Sri Lanka Survey:
Issues In Local Bond Market Development

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Over the past few years, Sri Lanka has been working to develop its local currency bond markets, particularly for government securities, but for corporate securities as well. This study considers the prospects for developing corporate bond markets in Sri Lanka and the impediments to such efforts. It covers issues ranging from economic policy to the specifics of trading, clearing and settlement, and ways to facilitate bond market development.

CURRENT STATE OF THE SRI LANKAN BOND MARKET

The Sri Lankan bond market consists of government securities (T-bills and T-bonds), corporate and bank bonds listed at the stock exchange, and unlisted corporate bonds. There are no mortgage or infrastructure bonds, although some of the bonds issued by banks are for housing finance. As of mid-1999, the bond market (not including T-bills) totaled about LKR 77 billion (table 1).

As figure 1 shows, Sri Lanka’s bond market is small in comparison with the markets of other Asian countries. Only China has a smaller bond market in relation to GDP. Government securities dominate the capital market in Sri Lanka, followed by bank depos-
Table 1. Estimated Total Bond Market, mid-1999  
(billions of Sri Lanka rupees)

<table>
<thead>
<tr>
<th>Bonds</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed nongovernment</td>
<td>6</td>
</tr>
<tr>
<td>Unlisted nongovernment</td>
<td>6</td>
</tr>
<tr>
<td>Treasury</td>
<td>65</td>
</tr>
<tr>
<td>Total</td>
<td>77</td>
</tr>
</tbody>
</table>

Source: Central Bank of Sri Lanka; Colombo Stock Exchange; dealers’ approximation for unlisted corporate bonds.

The equity market is fairly small, while the corporate bond market is minimal (table 2).

The Government Bond Market

With the gradual increase in trading in government bonds in recent years, Sri Lanka now has an active primary and secondary market.

Figure 1. Fixed Income Market as percentage of GDP


1 Figures for Sri Lanka are from mid-1999. Data on the fixed income market in other countries are from 1996, while GDP data are from 1995.
The Primary Market. As of mid-1999, some LKR 65 billion of T-bonds were outstanding (figure 1). In recent years there has been a decisive shift from nonnegotiable debt securities (so-called rupee loans) placed directly with the main lending institutions to marketable government securities (T-bills and T-bonds) sold through auctions. After a modest start with T-bond issuance in 1996, the government securities market now comprises bills and bonds with maturities ranging from 30 days to 5 years (figures 2 and 3).

The primary market for T-bills and T-bonds consists of weekly sealed electronic bid auctions. Bids can be competitive or noncompetitive.\(^2\) The central bank has the right to refuse up to 25% of the bids and to reduce the quantity of the offer accordingly. Thus, the primary market is more a call for bids than a real auction. Government securities are sold through primary dealers. As of mid-1999, Sri Lanka had 18 primary dealers in government securities, but this number is expected to drop to 8 or 9 in the near future.\(^3\)

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\(^2\) From having previously been mainly noncompetitive a growing proportion of the bids have gradually become priced.

\(^3\) Primary dealers in government securities are appointed by the Monetary Board, while the requirements and standards that apply to primary dealers are set by the central bank. The central bank may appoint secondary market dealers in government securities. There are no secondary dealers at present, however. Only appointed primary and secondary dealers can deal in government securities.

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Table 2. Size of the Markets, End of 1998
(billions of Sri Lanka rupees)

<table>
<thead>
<tr>
<th>Government Domestic Debt per debt instrument as per the end of 1998</th>
<th>LKR billion</th>
<th>percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed corporate bonds</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Rupee Securities</td>
<td>25</td>
<td>156</td>
</tr>
<tr>
<td>Unlisted corporate bonds approx. 5T-bills</td>
<td>120</td>
<td>27</td>
</tr>
<tr>
<td>Government domestic debt 447 T-bonds</td>
<td>49</td>
<td>11</td>
</tr>
<tr>
<td>Equity market capitalization</td>
<td>11</td>
<td>7</td>
</tr>
<tr>
<td>Other</td>
<td>27</td>
<td>6</td>
</tr>
<tr>
<td>Bank deposits (Commercial banks and NSB)</td>
<td>372</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>447</td>
<td></td>
</tr>
</tbody>
</table>

Figure 2. Outstanding Negotiable and Non-negotiable Bonds


Figure 3. Outstanding Bills and Bonds

**The Secondary Market.** Trading in shorter maturities is quite active. This secondary market is dominated by bill repos and has gradually become the busiest segment of Sri Lanka’s money and capital market. The secondary market in the shorter maturities has developed relatively fast while a short-term borrowing and lending market based on T-bills and bonds has grown even faster. This market, estimated to process LKR 4 billion to 5 billion daily, is commonly referred to as the repo market.\(^4\) The central bank offers repo and reverse repo rates but has otherwise not engaged in open market operations on a large scale. Of the LKR 447 billion outstanding government securities, only LKR 49 billion, or 11\%, consist of tradable treasury bonds. Non-negotiable, nonmarketable rupee securities are gradually being replaced by T-bonds, which are growing at a steady pace. As noted below, trading is done through a central bank system, but provisions are being made for the trading of T-bills and T-bonds. At present, there is no screen-based bidding and dealers do not know the spreads and volumes of other dealers.

**The Yield Curve.** The yield curve for government securities (from 30 days to 5 years) serves as a benchmark for nongovernment bonds. Figure 4 shows the benchmark yield curve as of June 1999. It also illustrates the interest anomaly that exists in the Sri Lankan capital market: bank deposits yield a lower return than the risk-free government securities.

**The Corporate Bond Market**

Like the government market, the corporate bond market has a primary and secondary level.

**The Primary Market.** The nongovernment market consists of listed and nonlisted bonds. Listed bonds are normally referred to as corporate bonds, although most of them are either issued or guaranteed by banks. The market is small in comparison with government borrow-

\(^4\) A large part of the so-called repo market is a money market using T-bills and bonds as collateral.
ings, but it has grown rapidly from a single issue of LKR 1.3 billion in 1995 to 19 listed issues totaling LKR 6.7 billion in August 1999.

As figure 5 shows, 11 issues were launched in 1998. The market rose from only 1 or 2 issues per year in the period 1995–97 to 11 issues worth LKR 2.6 billion in 1998. All but two of the issuers have been financial institutions (predominantly banks), driven by recently introduced capital adequacy requirements (most of the bank bonds

![Benchmark Yield Curve, June 1999](image)


![Listed Nongovernment Bonds Issues 1995-99](image)

Source: Colombo Stock Exchange; Samarakoon Lalith P.
were issued in 1998), and by a need to correct maturity mismatches resulting from the banks’ growing housing loan portfolio. Many bank bonds were placed with major depositors, which allowed banks to transfer liabilities from deposits to bonds, that is, into tier-2 capital, and thereby meet the new, more onerous, capital adequacy requirements. Vanik, a licensed finance company, has been the most active bond issuer with five bonds listed as well as one unlisted issued in 1999. The total amount outstanding is LKR 1.75 billion (including LKR 200 million in unlisted bonds).

The 19 bonds listed on the Colombo Stock Exchange (CSE) were issued by 11 companies, again dominated by banks and other financial institutions (table 3). Only two bonds listed on the CSE were issued by nonfinancial companies, namely, Ceylon Glass Company and Overseas Reality (a property company that owns the World Trade Center in Colombo).

Data on the volume and number of unlisted issues are limited. According to traders, unlisted outnumber listed issues and their estimated value is between LKR 6 billion and 9 billion. A large number of those issues have been privately placed with captive investors. The privatization of many plantations, for instance, was financed in part by bonds taken up by government entities. The privatization of tea plantations was funded in part by bonds (in lieu of equity) placed mainly with the two large provident funds.

**Secondary Market.** In contrast to the primary market for nongovernment bonds, the secondary market has had limited trading. With a total of over LKR 6 billion of outstanding listed bonds, daily trading has averaged only about LKR 3 million, and it has been confined to 9 of the 19 issues. Of those nine, only two have been traded on a regular basis.

