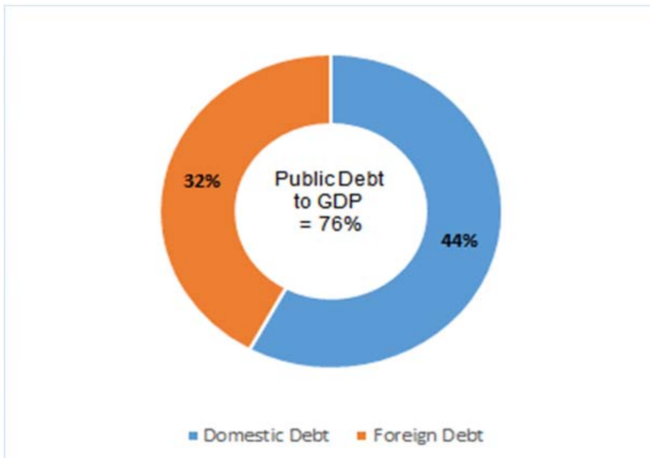
[17] India is rated BBB-/BBB-, Bangladesh BB-/BB-, Pakistan B-/B by S&P and Fitch respectively.

Issue No.	Issue Date	Amount (USD Mn.)	Maturity (yrs)	Maturity Date	Issue Yield %
8	5/28/2015	650	10	6/3/2025	6.125
9	10/27/2015	1,500	10	11/3/2025	6.850
Total		7,650			

Source: Central Bank of Sri Lanka

139. **Debt profile:** As at the end of 2015, the total public debt outstanding stood at Rs. 8.5 trillion with 58% domestic debt and 42% foreign debt (Table 10). The largest component of domestic debt is Treasury bonds constituting 39% of the total debt. Commercial foreign borrowings are 15% of the total debt, and the largest component of that is sovereign bonds. The total public debt represents 76% of the GDP with domestic and foreign debt amounting to 44% and 32% of the GDP respectively (Figure 12).

Figure 12: Public Debt as a Percentage of GDP in 2015



Source: Central Bank of Sri Lanka Annual Reports

Table 10: Debt Profile of Sri Lanka in 2015

Type of Debt	Amount (Rs. Bn.)	% of Total Debt
Domestic Debt	**4,959**	**58.3**
Treasury Bills	658	7.7
Treasury Bonds	3,305	38.9
Rupee Loans	24	0.3
Sri Lanka Development Bonds	668	7.9
Central Bank Advances	151	1.8
Other	152	1.8
Foreign Debt	**3,544**	**41.7**
Concessional	1,730	20.3
Non-concessional	507	6.0
Commercial Borrowings	1,307	15.4
International Sovereign Bonds	958	11.3

Type of Debt	Amount (Rs. Bn.)	% of Total Debt
Non-resident Investments in Treasury Bills	5	0.1
Non-resident Investments in Treasury Bonds	299	3.5
Other	45	0.5
Total Outstanding Debt	**8,503**	**100.0**

Source: Central Bank of Sri Lanka Annual Report 2015

140. **Ownership of government securities**. Treasury bills are predominantly held by the banking sector (Table 11). The banking sector owns 67% of bills with the largest owner being commercial banks. The ownership of the non-bank sector is 32% with savings institutions and insurance companies holding 10% and 7% respectively. The private ownership is 14% of the total. Foreign investors own about 1% of bills. In contrast, a majority of Treasury bonds (77%) is held by the non-bank sector with the EPF being the largest holder with 45% of bonds. Foreign investor ownership of bonds is about 8%.[18] According to LankaSecure, there were 86,944 investors in government securities during 2014.

Table 11: Ownership of Government Securities in 2015

Owner	Treasury Bills		Treasury Bonds	
	Rs. Mn.	%	Rs. Mn.	%
1. Bank Sector	**445,418**	**67.2**	**517,613**	**14.4**
1.1 Central Bank	104,754	15.8		
1.2 Commercial Banks	340,664	51.4	517,613	14.4
2. Non-Bank Sector	**212,822**	**32.1**	**2,787,635**	**77.3**
2.1 Employees' Provident Funds	-	**-**	1,612,461	44.7
2.2 Other Provident Funds	162	0.0	42,713	1.2
2.3 Savings Institutions	67,766	10.2	358,470	9.9
2.4 Insurance and Finance Companies	47,375	7.1	58,808	1.6
2.5 Departmental and Other Official Funds	7,570	1.1	245,045	6.8
2.6 Private and Other	89,949	13.6	470,138	13.0
3. Foreign Investors	**5,045**	**0.8**	**298,734**	**8.3**
Total	663,285	**100.0**	3,603,982	**100.0**

Source: Central Bank of Sri Lanka Annual Report 2015

141. **OTC secondary market:** The secondary market for government securities is an over-the-counter market operated through primary dealers who provide bid and ask quotes over the trading system. The trading system used for secondary market trading is the

[18] The foreign ownership limit for government securities is 12.5% of the outstanding amount. The 2016 Budget proposed to reduce the limit to 10%.

Bloomberg trading platform. Sovereign bonds are listed on the Singapore and Berlin Stock Exchanges. In 2014, the total value of secondary market transactions in government securities recorded in the LankaSecure amounted to Rs. 38.4 trillion with Treasury bills and bonds accounting for Rs. 15.1 trillion and 23.4 trillion respectively. Repo and reverse repo transactions accounted for 85% (Rs. 32.7 trillion) of secondary market transactions while outright transaction represented only 15% (Rs. 5.7 trillion) of the total.

142. **Listed secondary market**: From 2004, the CSE began trading government securities. As the data in Table 12 shows, trading of government securities on the exchange has been low and continued to decline. There has not been any trading of government securities since July 2012. Investors in government securities dominated by institutions have been long accustomed to trading of government securities in the OTC dealer market which is much more active than the CSE in terms of volume of transactions and provides better price discovery. Therefore, there is no fundamental reason for investors to trade in a small and thinly traded CSE.

Table 12: Listed Government Bond Trading Statistics

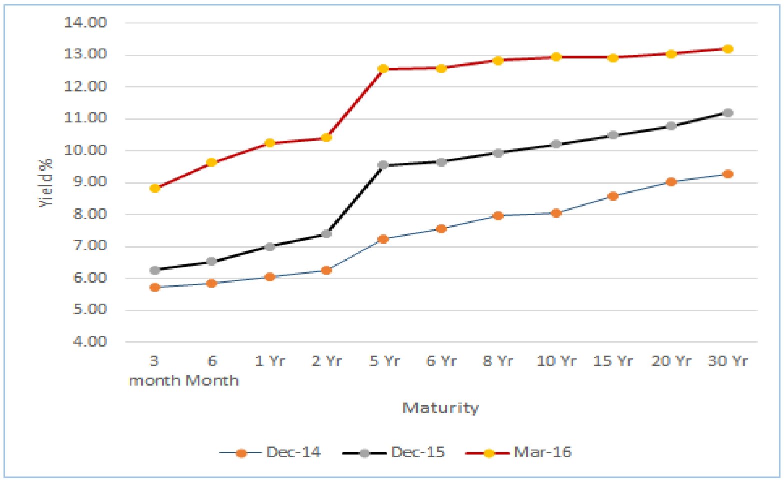
Year	Turnover (Rs. Mn.)	No of Trades	No of Bonds Traded (No. Mn.)
2004	1,987.9	1,343	553.5
2005	326.4	522	307.0
2006	207.1	379	213.2
2007	709.3	208	742.7
2008	195.2	69	208.2
2009	99.0	42	102.8
2010	45.7	18	46.8
2011	28.4	7	28.9
2012	6.1	2	6.7

Source: Colombo Stock Exchange

143. **Treasury yield curve.** Outstanding government securities have maturities ranging from 3 months to 30 years. The secondary market average buying and selling yields on government securities reported by the primary dealers provide an indication of the behavior of market yields. It should be noted that the two-way quotes of primary dealers do not necessarily represent transaction yields since trades may not have occurred for some maturities. Figure 13 shows the government securities yield curve based on the average of the two-way quotes at the end of 2014, 2015 and March 2016. Yields have increased across all maturities and more so for medium to long-term bonds with 5 to 30 year maturities. The first three months of 2016 have seen about 300 basis-point rise in yields across the board reflecting monetary policy tightening by the CBSL to control the excessive growth in money supply and upward trend in underlying inflation.[19]

[19] The CBSL increased the statutory reserve ratio from 6.0% to 7.5% on January 16, 2016, and the standing deposit rate from 6% to 6.5% and standing lending rate from 7.5% to 8% on February 19, 2016.

Figure 13: Sri Lanka Treasury Yield Curve



Source: Department of Public Debt, Central Bank of Sri Lanka

B. Concerns and Impediments

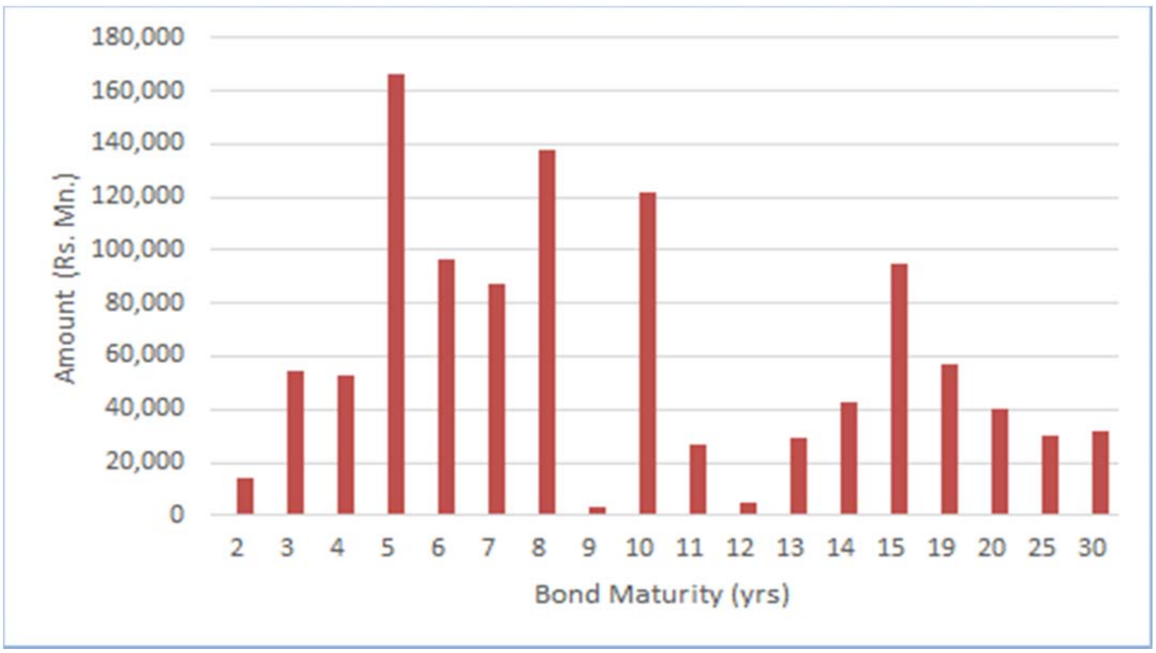
144. *Bond maturities are mostly concentrated in short to medium term bonds.* About 56% of the outstanding Treasury bonds have maturities of 8 years or less (Figure 14) and 40% of the issues are from just 5, 8 and 10 years maturities. The average time to maturity of the government bonds portfolio was 6.98 years the end of 2014. The rest of the bonds mature from 9 to 30 years and are fairly unevenly distributed across maturities. From all the bond series issued since 1997, 94% of them had maturities up to 10 years. Clearly, the number of long-term bond issues with maturities of more than 10 years has been few. This makes the amount of bonds available for secondary market trading at long-term maturities low, reducing liquidity and price discovery for such maturities.

145. *A larger portion of outstanding redemptions are concentrated within the next 8 years*. This bunching of debt is a direct result of issuing a majority of bonds in short to medium-maturities, mostly maturing in the next 8 years. About 58% of the outstanding bonds will need to be paid off by 2023, and there is a large concentration of redemptions in the 2018 to 2023 time period (Figure 15). This creates a large need for refinancing during this period of 6 years which potentially leads to refinancing risk when large amounts will have to be refinanced and a larger impact on interest rates at the time of refinancing.

146. *The secondary market trading in government bonds in the primary dealer market is fairly illiquid, particularly in longer maturity government bonds*. The major reason for lack of secondary market trading is that a vast majority of bonds are held by institutional investors such as provident funds, insurance funds and unit trust funds that tend to hold them to maturity. Most secondary market yields are just bid and ask quotes from primary dealers and do not represent actual transaction yields due to very infrequent secondary market transactions. As a result, the secondary market yields are not very reliable and do not provide a reliable risk-free yield curve across all maturities. This lack of a reliable Treasury yield curve hampers efficient and transparent pricing of both government and corporate bonds as well.

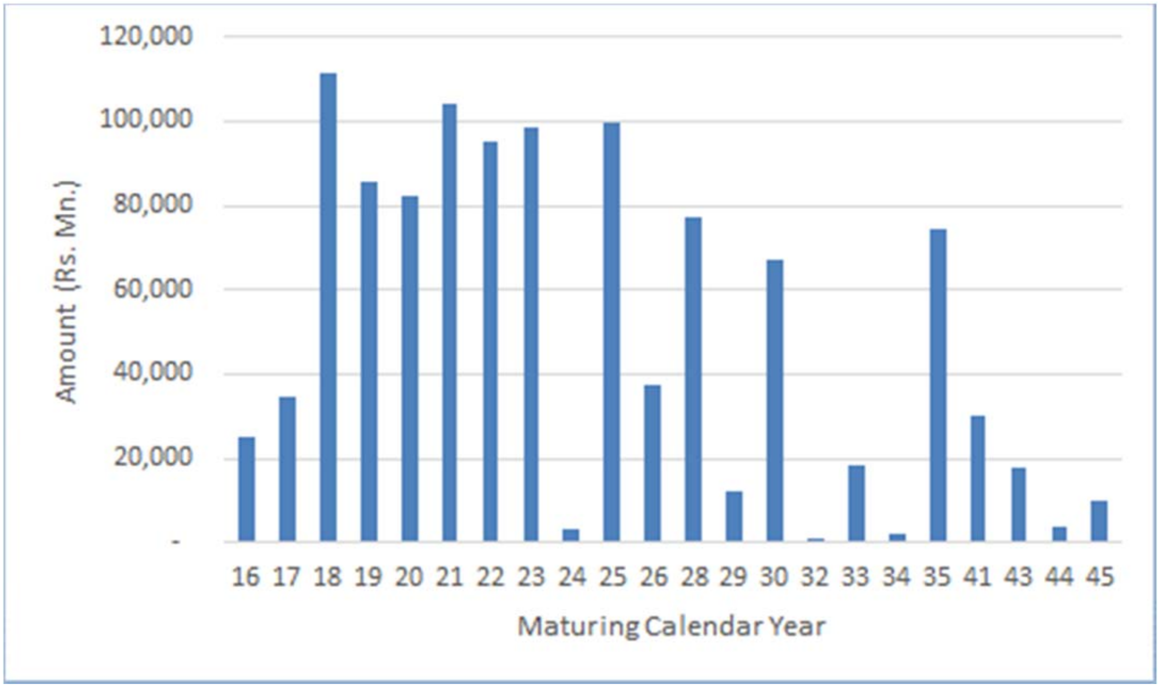
147. *There has been a lot of recent public discussion in Sri Lanka of private placement of government securities outside of the auction process, particularly prior to 2015.* For example, only 71% and 68% of the funding through bills was conducted through the primary auction in 2005 and 2006 respectively. As for bonds, however, only 23% and 15% was sold through the auction in 2005 and 2006. There is no publicly available data to verify the occurrence and severity of private placements in the past 10 years. If in fact it occurs, the concern is that private placements undermine the validity and efficiency of the price discovery process which is a prerequisite for developing benchmark interest rates. Some have expressed the view that privately placed bonds receive a better rate causing a divergence of yields between the primary and the secondary markets.

