

**DEVELOPING A CORPORATE BOND MARKET IN SRI LANKA:
MEDIUM TO LONG-TERM ROADMAP**

2008

*Maninda Wickramasinghe**

* Maninda Wickramasinghe, Consultant Ernst & Young.

Abbreviations

PD	Primary dealers
GOSL	Government of Sri Lanka
CSE	Colombo Stock Exchange
IPO	Initial Public Offers
USAID	United States Agency for International Development
CBSL	Central Bank of Sri Lanka
SEC	Securities Exchange Commission
RBI	Reserve Bank of India
REPO	Repurchase Agreement
SEBI	Securities and Exchange Board of India
OTC	Over the Counter
DVP	Delivery Vs Payment
PSU	Public Sector Undertaking
FRA	Forward Rate Agreement
IRS	Interest Rate Swap
PDS	Private Debt Securities
CAGAMAS	National Mortgage Corporation
BNM	Bank Negara Malaysia
RAM	Rating Agency Malaysia
SPEEDS	Settlement and trading platform, Malaysia (old)
FAST	Fully Automated System for Tendering
RENTAS	Real Time Gross Settlement System, Malaysia
ISCAP	Institutional Securities Custodian Program
NBMC	National Bond Market
SC	Securities Commission
PN	Promissory Note
CP	Commercial Paper
YTM	Yield to Maturity
Lanka Settle	Real Time Gross Settlement System, Sri Lanka
Lanka Secure	Scrip-less Securities Settlement System, Sri Lanka
CDS	Central Depository System
SPV	Special Purpose Vehicle
IRD	Inland Revenue Department
WHT	Withholding tax
FRL	Fitch Rating Lanka Ltd.
LRA	Lanka Rating Agency Ltd.
EPF	Employees Provident Fund
ETF	Employees Trust Fund Board
IBSL	Insurance Board of Sri Lanka
M&A	Mergers and Acquisitions
DEX	Debt Exchange
REIT	Real Estate Investment Trust
SMIB	Sate Mortgage and Investment Bank
HDFC	Housing Development and Finance Corporation Ltd
NSB	National Savings Bank
BOC	Bank of Ceylon

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“The existence of a deep and liquid corporate bond market could make emerging economies less vulnerable: especially to volatile capital inflows”
– Alan Greenspan, Former Chairman, Federal Reserve Bank.

I. INTRODUCTION

Although Sri Lanka is 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.¹ These sentiments were expressed in a World Bank study of debt markets done in Sri Lanka as early as the year 2000. It would be correct to say that we are still at a similar cross-road. This paper will attempt to provide analysis of debt markets and offer some insight into developing the debt markets with special emphasis on corporate debt.

The benefits of a government bond market are not limited to the financing of a country’s fiscal deficit, or achieving certain objectives in the area of monetary policy. For a developing country, a functioning government bond market helps facilitate the growth and functioning of a corporate bond market, in part by establishing a benchmark yield curve for pricing fixed-income instruments like bonds.²

Sri Lanka was one of the first countries in the region that de-regulated markets and built infrastructure to facilitate efficient financial markets. While countries in the region of South-Asia and South-East Asia were slow to start their own reforms in financial markets, they have continued to make rapid strides and have developed there markets way beyond. Sri Lanka is fortunate to have the opportunity to learn from others mistakes, experiences and models to emulate from the region. One can only hope that the reforms continue sooner than later.

II. HISTORICAL PERSPECTIVE

Local bond markets play a much greater role in rich countries than in poor countries; second and more importantly rich countries have mixed funding structures whereas poor countries depend heavily on bank debt.³

Thus began the initial steps to reforms in debt markets, in 1992 as legislation was being drafted to create primary dealers (PD’s) as intermediaries for the Government of Sri

¹ Lennart, K. and Malin, N. (2000).

² Tadashi, E. (2000).

³ Pettis, M. (2000).