There is an over-the-counter (OTC) market, but it is restricted to securities that are not traded on Colombo Stock Exchange. These are mainly short-term corporate papers that are bought and sold by and between banks and other finance companies on a negotiated basis. There is no quotation system or any systematic dissemination of market data, and clearing and settlement are handled on a gross basis, with a physical transfer of securities (see the next section).
**Table 3. Bonds listed on the CSE**

<table>
<thead>
<tr>
<th>Date of issue</th>
<th>Issuer</th>
<th>Amount of issue (LKR)</th>
<th>Annual yield (percent)</th>
<th>Maturity (years)</th>
<th>Other information</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 1994</td>
<td>Overseas Realty</td>
<td>1,300 million</td>
<td>6 (semi-annual)</td>
<td>5</td>
<td>Secured by the properties of the company; matures in November 1999; dollar-denominated.</td>
</tr>
<tr>
<td>August 1997</td>
<td>Vanik</td>
<td>150 million</td>
<td>18 (semi-annual)</td>
<td>3</td>
<td>Unsecured.</td>
</tr>
<tr>
<td>December 1997</td>
<td>Vanik</td>
<td>1,000 million</td>
<td>15 (annual)</td>
<td>10</td>
<td>Unsecured.</td>
</tr>
<tr>
<td>June 1998</td>
<td>Ceylinco Securities</td>
<td>100 million</td>
<td>17.5 (semi-annual)</td>
<td>4</td>
<td>Unsecured.</td>
</tr>
<tr>
<td>August 1998</td>
<td>Ceylon Glass</td>
<td>50 million</td>
<td>13.5 (semi-annual)</td>
<td>3</td>
<td>Capital and interest guaranteed by DFCC.</td>
</tr>
<tr>
<td>November 1998</td>
<td>Commercial Bank</td>
<td>250 million</td>
<td>T-bill+1%</td>
<td>5</td>
<td>Unsecured (commercial bank).</td>
</tr>
<tr>
<td>December 1998</td>
<td>Vanik</td>
<td>363 million</td>
<td>15.0 (annual)</td>
<td>5</td>
<td>Capital guaranteed by USAID.</td>
</tr>
<tr>
<td>December 1998</td>
<td>Vanik</td>
<td>37 million</td>
<td>14.2 (annual)</td>
<td>5</td>
<td>Capital guaranteed by USAID.</td>
</tr>
<tr>
<td>February 1999</td>
<td>Mercantile Leasing</td>
<td>220 million</td>
<td>14 (semi-annual)</td>
<td>5</td>
<td>Capital and interest guaranteed by IFC and NDB.</td>
</tr>
<tr>
<td>April 1999</td>
<td>People’s Merchant Bank</td>
<td>150 million</td>
<td>13.5 (quarterly)</td>
<td>4</td>
<td>Capital guaranteed by IFC and NDB.</td>
</tr>
<tr>
<td>July 1999</td>
<td>Sampath Bank</td>
<td>500 million</td>
<td>14.2 annual; 13.5% quarterly; T-bill+1%</td>
<td>5</td>
<td>Unsecured (commercial).</td>
</tr>
<tr>
<td>September 1999</td>
<td>National Development Bank (NDB)</td>
<td>500 million</td>
<td>T-bill+1% (annual) (12.5 guaranteed minimum return)</td>
<td>5</td>
<td>Unsecured (development bank).</td>
</tr>
</tbody>
</table>

**19 issues** Total issued **6,620 million**

CURRENT STRUCTURES AND ISSUES

The corporate bond market in Sri Lanka is shaped by both external and internal factors.

Around the Bond Market

On the external side, the primary influences are the political environment, the macroeconomic situation, and the broader regulatory environment.

The Political Environment. Although Sri Lanka calls itself a “socialist republic,” it has a longer tradition of multiparty democracy than any other country in the region except India. The current coalition party in power, has its roots in Sri Lanka’s socialist movement, yet has proven to be more market and reform oriented than its election campaign suggested. The opposition party, if elected in the next round, would not be likely to pursue substantially different economic policies. The issues dividing the political parties in Sri Lanka are no longer mainly those of capitalism versus socialism.

Despite the government’s growing interest in economic reform and privatization, progress toward the latter has been slow. Union resistance in combination with increased electioneering is likely to preclude a more decisive reform of the financial sector in the near future. The government will therefore remain the regulator and the dominant actor on both sides of the capital market. At the same time, the move to give different government entities more distinct roles and to create more distance between the government and the entities is likely to continue. Restrictions on capital flows between Sri Lanka and the international capital market are unlikely to undergo further liberalization as long as the government believes that those restrictions saved the country from the Asian crisis.

Another problem for longer-term securities markets is that the civil war continues to consume financial resources and political energy, although it has not posed a serious threat to Sri Lanka and its institutions. The war fuels the government’s borrowing (both directly and indirectly through the rising interest on an ever-increasing national debt). It also deters foreign investment.
The Macroeconomic Situation. Despite the ongoing civil war, Sri Lanka’s macroeconomic environment has remained surprisingly stable. Budget deficits and inflation have been kept within manageable bounds. In recent years inflation has hovered at around 10% a year (figure 6). The effect of inflation on exports has been managed by a crawling peg exchange rate regime. If allows the exchange rate to vary within a band that is pegged to a basket of currencies, which includes the U.S. dollar.

The government runs small budget deficits in its borrowings, both in absolute terms and in relation to the region as a whole: the deficit has been between 8% and 11% over the past five years, (figure 7). It has financed these deficits mainly by domestic market borrowings, with limited borrowings in the international market. The main lenders have been state pension funds, insurance companies, and banks.

Although annual net domestic government borrowings increased from 3.4% of GDP in 1997 to 7% in 1998 (from LKR 30 billion to 71 billion), the margin of savings over government borrowings increased considerably (from 8% of GDP in 1994 to almost 11% in 1998; see figure 8).

This suggests limited crowding out of private sector borrowings. Interest rate volatility is a problem, however. In recent years, short-

Figure 6. Inflation (WPI) 1989–98

Term interest rates have ranged from a low of about 10% to a high of almost 20%. The main cause has been irregular government borrowings. The tendency has been for interest rates to drop during the first half of the year, then to increase during the second half along with borrowing requirements.

**Figure 7. Budget Deficit as Percentage of GDP**

![Graph showing budget deficit as percentage of GDP from 1994 to 1998.](source: Central Bank of Sri Lanka Annual Report 1998.)

**Figure 8. Savings and Deficit Financing**

![Graph showing savings and deficit financing as percentage of GDP from 1994 to 1998.](source: Central Bank of Sri Lanka Annual Report 1998.)
Broader Legal and Regulatory Environment. The taxes levied on the capital market, especially on listed securities, are by and large quite favorable for market development. Sri Lanka has no capital gains tax, for example, and companies that list their shares on the stock exchange are allowed several exemptions. The stamp duty and withholding tax structure, which previously acted as a disincentive for capital market development, has gradually been overhauled and made more favorable. Stamp duty and withholding taxes on listed bonds were recently removed, as was the stamp duty on repos of T-bills. Moreover, bonds are favored over bank loans because of a 6.25% defense levy on interest charged by banks (which does not apply to bonds and debentures) along with a bank reserve requirement of 11% of deposits.

Sri Lanka accounting standards (SLAS) are set by the Institute of Chartered Accountants of Sri Lanka and are in line with most currently valid international accounting standards. Under Sri Lanka’s Companies Act, firms are required to maintain proper accounts and to keep a record on file at the Registrar of Companies. The act calls for certain disclosures, but does not insist that SLAS be followed. There is little monitoring of accounting standards, and penalties are very low. However, the CSE requires all listed companies to prepare financial statements, in compliance with SLAS. Furthermore, a new law requires all “specified business entities” and their auditors to prepare financial statements in accordance with SLAS for financial periods beginning January 1, 1999.5

With the exception of the banks’ parate rights, Sri Lanka’s legal system offers essentially the same adjudication possibilities as do other Anglo-Saxon legal systems. Bondholders’ rights are contained in a trust agreement lodged with a trustee. The so-called parate powers

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5 Specified entities have been defined as entities engaged in the business of banking, insurance, leasing, and factoring; finance companies; quoted public companies; fund management companies; stock brokers and stock dealers; a company operating a stock exchange; unit trusts; public corporations; unlisted companies of a certain size (having either a turnover exceeding US$7 million, gross assets exceeding US$4 million, equity or liabilities to banks and financial institutions exceeding US$1.4 million, or staff exceeding 1,000); a group of companies, any one of which falls within any of the above categories.
allow trustees to foreclose on loan collaterals without the intervention of the courts. However, it takes a long time to settle default cases that reach the courts. Defaulters can obtain restraining orders against banks, which prolongs such cases even more.

Recent legislation has made it easier for banks to enforce financial contracts. Under their so-called parate powers, commercial banks are able to foreclose on collaterals without the intervention of the courts. These are unique powers and favorable for the banks, but they do not apply to financial institutions other than commercial banks. Since these institutions are dominated by the two state-owned banks, the privilege benefits mainly the state.6

**Across the Financial System**

As the foregoing suggests, the banking system dominates the financial sector in Sri Lanka.

*The Banking System.* The interest rate anomaly in Sri Lanka, whereby bank deposits yield lower returns than government securities, can be traced to the banking system. The three large state-owned banks that dominate the banking sector have by far the largest branch network in the country. Through it they have traditionally offered what are perceived to be risk-free accounts. This is indeed the case for the largest deposit taker of those three, the National Savings Bank (NSB), since it invests mainly in government securities (75%) and in bank deposits or bank-guaranteed papers. In essence, the NSB, and to a somewhat lesser extent the two state-owned commercial banks, have served as retail savings collection agencies for the dominating borrower, the central bank. The NSB therefore has no option but to offer savings yields below those of T-bills and bonds. In practice, this is a way for the government to channel savings into government borrowings. This has also allowed the other banks to attract funds at below T-bill cost but to lend them to corporate customers with a relatively large spread of 5% to 7%.