Figure 14: Outstanding Government Bonds by Original Maturity (a)



(a) Bonds outstanding for redemption from 2016 and beyond from issues up to Feb, 2016.
Source: Central Bank of Sri Lanka

Figure 15: Outstanding Government Bonds by Redemptions Year (a)



(a) Bonds outstanding for redemption from 2016 and beyond from issues up to Feb, 2016.
Source: Central Bank of Sri Lanka

148. *The lack of an auction calendar makes auctions and interest rates less predictable and undermines the credibility of auctions.* The Central Bank does not publish an auction schedule in advance. This makes it difficult for the market participants to predict the timing and amounts of the future Treasury auctions and increases the uncertainty of the level and direction of future interest rates.

149. *The practice of outright rejection of auction bids undermines the credibility of the primary market*. Since January 2015 to April 01, 2016, there have been 4 Treasury bill auctions and 30 Treasury bonds auctions in which none of the offers were accepted. In many cases, this resulted in significant jumps in the subsequent auction yields resulting in drastic changes in market interest rates and bond prices. In addition to creating higher interest rate and price volatility, outright rejection of offers leads to inefficient price discovery and undermines investor confidence in the auction mechanism.

150. *The lack of a competitive primary dealer system reduces liquidity, increases transaction costs, and seriously undermines the efficiency of the price discovery process.* Existing primary dealers, which include eight banks and seven dedicated dealer institutions, represent a much less diversified investor base. The requirement that all government institutions and agencies must invest their funds through the state banks has also reduced competition and created an uneven playing field among primary dealers. The bank-based primary dealers dominate the primary market, and the contribution of dedicated primary dealers to the primary auction is low.

C. Recommendations

151. *Developing a reliable benchmark yield curve across the entire term structure must be considered a top debt management strategy.* A viable benchmark yield curve is not only important for well-functioning government securities markets, but also forms the foundation for accurate market pricing of a range of financial instruments such as corporate bonds, debentures, repos, interest rate futures and swaps. Pension funds and insurance companies have a need for longer term instruments for asset and liability management. Issuance of more long-term securities will help improve liquidity at the long-end of the yield curve leading to more trading and reliable price discovery.

152. *Issuance of fairly evenly distributed maturity structure that spans both medium-term and long-term segments will benefit both the Government and the investors in the long-run.* For the Government, such a strategy will help reduce refinancing risk of the debt portfolio. The Treasury securities market is dominated by government-run superannuation funds, commercial banks, savings institutions and insurance and finance companies. Many of these institutions have a fundamental need for long-term bonds to manage their investments in long-term portfolios and reduce asset-liability maturity mismatches. Long-term government securities play a very important role in this regard. It is critically important that the debt issuance strategies aim at establishing a market for all key maturity segments. Maturing short to medium term government securities should be converted into long-term securities in order to increase the quantity of bonds at long maturities and to increase the average time to maturity of the government bonds portfolio beyond 6.98 years observed at the end of 2014.

153. *Emphasis must be placed on creating an even maturity profile by issuing relatively more of benchmark securities at key points along the yield curve.* In order to create a proper yield curve, the Government needs to identify the maturities that are considered key by the market and viable in the long-run. For example, benchmark bonds may be issued in 2, 5, 10, 15, 20, and 30-year maturities rather than spreading out at too many maturities as it is the case now. The Government could establish a maturity target for the entire debt stock as a guide for structuring instruments across the yield curve.

154. *The Central Bank needs to publish a Treasury auction calendar in advance in order to provide credibility and predictability to auctions.* This will also make government borrowing more predictable. It is important to publish an annual auction calendar indicating, at the minimum, aggregate monthly data on the types of securities and the volume of funding that the Government plans to obtain through Treasury auctions, and a more detailed quarterly schedule of forthcoming auctions containing security type, term to maturity, coupon rate, volume, announcement date, auction date and settlement date. If the absence of the auction calendar is due to lack of predictability of the details of the Government's future funding needs, then it is critically important that the the Treasury prepare a detailed annual funding plan to facilitate the development of an auction calendar.

155. *A market-based government funding strategy is critical to the development of the debt securities market.* Practices such as private placements, partial filling of offered amounts, outright cancellation or rejection of announced auctions etc. must be limited to exceptional circumstances. In order to preserve the credibility of the auction process, it is necessary to fill the entire amount offered to the auction except in the event of an under-

subscription and unusual market conditions. If carried out consistently over time, except under unusual market conditions, such practices have perverse effects on the development of an efficient and transparent market for government securities. Determination of primary market yields on a competitive and market basis is important to create yields that fairly and accurately reflect fundamental market and economic conditions.

156. *Enhancing the competition in the primary market by creating a more diversified pool of investors in government securities is important.* One possible option for enhancing the competition in the primary market is to allow large investors such as provident funds, insurance companies, savings institutions, and mutual funds (unit trusts) directly participate in the primary auction rather than through primary dealers. Higher demand from sources outside of the banks will also provide stability to the auction market. The Government needs to study the effectiveness of the existing primary dealer structure with the aim of increasing the competition, creating stable demand, and deepening the market for government securities through a diversified investor base. Policies are also required to remove restrictions for government agencies to invest only through state banks to create a level playing field for primary dealers.

157. *A more transparent and efficient trading platform for government securities must be established*. Whether this involves enhancing the infrastructure of the existing broker-dealer OTC market for government securities with new technologies or setting up of an electronic exchange-based trading system, such as the the ATS of the stock exchange, needs to be carefully evaluated. Given the small size of the debt market in Sri Lanka and the need for improving liquidity, consideration must be also given to the importance of developing a single, transparent secondary market trading system for both government and corporate debt securities.

158. *Reforming the exiting market making mechanism for government securities is important to enhance transparency, efficiency, price discovery, and investor confidence in the market.* The process of market making is highly opaque and potentially leads to collusion and other anti-competitive practices as well. The present system of market making by primary dealers is not a mandatory market maker system. Rather, they are required to provide two way quotes. Lack of a robust market making system undermines the reliability of yield and prices as reflecting true economic conditions and competition and diminishes investor confidence as to transaction prices and yields. Therefore, along with a new trading platform, serious consideration should be given to revamping the market making mechanism and making market making mandatory.

159. *The government securities market needs a central counter party mechanism with a bond clearing house.* Although the original plan was to develop one CCP for Sri Lanka in conjunction with the CSE and the SEC, the CBSL has recently announced its intention to establish a CCP system separate from the one that is being currently developed for the CSE. However, it is important consider significant cost and other advantages associated with having one single CCP for Sri Lanka.

IX. THE CORPORATE BOND MARKET

A. Overview of the Corporate Bond Market

160. The primary market for listed corporate debt has been very active since 2013. In order to encourage corporate debt listing, the CSE enacted new listing rules for corporate debt in 2013. The Government provided tax incentives for investing in listed debt securities in the 2013 budget by exempting interest income received from listed debt from income and withholding taxes with effect from January 01, 2013 which had led to a resurgence of primary market for corporate debt.[20] In 2013, 28 debt issues raised Rs. 68 billion representing 72% of all the capital raised through the CSE through equity, rights and debt issues (Table 13 & Figure 16). Companies raised Rs. 54 billion in 2014 and Rs. 83 billion in 2015 through debt issues. The 2015 debt issues represented 85% of the total capital raised through the CSE. 2016 Budget has extended these tax incentives through 2016. The CSE also changed the maximum tick size to Rs. 10,000 in 2013 to improve liquidity.

161. The listed corporate debt market in Sri Lanka commenced in 1997. Since then, the turnover in the corporate debt market has increased from Rs. 57 million to Rs. 4,714 million in 2015 (Table 14). However, the corporate debt market turnover is only about 19% of the stock market turnover of Rs. 253 billion in 2015. The market capitalization of the listed corporate debt market was Rs. 239 billion in 2015. Relative to the stock market size of Rs. 2,938 billion in the same year, the corporate debt market was about 8% of the size of the stock market indicating that the corporate bond market in Sri Lanka is significantly smaller compared with the stock market. This is primarily due to the preference for bank-based financing by companies for their borrowing needs.

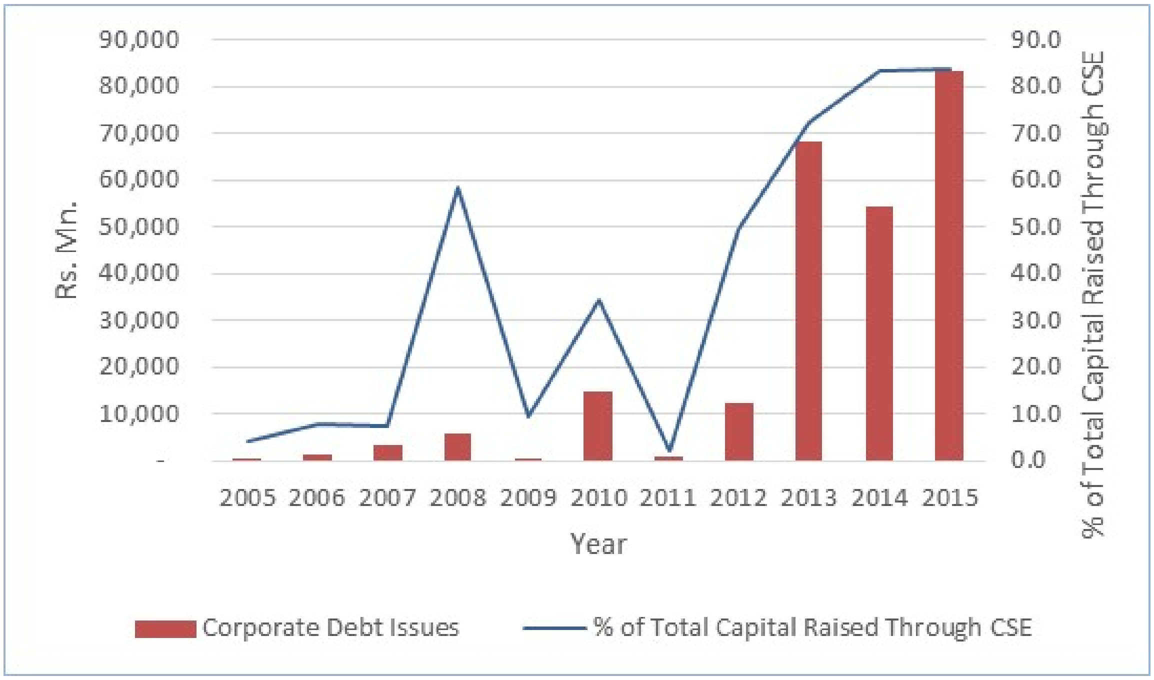
Table 13: Primary Market Activity of the Corporate Debt

Year	No. of Corporate Debt IPOs	Amount of Corporate Debt IPOs (Rs. Mn.)	Corporate Debt IPOs as a% of Total Capital Raised via CSE
2005	2	350	4.4
2006	1	1,257	8.1
2007	3	3,571	7.3
2008	4	5,866	58.3
2009	1	631	9.7
2010	1	15,000	34.3
2011	1	1,000	2.1
2012	3	12,500	49.3
2013	28	68,262	72.4
2014	20	54,235	83.4
2015	25	83,414	83.5

Source: Colombo Stock Exchange

[20] The 2016 Budget Speech recognized that the corporate debt securities market in Sri Lanka has been active in raising almost Rs. 50 billion in 2014 which is a fourfold increase over 2012. In order to facilitate the expansion of the corporate debt securities market, the Budget proposed to waive the income tax and withholding tax applicable to those activities into 2016.

Figure 16: Corporate Debt Issues at the CSE



Source: Colombo Stock Exchange

162. The secondary market trading activity has shown significant growth since 2013 (Table 14). The market cap of listed debt stood at Rs. 230 billion in 2014.[21]

Table 14: Corporate Debt Trading Statistics

Year	Turnover (Rs. Mn.)	No. of Trades	No of Debentures Traded (No. Mn.)	Market Cap (Rs. Mn.)
1997	57	203	0.6	329
2000	425	1,701	25.1	5,803
2005	207	625	2.2	24,600
2010	72	92	0.7	30,100
2011	2,691	62	25.9	37,859
2012	76	39	0.7	46,311
2013	2,229	173	20.0	165,700
2014	7,140	401	56.9	230,300
2015	4,714	220	42.2	238,735

Source: Colombo Stock Exchange

163. Stock brokering firms are expected to deal in both equity and listed debt securities. There are 28 members and trading members of the CSE who act as brokers to both equity and listed debt. Additionally, in order to attract specialist intermediaries to deal in corporate debt securities, the CSE began admitting primary dealers as debt trading

[21] Calculated based on year-end closing prices

members since 2013. So far, 8 of the 15 primary dealers have become debt trading members who deal in debt securities only.

B. Concerns and Impediments

164. *The supply of corporate debt securities is primarily concentrated in the bank, finance and insurance sector.* Banks issue corporate bonds primarily because they help meet tier II capital. There are only a few debenture issues in beverage, food and tobacco, construction and engineering, diversified holdings, health care, investment trusts, plantations, and trading sectors. The concentration of corporate debt limits diversification opportunities for investors across different industries with different sensitivities to the overall business cycle.

165. *The secondary market for listed corporate debt is highly inactive and illiquid*. The ability to sell an asset quickly without affecting its price is an important characteristics of a good market. The number of trades as well as number of debentures traded have been very low (Table 14). Trading activity reached the lowest level in 2012 when the turnover was just Rs. 76 million and the number of trades was 39. Although trading activity picked up since 2013 relative to the period preceding, the absolute level of trading is very low. According to debt market specialists, this low level of trading in corporate debt reflects the preference for Sri Lankan investors in corporate bonds to buy and hold them to maturity rather than selling them prior to maturity. A vast majority of investors in corporate bonds are institutional investors such as unit trusts, banks, pension funds and insurance funds, and given the smaller size of the listed corporate debt market and the large sizes of the these institutional investors, their holding of corporate debt is very small in absolute values as well as relative to their portfolios. Therefore, there is no fundamental portfolio rebalancing or cash flow need for institutional investors to trade their corporate debt holdings. On the other hand, potential investors become hesitant to invest due to lack of liquidity which in turn could reduce the primary market demand for corporate debt limiting the ability for companies to raise funds through debt issuances. Lack of liquidity does not allow investors to engage in dynamic portfolio strategies either.

166. *There is no market making mechanism for corporate bonds*. This is the case for equities as well. The role of a market maker is to stand ready to buy or sell an asset at any time irrespective of whether there is a counterparty to a transaction. Market makers essentially act as liquidity provides. Stock brokers and debt trading members in Sri Lanka are only obligated to act as intermediaries to transactions between buyers and sellers. They are allowed to trade on their own portfolios. However, the CSE does not have a formal market maker mechanism to ensure a continuous and liquid secondary market.

167. *Participation of stock brokers and debt trading members in secondary market trading is low.* As a strategy to expand secondary market trading in corporate bonds on the CSE, primary dealers were allowed to trade in listed debt securities from 2013. Although the turnover has increased since then, trading activity remains low suggesting low level of participation of debt securities dealers in the listed corporate bond market.

168. *Transactions costs on large trades are high*. The transaction costs for corporate debt consist of the brokerage commission and fees (SEC, CSE and CDS fees). Currently, the brokerage commission is negotiable and fees are 2 basis points. Although the brokerage

is negotiable, even a smaller brokerage commission can result in a large amount of brokerage fees for large trades.

169. *Secondary market pricing of corporate debt is hampered by the lack of an efficient Treasury yield curve.* One of the biggest challenges to the development of a vibrant corporate bond market is the lack of an efficient secondary market for government bonds. The listed government bond market is completely inactive and secondary market trading in government bonds in the primary dealer market is low, particularly in longer maturity government bonds. Most secondary market yields are just bid and ask quotes from primary dealers and do not represent actual transaction yields due to very infrequent secondary market transactions. As a result, the secondary market yields are not very reliable and do not provide a reliable risk-free yield curve across all maturities. This lack of a reliable Treasury yield curve hampers efficient and transparent pricing of corporate bonds and significantly diminishes the value of the listed corporate debt market as an efficient price discovery mechanism.

170. *Unlisted corporate debt including bonds, debentures, commercial paper and promissory notes is unregulated*. Given the growing importance of these unlisted instruments in the market, if left unregulated, this segment of the market could lead to unscrupulous financing and investment practices leaving the investors unprotected. Lack of regulations could also result in building up of systemic risk in the financial system.

C. Recommendations

171. *Increasing the size of the listed corporate bond market is important in order to deepen the market and expand diversification opportunities for investors.* This requires continuation of a more active primary market for capital raising through debt IPOs. It is important to encourage companies, particularly from sectors outside the banking and finance industry, to use the corporate debt market as opposed to bank-based borrowings to raise their debt capital.

172. *In the long-run, conditions must be established such that debt financing through the capital market becomes more beneficial to companies than bank-based financing*. The upsurge in primary market activity in the recent years has been primarily induced by favorable tax treatment of corporate bonds. Although tax advantages have been extended through 2016, they may end at some point in time. In the long-run, the market growth will critically depend on the ability of companies to raise funds at more competitive terms through the capital market compared with bank-based borrowings. In this context, it is important to review existing listing rules and economic and other advantages and disadvantages for companies to raise funds through debt issues through the CSE to assess and create conditions necessary to make raising debt through the CSE more beneficial to companies.

173. *Policies and reforms to increase the institutional investor participation in the listed corporate debt market are important in order to create a strong investor base for corporate debt.* Typical investors in corporate bonds are institutional portfolios such as pension funds, savings institutions, insurance companies, and mutual funds due to their large size and long term investment horizon. However, the institutional investor sector in Sri Lanka such as the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), and unit trusts have invested only modest portions of their funds in corporate

bonds reflecting the constraints such as small size, illiquidity, and inefficient price discovery, among others.

174. *Introducing a formal market making mechanism will greatly help increase trading and market liquidity*. Since lack of market makers is a weakness in the entire exchange-traded market, introducing market making must be considered a critical systemic change in the current brokerage system that spans all listed instruments and implemented in a holistic regulatory framework rather than through piecemeal changes affecting only some sectors of the listed capital market.

175. *A central counterparty clearing and settlement system is an essential component to mitigate settlement risks and promote investor confidence in the capital market.* The initiatives underway in this regard include the establishment of a Central Clearing Corporation with a central counter party and moving to the DVP settlement system for all debt securities. Therefore, the expeditious completion of the CCP project should be considered a priority.

176. *Introducing repurchase agreements (repos) on corporate debt securities will lead to more trading of corporate bonds and enhance market liquidity*. Currently, unlike government securities, there is no repo market for corporate debt. Repos on corporate bonds will help generate demand for underlying corporate bonds since the intermediaries such as primary dealers as well as investors will need underlying bonds to execute repo agreements. Brokers and dealers points out this being very important to creating a more active market for listed corporate debt. In fact, the CSE has already identified the importance of introducing repos on corporate debt. Exchange traded repos will require the central counterparty system for managing credit risk. Therefore, the introduction of the CCP will enable the CSE to introduce trading of repos on the stock exchange where bid and ask prices and volumes of repos will be observable on the automated trading system.

177. *Lowering transactions costs for debt securities is also important*. The CSE is considering specifying a brokerage fee cap of Rs. 10,000 per trade in order to lower high transaction costs associated with large volume traded.

178. *Unlisted corporate debt market needs to be regulated.* This is important to provide adequate information and protection to investors and to mitigate against any systemic risk emanating from build-up of unlisted debt.

179. *Introducing bond derivatives will also contribute to the development of the market.* The lack of a formal and developed derivatives market in bonds further constraints active trading of corporate bonds. Bond derivatives provide important instruments for hedging interest-rate risk and are an important part of risk management tools. Therefore, in addition to strategies for creating a sizable and active corporate bond market, Sri Lanka also needs a comprehensive road map and a framework for developing an organized corporate bond derivatives market.

180. *Technical capacity of stock brokers on debt instruments and trading needs to be enhanced.* The SEC needs to revise, upgrade and expand the existing financial industry qualification framework to include a fully-fledged training and certification requirement for dealing in debt securities.

X. DERIVATIVES MARKETS

A. Overview of Derivatives Markets

181. Currently, Sri Lanka does not have an organized derivatives market. The SEC and the CSE have long considered facilitating the development of derivative securities and markets. The 2006 SEC Capital Market Master Plan recommended to reassess the need and timing for derivatives products. However, there has not been any policy or regulatory progress on derivatives. A well-developed derivatives markets form an important component of a complete financial market. They serve a very fundamental role in the financial system by providing tools for investors to minimize and manage market risks and volatility, and hence the introduction of a robust derivatives market in Sri Lanka is essential and should be considered a vital part of capital market development. According to the CSE Strategic Plan 2016-2018, it intends to launch equity derivatives (index futures) by the end of 2017.

B. Concerns and Impediments

182. *The regulatory, trading, and clearing and settlement infrastructure are yet to be developed*. The new SEC Act is expected to have provisions enabling derivatives products, markets and trading. The central counter party mechanism and clearing house infrastructure are essential pre-requisites for introducing derivatives. The CSE has begun the initial process of developing the trading, clearing and settlement mechanisms and infrastructure.

183. *Introduction of derivatives requires liquid underlying securities such as stocks and bonds*. Presently, many stocks do not have acceptable levels of free-float and liquidity, severely limiting the viability for introducing a robust equity derivatives market. The secondary market for listed bonds is extremely inactive and provides no opportunity for derivatives on exchange-listed bonds.

184. *There is a severe lack of knowledge of financial derivatives*. Industry participants from policy makers to traders have to develop knowledge of derivatives as well as competencies for trading derivative securities and using them for risk management as appropriate to their level of decision making and market participation.

C. Recommendations

185. *Regulations for introducing derivatives products needs to be developed*. The proposed new SEC Act is expected to contain provisions that will allow for derivatives products. Although the exact provisions in the new Act are not known, it is likely that additional rules and regulations will be necessary for introducing derivative products in Sri Lanka.

186. *Trading, clearing and settlement technology and mechanisms need to be developed to facilitate introduction of derivatives.* The development of a CCP system by the CSE is expected to accommodate derivatives trading.

187. *Sri Lanka needs to undertake a comprehensive assessment and prepare a realistic road map for developing derivatives products and markets*. Such an assessment should draw

from other successful regional and worldwide experiences in introducing derivative products and identify the feasible types of derivative securities for Sri Lanka along with a realistic phased timeline for introducing them. Past deliberations among various constituents of the Sri Lankan capital market had identified individual stock options and futures as well as equity index options and futures as potentially feasible derivatives at the initial stages of market development whereas bond derivatives may be considered in a later stage.

188. *The SEC and CSE should also link the initiatives for increasing the size and liquidly of the stock market to the development of derivatives.* The existence of a reasonable number of highly liquid underlying stocks and a liquid underlying market index are pre-requisites to introducing equity derivatives.

189. *The CBSL, SEC and CSE should explore the potential for introducing derivatives on government securities.* Since government securities, particularly short to medium term maturities, are frequently issued with good quantities and trading in government securities in the OTC market is more active than the listed debt market, the logical starting point for introducing derivatives is likely to be government bonds.

190. *It is important to develop knowledge and competencies relating to derivatives products, and markets.* Sri Lanka needs to develop fundamental and technical knowledge and skills capacity both within the SEC and CSE and among market participants including policy makers, intermediaries, and investors as far as the role of derivatives in a financial market and the economy, benefits and mechanisms for derivatives trading and using them for risk management by various classes of investors and companies.

XI. COMMODITIES MARKETS

A. Overview of Commodities Markets

191. There have been discussions at the SEC level for establishing a commodities exchange and creating an enabling regulatory environment and market mechanisms. In 2011, the SEC even called for expressions of interest for establishment and operation of a fully-fledged, multi-asset class commodities exchange.[22] However, there has not been much progress beyond this. The 2016 Budget Speech underscored the need for setting up a commodities exchange. It stated that in spite of the fact that tea, rubber, coconut and a whole host of commodities are a significant part of the export economy, Sri Lanka does not have a commodities market, and therefore it is now the time to implement a commodity exchange regulated by the Securities and Exchange Commission.

192. Sri Lanka has long been a producer and exporter of a number of agricultural commodities that include tea, rubber and coconut. It is one of the largest producers and suppliers of tea in the world. Therefore, Sri Lanka has the potential for developing a robust commodities exchange, at least for tea. Such an exchange will have significant economic benefits to the producers in terms of providing a futures markets for their commodities as well as an efficient price discovery process and risk management

[22] SEC invitation for Expression of Interest for Establishment and Operation of a Commodities Exchange (March 2011), http://www.sec.gov.lk/?p=1116

instruments. Given the extensive tea producer and intermediary base that is well-established in the country, the supply side of the market is likely to be deep. Similarly, there is also a large and natural demand for commodities futures contracts both from the producers and big exporters and multinationals who sell and export these commodities. The potential benefits to the Sri Lankan economy and the financial markets of having a vibrant commodities exchange are likely to be significant.

B. Concerns and Impediments

193. *There is no regulatory framework for the establishing, operation and regulation of a commodities exchange.* The proposed new SEC Act is expected to include provisions for introducing a commodities exchanges.

194. *There is a lack of knowledge and expertise needed for the operation of a commodities market system and trading of commodities*. Given there has not been forwards and futures markets for commodities in Sri Lanka, there has not been a need for developing such knowledge and expertise.[23]

C. Recommendations

195. In terms of the trading of tea, Sri Lanka has a long history of trading tea through a public auction, called the Colombo Tea Auction (CTA), since 1883. Auctions are organized by the Tea Traders Association and held weekly effectively linking the tea producers and exporters through tea brokers and traders. The tea auction represents a spot market in that what is sold at the auction is what has been produced and available for delivery at the time of the auction. It does not represent a forward or futures market. Tea producers sell at the best available offer price and are essentially price takers since the prices are determined by the exporters based on export demand. This exposes the produces to price risk (see Figure 17). One key advantage of tea futures would to provide instruments for producers and importers to hedge against price risk.[24]

196. There are no tea futures markets in the world, either traditional commodities futures or index futures. This is primarily due to the well-established and the long history of the auction trading systems at trading centers such as Colombo, Kolkata (India) and Mombasa (Kenya) and difficulties associated with defining standard contracts for delivery because of wide heterogeneity in grade and quality of tea. Given the challenges associated with defining the quality for delivery, some have argued that tea index futures might be a more feasible option rather than traditional commodities contracts as long as there is a viable index of tea prices.[25] India, Dubai and Indonesia have shown interest in developing tea futures. News media reported in September 2015 that the Dubai Gold & Commodity Exchange was in talks with Indian tea producers as well as those in countries such as Kenya and Sri Lanka to work out the modalities of tea futures.[26] In

---

[23] The only exception is that there are forward contracts on rubber in Sri Lanka.

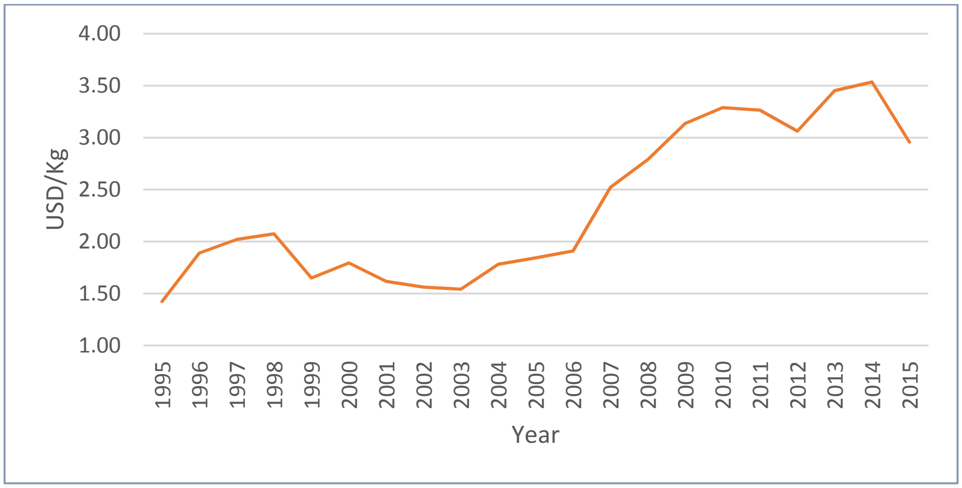
[24] A concern expressed by the tea industry is the possibility that speculative activity at a tea futures market might lead to more price volatility in the spot tea auctions.

[25] Risk Management Practices in Tea Markets: A Case Study of Possible Futures Contracts in India, FOA, 2012.