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6 Sri Lanka has also instituted specialized commercial courts. With those it should be possible to reduce the long processing time of the ordinary judicial system.
While state-owned banks maintain their grip on the market outside Colombo (outstations), there are signs of increasing competition for deposits in the Colombo area, both among the banks and between banks and other deposit-taking finance companies. A large part of the so-called repo market is one area in which banks and others compete actively for deposits. However, these are mainly short-term deposits and savings.

Bank liquidity requirements were reduced in mid-99 from 12% to 11% of deposits. Previously, banks had to satisfy the liquidity requirements on a weekly as opposed to a daily basis, which created considerable volatility in the money market that also spilled over into the capital market. This has since changed, and daily fluctuations must now be within 10% of the weekly requirement.

The Money Market. The money market comprises an interbank or call money daily market, T-bills, a repo market, commercial papers issued by corporations, and promissory notes (so-called pro-notes). The money market has been thin but the activity in the market has been increasing.

The Government Securities Markets. As already mentioned, the government securities market has been growing, and efforts are under way to make it more market oriented and active. The main concerns at this stage are market liquidity, usefulness of the securities as a benchmark, and dealer profitability.

The lack of liquidity in the secondary T-bond market has two effects on the corporate bond market. First, it detracts from the yield curve and the value of T-bonds as benchmarks. Second, it does not allow corporate bondholders to manage the interest rate risk of their portfolio by hedging or diversification.

Three factors detract somewhat from the usefulness of the yield curve as a benchmark. First, auctions in the primary market are more calls for bids than real auctions. Second, the yields for longer maturities are derived from quoted prices rather than actual transactions (the trade in longer maturities is not daily). Third, the government influences decisionmaking among the dominating investors, which are state owned.
Another concern is the order-driven trading used for government bonds. In the past, trades were negotiated over the telephone and transactions settled through the transfer of physical paper and bank checks. But the central bank is currently developing a new screen-based trading system, to be used only by primary dealers and only for T-bills and bonds, which will be order driven. Moreover, by the end of 1999 T-bills and T-bonds were to be traded over the CSE, which is also order driven. In addition, trading through the CSE was expected to face high commissions. At the same time, trading through the CSE was expected to increase competition, since it is an alternative to the central bank system, in which trade has to be channeled through the primary dealers.

The central bank is also developing a new system for clearing and settlement that will enable primary dealers to settle trades between themselves and major investors through a “semi-scripless” system that employs book-entry and electronic registry, as well as paper. There will be a central depository and a book-entry system in which each primary dealer will have two accounts, one for the dealer’s own trading and one for trading on behalf of customers. Trading on the primary dealer’s accounts will be paperless. Trading on behalf of customers can be paperless but the option of providing the customer with a certificate will remain. If a certificate is provided, the bond will be transferred to another register. The name of the holder will not be registered in the central bank system, but by the dealer. Thus

7 A local software firm, SasiaNet, has developed a trading system in response to the central bank’s request for proposal, but the system has not yet been accepted by the bank or the dealers, purportedly because of the uncertainty concerning the number of primary dealers and the functioning of the related clearing and settlement system the Bank is working on. The SasiaNet system includes a sophisticated monitoring function for the central bank, in which the central bank can follow every trade made by every dealer and thus have access to the position of each dealer on a real time basis. This would give the regulator access to considerably more information than is available in most large and developed bond markets in other countries.

8 The physical security can then be deposited with the CDS at CSE, after which it can be traded through the CSE trading system, using the CSE clearing and settlement system. The same rules will apply to government securities as for other securities, so that, once deposited, the security has to be traded through the CSE system through CSE member stockbrokers.
trading through primary dealers will be paperless, but not trading between other parties. Although it will be possible for large investors to open a paperless investor account, trading based on bonds in such an account will have to go through a primary dealer. Settlements will be made on a delivery-versus-payment basis. All primary dealers have a current account with the central bank, which means that payments will be made by direct transfers between accounts.

This new system should facilitate the development of the secondary market in government securities. One of its important features is that all trades in the secondary market will have to be channeled through the primary dealers in order to be cleared and settled through the paperless system. The system will thus give primary dealers extensive control over secondary market operations, but this could deter competition and further development of the secondary market in government securities. At present, primary dealers also exercise control over the secondary market since all secondary market transfers have to be endorsed by a primary dealer or a bank. However, this is less of an issue for a body made up of 18 primary dealers. Since investor bond ownership will be registered with the primary dealers (who in turn will enter their consolidated register in the depository), the borrowing and lending of dematerialized securities and, as a consequence, short selling, would be difficult for anyone but primary dealers.

Of the 18 current primary dealers, only a few are active in the secondary market. The central bank’s new rules, as already mentioned, are expected to bring their number down to around 8. Some of the current nonbank primary dealers who will not remain primary dealers under the new rules would like to be licensed as secondary dealers, with access to central bank clearing and settlement, and would like to deal in corporate bonds as well. This would benefit the secondary market in both government and corporate bonds.

Primary dealer profitability can also affect dealers’ ability to support the market. Several of the large investors, such as Employee Provident Fund buy from primary dealers at no cost, that is, at no commission and no spread. From their position of dominance, the two provident funds have been able to squeeze the margins of primary dealers to an absolute minimum. Since they and the NSB, also a primary dealer, account for a large proportion of the primary mar-
ket, the profit primary dealers can earn in the primary market is negligible. Moreover, primary dealers are not allowed to keep a spread on trades exceeding LKR 5 million. The reason for selling large quantities without profit is that the central bank has volume requirements for the primary dealers, and the primary dealer’s license can be withdrawn if these are not met.

Several primary dealers claim they have to make their money in the secondary market. The difficulty they encounter in making profits may be one reason why the central bank has not tried to enforce the rule that requires primary dealers to post two-way prices, that is, to make a market. Perhaps that is also why the new scheme accords primary dealers privileges in the secondary market.

Inside the Corporate Bond Market

Within the corporate bond market, the principal factors that affect market development are regulations and regulators, central market infrastructure, market participants, and intermediaries.

Regulations and Regulators. Whereas government securities come under the central bank’s market rules and regulations, equities traded on a formal exchange must abide by SEC and CSE rules, although some changes have recently been made for corporate debt. One such regulation prohibits short selling for either listed securities or government papers. This rule will not be easy to change, since short selling of scripless securities does not appear to be possible under present laws. Second, there are no rules for unlisted fixed income securities. Bonds that are listed on the stock exchange and/or traded by licensed stock brokers fall under the indirect supervision of the SEC. The issuing of listed bank guaranteed bonds is also subject to central bank guidelines. Neither the central bank nor the SEC is responsible for unlisted nongovernment securities, except for commercial papers, for which there are central bank guidelines. Third, there are no regulations for the OTC market in which such securities are traded. Existing regulations pertain to the financial intermediaries, which guarantee, market, and trade in these securities. Thus a listed bond cannot be traded in the OTC market. Only securities listed on the CSE can be settled through the CSE clearing and settlement system.
Central Market Infrastructure. The noteworthy features of the central market infrastructure are the channels of trading, the means of clearing and settlement, the OTC market, and credit-rating agencies.

Trading. Corporate bonds are listed and traded on the Colombo Stock Exchange. All securities listed on the stock exchange must be traded through the brokers of the exchange and through its trading system. Trading at the CSE takes place through an automated screen-based system. Brokers trade through a wide area network that enables them to operate from their own offices. Trading is conducted on all market days between 9:30 a.m. and 12:30 p.m. As with most modern stock exchanges, the trading system is order driven.

A number of new rules were recently introduced to facilitate the trading and issuance of corporate bonds on the CSE. To begin with, companies with unlisted shares are now able to list bonds. Listing rules for bonds are slightly less stringent than for shares. The SEC has also removed the stamp duty and withholding tax on listed bonds. In addition, clearing and settlement day has been brought down to T+1 for corporate bonds, while it remains T+6 for equity trade.

Several features of the infrastructure at CSE are likely to hinder secondary trade in listed bonds. In particular, the system is order driven, there are no dealers or market makers, short selling is not possible, and stock brokers’ trading privileges create high transactions costs and a “lock-in” effect (all listed securities have to trade through the stock exchange by its licensed brokers).

The order-driven system is a hindrance because bond traders typically shun automated trading systems of this nature in favor of screen-based quotation systems and negotiations by phone. Indeed, attempts to introduce order-driven trading have failed in several developed bond markets elsewhere. The bond trade in official exchanges is limited for a number of reasons.

For one thing, bonds are traded on terms whereas stocks are sold and bought because of expectations related to the issuer. A stock investor normally wants to buy a specific stock, while a bond investor looks for a combination of yield, maturity, liquidity, and credit risk. The bond investor seldom has a strong preference for a specific bond issue as long as his or her parameters are satisfied. Bond trading therefore involves a larger proportion of negotiation than trading in stocks.
For another thing, bond trades typically involve much larger amounts than stock trades, and dealers’ margins tend to be volume sensitive. In addition, transaction costs in the form of fees and commissions are often higher in the stock exchange than in the OTC market. Furthermore, a stock exchange normally has no minimum trading volumes and shorter trading hours. Trading in bonds requires somewhat different skills than stock trading, and it is carried out largely by dealers, whereas brokers tend to dominate the trading of stocks. Finally, the lower degree of transparency in the OTC market might benefit the dealers, by way of reduced competition and higher spreads.