[26] DMCC may launch tea futures trading, http://articles.economictimes.indiatimes.com/2015-09-16/news/66604345_1_tea-futures-tea-industry-tea-board

October 2015, Jakarta Futures Exchange in Indonesia announced its plans to launch the world's first tea futures contacts.[27]

Figure 17: Prices at the Colombo Tea Auction



Source: World Bank Commodity Price Data

197. *Given the potential economic benefits of having a commodities exchange in Sri Lanka and the recent developments for setting up tea futures trading by other countries, Sri Lanka should proactively assess the economic and practical feasibility of setting up commodities trading.* This might involve the establishment of a separate exchange or expanding the CSE to commodities trading. The SEC would need to undertake a comprehensive feasibility for the development of a commodities exchange. It is also important to explore the possibility for technical cooperation with reputed and experienced commodities exchange in other countries such as the Chicago Mercantile Exchange (CME) and assess and learn from experiences in similar exchanges in the region.

198. *The development of trading, clearing and settlement structure would need to consider scalability to accommodate potential commodities trading in the future.* This is particularly important since Sri Lanka is in the process of carrying out significant investments to build more robust clearing and settlement systems. The expected development of the trading, settlement and clearing market infrastructure and risk management procedures and IT systems could potentially overlap with the infrastructure needs of commodities trading.

199. *The SEC should consider the need for a separate commodities legislation to facilitate the development of fully-fledged commodities trading*. After the feasibility study on setting up of a commodities exchange, the SEC may need to draft and enact into law a

[27] JFX to Open World's First Market for Tea Futures Contracts, http://en.tempo.co/read/news/2015/10/13/056709114/JFX-to-Open-Worlds-First-Market-for-Tea-Futures-Contracts

Commodities Act followed by rules and regulations for the operation of such an exchange or trading.

200. *Sri Lanka should also be proactive to develop knowledge and competencies on trading commodities and using them for risk management purposes.* This technical capacity building needs to be done across all the market participants including the policy makers, the SEC, the CSE, intermediaries and investors.

XII. THE UNIT TRUST INDUSTRY

A. Overview of the Unit Trust Industry

201. The unit trust industry in Sri Lanka dates back 25 years. It began with the formation of the National Asset Management Limited (NAMAL) in 1991. Unit trusts are regulated under the Unit Trust Code of 2011 which was enacted under the SEC Act of 1987.[28] As of the end of 2015, there were 14 unit trust management companies (UTMCs) operating 72 unit trusts. The total size of the unit trust industry, as measured by the value of net assets under management, was Rs. 129 billion in 2015. Over the 10-year period from 2005 to 2015, the industry's net assets have recorded an average annual growth of about 46%. However, the growth has been highly variable over the years, and largely influenced by a few years of very high growth, particularly in 2009, 2010, 2013 and 2014. The number of total unit holders was 37,526 at the end of 2015. Although there has been encouraging growth in the past two years, on average, unitholders grew only at about 5% per year over the past 10 years (Table 15).

202. There are two closed-end funds (CEFs) in Sri Lanka. In 2009, the National Asset Management Limited launched Namal Acuity Value Fund, which is a closed-end term trust with a defined maturity of 10-years. The investment objective of the fund is to achieve long-term capital appreciation by adopting a dynamic asset allocation strategy for investment in listed equities as well as listed and unlisted fixed income securities. The second CEF, the Candor Opportunities Fund, was launched in 2015 by Candor Asset Management (Pvt) Ltd. It is also a term trust with a 5-year maturity. The target asset allocation of the fund is 97% equity and 3% fixed income, cash and cash equivalents. The Namal Acuity Fund is listed on the CSE.

203. The unit trusts operating in Sri Lanka can be classified into five broader categories in terms of their asset allocation and investment objectives. They are money market, gilt-edged, income, growth, and balanced funds (Table 16). The largest fund type by far is represented by money market funds which invest in short-term fixed income securities such as Treasury bills, bank deposits, commercial paper, asset backed securities and repurchase agreements. They represent 56% of the industry net assets and 28% of the number of unit trusts. The second largest category constituting 19% of the industry is income funds whose primary objective is to maximize interest and dividend income by investing in fixed income securities, bank deposits, repurchase agreements and equities. Gilt-edged funds which invest only in government securities such as Treasury bills, Treasury bonds and repurchase agreements on government securities, have an asset allocation of 12%. Gilt-edged, money market, and income funds combined, all of which

[28] The Unit Trust Code of 2011, The Gazette of the Democratic Socialist Republic of Sri Lanka, No. 1723/4, September 12, 2011.

are on the lower end of the risk spectrum, has an 87% share of the industry in terms of net assets. The balanced funds which have both the income and growth orientation and invest in both fixed income securities and equities constitute only a 7% share of the industry. Growth funds whose primary objective is capital appreciation with a larger asset allocation to equities account for only 6% of the net assets although there are 24 such funds, representing the second most number of funds behind the 28 money market funds.

Table 15: Key Data on Unit Trusts in Sri Lanka as at December 31, 2015

Year	Net Asset Value (NAV) (Rs. Mn.)	Growth in NAV (%)	No. of Unit Holders	Growth in Unit Holders (%)	No. of Unit Trusts	No. of UTMCs
2005	4,495		23,654		13	6
2006	5,352	19.1	23,417	-1.0	13	5
2007	6,296	17.6	23,191	-1.0	14	5
2008	6,780	7.7	22,685	-2.2	17	5
2009	9,952	46.8	23,117	1.9	18	5
2010	22,228	123.4	24,649	6.6	21	5
2011	24,059	8.2	26,636	8.1	33	6
2012	31,062	29.1	27,952	4.9	48	11
2013	54,304	74.8	29,648	6.1	62	11
2014	127,356	134.5	32,619	10.0	74	14
2015	128,850	1.2	37,526	15.0	72	14
Average Annual Growth Rate (%)		46.2		4.9		

Source: SEC Annual Reports, Unit Trust Association of Sri Lanka, CBSL Annual Reports

204. The distribution of the unit holders across fund types, however, gives a different picture of investor preferences (Table 16). Although balanced funds rank the fourth in terms of net assets, they have attracted the largest number of investors accounting for 63% of the unit holders. This suggests that a vast majority of unit holders have small investments in unit trusts and prefer a more balanced investment approach. Interestingly, the second largest group of subscribers represents investors in growth-oriented funds. Similar to balanced funds, however, the total net assets in growth funds rank the lowest in the industry indicating that a large number of investors have made smaller investments in funds that primarily invest in the stock market. Although money market funds have the largest net assets under management, only 11% of the unit holders own units of such funds. The number of unit holders is relatively smaller in gilt-edged and income funds as well. It appears that a relatively smaller number of investors dominates investments in money market, gilt-edged and income funds in Sri Lanka.

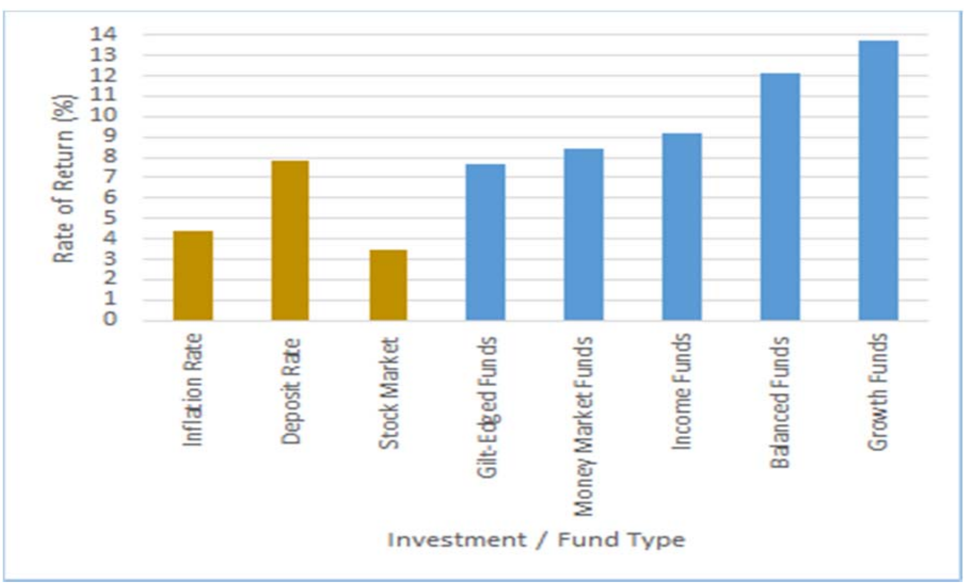
Table 16: Distribution of Unit Trusts by Fund Type as at December 31, 2015

Fund Type	Net Asset Value (NAV) (Rs. Mn.)	NAV %	No. of Unit Holders	% Unit Holders	No. of Unit Trusts	% Unit Trusts
Gilt-Edged	15,197	12	1,270	3	13	18
Money Market	72,510	56	4,287	11	20	28
Income	24,487	19	2,104	6	14	19
Balanced	8,634	7	23,721	63	8	11
Growth	8,022	6	6,144	16	17	24
Total	128,850	100	37,526	100	72	100

Source: The Unit Trust Association of Sri Lanka

205. All the unit trust funds have outperformed the inflation, bank deposit rate and the stock market over past five year period from 2011 to 2015 (Table 17 and Figure 18). The average inflation was about 4.4%, deposit rate was about 7.8%, and the total return on stocks was just 3.5% during the five-year period. In contrast, unit trusts recorded average returns ranging from about 7.7% (gilt-edged funds) to 13.7% (growth funds) in a pattern that perfectly correlates with the risk associated with fund types. Growth and balanced funds outperformed the stock market in each of the past five years. Money market, gilt-edged, and income funds recorded very impressive absolute returns from 2011 through 2013, underperformed the risky assets in 2014, and did well in 2015.

Figure 18: Average Performance of Unit Trusts and Benchmarks (2011-2015)



Sources: The Unit Trust Association of Sri Lanka, Central Bank of Sri Lanka, Colombo Stock Exchange.

Table 17: Performance of Unit Trusts (2011-2015)

	Annual Rate or Returns (%)					
Year	**2011**	**2012**	**2013**	**2014**	**2015**	**Average**
Inflation Rate (1)	4.9	9.2	4.7	2.1	0.9	4.4
Average Deposit Rate (2)	7.2	10.1	9.4	6.2	6.0	7.8
Stock Market (3)	-6.8	-4.4	7.8	26.3	-5.2	3.5
Gilt-Edged Funds	6.3	9.4	11.6	5.0	6.1	7.7
Money Market Funds	7.5	9.8	12.0	6.3	6.3	8.4
Income Funds	8.8	9.9	10.8	8.9	7.3	9.2
Balanced Funds	14.3	5.2	8.6	26.8	5.7	12.1
Growth Funds	18.3	5.2	10.5	28.7	5.9	13.7

(1) Year-on-year change in the Colombo Consumer Price Index, 2006/07=100, (2) Average Weighted Deposit Rate of Commercial Banks (AWDR), (3) Change in the All Share Total Return Index.

Sources: CBSL Annual Report 2014, CBSL Monthly Economic Indicators for 2015, Unit Trust Association of Sri Lanka

B. Concerns and Impediments

206. Unit trusts and mutual funds are essential to developing a vibrant capital market. They perform the vital task of mobilizing savings for investing in unit trust funds which in turn create demand for capital market securities. This role of unit trusts in generating a constant demand for securities is one of the most critical backbones of a strong capital market. As a result, a robust unit trust industry is key to the demand side of securities markets. However, several structural and other factors have constrained the industry’s ability to develop into a more widespread avenue for savings for Sri Lankans and play a stronger role on the demand side of the capital markets.

207. *Penetration of unit trusts into the savings base in Sri Lanka remains extremely low*. Savings in Sri Lanka are predominantly absorbed by the baking and non-banking financial institutions rather than unit trust or securities market products. In 2015, the total savings and fixed deposits held in deposit-taking institutions in Sri Lanka was Rs. 5,151 billion whereas total net assets of unit trusts was only Rs. 129 billion amounting to about 2.5% of the entire deposits. This highlights both the lack of penetration of unit trusts among savers as well as the potential for growth with appropriate structural and strategic changes.

208. *Participation in unit trusts by the Sri Lankan population remains low*. The number of unit trust holders in 2015 was only 37,526, and the growth in the number of unit holders has averaged about 5% over the past 10 years. This contrasts with the 581,775 accounts held in the CDS of the CSE by local individual investors suggesting there are almost 16 times more accounts with stock brokers than with unit trusts.[29] The total economically active population excluding self-employed and contributing family workers in 2015 was

[29] The number of active CDS accounts, however, is much lower.

about 5.2 million.[30] Thus, only about 0.7% of the economically active population has invested in unit trusts highlighting the extremely low participation in unit trust funds.

209. *The lack of awareness about saving and investing through unit trusts makes it difficult to attract more investors*. Both the unit trust industry and the stock exchange have held many investment awareness seminars. However, the growth in the subscriber base has been low.

210. *Saving and investing public's preference for a fixed rate of return is a big impediment to attract more subscribers.* Traditionally, people are used to depositing money in savings and fixed deposit accounts with banking and non-banking financial institutions because of higher fixed interest rates they were able to earn. This also seems to suggest a fairly high level of risk tolerance on the part of the savers and the investing public.

211. *The industry has very limited distribution channels making it difficult to reach out to potential investors.* Unit trusts are primarily sold through unit trust companies themselves. Given the smaller asset base and lack of wide interest in unit trusts, it is not feasible for UTMCs to have their own branch networks in the country. Stock brokers and banks in Sri Lanka generally do not deal with unit trust products either. This is because brokers would prefer people investing in stocks while banks would prefer people depositing money in savings and fixed deposits. Although some UTMCs experimented with these avenues for distribution, the competing interests have made it infeasible to leverage the broker and bank branch networks as a way to expand distribution of unit trusts.

212. *Contractual savings system in Sri Lanka does not allow investment choice to subscribers.* It is mandatory for employers to contribute on behalf of employees to the Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) both of which are state-managed, defined contribution retirement funds. These funds in turn decide where such contributions will be invested and, as such, Sri Lanka does not have a retirement system whereby employees have the discretion to direct their retirement contributions to investments of their choice as in the case of developed markets. The EPF and ETF primarily channel these funds to government securities with a small allocation to equities, corporate bonds and other investments. What this means is that unlike in countries where the pension sector has been liberalized and is market-driven, Sri Lankan economy does not provide a natural source of demand for unit trusts and mutual funds which in turn leads to a less vibrant professional fund management industry.

213. *The unit trust industry is proliferated with too many funds with a very small number of subscribers with smaller amounts of assets under management*. As the data show (Table 18), 10 funds have less than or equal to 50 unit holders, and 32 funds have between 51 and 100 unit holders. Thus, a total of 42 funds or 58% of the number of funds have less than or equal to 100 subscribers resulting in a vast majority of them having relatively smaller amounts of funds under management.

---

[30] According to the 2015 4th quarter Labor Force Statistic Quarterly Bulletin of the Department of Census and Statistics, Sri Lanka had 8.6 economically active population which comprises of 4.9 million employees, 0.3 million employers, 2.7 million own account workers and 0.7 million contributing family members. Excluding own account workers and contributing family members, the economically active labor force was 5.2 million.

Table 18: Distribution of Unit Trust Subscribers as at December 31, 2015

No. of Subscribers	No. of Funds	Cumulative No. of Funds	Cumulative % of Funds
1 to 50	10	10	14
51 to 100	32	42	58
101 to 200	8	50	69
201 to 500	10	60	83
501 to 1,000	3	63	88
1,001 to 2,000	6	69	96
2,001 to 5,000	1	70	97
5,001 to 10,000	1	71	99
10,001 to 15,000	1	72	100

Source: The Unit Trust Association of Sri Lanka

214. *The unit trust industry is proliferated with too many similar types of funds making it undistinguishable and uncompetitive* (Table 16). There are 13 gilt-edged funds, 20 money market funds, 14 income funds, 8 balanced funds, and 17 growth funds. Given the smaller size of the overall capital market and the unit trust industry, having too many funds with similar investment objectives makes them uncompetitive.

Table 19: Market Structure of the Unit Trust Industry

Unit Trust Management Company	Total Fund Size Rs. Mn.	Market Share %	Cumulative Market Share %
NDB Wealth Management	32,256	25.0	25.0
Capital Alliance Investments	19,263	14.9	40.0
JB Financial	13,633	10.6	50.6
National Asset Management	13,368	10.4	60.9
Assetline Capital	11,292	8.8	69.7
Ceybank Asset Management	10,187	7.9	77.6
Ceylon Asset Management	6,423	5.0	82.6
Guardian Acuity Asset Management	5,779	4.5	87.1
First Capital Asset Management	5,505	4.3	91.4
Comtrust Asset Management	5,504	4.3	95.6
Asset Trust Management	2,158	1.7	97.3
Candor Asset Management	1,589	1.2	98.5
Investrust Wealth Management	1,454	1.1	99.7
ArpicoAtaraxia Asset Management	440	0.3	100.0
Total	128,850	100	

Source: The Unit Trust Association of Sri Lanka

215. *The unit trust industry is highly unconcentrated with too many smaller firms making it less strong (Table 19)*. NDB wealth management is the market leader accounting for 25% of the market share in terms of fund size, and the rest of the market is shared by 13 unit trust management companies (UTMCs). The top-4 concentration ratio is 61% while top-6 UTMCs have a market share of 78%. The balance 22% of the market is shared by eight UTMCs each having a smaller share ranging from 0.3% to 5%. The Herfindahl Index, which measures the extent of industry competitiveness, is 0.13 suggesting that the unit trust industry in Sri Lanka is unconcentrated. Having too many small firms with relatively smaller amounts of funds under management and with smaller number of subscribers makes the industry too scattered with many firms potentially struggling to expand its business to a viable scale and profitability.

216. *Mutual funds in Sri Lanka are non-listed, open-end funds limiting investment choices.* Except for Namal Acuity Value Fund and the recently launched Candor Opportunity Fund which are both closed-end funds, all other funds are non-listed, open-end funds. Exchange-traded mutual funds provide the opportunity for investors to trade on the stock exchange and have the potential to broaden investor participation in mutual funds. The lack of an array of exchange-traded mutual funds limits investment choices, investor participation, and the growth of the unit trust industry as well as the overall capital market.

217. *The two available closed-end funds (CEFs) are term trusts having a defined maturity rather than perpetual trusts that are more common in developed markets potentially limiting investor interest.* The main structures for CEFs are perpetual trusts and term trusts. Most CEFs are structured as perpetual trusts without a defined maturity enabling the fund to exist and trade on an exchange indefinitely. Term trusts, however, have a defined maturity date at which time the fund is dissolved and net assets are distributed among the subscribers. The two CEFs that have been launched in Sri Lanka fall into the term trust category which are less common due to inherent limitations of such funds. Given these are equity funds, having a pre-defined exit date creates challenges for managing them particularly as the funds reach the maturity date due to the unpredictable nature of stock market conditions and directions. As a result, these funds have potentially added risk due to the importance of market timing strategies possibly limiting interest in subscribing to these funds as well as trading them on the exchange.[31]

C. Recommendations

218. The unit trust industry in Sri Lanka has excellent potential to develop to be a strong component of capital markets with appropriate changes in the industry structure, products, distribution methods, and investment education.
.

219. A comprehensive survey and study to assess the market for unit trusts and to identify various impediments for the public to invest in unit trust needs to be conducted.

220. *The unit trust industry needs a comprehensive plan for educating the saving and investing public about benefits of unit trusts as a saving and investing vehicle.* Education

[31] Although, CEFs with fixed maturity, also called fixed-maturity plans (FMPs), are most common in India, they are fixed income funds rather than equity funds.

and awareness initiatives could take a two-pronged approach. First approach is to educate the general public through various investor seminars and media events and discussions. The second approach is to identify types of potential investors and to implement targeted education and awareness campaigns for each group.

221. *The unit trust industry also needs to establish wider distribution channels for their products.* Given bank branches do not seem to be viable due to competing interests, the entire capital market will benefit from having one distribution mechanism for all capital market products including stocks, bonds and unit trusts. The most practical mechanism is the existing stock brokering firms and their branches. In this context, it is important that the SEC, the CSE, the stock brokerage industry and the unit trust industry work together to expand the scope of the stock brokering industry to include other capital market products and strengthen their institutional capacity and professional skills to handle a wider range of products that include unit trusts. This will require revisiting the existing fee structures of unit trusts to provide more incentives for stock broker firms to market and deal in unit trust products. This will also benefit brokers to develop a more diversified revenue structure rather than being completely dependent on commissions on stock transactions.

222. *Pension reforms needs to include external fund management of pension funds*. Currently, there is no pension reform plan. Pension funds, such as the EPF and ETF, should consider outsourcing a fraction of their funds to fund management companies for professional portfolio management. This will help pension funds to diversify their portfolios and optimize risk and returns. This will also contribute to growth in the unit trust industry and increase demand for securities market products which is important to increase the size and liquidity of the Sri Lankan capital market.

223. *The unit trust industry will need consolidation in order to make it more competitive and sustainable*. As discussed earlier, the industry is proliferated with 14 UTMCs and 72 funds resulting in too many UTMCs and too many funds with smaller amounts of assets under management and smaller number of subscribers. Industry competitive structure, profitability, financial stability and its contribution to capital markets could be strengthened through an appropriately designed consolidation strategy. Towards this, the regulators will need to undertake a number of tasks.

    i. Commission a comprehensive study of the competitive structure of the unit trust industry with a view to analyze the current competitive dynamics, optimal number of UTMCs and unit trust funds given the size of the industry and the economy, optimal strategies for industry consolidation, and a plan for consolidation.
    ii. Design a consolidation strategy in consultation with the industry and other stakeholders.
    iii. Provide for any necessary legal and regulatory guidelines for industry consolidation.
    iv. Implement the consolidation plan in a properly phased manner.

224. *It is also important to introduce new listed mutual fund products.* New listed mutual fund products will further help the Sri Lankan capital market to solve the “small size and illiquidity puzzle” and propel the growth and trading with greater investor participation.

    i. Perpetual closed-end funds: The unit trust industry needs to consider developing perpetual closed-end mutual funds, rather than defined maturity close-end funds, that are listed and traded on the stock exchange.

ii. Exchange traded funds (ETFs): Establishing exchange-traded funds is another growth option. A natural starting point will be ETFs on stock indices. The major obstacle to establish ETFs is the need for liquid investable indices, whether they represent the overall market or specific sectors within the market. It may be possible to create such a market index with the most liquid and large capitalization stocks with good free-float. However, this further points to the need for reforms to increase the liquidity of listed stocks.[32] No ETFs have been established in Sri Lanka. There are no ETFs based on the Colombo stock market either, i.e. a country ETF, listed on any foreign stock exchange.[33] It is important to draft a comprehensive policy paper on introduction of ETFs.

iii. Real Estate Investment Trusts (REITs): The 2016 Budget Speech also provides for the introduction of REITs. It proposed to introduce Listed Real Estate Trusts (REITs) in order to provide capital to real estate and infrastructure development and to enable small investors to directly benefit from the growth of the real estate sector. The Budget also stated that transfer of real estate assets to a REIT structure that distributes 90 percent or more of income to REIT unit holders will be exempted from stamp duty.[34]

225. *It is important to review the existing taxation framework for unit trusts and make appropriate changes to provide proper economic incentives for the operation of and investing in unit trusts*. The 2013 Budget slashed the corporate tax for income from unit trust investments to 10% from 28% in order to strengthen the management of unit trusts, attract more investors to the industry and strengthen the capital markets of the country. This incentive resulted in a number of corporates establishing unit trust companies in order to channel company funds to unit trusts to take advantage of the lower tax.[35] Any reversal of this tax incentive might lead those investors who invested primarily to take advantage of the tax incentive to withdraw funds leading to a significant shrinkage in the industry.

226. *The development of the unit trust industry also requires a SEC-mandated robust licensing framework for professionals in that industry*. The SEC needs to revise and expand the existing financial industry qualification framework in order to ensure that

---

[32] The Unit Trust Code specially defines and allows for the creation of ETFs in Sri Lanka. The Unit Trust Code defines an ETF as "a unit trust which tracks an index or price of gold or any other commodity approved by the Commission, units of which are listed on a stock exchange and can be bought/ sold at prices, which shall reflect or approximately reflect the net asset value of such unit trust." Accordingly, the definition of an ETF is broad enough to encompass indices representing any underling financial asset such as stocks, bonds or commodities.

[33] MSCI Sri Lanka Index began in November 2007. Sri Lanka was removed from the MSCI Emerging Market Index in June 2001. Bangladesh, India and Pakistan has their country ETFs listed on foreign exchanges. In addition, India has a large number of ETFs on gold, index (S&P CNX Nifty, CNX 100, Sensex, BSE 100), banking sector, money market, and international indices (Nasdaq, Hang Seng) traded on the Bombay Stock Exchange and the National Stock Exchange. Gold and index ETFs dominate in India. No ETFs are traded in Bangladesh or Pakistan stock exchanges.

[34] The CSE Strategic Plan 2016-2018 has also identified ETFs and REITs as areas for product development.

[35] Further, the 2015 budget provides for exemption of income arising or accruing to any unit trust from investments made on or after 1 January 2015 in US dollar deposits or US dollar denominated securities listed on any foreign stock exchange.

professionals in the unit trust industry have a high degree of knowledge and competencies.

XIII. Pension Funds

A. Overview of the Superannuation Funds

227. The Employees' Provident Fund (EPF), and the Employees' Trust Fund (ETF) are the two largest pension funds in Sri Lanka. Both are state-managed and defined contribution plans which provide lump sum benefits to contributors upon retirement. The contribution to the EPF is 20% consisting of 12% by the employer and 8% by the employee. The EPF had total investment portfolio Rs. 1,604 billion while the value of ETF was Rs. 211 billion as of the end of 2015 (Table 20).

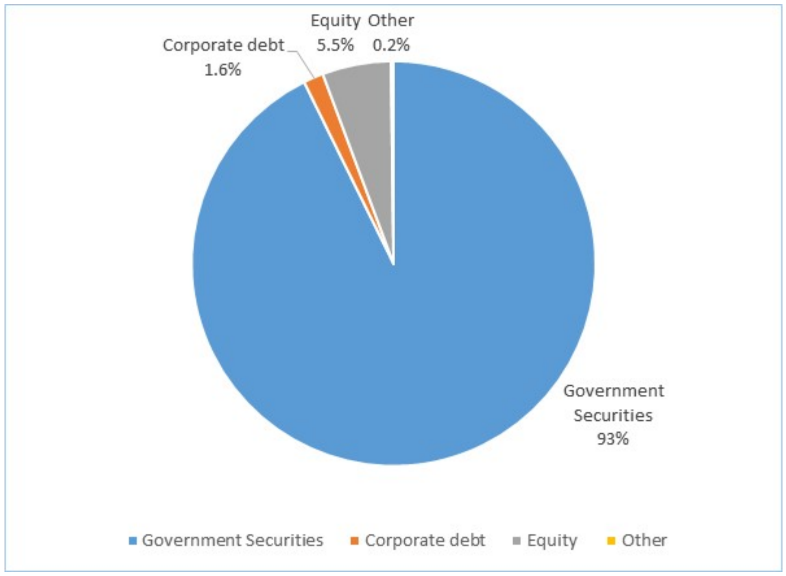
228. The investment policy of EPF is to provide a long term positive real rate of return to the members while safeguarding the value of the fund and maintaining sufficient liquidity to meet withdrawals and expenses of the fund. Thus, capital preservation is the overriding investment objective. Consistent with this objective, EPF's investment portfolio consisted 93% allocation to government securities. EPF is allowed to invest up to 10% in equities and investments in equities was 5.5% and corporate debt was 1.6% as of the end of 2015. (Figure 19), A smaller percentage of EPF funds are invested in high liquid securities such as reverse repurchase agreements in order to maintain an optimal liquidity position.

Table 20: Key Data on Superannuation Funds as of December 31, 2015

	Employees' Provident Fund (EPF)	Employees' Provident Fund (ETF)
Total Investment Portfolio (Rs. Bn.)	1,604	211
Total Assets as % of Finance Sector	12.2	1.6
Total Assets as % of GDP	14.9	2.0
No. of Member Accounts (Mn.)	16.0	12.5
No. of Active Member Accounts (Mn.)	2.4	2.4
Asset Allocation %		
Government Securities	92.7	91.0
Government Guaranteed Securities		1.3
Corporate debt	1.6	
Equity	5.5	5.6
Other	0.2	2.1
Total	100	100

Sources: Employees' Provident Fund, Employees' Trust Fund, Central Bank Annual Report, 2015.

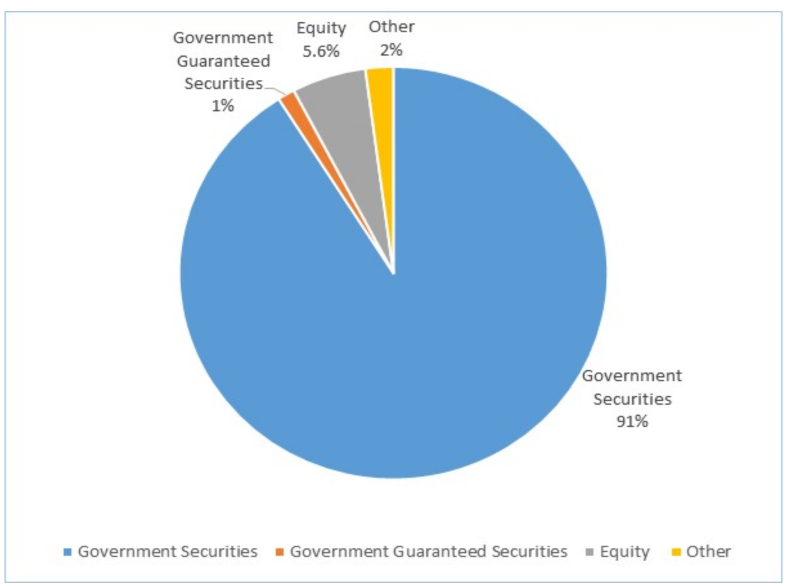
Figure 19: Investment Portfolio of EPF as of December 31, 2015



Source: Central Bank Annual Report 2015.