Another important point to note is the broker cartel in the stock exchange and the noncompetitive manner in which fees and commissions are established. Both have likely helped curtail stock and especially bond trading. In a highly competitive bond market, bonds are traded only on spread, which may be as low as 5 basis points. By comparison, the current CSE commission for bonds is 0.20% of the traded amount, to which may be added a considerable spread on account of the limited liquidity of the market. High brokerage fees and commissions as well as high spreads add to the “lock-in” effect, which dampens the secondary market. In the long run, brokers themselves become the victims of a lack of market growth.

**Clearing and settlement.** The CSE clearing and settlement system in use in May/June 1999 allowed settlement to take place six days after trade at the earliest. This serves the needs of mainly equities and corporate bonds, but provisions are being made for T-bills as well.

In September 1999 the system began allowing settlement one day after trade (T+1) for bond trades. Settlement takes place through the Central Depository System (CDS), which also registers the transactions. This procedure is automated. Those who want to trade their securities will let their broker deposit the physical paper with CDS, and security ownership is then transferred by way of book-entries. Only transactions through the stock exchange can be registered. The CDS is a separate company, which is fully owned by the CSE.

Securities change hands by way of book-entries at CDS, and a schedule is presented for net settlement between brokers at T+6.
The settlement bank is ANZ Grindlays, and each broker and the custodian banks have an account there. The buyer has to pay the broker on T+5 in order for the check to clear by T+6. The buying broker is required to have sufficient funds on account at ANZ Grindlays. If a broker fails, which has not happened as yet, the Settlement Guarantee Fund operated by the SEC covers the loss. However, any broker who causes a withdrawal from the fund will have their trading privileges revoked. Since securities are transferred at T-day, the buyer pays at T+5, and the seller is paid at T+6, there is no delivery versus payment. Because it is possible to reverse the transfer of the security on the trading day (T), the counterpart risk is limited to one day in the paperless system.

The six-day delay from the day of the trade to settlement is intended to allow checks to clear. Check clearance takes one day within Colombo and the Western province, two to four days for many other parts of the country, and up to seven days for war-stricken areas. Since many brokers require buying customers to pay on T-day or even deposit an advance, the current practice creates a positive float on which brokers can earn interest.

Allowing for settlement of trade in corporate bonds by T+1 would significantly reduce risks, but it might also cause difficulties for traders outside Colombo and a loss of a profitable float for Colombo brokers. Outstation buyers would be unable to meet the T+1 limit because there are no facilities for wire transfer of funds and securities that are not lodged with the CDS have to be presented in kind. Some brokers have objected to the proposed T+1 rule. The loss of the float may not be the only reason. The time may be too short for brokers to notify clients of the trade, receive funds from clients, and allow for check clearance.

The OTC market. Colombo has an OTC market, mainly in money market instruments such as commercial papers and so-called promos, which are unlisted. There is reportedly very little trade in unlisted bonds, and the secondary trade in listed bonds must take place in the stock exchange.

Under the proposed T-bond and primary dealer structure, primary dealers will control all secondary market T-bond trades that are to be scripless, but their activities will be restricted to govern-
ment securities. A semi-scripless clearing and settlement system for government securities only will support a screen-based trading system. This will serve to keep dematerialized government securities out of the OTC market and will concentrate bond trading capital and competence on T-bills and bonds.

The proposed new rules would, however, allow materialized T-bonds to be listed on the CSE and to be dematerialized and entered into its CDS. This would allow for secondary trading outside the purview of primary dealers in the case of materialized bonds.

**Credit-Rating Agencies.** A credit rating agency (CRA) was set up in July 1999 and was to become operational before the end of 1999. It is to be owned by a number of institutional investors, including IFC, the central bank, NDB, and the Development Finance Corporation of Ceylon. The technical partner and major owner will be Duff & Phelps, the third largest credit-rating agency in the United States, which also operates a rating agency in India.

The CRA is expected to affect the market in two ways: it should reduce the issuers’ dependence on bank guarantees and thus the cost of issuing debt, and it should expand the market for corporate bonds. With a CRA, many institutional and contractual investors will not need to be as constrained as they are today by rules that prevent them from investing in corporate bonds other than those secured by bank guarantees. Credit rating would make it possible to reduce this restriction and allow portfolios to include different grades of bonds. Furthermore, credit rating is thought to improve the risk-reward structure in the bond market, by distinguishing between companies with different risk profiles. The result is likely to be a much wider range of interest spreads.

**Market Participants**

Market participants can be divided into issuers, investors, and intermediaries.

**Issuers.** As already noted, financial institutions make up most of the current investor base, with banks being predominant. There are several potential issuers in Sri Lanka, and these can be divided into
three main groups: large, well-established domestic conglomerates, leasing companies, and telecom companies.

Large, well-established domestic conglomerates. This group includes firms such as Aitken Spence, John Keells, Hayleys, and Richard Peries. These companies have strong balance sheets and a good reputation, and they are well known. Many of them see the bond market as a means of reducing their dependence on short-term borrowings. Several are waiting to find out if CRA ratings would reduce the need for bank guarantees. Some consider the current risk-reward structure to be inadequate in the sense that the price difference between them and higher-risk companies is too small. The CRA is expected to help address this problem.

Leasing companies. With a growing number of banks starting their own leasing operations, leasing companies are not only experiencing increased competition but are having difficulty gaining access to funds and bank guarantees for bond issues. This group of companies is extremely interested in bonds, and they place great hope in the CRA, which might enable them to raise funds without bank guarantees.

Telecom companies. Firms in this group include Suntel, Dialog, and Sri Lanka Telecom. The telecom industry is growing rapidly and thus has a large need for capital. Furthermore, it has good prospects for profitability. Bonds issued by those companies would probably stand a good chance of competing with bank loans in the area of cost.

Investors. The principal investors in Sri Lanka are provident funds, insurance companies, banks, unit trusts, and individuals. The main categories of institutional bond market investors have deposits totaling more than LKR 500 billion, almost half of which is invested in T-bonds and other government securities (see table 4). The balance is made up of commercial bank loans. The annual increase in deposits is currently about LKR 100 billion, a growing portion of which is to be channeled through long-term investors such as pension funds and insurance companies. With government borrowings
currently running at LKR 40 billion to 50 billion annually but set to
decline, there will be an increased demand for nongovernment long-
term securities.

The main concern about investors is that they are dominated by
a few large state-owned institutions, mainly banks and two provi-
dent funds. Generally speaking, this has limited competition among
banks, pension and provident funds, housing finance institutions,
and insurance companies in several ways. For instance, the govern-
ment has used its regulatory powers to impose rules favoring gov-
ernment entities. It has also excluded private sector competitors from
government business in the case of both pension and provident fund
management and insurance, and it has granted its own entities ex-
clusive access to funds. Being both large and dominant, government
entities have been able to set prices and extract margins on the basis
of cost plus rather than market forces. This has allowed more effi-
cient private companies to increase profit margins rather than com-
pete on price and efficiency.

Pension and provident funds. The pension and provident fund sector is
dominated by the two state-controlled provident funds, EPF and
ETF, which together account for over 90% of the total market (see
table 5). EPF is larger than ETF and has an investment portfolio of

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Table 4. Principal Investors

<table>
<thead>
<tr>
<th>Approximate figures (LKR billion)</th>
<th>Total capital</th>
<th>Annual inflow</th>
<th>Government securities portfolio</th>
<th>Corporate bond portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provident funds</td>
<td>210</td>
<td>50</td>
<td>165</td>
<td>6</td>
</tr>
<tr>
<td>Insurance industry</td>
<td>22</td>
<td>4</td>
<td>13</td>
<td>0.5</td>
</tr>
<tr>
<td>Commercial and savings bank</td>
<td>300</td>
<td>50</td>
<td>40</td>
<td>&lt;1</td>
</tr>
<tr>
<td>(in deposits)</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Unit trust</td>
<td>3</td>
<td>0.2</td>
<td>0.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Corporations and individuals</td>
<td>n.a</td>
<td>n.a</td>
<td>—</td>
<td>around 4</td>
</tr>
<tr>
<td>Total</td>
<td>535</td>
<td>104</td>
<td>219</td>
<td>around 12</td>
</tr>
</tbody>
</table>

Sources: EPF; ETF; approximations by private provident holders; Insurance companies; Central Bank of Sri Lanka; National Savings Bank; unit trust management companies.

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9 There are no pension funds in Sri Lanka, except for a few small in-house pension funds serving only employees of the institution in question. Contributions
approximately LKR 170 billion, of which 85% is placed in government-related investments. ETF’s investment portfolio totals LKR 23 billion, of which approximately 60% is invested in government papers. Hence at least 65% of all provident savings are invested in government securities. EPF and ETF buy government securities mainly in the primary market.