229. The ETF's investment policy is very similar to that of EPF. Its primary objective is to ensure the safety of principal while managing liquidity to pay financial obligations and providing optimum investment return using authorized instruments. The specific return objective is to obtain the highest available return while taking into account investment constrains and cash flow needs. Its principle objective is the safety of capital and as a result it had a 91% allocation to government securities in 2015. ETF's maximum permissible allocation to equity is 6% and it had invested 5.6% in equity (Figure 20).

Figure 20: Investment Portfolio of ETF as of December 31, 2015



Sources: Central Bank Annual Report 2015, Employees' Trust Fund

Table 21: The Performance of Superannuation Funds (2006-2015)

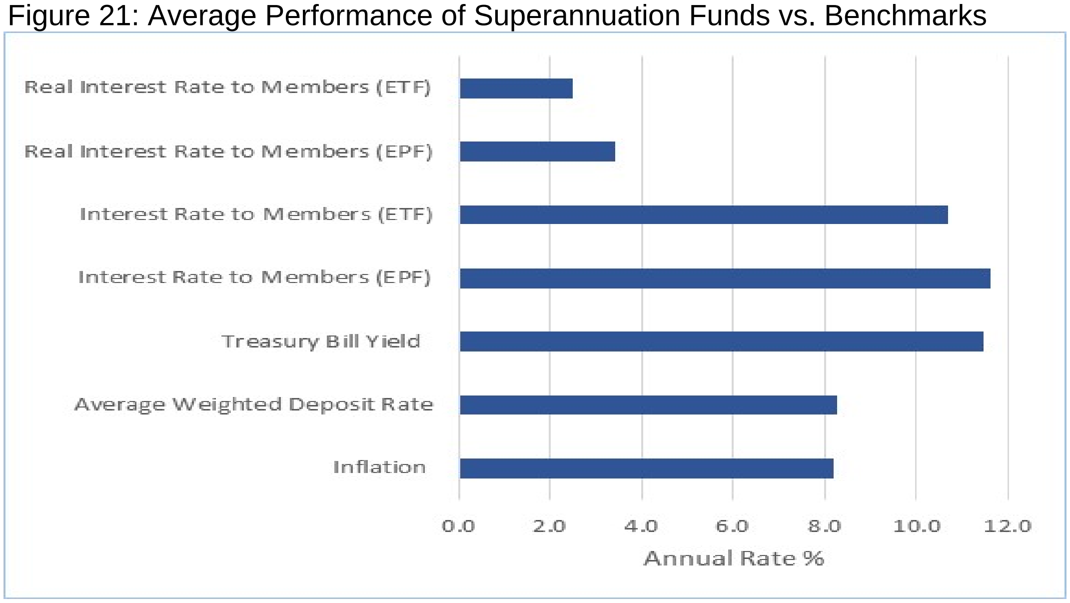
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Average
Interest Rate to Members % (EPF)	10.1	11.2	13.4	13.8	12.5	11.5	11.5	11.1	10.5	10.5	11.6
Interest Rate to Members % (ETF)	10.0	10.3	12.0	13.0	12.5	10.0	10.0	10.0	10.0	9.0	10.7
Inflation Rate % (1)	13.5	18.8	14.4	4.8	6.8	4.9	9.2	4.7	2.1	2.8	8.2
Treasury Bill Yield % (2)	10.4	13.0	20.0	19.1	9.3	7.6	9.3	11.7	8.3	6.0	11.5
Average Weighted Deposit Rate %	7.6	10.3	11.6	8.0	6.2	7.2	10.1	9.4	6.2	6.2	8.3
Real Interest Rate to Members % (EPF)	-3.4	-7.6	-1.0	9.0	5.7	6.6	2.3	6.4	8.4	7.7	3.4
Real Interest Rate to Members % (ETF)	-3.5	-8.6	-2.4	8.2	5.7	5.1	0.8	5.3	7.9	6.2	2.5
Risk Premium to Members % (EPF)	-0.3	-1.8	-6.5	-5.4	3.2	4.0	2.2	-0.6	2.2	4.5	0.1
Risk Premium to Members % (ETF)	-0.4	-2.7	-8.0	-6.1	3.2	2.5	0.7	-1.7	1.7	3.0	-0.8
Return Premium over AWDR %(EPF)	2.5	0.9	1.8	5.7	6.3	4.3	1.4	1.7	4.3	4.3	3.3
Return Premium over AWDR % (ETF)	2.4	-0.1	0.4	5.0	6.3	2.8	-0.1	0.6	3.8	2.8	2.3

(1) Inflation rate: (2002=100 up to 2009; 2006/07=100 thereafter), (2) Previous-year end Treasury Bill yield

Sources: Employees' Provident Fund, Employees' Trust Fund, Central Bank Annual Reports

230. Over the past 10-year period from 2006 to 2015, EPF paid an average nominal interest rate of 11.6% to its members while EPF paid 10.7% (Table 21 and Figure 21). During the same period, one-year Treasury bills earned an average return of 11.5%. Thus, the EPF paid a return in line with the one-year Treasury bill yield, whereas the ETF paid about 1% less than the Treasury bill yield. Both funds earned positive real returns to their members. The real rate of return was 3.4% at EPF and 2.5% at ETF. Both funds also did better than the deposit rate available at commercial banks. ETF underperformed the EPF by about 1% annually both in nominal and real terms.

Figure 21: Average Performance of Superannuation Funds vs. Benchmarks



Sources: Employees' Provident Fund, Employees' Trust Fund, Central Bank Annual Reports

B. Concerns and Impediments

231. *The interest paid to contributors is relatively low compared to the risk of investment portfolios*. Compared with the average Treasury bill yield, which is the short-term risk-free benchmark, EPF paid a similar return whereas ETF paid about 1% less. This means the funds did not pay a risk premium to contributors beyond the short-term risk-free rate although the portfolios of investments consisted of assets such as Treasury bonds, equities and corporate bonds that are more risky than short-term Treasury bills.[36] This could be due to a number factors including operating expenses of the funds, the relatively low allocation to stocks and corporate bonds, the performance of the stock and bond markets or portfolio management decisions such as security selection and market timing.

232. *The portfolios of superannuation funds are less diversified across asset classes.* While the smaller size in the corporate debt market limits their ability to increase investments into corporate bonds, their participation in the stock market is low. On average about 92% of investments are in government securities, and investments in more risky assets outside of government securities are relatively low. In the long-term, high concentration in government securities could limit the ability of these funds to provide better returns to the subscribers. The major limitations for superannuation funds to expand their asset allocation to equity and corporate debt securities is the lack of acceptable levels of liquidity of those instruments and the potential market impact arising from large investments by the funds.[37]

233. *The superannuation funds do not provide investment options with different risk-reward structures to their subscribers.* All investment decisions are taken by the funds. The lack of choice inhibits the creation of portfolios with varying degrees of asset allocation across different asset classes to suit subscriber preferences.

C. Recommendations

234. *Pension funds should consider creating more broadly diversified portfolios*. This will involve increasing asset allocation to other asset classes such as stocks, corporate bonds and mutual funds over time with prudent investment strategies. This will help the pension sector to optimize returns to subscribers, extend the maturity of investment portfolios to provide better asset-liability matching, and contribute to the development of a vibrant capital market.[38]

235. *Policy makers should consider pension reforms as vital to the development of a more deep and liquid capital market.*[39] The long-term growth of capital markets of Sri Lanka will critically depend on demand side reforms in order to generate organic demand for

[36] The EPF paid a smaller risk premium of just 0.1%.

[37] The EPF expressed the need for enhancing corporate governance of listed companies as an important factor for the Fund to consider expanding asset allocation to equities.

[38] Since subscribers can withdraw funds at the termination or change of employment after completion of five years, the ETF portfolio is managed with a target duration of 10 years.

[39] The government brought forward a draft proposal for the consolidation of EPF and ETF in 2015. The proposal reportedly envisaged creating a combined entity and making it more independent. There is no information on the progress on this proposal.

securities. To this end, pension reforms play a critical role in channeling retirement savings into the capital market. This will create regular and sustainable demand for securities market products and is key to solving the dual issues of small size and illiquidity that have been characteristic of the Sri Lankan capital market. Supporting pension reforms will go a long way to develop a large, liquid, vibrant and sustainable capital market and should be considered a priority in capital market reforms. While specific policy reforms are outside of the the purview of the SEC and the CSE, pensions reforms must be considered an important initiative to develop a strong capital market that will benefit the entire economy.

236. *A key aspect of pension reforms should involve offering portfolio choices to subscribers and creation of investment portfolios based subscriber choices.* Alternative risk-reward structures that match investment risk and return preferences of contributors will contribute to more activity in the secondary market as well. Subscribers can be offered an array of portfolio choices such a Treasury bill fund, a Treasury bond fund, a Treasury securities (bills and bonds) fund, a fixed income securities (government and corporate) fund, an income fund (fixed income securities and high yielding stocks), a balanced fund (fixed income and equity) and a growth fund (equity). These options resemble the types of unit trusts available in the market. Options could provide for the number of funds and the asset allocation flexibilities as far as the percentage of contributions that will go into each chosen fund. The subscriber choice approach provides an excellent way to pension management reforms since the investment choices will be at the discretion of subscribers rather than mandated by the Government. This approach will also yield greater long-term benefits of subscribers becoming educated about investment choices over time, contributing to the development of a more knowledgeable and educated investor base.

237. *Pension funds should consider strengthening the capacity for in-house fund management.* Building the technical capacity, knowledge and competency of the EPF, ETF and other key contractual savings institutions should be considered a very important part of capital market development. The capacity building needs may involve establishing investment policy frameworks and policies, portfolio management expertise, and infrastructure and ICT systems for fund management operations. A need assessment for capacity building of pension funds is recommended.[40]

238. *Pension industry should consider incorporating external fund management into their portfolio management options.* At present, pension funds are exclusively managed internally. As the size of the funds grow and the capital market develops with more investment choices, it might be prudent to outsource a fraction of pension fund assets for management by external professional fund management companies. Sri Lanka's fairly well-developed unit trust industry is an ideal choice since they have the capacity to manage retirement portfolios on behalf of pension funds. This also will necessitate changes to investment policy statements of retirement funds and also formulating guidelines and procedures for selecting unit trust management companies, management fees, and performance monitoring and reporting. Under this approach, the selected UTMCs could create and manage customized portfolios on behalf of state retirement funds under agreed upon investment policy guidelines. External fund management could help diversify portfolios of retirement funds and enhance returns to subscribers. This will also provide important knowledge transfer to internal fund management. The additional

[40] The NDB Bank is engaged by the ETF as its investment advisor.

demand for capital market securities created as a result of the investments by retirement funds will help create a more liquid capital market as well.

239. A comprehensive analysis of the performance of pension funds in Sri Lanka should be carried out with a view to provide recommendations for reforms and improvements in line with pension management best practices from similar organizations in comparable countries.

XIV. EDUCATION, TRAINING AND LICENSING

A. Overview of the Licensing Framework

240. The Capital Market Education and Training (CMET) division of the SEC is in charge of capital market training and education with the objective of enhancing knowledge and skill levels of market professionals, investors, issuers and market institutions. In 2008, for the first time, CMET introduced a financial industry qualification framework under ADB technical assistance (Figure 22)[41]. The purpose of the qualification framework is to ensure that financial industry professionals have a minimum level of proficiency required for their jobs functions in order to safeguard the interests of the investing public, maintain the integrity of the financial markets, and enhance professionalism and credibility of the investment industry.

241. The Certificate in Capital Markets (CCM) is the basic securities market certification that is mandatory to be licensed as a Registered Investment Advisor (RIA) in Sri Lanka. It consists of three study modules of study on equity securities, debt securities, and regulation, ethics and marketing. The SEC has so far licensed approximately 400 RIAs over the past 7 years which is highly commendable (Table 22). The second level of the qualification system is the Diploma in Capital Markets (DCM) which consists of three modules on corporate finance, investments, and derivatives. This program, however, has produced only 8 DCM holders. The third layer of the qualification system is the continuing professional education requirement.

Table 22: Outcomes of Training under the Financial Industry Qualification Framework

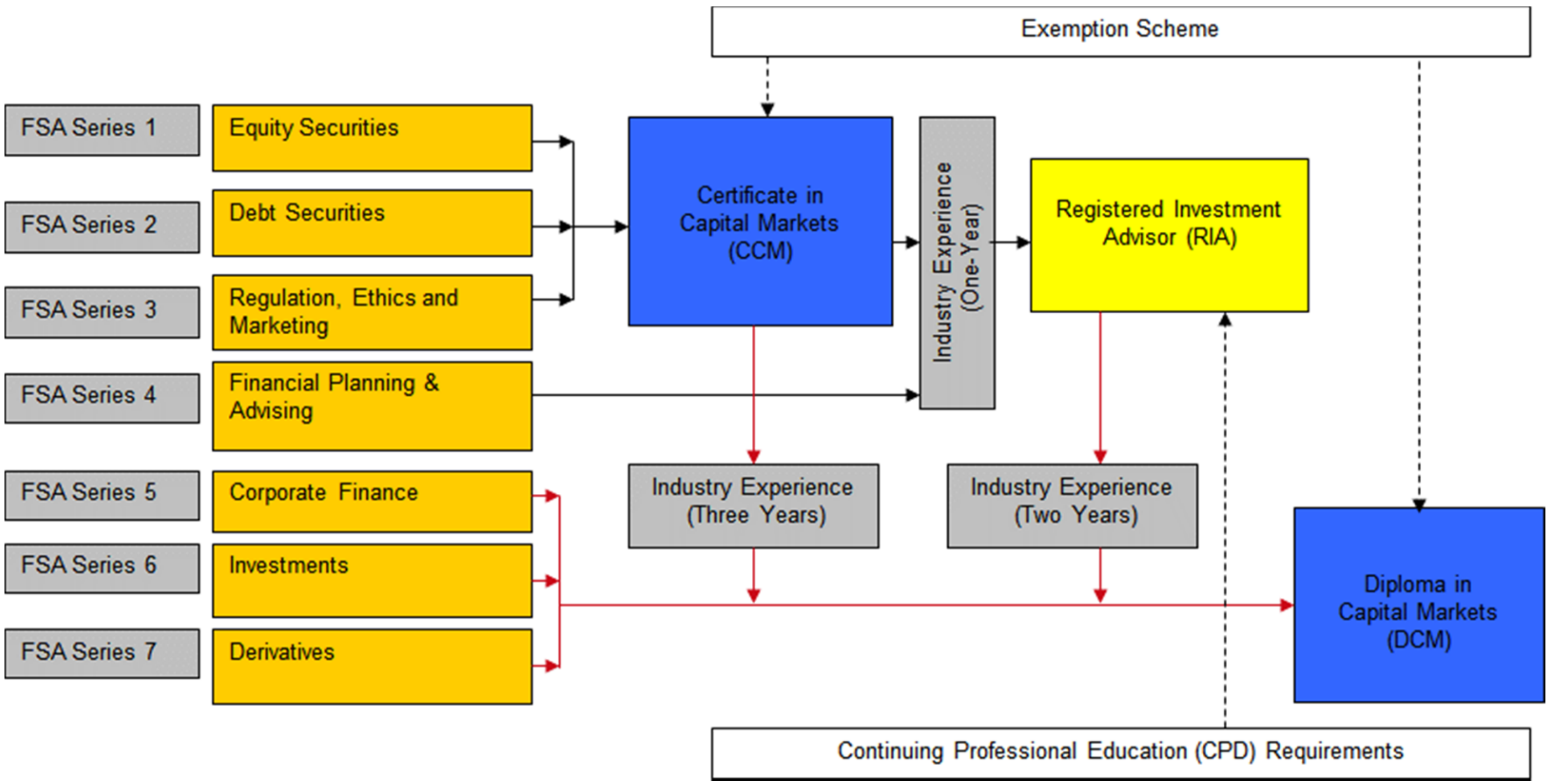
Year	# of CCM Holders	# of DCM Holders*	# of CPD Programs	# of RIAs Approved
2009	28		01	10
2010	67		05	44
2011	262		08	68
2012	250	01	11	105
2013	111	-	09	111
2014	62	05	07	41
2015	37	02	07	20
Total	817	08	48	399

*DCM program commenced in 2011.
Source: Securities and Exchange Commission of Sri Lanka

[41] Developed by Lalith P. Samarakoon in the capacity of the ADB Debt Market Advisor and Capital Market Development Expert.