EPF and ETF face three problems. First, they are only allowed to buy corporate bonds guaranteed by banks. This restriction is likely to be lifted when the CRA comes into operation.10

<table>
<thead>
<tr>
<th>Provident fund (all amounts in LKR)</th>
<th>Total capital</th>
<th>Approximate market share</th>
<th>Government securities holdings</th>
<th>Corporate bonds holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPF</td>
<td>170 billion</td>
<td>81%</td>
<td>150 billion</td>
<td>3.1 billiona</td>
</tr>
<tr>
<td>ETF</td>
<td>23 billion</td>
<td>11%</td>
<td>15 billion</td>
<td>approx 3 billionb</td>
</tr>
<tr>
<td>Private provident funds</td>
<td>approx. 17 billion</td>
<td>8%</td>
<td>n.a</td>
<td>n.a</td>
</tr>
<tr>
<td>Total</td>
<td>approx. 210 billion</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a As of the end of 1998, EPF bond holdings consisted of one corporate bond (Vanik) worth LKR 10 million, commercial papers worth LKR 55 million, plantation debentures worth LKR 1,643 million, and development bank debentures worth LKR 1,369 million.

b Includes LKR 600 million in corporate bonds. The remaining amount consists mainly of plantation debentures.

Sources: EPF; ETF; approximations by private provident holders.

to EPF and ETF are mandatory. They are deducted from the payroll along with income tax. Evasion is thought to be widespread, however. The funds are contribution schemes, and as such are fully funded. The accumulated benefits, including returns, are paid as a lump sum to the beneficiary on retirement or death. ETF, but not EPF, allows for withdrawal upon termination of employment and also provides a limited health insurance. A draft bill presented to Parliament at the beginning of the 1990s included proposals for the merger of the two provident funds into one provident and pension scheme that would allow for a combined lump-sum payment and annual payments. The bill was turned down after objections from the trade unions.

10 Companies have a choice of contributing to EPF or to a closed company specific provident fund. There are about 200 such funds of different sizes but only two that serve the needs of more than one company. The Ceylon Chamber of Commerce has a provident fund that manages the provident capital of employees of the Chamber’s member companies, and there is another similar fund for plantation companies. With the exemption of privatized plantation companies, these funds have not been allowed to take in new members since 1996, when the Employees’ Provident Fund (Special Provisions) Law No. 6 of 1975 came into effect. This law prohibits the establishment of new private pension and provident funds.
Second, the funds are very large in relation to the market. EPF is the single largest primary market investor, with an annual inflow of LKR 45 billion to 50 billion in funds. It would trade, on average, LKR 1 billion worth of securities per month in the secondary market. Now that its investment policy has been liberalized, EPF is gradually moving into private sector papers and investments. However, it is looking into outsourcing of fund management for a smaller part of its portfolio and is considering proposals aimed at creating several separately managed funds.

Third, the pension and provident system has been operating without any return on investment targets, so it can hardly be said to have the interests of the contributors at heart. Payroll deductions in favor of EPF and ETF have been mandatory, similar to those of taxes, and the funds have been used mainly for financing the government’s budget deficit, as in the case of taxes. Furthermore, the government has used its regulatory powers to limit the scope of competing private provident funds. This has helped keep the national savings rate in Sri Lanka lower than in most other Asia countries.

*Insurance companies.* Sri Lanka has seven insurance companies, two of which are owned by the state. The largest state-owned company accounts for over 50% of the market. The state insurers are performing poorly, while two of the private companies appear to be under financial strain.

The capital of the entire insurance industry amounts to LKR 21 billion to 22 billion, of which approximately 20% is classified as free reserves and is available for investment in corporate bonds. The insurance market is growing rapidly. During 1998 alone, the total life insurance market grew by 20%, and the figures for the first half of 1999 indicate an even higher growth rate. Thus the annual increase in investment capital from the insurance industry would amount to LKR 4.4 billion, of which approximately LKR 1 billion would be available for investment in corporate bonds and other nonspecified forms of investments.¹¹

¹¹ Total purchases as of April 1999 amounted to LKR 15.9 billion.
Efforts to modernize insurance regulation have been under way since 1995. A new law has been drafted that would allow for greater flexibility in choosing investment alternatives, so that only 30% of life and 20% of general insurance would have to be invested in government securities, while the remaining capital would be open to all sorts of investment. When the law will go into effect remains unclear.

For the time being, the insurance industry remains heavily regulated, although the resources devoted to supervision are very limited. Under current regulations, the companies’ capital less accumulated profits (the so-called reserve fund) has to be invested in the following manner: government securities must make up at least 50% of the reserve fund for life insurance (30% for general insurance), equity can make up a maximum of 5% of the reserve fund, and the remaining part can only be invested in a number of specifically permitted forms of investment excluding corporate bonds/debentures and real estate.

Accumulated profits (the so-called free reserve) can be invested as the company sees fit, and from this source investments are made in corporate bonds, debentures, and other such entities. At present, insurance companies have more than 50% of their total capital in government securities because few alternatives are open to them. Insurance companies buy mainly in the primary market.

The government has protected the state-owned insurance company from competition insofar as insurance by the public sector is concerned. It has also reduced the return on investment of the entire sector by onerous investment restrictions in favor of government debt. However, the private insurance companies seem to be able to take advantage of the inefficiencies in state institutions and to attract new customers and funds.

**Banks.** The National Savings Bank is a wholly state-owned institution. It collects savings through a large number of branches covering the whole country. The NSB portfolio consists of 75% in government securities, and the bank is required to invest at least 60% of money deposited by customers in government securities. As of the end of 1998, the total deposits of NSB amounted to LKR 84 billion. Deposits increased 9% during 1998. Until recently, the NSB
was not allowed to invest in equity; in the area of corporate debt, the bank is allowed to invest only in listed bonds secured by bank guarantee. Part of the portfolio is deposited with commercial banks and merchant banks. NSB holds approximately 25% of the outstanding government debt. In 1999, NSB planned to buy some LKR 20 billion worth of government bonds.

As to be expected, commercial banks use most of their funds for commercial lending activities. They invest mainly in government securities, partly because government bills can be included in their liquidity requirement. Most banks have some investments in debentures, equity, and listed bonds. During 1998, total deposits of commercial banks increased by LKR 37 billion (or 12%).

The operating inefficiencies and dominating market position of the two state banks and the National Savings Bank are said to be responsible for Sri Lanka’s interest anomaly, whereby bank deposit rates are considerably lower than the rate of the risk-free government securities. The losers are first and foremost the savers, and the winners are the private commercial banks, which enjoy a comfortable spread.

The housing finance sector has been dominated by two government institutions, but commercial banks and development banks have taken an interest in the sector. Competition is therefore likely to increase.

**Unit trusts.** Sri Lanka has five management companies at the moment with 12 open-ended unit trusts, with a total value of LKR 3 billion. Approximately LKR 800 million is invested in fixed-income funds, of which LKR 110 million is in corporate bonds. Unit trusts are regulated by the SEC.

The drastic decline in stock values over the past five years hit unit trusts rather hard, since their portfolios comprised mainly stocks. Yields have been low, at 3% to 4% a year. Many of the unit trusts entered the market in 1993/94, when the stock market reached a peak. Individuals who invested in the funds at that point have seen nothing but losses so far. The current inflow of funds is limited (LKR 2 million per month for the whole industry), and for some funds outflows are larger than inflows. Another drawback is that foreign investors have not been allowed to invest in unit trusts. During part
of the last five years, foreign investments in the stock market accounted for as much as 50% of turnover. Indications are that this limitation might be removed in the case of equity funds.

Some unit trusts have started fixed-income funds, of which approximately 25% is invested in corporate instruments and the remaining 75% in government securities. Unit trusts claim that the problem with corporate instruments is availability. Furthermore, government bonds are more liquid than corporate bonds, and thus preferable.

**Individuals.** Individuals invest in corporate bonds on a small scale, but they generally do not trade, preferring to hold to maturity. Some of the issuers of bonds—Vanik for instance—have advertised heavily in rural areas in order to persuade individuals to subscribe to their bond issues, and subsequently have gotten a number of individual subscribers (approximately 25% of the subscribers were individuals). Other individuals buy their bonds through a broker.

Since the unit trusts have been performing poorly and are attracting less and less funding from individuals, one of the most important intermediaries between individuals and the capital market is missing in Sri Lanka.

**Intermediaries.** The following intermediaries participate in Sri Lanka’s securities market: 18 primary dealers, 15 stockbrokers, 14 custodian banks, and 5 moneybrokers. None of these entities act as market makers or so-called specialists, in the sense that they post firm buy and sell prices with maximum transaction volumes. The new central bank rules for primary dealers aim at creating a market maker situation.

**Dealers.** The only licensed dealers in Sri Lanka are the primary dealers in government securities. Although the CSE presents no formal obstacles to dealers, it has no rules for them as yet. Since there are no dealers, there are no market makers. The primary dealers in government securities are the most experienced bond market intermediates. Currently they deal in corporate securities as well, but their business volume in this area is limited by the small size of the corporate bond market. Primary dealers would be in a good position to
develop the corporate bond market. The new central bank rules (requiring them to deal exclusively in government securities) will raise their cost for participating also in the corporate bond market since this would have to be done through another corporate entity.

The CSE does not allow short selling, without which dealers and market makers must face high finance costs for the inventory they have to maintain. Allowing short selling is likely to be complicated under the present laws, especially in the case of scripless securities. The CDS at the CSE is a company of its own, but fully owned by the CSE. Clearing and settlement through this CDS are only available for securities listed on the CSE. This restriction is likely to inhibit the growth and development of the OTC market since it will place OTC-traded securities at a disadvantage.

Money brokers. There are five moneybrokers in the primary market. These brokers are important intermediaries for Primary dealers, but this is expected to change with the new trading system between the primary dealers. John Keells, Sri Lanka’s largest conglomerate, recently closed down its moneybroking firm, not because of losses, but because it did not see a future for this activity. Others can be expected to follow suit.

Stockbrokers. Stocks and corporate bonds are listed and traded on the Colombo Stock Exchange, which is owned by the 15 stockbrokers who are members of the exchange. Since they are brokers, these members are not allowed to act as dealers, that is, trade for their own account. There are provisions for dealers under the SEC rules, but so far no one has applied. Thus there are no dealers in Sri Lanka, except for the primary dealers in government securities. The CSE is not yet prepared to admit dealers, since there are no CSE rules for dealers. Brokers’ commissions are fixed, determined by the CSE in consultancy with the SEC, and are fairly high by international standards. All CSE trades have to be conducted through licensed brokers, and all securities listed on the CSE have to be traded on the CSE. These rules assure brokers of a certain level of remuneration, but they are also likely to inhibit the growth of the secondary market. Thus it affects the brokers negatively as well, since the volumes of their trades are less likely to grow.
Custodian banks. Custodian banks execute trade on behalf of foreign investors, but they, too, have to trade through brokers. Since foreigners are not yet allowed to invest in corporate bonds, they have little impact on the corporate bond market at present. This might well change in the near future.

POSITIVE SIGNS FOR THE BOND MARKET

Despite the impediments described earlier, Sri Lanka is interested in developing its corporate bond market. Potential users are showing interest in such a market, and several factors suggest that investor demand for corporate bonds is likely to increase in the near future. Also important is the fact that corporate bonds are competitive with other financial instruments.

The Need for a Better Bond Market

Although they are growing rapidly, Sri Lanka’s government and corporate bond markets are still very small in relation to GDP. In Asia, only China has a smaller bond market. An expanded bond market would improve the efficiency of Sri Lanka’s capital market by lowering spreads, extending maturities, and raising the return on long-term investment portfolios.

Lowering Spreads. A more developed corporate bond market would lower the spreads by increasing the competition for borrowers and among different financial intermediaries. As of mid-1999, the prime rate for bank loans was approximately 17%, while the bank long-term deposit rate averaged about 11%. The spread of approximately 6% can be broken down as follows: 1% represented tax on interest, 1.5% was the bank cost of reserve requirement, and the remaining 3.5% was the bank’s lending margin. This spread would be put under pressure if the bond market became larger and more

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12 The tax on interest is 6%.
13 Sources for the data on bank borrowing are DFCC and borrowing corporates.
active, since the bond market would offer an alternative mainly for borrowers, but also for some investors.

Furthermore, the bond market could increase the competition between banks and other financial intermediaries such as leasing companies, finance companies, and investment banks. As mentioned earlier, now that more and more banks are venturing into leasing, specialized leasing companies are finding it difficult to get bank loans. A well-functioning corporate bond market would allow them to partly offset the banks’ advantage in both cost and the availability of funds.

**Extending Maturities.** Sri Lankan commercial banks seldom offer loans for longer terms than two to three years. To date, only two long-term lending institutions (NDB and DFCC) have been able to meet demand by sourcing themselves in the international market or from multilateral development banks. Without further government guarantees, they are unlikely to be able to do so in the future.

In Sri Lanka, as in many other developing countries, companies frequently operate with considerable asset liability mismatches. They have long-term assets financed by short-term bank borrowings, which are rolled over on a continuous basis. This exposes companies to unnecessary risks and stifles long-term investments in general. At present, NDB and DFCC loans are the only options for correcting companies’ maturity mismatches.

Bonds could help correct such mismatches, since they have longer maturities than bank loans, typically five years. Bonds can also increase the supply of housing finance and the competition for the mainly state-owned housing finance institutions. In the absence of sufficient demand for funds from the corporate sector, many banks have ventured into housing finance. Further growth of their housing loan portfolios is constrained by a growing maturity mismatch, which can only be addressed by borrowings in the bond market. A large number of the listed corporate bond issues in recent years have been driven by the need to correct this mismatch.

**Increasing Returns.** With a larger and more developed corporate bond market, the main investors—the provident funds, insurance companies, and banks—would be able to increase the return on their in-
vestment portfolios, since corporate bonds yield higher return than government bonds. The return on some of these portfolios at present hardly covers inflation. The primary market yields of bank-guaranteed corporate bonds are currently 1% over the corresponding T-bond yield, but they trade at a discount in the secondary market. The secondary market is very thin and illiquid, however. If the availability and the liquidity of corporate bonds were to increase, corporate bonds would become even more attractive to investors.

Moreover, a well-developed bond market would have a better diversity of yields in relation to risk and would allow investors to match their yield requirements with risk. A well-functioning secondary corporate bond market would furthermore improve the risk-reward structure of the overall capital market and therefore stimulate thrift. The need for a better bond market is confirmed by the interest of potential issuers and investors’ need for alternative investments.

**Interest among Potential Issuers**

This review of the bond market in Sri Lanka included a survey of 15 potential corporate issuers in the financial sector, the telecom industry among the large conglomerates, and the plantation groups. The near-term (within one year) demand for funds for which bonds were considered was in the range of LKR 3 billion to 5 billion. In the medium term, the main demand for bond borrowings is likely to come from the banking sector for housing finance purposes (LKR 2 billion to 3 billion annually), the leasing industry (0.5 billion to 1 billion annually), the telecom sector (1.5 billion to 2 billion annually), and industry (0.5 billion to 1 billion annually).

This suggests an average of about LKR 5 billion to 7 billion worth of new issues per year in the medium term. If the privatization process picks up, the amount required by the industrial issuers could become considerably higher. Infrastructure and municipal bonds, on the other hand, are not likely to appear until later.

The market currently requires nonbank corporate bonds to be secured by a bank guarantee. This increases the borrower’s costs by 1 to 1.5%, which is seen as a considerable obstacle. Several surveyed companies expected the coming CRA to reduce the need for
guarantees and thus make bond issues more competitive with bank loans. This applies in particular to issuers such as leasing companies, which compete with the banks’ in-house leasing operations.

The surveyed potential issuers were interested in promoting market making for their securities since this would help reduce costs (interest would be 0.25% to 0.5% lower, according to several large investors) and would facilitate exit for the issuer in case the market changed.

**Investors Will Demand More Corporate Bonds**

Several factors will combine to increase the demand for corporate bonds: the government intends to reduce its borrowing; financial sector reforms are likely to lead to increased pension and insurance savings, which are very low in Sri Lanka; and the liberalization of investment restrictions for provident funds, insurance companies, and unit trusts would benefit mainly corporate bonds.

The three main categories of institutional bond market investors have total deposits of more than LKR 500 billion, almost half (LKR 220 billion) of which is invested in T-bonds and other government securities. The balance is mainly commercial bank loans.

The annual increase in deposits is estimated to be LKR 100 billion, and the long-term investors such as pension funds and insurance companies are likely to account for a growing portion of this.

### Table 6. Deposits of Main Investors

*(approximate figures in billions of Sri Lanka rupees)*

<table>
<thead>
<tr>
<th>Investor</th>
<th>Total capital</th>
<th>Annual inflow</th>
<th>Holdings of government securities</th>
<th>Holdings of corporate bonds</th>
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*Sources: EPF; ETF; approximations by private provident holders; Insurance companies; Central Bank of Sri Lanka; National Savings Bank; unit trust management companies.*
With government borrowings currently at LKR 40 billion to 50 billion a year but set to decline, there will be an increased demand for nongovernment long-term securities.

**Corporate Bonds Are Competitive**

Sri Lankan corporate bonds, typically secured by bank guarantees, have slightly higher yields than long-term government securities, but they cost the borrower less than the prime rate payable on bank loans. The annual cost of a bond to the issuer is made up of the coupon rate paid annually to the investor (14%), the one-time cost of issuance (0.4%), the annual bank guarantee fee (1.5%), and taxes. There are no taxes on listed securities, and most bonds that are listed are bank guaranteed. As of mid-1999, the approximate annual cost of a bank-guaranteed listed corporate bond with a normal 14% coupon was just under 16%.

Bonds can compete with banks, both on the investment side and on the borrowing side. Most of the corporate bonds issued in Sri Lanka are bank guaranteed. They are therefore not corporate bonds in the normal sense, since they carry a bank risk and since the banking sector is perceived as risk-free.