242. A candidate who has obtained the CCM qualification is eligible to obtain the Registered Investment Advisor designation by completing a study module on Financial Planning and Advising and satisfying a one-year industry experience. The experience obtained either before or after obtaining the CCM qualification counts toward this requirement. The experience requirement needs to be fulfilled through full-time employment of an institution acceptable to the SEC. These requirements are designed to ensure that RIAs have the requisite knowledge of all basic investment products, financial planning, investment advising and relevant industry experience.

Figure 22: The Financial Industry Qualification Framework



Source: Securities and Exchange Commission

243. The SEC, by its circular No. 08 of 2009, made it compulsory for persons to obtain the RIA designation to work as an investment advisor in a stock brokering company. The SEC further mandated that industry participants must fulfill the continuous professional development requirements in order to maintain the RIA designation.

B. Concerns and Impediments

244. *The existing qualification framework does not adequately accommodate licensing needs of different asset classes*. By design, it was primarily intended to serve as a licensing framework for stock brokers. However, in the context of market developments, a more comprehensive licensing system covering stocks, bonds and unit trusts is needed.

245. *The books and other material used for training and licensing are not current*.[42] The qualification framework almost exclusively relies on three books and instructor resources dealing with the Sri Lankan securities markets which are published by the SEC. They are The Financial Market in Sri Lanka (2011, Sinhala and Tamil), Equity Securities: Theory and Practice (2010, English) and Debt Securities: Markets, Instruments and Analysis (2010, English). The latter two were developed for the SEC under 2008 ADB technical assistance as well. These books have made the education and training programs sustainable. However, these books do not reflect the market and regulatory developments over the past 8 years.

246. *There is a lack of a robust series of continuing professional development courses*. One of the key components of the qualification framework is the requirement that RIAs keep their knowledge and skills current through continuing professional development courses in fundamental areas relating to capital markets. However, the SEC has not been able to develop such courses

247. *There is a lack of properly trained local resource people needed in order to sustain all the components of the licensing and training programs*. The SEC needs to have a robust pool of trained instructors for the successful implementation of the entire licensing program. The SEC was able to train a number of local instructors drawn from the industry and local universities under the 2007-2009 ADB technical assistance program.

248. *Most of the training material and the delivery of training and education are in English.* The availability of training material in the local Sinhala language is very limited. This limits the ability to reach out to a wider segment of the population and the investing public.

C. Recommendations

249. *Sri Lanka should develop a multi-layered licensing framework to accommodate all asset classes and facilitate capital market development.* While this qualification framework has

[42] The three books are Equity Securities: Theory and Practice. First ed., 2010, Debt Securities: Markets, Instruments, and Analysis. First ed. 2010, and The Financial Market in Sri Lanka. First ed., (2009 Sinhala edition and 2011 Tamil translation), all authored by Lalith P. Samarakoon and published by the SEC.
.

worked well so far, this licensing framework needs to be revised in the context of market developments since its introduction in 2008 and the anticipated expansion into other securities such as derivatives and mutual funds. The revised qualification system should have multiple layers of licensing to accommodate different asset classes such as equity, bonds, unit trusts and derivatives. The existing RIA qualification should become the terminal qualification in the securities industry. The new system should be benchmarked to other jurisdictions and enable potential accreditation by securities regulatory bodies such as the IOSCO.

250. *The books and other material used for training and education must be revised and updated to make them current*. Given that the books and other training material were developed about eight years ago, it is important to revise and update them include all the relevant developments in Sri Lankan equity and bond markets and draft updated texts. This is very important for the sustainability of the qualification system. Without these resources, it will be difficult for the SEC to ensure a high quality and sustainability of the licensing framework.

251. *The SEC should update and create new exams for its licensing examinations*. Along with updated books and other material, it is important to revise existing the exams and develop new exams for modules on equity securities, debt securities, and regulation, ethics and marketing.

252. *The SEC should consider revising the curriculum of the Diploma in Capital Markets program*. A comprehensive and multi-layered licensing system will likely change the structure of the existing certification programs, and as a result the DCM program will need to be revised and resigned consistent with the new licensing system.

253. T*he SEC should develop training material and resources on mutual funds, derivatives and commodities markets.* This will contribute to enhancing the knowledge of market professionals and investors on financial derivatives and commodities and facilitate introduction of such products in the future.

254. *The SEC should develop a series of continuing development courses.* Beyond the CCM and DCM programs, the SEC needs to offer short courses to enhance skills and capacity of securities market professionals. These short courses will fulfill continuous professional development requirements for securities market professionals. The areas that are important to the Sri Lankan market include Financial Statement Analysis & Forecasting, Equity valuation, Investment Management, Debt securities, Derivatives, and Mutual Funds. The SEC should develop curriculum and material for such short courses.

255. *It is also important to prepare training and education material in Sinhala and Tamil languages.* This will facilitate training of investment professionals the Sinhala and Tamil media. Towards this, the SEC needs to translate and publish the books on equity and debt securities into Sinhala and Tamil. This will go a long way of educating the general investing public on equity and debt markets and enable penetration by stock brokers, unit trusts and other security market intermediaries.

256. *The SEC should design a comprehensive program to train local professionals as instructors for its licensing programs*. This becomes even more important with the development of a comprehensive licensing system. The sustainability of the SEC's

training and education initiatives critically depends on the availability of a highly-trained and competent pool of trainers.

XV. RECOMMENDATIONS MATRIX

257. Table 23 provides a summary of concerns and impediments and recommendations relating to the Sri Lankan capital market covering the regulatory and institutional environment, trading, clearing and settlement systems, the equity market, the government securities markets, the corporate bond market, derivatives markets, commodities markets, the unit trust industry, pension funds, and education, training and licensing.

Table 23: Summary Recommendations Matrix

Area / Concerns / Impediments	Recommendations
REGULATORY AND INSTITUTIONAL	
1. (a). Regulatory deficiencies constraining the SEC's enforcement powers against securities law violations. 1. (b). Lack of regulatory provisions allowing demutualization of the CSE. 1. (c). Lack of regulations for establishing a central counterparty (CPP) clearing and settlement system and for the introduction of new securities products such as derivatives and commodities. 1. (d). Lack of adequate regulations for investor protection.	1. Complete the drafting of the new SEC Act including provisions to strengthen regulatory powers, allow demutualization and establishing a CCP mechanism, provide for the development of new capital market products, and enhance investor protection. Enact the new SEC Act into law expeditiously.
2. Lack of a comprehensive demutualization plan.	2. Develop a comprehensive demutualization plan encompassing all aspects of demutualization of the CSE including exchange listing, and implement the plan expeditiously.
3. Lack of regulatory provisions enabling demutualization of the CSE.	3. Complete the drafting of the Demutualization Act and enact it into law expeditiously.
4. Viability of running the demutualized stock exchange as a profitable and financially strong entity.	4. Develop a viable business plan for the demutualized stock exchange.
5. Various Deficiencies in the Takeovers and Mergers Code including areas of investor protection and compliance.	5. Proceed with the enactment of the new Takeovers and Mergers Code expeditiously.
6. Lack of laws enabling and regulating securitizations.	6. Develop a comprehensive legal and regulatory foundation for securitizations with a securitization act.
7. Segregation of composite insurance companies into long-term and non-life businesses and listing them on the exchange.	7. Complete the segregation and listing of insurance companies within an acceptable time frame.
8. Risk-based capital framework for insurance companies.	8. Complete the implementation of the already gazetted Risk-Based Capital (RBC) model within an acceptable time frame.
9. Deficiencies in the competitive structure, profitability and	9. Revise the Financial Sector Consolidation Plan appropriately

Area / Concerns / Impediments	Recommendations
financial stability of financial institutions with potential systemic risk.	and implement it in a properly phased approach.
10. Regulatory, supervisory and enforcement powers in respect of securities markets are vested with multiple governmental agencies contributing to significant regulatory and market development inefficiencies.	10. Consider establishing a unified or single regulatory and supervisory mechanism or rationalize and consolidate securities market regulations if a single regulator model is deemed infeasible.
11. Need for developing organizational capacity and strengthening the internal and external governance of the SEC.	11. Review the existing organizational and governance structure of the SEC with benchmarking to International Organization of Securities Commissions (IOSCO) standards.
12. Need for technical capacity building across all divisions of the SEC.	12. Prepare a detailed assessment of technical capacity building needs across all divisions of the SEC, identify modalities for such capacity building, and implement the plan in a properly sequenced approach.
13. Need for strengthening corporate governance from the present voluntary compliance system.	13. Develop and implement comprehensive corporate governance reforms in line with international principles such as G20/OECD Principles of Corporate Governance.
TRADING, CLEARING AND SETTLEMENT SYSTEMS	
14. Lack of a single, transparent secondary market trading mechanism for government securities to ensure better liquidity, transparency, and price discovery.	14. Establish a single, transparent trading system with a market making mechanism where all secondary market trading of government securities is conducted.
15. Lack of a regulatory framework for a central counter party system with a clearing house for exchange-listed securities.	15. Enact provisions for establishing and regulating a central counter party system and a clearing house for exchange-listed securities through the new SEC Act.
16. Lack of a central counter party clearing system with a clearing house for exchange-listed securities.	16. Establish a central counter party system and a clearing house for exchange-listed securities.
17. Lack of a central counter party clearing system with a clearing house for government securities.	17. Establish a central counter party system and a clearing house for government securities.
18. Segregation of trading, clearing and settlement systems for corporate and government debt securities across different	18. Notwithstanding the above, consider establishing an integrated, common trading, clearing and settlement

Area / Concerns / Impediments	Recommendations
trading platforms and clearing and settlement systems potentially creating access barriers and raising costs to investors.	infrastructure with appropriate legal and regulatory frameworks for both corporate debt and government securities.
19. Lack of links to international settlement systems such as Euroclear or Clearstream which provide settlement, safe-keeping and servicing of domestic and cross-border securities.	19. Consider linking the domestic clearing, settlement and depository systems with international platforms such as Euroclear or Clearstream to enhance market access for foreign investors.
THE EQUITY MARKETS	
20. The equity market is small in size on its own as well as relative to the economy and regional counterparts limiting attractiveness for investments, diversification and growth.	20. (a). Encourage listing of large privately-owned enterprises. 20. (b). Establish a national policy framework for public enterprise reforms linked to capital market development. 20. (c). Implement public enterprise reforms to restructure SOEs to make them profitable and financially strong. 20. (d). List at least a minority stake of viable SOEs on the stock market. 20. (e). Establish infrastructure development corporations and leverage capital markets to raise funds for infrastructure development projects 20. (f). Consider the viability of establishing a small and medium scale enterprises board (SME Board) for listing SMEs. 20. (g). Consider the viability of establishing a BOI Board for listing BOI companies. 20. (h). Consider the viability for establishing a dollar board for registration of foreign and domestic companies which would be permitted to issue dollar-denominated securities.
21. (a). The equity market is less liquid on its own and relative to regional counterparts and emerging markets. 21. (b). Many listed firms have a smaller public free-float impeding active trading. 21. (c).Lack of market making severely limits liquidity.	21. (a). Implement the already announced higher public float requirements to increase liquidity. 21. (b). Establish a market making mechanism to ensure a continuously liquid market for listed stocks.
22. Transaction costs on stock trades in Sri Lanka are high.	22. Lower transactions costs and consider introducing

Area / Concerns / Impediments	Recommendations
	negotiated brokerage.
23. There are too many intermediaries in the Sri Lankan stock market.	23. Design and implement a brokerage industry consolidation plan to create a financially strong and competitive brokerage industry.
24. Having specialized brokers for different capital market products might not be economically viable.	24. Adopt a universal brokerage model where market intermediaries deal in all capital market products such as equity debt, mutual funds, and derivatives etc.
25. There is no minimum capital requirements for the brokerage industry.	25. Develop and implement a comprehensive framework for risk-based minimum capital requirements for market intermediaries.
26. Brokers are adequately equipped to deal with stock trading only, and they lack adequate technical skills necessary to trade and provide investor advice on other instruments.	26. Expand the existing financial industry qualification framework to include multiple capital market instruments.
THE GOVERNMENT SECURITIES MARKETS	
27. A majority of bond issues have been of short to medium maturity resulting in lower liquidity at long maturities and higher refinancing risk.	27. Establish a fairly evenly distributed maturity structure that spans both medium-term and long-term segments.
28. The secondary market trading in government bonds is fairly illiquid at longer maturities hampering the reliability of the Treasury yield curve.	28. Develop a reliable benchmark yield curve by issuing relatively more of benchmark securities at key points along the yield curve.
29. The lack of an auction calendar makes auctions and interest rates less predictable and undermines the credibility of auctions.	29. The Central Bank needs to publish a quarterly Treasury auction calendar in advance containing security type, term to maturity, coupon rate, volume, announcement date, auction date and settlement date in order to provide credibility and predictability to auctions, and to make government borrowings more predictable.
30. (a). Private placement of government securities outside of the auction process in the past undermined the validity and efficiency of price discovery. 30. (b) Practice of outright rejection of auction bids undermines the price discovery process and investor confidence in the auction mechanism.	30. Minimize practices such as private placements, partial filling of auctions and outright cancellation or rejection of announced auctions in order to ensure a market-based, continuous price discovery process.

Area / Concerns / Impediments	Recommendations
31. Lack of a competitive primary dealer system reduces liquidity, increases transactions costs, and seriously undermines the efficiency of the price discovery process.	31. Enhance competition in the primary market by creating a more diversified pool of investors in government securities.
THE CORPORATE BOND MARKET	
32. The supply of corporate debt securities is primarily concentrated in the bank, finance and insurance sector.	32. Establish conditions to make debt financing through the capital market more beneficial to companies than bank-based financing to increase debt issuance by a wider spectrum of industries.
33. The secondary market for listed corporate debt is highly inactive and illiquid.	33. (a). Undertake policy reforms to increase institutional investor participation in the listed corporate debt market in order to create a strong investor base for corporate debt. 33. (b). Consider the viability of introducing repurchase agreements on listed corporate debt securities. 33. (c). Develop the necessary framework for Introducing corporate bond derivatives in the future when market fundamentals are suitable for bond derivatives.
34. There is no market making mechanism for corporate bonds.	34. Introduce a formal market making mechanism for listed debt securities.
35. Transactions costs on large debt trades are high.	35. Lower transactions costs for debt securities trading.
36. Unlisted corporate debt including bonds, debentures, commercial paper and promissory notes is unregulated.	36. Enact necessary rules and regulations to bring unlisted corporate debt market under the SEC regulation.
37. Inadequate level of knowledge and skills of stock brokers on investing and trading in debt securities.	37. Enhance technical capacity of stock brokers and other market professionals on debt instruments and trading by strengthening the existing financial industry qualification framework.
DERIVATIVES MARKETS	
38. Absence of regulatory, trading, and clearing and settlement infrastructure for developing an organized derivatives	38. Establish the regulatory framework for derivatives through the new SEC Act and develop the necessary trading,

Area / Concerns / Impediments	Recommendations
market.	clearing and settlement infrastructure for derivatives.
39. There is no comprehensive feasibility study for identifying pre-conditions and other requirements for introducing derivative products.	39. Undertake a comprehensive assessment and prepare a realistic road map for developing derivatives products and markets on stocks and bonds.
40. There is a severe lack of knowledge and skills on financial derivatives among market professionals and participants.	40. Enhance knowledge and competencies of market professionals and participants on financial derivatives by strengthening the existing financial industry qualification framework.
COMMODITIES MARKETS	
41. Absence of regulatory, trading, and clearing and settlement infrastructure for developing exchange-based commodities trading.	41. Assess the economic and practical feasibility of setting up a commodities exchange and the needs for an enabling regulatory, trading, clearing and settlement infrastructure.
42. Lack of knowledge and expertise needed for the operation of a commodities market system and trading of commodities.	42. Develop knowledge and competencies on trading commodities and using them for risk management purposes.
THE UNIT TRUST INDUSTRY	
43. Penetration of unit trusts into the savings base and participation in unit trusts by the Sri Lankan population remain low.	43. Undertake a comprehensive study to assess the market for unit trusts and to identify various impediments for the public to invest in unit trusts.
44. (a). Lack of awareness about saving and investing through unit trusts makes it difficult to attract more investors. 44. (b). The saving and investing public's preference for a fixed rate of return is a big impediment to attract more subscribers.	44. Develop a comprehensive plan for educating the saving and investing public about benefits of unit trusts as a saving and investing vehicle.
45. The industry has very limited distribution channels making it difficult to reach out to potential investors.	45. Establish wider distribution channels through a universal brokerage model.
46. Contractual savings system in Sri Lanka does not allow investment choice to subscribers.	46. Allow unit trusts to manage portions of pension portfolios.

Area / Concerns / Impediments	Recommendations
47. (a). The unit trust industry is proliferated with too many funds with a very small number of subscribers with smaller amounts of assets under management. 47. (b). The unit trust industry is proliferated with too many similar types of funds making it uncompetitive. 47. (c). The unit trust industry is highly unconcentrated with too many smaller unit trust management companies making it less strong.	47. (a). Carry out a comprehensive study of the industry competitive structure and profitability. 47. (b). Develop and implement an industry consolidation plan.
48. (a). Mutual funds in Sri Lanka are non-listed open-end funds limiting investment choices. 48. (b). The two listed closed-end funds are term trusts having a defined maturity rather than perpetual trusts that are more common in developed markets, potentially limiting investor interest.	48. Introduce new listed mutual fund products including perpetual closed-end funds, exchange-traded funds (ETFs) and rea estate investment trusts (REITs).
49. The recent industry growth has been primarily driven by tax incentives which may not be sustainable.	49. Assess the existing taxation framework for unit trusts and make any changes to provide proper economic incentives for long-term development of the unit trust industry.
50. Lack of a robust licensing framework for professionals in the unit trust industry.	50. Expand the existing financial industry qualification framework to include a certification for unit trust professionals.
PENSION FUNDS	
51. (a). Interest paid to contributors is relatively low compared to the risk of investment portfolios. 51. (b). Portfolios of superannuation funds are less diversified across asset classes.	51. Consider creating more broadly diversified portfolios subject to the investment constraints to optimize the risk-reward structure of the portfolios.

Area / Concerns / Impediments	Recommendations
52. The superannuation funds do not provide investment options with different risk-reward structures to their subscribers.	52. Offer portfolio choices to subscribers and create investment portfolios based subscriber preferences.
53. Superannuation funds are exclusively managed internally.	53. Allow external fund management of portions of pension portfolios as a way to help establish benchmarks, diversify portfolios and enhance returns to subscribers. .
54. Need for building technical capacity, knowledge and competencies as well as ICT systems at superannuation funds.	54. Strengthen the professional fund management and ICT capacities at superannuation funds.
TRAINING, EDUCATION AND LICENSING	
55. The existing qualification framework does not adequately accommodate licensing needs of different asset classes.	55. (a). Develop a multi-layered licensing framework to accommodate all asset classes and facilitate capital market development. 55. (b). Revise and strengthen the curriculum of the Diploma in Capital Markets program.
56. Books and other material used for training and licensing are not current.	56. (a). Revise and update the books and other material used for training and education to make them current. 56. (b). Update and create new exams for its licensing examinations.
57. There is a lack of a robust series of continuing professional development courses.	57. Develop a series of continuing development courses.
58. There is a lack of properly trained local resource people needed in order to sustain all the components of the licensing and training programs.	58. Design a comprehensive program to train local professionals as instructors for its licensing programs.
59. Most of the training material and the delivery of training and education are in English.	59. Prepare and publish more training and education material in Sinhala and Tamil languages.
60. Lack of training material on mutual funds, derivatives and commodities products.	60. Develop training material and resources on mutual funds, derivatives and commodities markets.
CAPITAL MARKET POLICY	
61. Lack of a consistent incentive framework across capital	61. Carry out a comprehensive assessment of the existing

Area / Concerns / Impediments	Recommendations
market instruments, investments and institutions has created distortions in investment incentives inhibiting long-term development of capital markets.	economic incentive structures including taxation regimes relating to capital market instruments, investments and institutions, and recommend a robust incentive and taxation policy to ensure a level playing field while providing appropriate incentives for developing segments of the capital market.
62. Need for a comprehensive national level capital market development plan with participation and commitment of all key constituents of the financial sector and capital markets of Sri Lanka including the highest levels of the Government.	62. Draft a capital market development master plan with sequenced initiatives and performance indicators for capital market development in consultation with the key stakeholders including the Ministry of National Policies and Economic Affairs, Ministry of Finance, Ministry of Public Enterprise Development, Securities and Exchange Commission, Insurance Board of Sri Lanka, Colombo Stock Exchange and the Central Bank of Sri Lanka.

APPENDIX A: BIBLIOGRAPHY

1. Boyagoda, Mangala. “Development of the Listed Debt Market in Sri Lanka.” 2006.
2. Boyagoda, Mangala. “Development of Government Bond Markets in DMCs – Sri Lanka.” ADB Conference on Government Bond Markets and Financial Sector Development in Developing Asian Economics, March 2000.
3. Central Bank of Sri Lanka, Annual Reports, 2005-2015.
4. Central Bank of Sri Lanka, Monthly Economic Indicators, 2005-2015.
5. Central Bank of Sri Lanka, Weekly Economic Indicators, 2005-2015.
6. Central Bank of Sri Lanka, Master Plan on Consolidation of the Financial Sector, 2014.
7. Central Bank of Sri Lanka, Financial Sector Reforms Committee Minutes, February 2004.
8. Colombo Stock Exchange, Strategic Plan 2016 -2018.
9. Colombo Stock Exchange, Listing Rules, August 2015.
10. Colombo Stock Exchange, Annual Reports, 2005-2014.
11. Employees’ Provident Fund, Annual Reports, 2012-2013.
12. Employees’ Trust Fund, Annual Report, 2012.
13. Insurance Board of Sri Lanka, Risk-Based Capital Rules, December 2015.
14. Insurance Board of Sri Lanka, Annual Reports, 2014.
15. International Science and Technology Institute, Development of Portfolio Management of the Employees’ Provident Fund, 1999.
16. Maxwell-Stamp Inc., EPF-ETF Amalgamation Report, 2005.
17. McKinsey & Company. Capital Market Master Plan, Colombo Stock Exchange, February 2012.
18. OECD. G20/OECD Principles of Corporate Governance, 2015.
19. Samarakoon, Lalith P. Debt Securities: Markets, Instruments and Analysis, Securities and Exchange Commission of Sri Lanka, 2010.
20. Samarakoon, Lalith P. Equity Securities: Theory and Practice, Securities and Exchange Commission of Sri Lanka, 2010.
21. Samarakoon, Lalith P. Sri Lankave Moolya Velandhapola (The Financial Market in Sri Lanka), Securities and Exchange Commission of Sri Lanka, 2009.
22. Samarakoon, Lalith P. Sri Lankan Corporate Bond Market. 2000.
23. Securities and Exchange Commission of Sri Lanka, Vision 20/20, 2015.
24. Securities and Exchange Commission of Sri Lanka, Annual Reports, 2005-2014
25. Securities and Exchange Commission of Sri Lanka, Capital Market Progress Report, 2014
26. Securities and Exchange Commission of Sri Lanka, Consultation Paper 24, Draft of the New Takeovers and Mergers Code, 2014.
27. Securities and Exchange Commission of Sri Lanka, Consultation Paper 18, Policy Decisions to Develop the Corporate Bond Market, 2013.
28. Securities and Exchange Commission of Sri Lanka, Capital Market Master Plan, 2013
29. Securities and Exchange Commission of Sri Lanka, Capital Market Opportunities and Challenges, 2013.
30. Securities and Exchange Commission of Sri Lanka and the Institute of Chartered Accountants of Sri Lanka, Code of Best Practice on Corporate Governance, 2013.
31. Securities and Exchange Commission of Sri Lanka, Consultation Paper 14, Regulation of Demutualized Exchanges and Clearing Houses, 2012.
32. Securities and Exchange Commission of Sri Lanka, Unit Trust Code, September 2011.
33. Securities and Exchange Commission of Sri Lanka, Capital Market Master Plan, 2006.

34. Senathi Rajah, R. and Balendra, M., Securitization in Sri Lanka, Julius & Creasy, Attorneys-at-Law & Notaries Public, 2000.
35. Shah, Ajay and Thomas, Susan. “Derivatives Trading in Sri Lanka.” Securities and Exchange Commission of Sri Lanka, 2008.
36. Siriwardena, C. P. J., “Bond Market Development in Sri Lanka.” 2006.
37. Sri Lanka Association of Investment Analysts, Sri Lanka Finance Reform Conference Recommendations, March 2002.
38. The Government of Sri Lanka, Budget Speech 2016, December 2015.
39. The Government of Sri Lanka, Economic Policy Statement of the Prime Minister, November, 2015.
40. Unit Trust Association of Sri Lanka, Performance Report, 2015.
41. Wickremasinghe, Maninda. “Developing a Corporate Debt Market in Sri Lanka - Medium to Long-Term Road Map.” November 2007.
42. World Federation of Exchanges, Monthly Reports, 2005-2015.

APPENDIX B: MEETINGS AND INTERVIEWS

1. Abeysuriya, Ravi, Director and Chief Executive Officer, Candor Group of Companies, and President of the Stock Brokers Association.
2. Arandara, Rathnija, Operations Officer, World Bank Group, Colombo Office.
3. Asokan, P., Director / Chief Executive Officer, Comtrust Asset Management (Pvt) Ltd., and the President of the Unit Trust Association.
4. Bandaranaike, Rajeeva, Chief Executive Officer, Colombo Stock Exchange.
5. Boyagoda, E. M. M., Director, Wealth Trust Securities Ltd.
6. Cooke, Anil, Managing Director & CEO, Asia Siyaka Commodities Plc.
7. Dedigama, Dihan D., Chief Executive Officer, Softlogic Stockbrokers (Pvt) Ltd.
8. Ekanayake, Deepta, Managing Director, Assetline Securities (Pvt) Ltd.
9. Ekanayake, Nilma, Head of Strategy, Colombo Stock Exchange.
10. Ellepola, Deva, Executive Deputy Chairman, Acuity Stockbrokers (Pvt) Ltd.
11. Fernando, Ajith, Managing Director, Capital Alliance Ltd.
12. Fernando, Damayanthi, Director General, Insurance Board of Sri Lanka.
13. Ferdinands, Ian, Manager Investments and Business Development, Ceybank Asset Management Ltd.
14. Harshapriya, W. G. R., Senior Assistant Superintendent, Employees' Provident Fund, Central Bank of Sri Lanka.
15. Jayasinghe, Chandrakanth, Chief Information Officer, Colombo Stock Exchange.
16. Karunaratne, Thilak, Chairman, Securities and Exchange Commission of Sri Lanka.
17. Kumara, Saman, Senior Assistant Superintendent, Employees' Provident Fund, Central Bank of Sri Lanka.
18. Kvintradze, Eteri, IMF Resident Representative, Sri Lanka and Maldives.
19. Mahihahewa, Mahinda, Chairman and Chief Executive Officer, Employees' Trust Fund Board.
20. Muralidaran, R., Managing Director, Bartleet Religare Securities (Pvt) Ltd.
21. Paranavitana, Lalin, Assistant General Manager, Enterprise Risk Management, Colombo Stock Exchange.
22. Thilakarathna, A. G. U., Additional Superintendent, Employees' Provident Fund, Central Bank of Sri Lanka.
23. Perera, Ruwan, Chief Operating Officer, NDB Wealth Management.
24. Perera, Suneth, Assistant Director, Capital Market Education, Training and Research, Securities and Exchange Commission of Sri Lanka.
25. Ranawana, Dhammikka, Managing Director, Wealth Trust Securities Ltd.
26. Salinas, Emanuel, Program Leader – Sri Lanka and Maldives, World Bank Group, Colombo Office.
27. Samarasekera, Prabodha, Chief Executive Officer, NDB Wealth Management.
28. Samaratunga Dr., R. H. S., Secretary, Ministry of Finance and Secretary to the Treasury.
29. Sathkumara, Chita, CEO and Executive Director, Ceybank Asset Management Ltd.
30. Sririwardana, K. M. M., Director, Economic Research Department, Central bank of Sri Lanka.
31. Sugathadasa, Indrani, Chairperson, Insurance Board of Sri Lanka.
32. Weerasinghe Dr., P. N., Deputy Governor, Central Bank of Sri Lanka.
33. Wickremasinghe, Maninda, Managing Director / Chief Executive Officer & Country Head, Fitch Ratings Lanka Ltd.
34. Wijayawardhane, Renuke, Chief Operating Officer, Colombo Stock Exchange.
35. Wijegunawardane, Vajira, Director General, Securities and Exchange Commission of Sri Lanka.