Bank deposits yield approximately 3 percentage points lower interest than bank-guaranteed corporate bonds while carrying the same risk and costing approximately 1 percentage point less than bank loans for the issuer/borrower of funds.

The 11% yield on bank deposit and the 14% yield on corporate bonds are not fully comparable, since the maturity period differs (1–2 years compared with 5 years). If the liquidity of the corporate bonds were to improve, however, bonds could be a competitive alternative. Currently there are little or no secondary market activities in most bonds. Potential investors are therefore mainly those who can afford to be “locked in” for the term of the bond. Corporate

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14 Sources for the data on cost of corporate bonds are Sri Lankan bond issuers. The cost of bond issuance, 0.4% per annum, is based on a five-year bond of LKR 500 million. The underwriting fee is 0.75% up front, making it 0.15% per year. Other costs of issuing, such as the listing fee, prospectus, and advertising, are approximately LKR 6 million, which equals 0.25% a year.
bonds thus have a competitive yield, mainly from the perspective of the issuer but also from the perspective of the investor. The record also suggests that they have been competitive: all seven listed corporate bonds that were issued in 1998 were oversubscribed.

Corporate bonds also can compete with government bonds on the investor side. In the primary market, bank-guaranteed corporate bonds currently have a 1% higher yield than the corresponding maturity T-bonds. Apparently this is a competitive yield since all issues have been oversubscribed. Almost half of all bonds listed on the CSE are bank bonds, and of those issued by other companies, some 50% are bank guaranteed.

Vanik issued three unsecured bonds in 1996 and 1997, and Ceylinco Securities issued one in 1998. Recent issues of nonbank companies have been bank guaranteed, and the view of issuers is that investors demand bank guarantees until the CRA comes into operation. In effect, the credit risk of the corporate bonds issued up to now by and large corresponds to the bank risk. The key features and risk factors for longer-term bank deposits, T-bonds, and corporate bonds are compared in table 7.

The three investment alternatives differ mainly with respect to their liquidity. The low liquidity risk on T-bonds\(^{15}\) gives banks a long-term yield against shorter-term deposits. Interviews with large institutional investors suggest that improved secondary market liquidity could reduce the “liquidity cost” by up to 0.5%. The current 1% spread between government and bank-guaranteed corporate bonds

\(^{15}\) Longer-term T-bonds are not traded on a regular basis but can be repoed through a central bank window.
compensates for the credit risk (that is, the bank risk) and the liquidity risk. Investors estimate the liquidity risk to be about 50 percentage points. In the future, when the Sri Lankan bond market has developed, there are likely to be fewer bank guarantees, and the spreads will be larger and more diverse.

The credit risk for nonbank companies is likely to exceed the bank guarantee fee, but will depend on how and if the company is rated by the CRA. If market-making arrangements are introduced, it should be possible to reduce the liquidity risk. Considering the low bank deposit rates and the demand from issuers and investors for corporate bonds, bonds will probably be competitive even in the future.

**Figure 9.**

<table>
<thead>
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<th>Basis points</th>
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<td>80</td>
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<tr>
<td>100</td>
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<td>120</td>
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- Bank credit risk
- Liquidity risk

**Figure 10.**

<table>
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<td>300</td>
</tr>
<tr>
<td>350</td>
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<tr>
<td>400</td>
</tr>
</tbody>
</table>

- Unrated credit risk
- Rated credit risk
- Bank credit risk
- Liquidity risk

**Current**

**Future**
RECOMMENDATIONS

For the market to develop, attention needs to focus on four broad areas:

- Improving the secondary T-bond market, which would allow better interest benchmarking—and thus enable primary dealers to trade in corporate bonds as well as government bonds and better manage the risks of their bond portfolio—and repo market supervision.
- Helping the OTC market function better by introducing scripless clearing system for OTC-traded securities; a screen-based quotation system; market making; short selling and borrowing and lending of securities; and regulation of OTC securities, issuers, and intermediaries.
- Improving the regulatory structure and investment guidelines, by creating independent and specialized regulatory agencies, and modern and flexible investment policies for contractual investors.
- Increasing the competition for banks, pension and provident funds, housing finance, insurance companies, and brokers and dealers.

Improved Secondary T-bond Market

To strengthen the secondary market, it will be necessary to improve interest rate benchmarks, allow primary dealers to deal in corporate securities, and rein in the repo market.

*Improve Interest Rate Benchmarks.* Although interest benchmarks have improved considerably, they need further attention. The secondary market in longer-term maturities is not daily and the yield curve for those securities is quotation rather than transaction based. Currently there are many small issues of government bonds. Fewer but larger issues (jumbo issues) would increase the free float of securities and enhance liquidity.

*Allow Primary Dealers to Deal in Corporate Securities.* Proposed new rules for primary dealers in government securities would require
them to deal only in government securities. This would create a segmented market, which could constrain the development of a corporate bond market. It would earmark a large proportion of the capital available for financing bond intermediation for government securities and would also prevent dealers from hedging corporate bond risks against T-bonds.

The best way to reduce the market risk of corporate bonds is to hedge corporates against government bonds. To do this, dealers typically maintain portfolios with a mix of treasury bonds, corporate bonds, housing bonds, and other entities. In fact, in most markets, corporate bonds are typically quite illiquid, but this is of little significance as long as the risk in mixed portfolios can be managed. Restricting the primary dealers to trade in government securities thus eliminates the most suitable trader in corporate bonds from the market.

A bond dealer faces three risks. The first is credit or default risk, that is, the risk of default on the part of the issuers. There is no credit risk for government bonds. For corporate bonds, this risk is measured through credit ratings and is reduced by bank guarantees or other forms of security. The second is liquidity risk, that is, the risk of not being able to exit and recoup the capital at any given point in time. Liquidity risk can be reduced by market-making arrangements, since a market maker would be required to buy and sell at least once at quoted prices. In the government securities market, this obligation rests with primary dealers. The third is market or interest risk, which is the risk that movements in the interest rate will change the value of the dealer’s inventory of securities. This is the main risk a dealer faces.

Rein in the Repo Market. Over the course of 1999, Sri Lanka saw the rise of a short-term deposit market, using bank T-bills and T-bonds as collateral. The borrowing bank or financial institution typically issues a letter that entitles the lender to a proportion of the borrower’s bond portfolio that corresponds to the value of the loan with accrued interest. Since bonds are bearer instruments, however, this is likely to be an unenforceable security unless the lender has physical possession of the security. This so-called repo market is thus burdened with two problems: the same collateral can be
used for several transactions, and the security cannot be executed if it remains with the borrowing bank, since bonds are bearer instruments.

This practice, which seeks to reduce transaction costs by avoiding physical transfer of instruments, is defined as a repo transaction rather than a deposit. It allows the banks to avoid liquidity reserve requirements and in principle would allow a chain of borrowing and lending transactions collateralized by the same (often unidentified) securities. A default of one of the borrowers could have far-reaching consequences beyond its effects on the money supply.

This particular segment of the repo market is not supervised and little detailed information is available on its volume. According to the banks, the entire repo market has a daily turnover of about LKR 3 billion to 5 billion.

Create a Well-Functioning OTC Market

Developments to date suggest that improved secondary market liquidity would make corporate bonds more competitive by reducing the interest spread with respect to T-bonds. Even in large and well-developed capital markets, however, liquidity for corporate bonds is often limited. In order to create an active and functioning secondary market in corporate bonds, it is essential to open up the CDS to OTC traded securities; establish an automated quotation system for the OTC-market; allow short selling for dealers and market makers to come into the market; decrease risks by regulating OTC securities, issuers, and intermediaries; and allow primary dealers to trade in corporate bonds.

Information Systems. An OTC market cannot function well unless dealers have access to one or more quotation systems, where indicative prices are quoted together with who posted the price, the minimum volume for which it is valid, and other such information. Dealers typically use this information to negotiate deals by phone. Because of the large amounts and narrow margins in bond trading, counter-part risks are large. The clearing and settlement systems need to be fast, cost-effective, and risk-free.
Under current CSE rules, the OTC market cannot gain access to the existing scripless clearing and settlement system of the stock exchange. Meanwhile, the future central bank clearing and settlement system is intended only for government securities and only for dedicated primary dealers. This leaves the OTC market without access to a CDS.

**Unlisted Securities.** There are no regulations for unlisted securities, except commercial papers, for which the central bank has issued some guidelines. The OTC market in which such securities are traded is not regulated either. The regulations that do exist pertain to some but not all of the financial intermediaries, which guarantee, market, and trade in these securities. A total of 10 merchant banks, 3 leasing companies, and 2 private development banks are currently outside the regulatory framework. Among the merchant banks, several are affiliated with commercial banks and/or active in the OTC market either as dealers/traders or as issuers. The regulatory framework should not allow regulated financial intermediaries to operate through unregulated affiliates.

Because OTC securities and several OTC intermediaries remain unregulated, OTC securities tend to be riskier than regulated securities. The credit risk on issuers would in addition be higher in the OTC market than at the CSE since there are no listing and disclosure requirements.

Regulations aimed at OTC-traded securities and intermediaries should support self-regulatory mechanisms to the extent possible. A national association of dealers is emerging, but to date it has focused on primary dealer issues. It will be important to ensure that others have a forum once the new primary dealer structure is in place.

**Market Making.** Most well-developed bond markets rely extensively on market making in order to maintain liquidity. So far, this has not been the case in Sri Lanka. Market makers have to be dealers; that is, they must maintain inventories in the securities for which they are to make a market. The current rules of the stock exchange do not provide for this and the primary dealers in government securities will not be allowed to deal in corporate securities. Unless and
until this situation changes, the prospects for a secondary market for listed bonds will probably be very limited.

The current prohibition against short selling is an additional impediment in the sense that it increases the market maker’s costs and risks. Unless this restriction is removed, dealers are unlikely to want to offer market-making services.

Market makers offer the market liquidity, but they do so at considerable risk in the case of illiquid markets. The value of liquidity translates into lower cost and greater flexibility for issuers. A bond that at the time of issue is accompanied by the promise of a reasonably liquid secondary market is likely to sell at a lower yield than one without the corresponding feature. Liquidity for a paper also offers issuers the option of either buying back all or part of their bond or of adding to it (on tap) if and when market conditions change.

Together, those factors give issuers an incentive to pay for a market-making service or to otherwise reduce costs and risks for market makers. Interviews with some large institutional investors in the Sri Lankan market suggest that they might be willing to accept a reduction in yield of up to 50 basis points for a corporate bond that has a market-making feature.

More Competition for Banks, Pension and Provident Funds, and Housing Finance and Insurance Companies

Government dominance has served to limit competition among banks, pension and provident funds, housing finance institutions, and insurance companies in several ways. The government has used its regulatory powers to impose rules favoring government entities. It has also excluded private sector competitors from government business in the case of both pension and provident fund management and insurance, and it has granted its own entities exclusive access to funds. As a result, government entities have been able to set prices and extract margins on the basis of cost plus rather than market forces. This has allowed more efficient private companies to increase profit margins rather than compete on price and efficiency. Table 8 shows the market share of state-owned companies.
BANKS

Contractual Savings

*Broker and Dealer Privileges.* Under the CSE rules, brokers have exclusive privileges and engage in noncompetitive pricing in a cartel-like manner. That is to say, all trades in listed securities have to go through licensed brokers that are members of the stock exchange and through its trading system, and only securities listed on the stock exchange can be settled through the stock exchange clearing and settlement system.

The secondary market in government securities may also evolve into a cartel, since all trades in the secondary market will have to be channeled through the primary dealers in order to be cleared and settled through the paperless clearing and settlement system. Furthermore, primary dealers function as trustees for their clients and register their clients’ bond holdings in bulk in the central bank depository, and a large investor, who can maintain a paperless investor account with the central bank depository, has to go through a primary dealer.

Primary dealers were accorded privileges in the secondary market probably because it is difficult for them to earn good returns in the primary market. Primary dealers are not allowed to keep a spread on trades exceeding LKR 5 million, and the large investors do not pay any commission. These rules ought to be changed so as not to favor primary dealers in the secondary market.

Otherwise, these cartels will segment the market and thus stifle market growth and product development. In particular, they may hinder the development of a market-making function, which is essential for the development of a corporate bond market.

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**Table 8. Market Share of State-Owned Companies and Institutions (percent)**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Share</th>
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</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>50–60</td>
</tr>
<tr>
<td>Pension and provident funds</td>
<td>80</td>
</tr>
<tr>
<td>Housing finance</td>
<td>75</td>
</tr>
<tr>
<td>Insurance industry</td>
<td>60</td>
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Need for New Bond Market Actors. Several new services are needed to facilitate bond market development. They, in turn, will require new skills and financial strength, especially in the area of market making and underwriting. Some of the major local financial institutions are considering establishing a bond house with a view to meeting these and other needs. The bond house would develop a corporate and retail investor network for market making and active trading in corporate and government debt, would invest and take positions for its own account (that is, act as a dealer), and would structure debt instruments and manage issues. The bond house would become a CSE dedicated debt broker and member. The CSE is expected to create rules for dealers for the bond house to function in this capacity. However, short selling remains an issue.

Better Regulatory Structure and Investment Guidelines

The institutional structure of Sri Lanka’s regulatory framework was created during an era when the state rather than the market dominated the economy. This structure needs to be modernized and improved to ensure that it will have the capacity and competence to deal with the realities of a free market economy.

The central bank of Sri Lanka combines a large number of functions, which in most market economies have been separated into different institutions. Most modern economies have established separate banking sector regulators and supervisors as well as separate national debt offices in order to allow their central banks to focus only on the critical issues of price stability and exchange rate policy.

The need for specialized competence and administrative and political independence will eventually force Sri Lanka to move in a similar direction. This would probably mean setting up a separate National Debt Office, which would be the issuer of all government securities and the manager of the entire national debt. It could also comprise a single financial sector regulatory body (as in the United Kingdom or Sweden) covering all financial intermediaries, that is, banks, merchant banks, finance companies, insurance companies, pension and provident funds, and unit trusts. An alternative could be a small family of specialized regulators such as those set up in
several other countries. Whatever regulatory structure is chosen, it must address three important issues: regulatory gaps and overlaps, professional competence, and supervisory capacity.

In the area of guidelines, the government has hitherto exercised full control over the investment policies of the provident funds so as to meet government financing needs. Under current rules, the two provident funds (EPF and ETF), private fund managers, and the insurance industry can invest a small portion of their funds, but only in bank-guaranteed corporate bonds. This has hitherto not acted as a constraint to market development since the volume of available corporate bonds has been within those limits. However, it has contributed to the very low returns on provident and insurance company funds, among other factors. Pension savings in Sri Lanka are very low by international standards.

Although government influence is gradually being reduced, policies have yet to relate portfolio risk to return objectives. One consequence of the liberalization is that EPF and ETF are investing in both equity and corporate bonds. The small size of those markets, in combination with the large concentration of resources in these two organizations, has nevertheless allowed them to become extremely large market actors. ETF is the largest single buyer on the stock exchange and together with EPF it effectively determines the spread of corporate bonds over T-bonds.

It has been proposed that the investment portfolio of provident funds be split into smaller portfolios, each under separate management, so as to increase market diversification and focus more on return on investment. As a first step in that direction, EPF is proposing to outsource fund management for a smaller part of its portfolio. Another way to increase market activity would be to allow more private pension and provident funds to compete for corporate clients. At present, Sri Lanka has only two private open provident funds, and they have not been allowed to accept new members since 1996. EPF has argued that a competent pension regulation authority needs to be put in place before more funds are opened up.

Insurance companies face even more onerous restrictions, since insurance supervision is limited, those rules tend to be ignored. A proposal for a new law that would allow greater flexibility in invest-
ment alternatives as well better supervision was drafted in 1995 but has yet to be promulgated.

In order to improve the regulation of the provident and pension fund sector and the insurance sector, separate regulators with increased supervisory capacity should be created for these two sectors. The provident fund regulatory role of the EPF Statutory Board and the Department of Labor would then be repealed. Requiring provident funds, unit trusts and insurance companies to mark to market their portfolio values would create better transparency and improve the incentive to trade for better returns.

In sum, the regulatory environment can be improved by separating banking sector supervision from the central bank and strengthening the supervisory capacity; creating a National Debt Office separate from the central bank; creating a provident and pension fund and insurance sector regulator, with increased supervisory capacity, and repealing the provident fund regulatory role of the EPF Statutory Board and the Department of Labor; and promulgating the proposed new insurance law.

CONCLUSIONS

Sri Lanka has taken numerous steps to build its local currency bond markets. It is suggested that the next steps should focus on:

First, improve T-bond trading. Suggested actions are: have fewer and larger T-bond issues (increased free float) and hence more liquidity; allow primary dealers to deal in all kind of bonds and stocks so that they can manage corporate bond portfolio risks better; and strengthen repo market supervision to reduce default risk due to the current practice of using nonenforceable collateral

Second, strengthen the OTC market. A well-functioning OTC market would require a scripless clearing system, a quotation system, and market makers who can sell short, borrow and lend securities. Thus, Sri Lanka should consider allowing regulated OTC-traded securities to use the CDS; establishing an automated quotation system for the OTC market; allowing dealers to sell short and thereby promote market makers; allowing primary dealers to
trade corporate bonds; and reducing investor risk by regulating OTC securities, issuers, and intermediaries.

Third, improve competition in the market. Several broad-based, well-known measures would contribute to this end such as restructuring state-owned banks, provident funds, and insurance companies into a larger number of smaller units; privatizing the majority of the resulting units, as well as the state housing finance units; and allowing banks, housing finance, broker/dealers, and contractual savings institutions to compete with another.

More specific to the bond market, it is suggested that Sri Lanka liberalize protective CSE rules so that listed securities can be traded outside the exchange (OTC); limit primary dealers privileges to avoid cartelization of government securities trading; amend the proposed government securities trading system so that primary dealers can earn a reasonable return in the primary market and all dealers can compete on equal terms in the secondary market; and require mark-to-market accounting by banks and contractual investors.