Lanka (GOSL) Treasury Bill market, the first of many commercial papers were being issued by some of the blue chip companies in Sri Lanka. This was the stepping stone to issuing of many short-term and long-term securities. It was around this time that the Asian bond market initiative made its presence felt. Many countries were undergoing reforms in their respective bond markets, such as India, Malaysia, South Korea, Thailand and Pakistan. It would be pertinent to note that about 10 to 12 years before that the capital markets in Sri Lanka had gone through a rapid transformation. The Colombo Stock Exchange (CSE) came into its own. Equity Unit Trusts (mutual funds) had been launched and many corporate's have had initial public offers (IPO's) and a lot of state owned enterprise had been privatized and listed. In the forefront of the transformation was United States Agency for International Development (USAID) facilitating the reforms. It was also a time when global economies were going through a massive transformation from a centrally planned state controlled enterprise to divested, privately managed companies.

The next phase of reform of the capital market was in debt securities with a special emphasis on a market determined rate for government securities. Treasury Bonds were issued for the first time in 1997 with statutory requirement being brought down from 15 to 10 per cent. Transformation of the PD's restricted to government bonds. Commitment from government was to bring fiscal discipline. Tier 2 capital was recognized and banks issued 5 year debentures. Corporate debt as an alternate or complimenting source of capital was never on any roadmap of either the Central Bank of Sri Lanka (CBSL) or the Securities Exchange Commission (SEC). Listed securities were being issued with no intermediary to underwrite or create a secondary market by running a portfolio; this explains why there is no liquidity; no reforms in pension or provident funds. In the year 2000 PD's were formed into separate companies. Interest rate climbed from 12 per cent to 22 per cent from 1999 to 2001 and down to 7.5 per cent by 2003 and then again from 7.5 per cent to 18.5 per cent from 2005 to 2007. These were shocks to the system. All state owned, quasi state owned enterprise had to invest through the state banks at non-competitive rates.

Towards the end of 2006, it was encouraging to note that 5 per cent (equivalent of \$413.7 million⁴) of outstanding government bonds (LKR.896 billion) were open to investment by foreigners. Equivalent of about \$100 million was snapped up by the foreign banks operating in Sri Lanka. Most of it has been discounted in the market by now and they no longer hold any significant inventory of long-term bonds. As at 1 January 2007, \$1 is equivalent to LKR.108.28. As at 1 November 2007, \$1 is equivalent to LKR.111.50

A far reaching enactment to be implemented that will help develop the corporate bond market will be the Securitization Act. It has been on the drawing board for almost two years and is due next year. In drafting this enactment, the need to amend many other legislative enactments maybe necessary, and this has led to some skepticism about its implementation. Among the most notable object of the Act is to appoint a Securitization Regulator. The regulator will be empowered to conduct investigations into activities, alleged violations, or contraventions of this Act or any rule, guideline, code or regulation (made there under or necessary or desirable for the implementation operation of enforcement of the Act), impose penalties, commence civil and/or criminal actions or other actions including, to prevent damage to or to protect investors, recovery actions or

⁴ Eligible Bond Series for Foreign Investors as at 19/01/2007 Central Bank of Sri Lanka (www.cbsl.gov.lk)

to require compliance with the provisions of this act.⁵ This Act will facilitate asset backed and mortgage backed securities. In fact the ability to securitize any cash flow such as infrastructure funding.

“In the past, we have had difficulty getting our public and private sector to talk with one another, but something like a dialogue is just beginning on how to improve the private markets, particularly debt securities. In the public sector, we have regulators and promoters who are extremely competent in their own spheres of micro or macro management, but who find it difficult to relate to the market players, and who are rooted in a different discipline. As a result, many people do not understand the market,”⁶ sentiments offered by a former governor of CBSL.

In short, we have to ask ourselves do we want a market, supply and demand driven or a non-competitive, predetermined market. In reality all portfolios marked to market in effect will have capital erosion in the real sense. PD system is almost defunct; still no intermediary for corporate debt. Corporate debt will always be benchmarked against a government bond yield curve. It is time for all stakeholders to start a meaningful dialogue.

III. BOND MARKETS IN THE REGION

The Asian financial crisis of 1997-1998 underscored the limitations of even reasonably regulated, supervised, capitalized and managed banking systems. The primary role of a banking system should be to create and maintain the liquidity needed to finance production within a short-term time horizon. The crisis showed that banking systems cannot be the sole source of long-term investment capital without making an economy vulnerable to external shocks. Against this backdrop and based on experience, it has been argued that bond financing reduces macroeconomic vulnerability to shocks and systemic risk through diversification of credit and investment risk.⁷ An understanding of the development of bond markets of India and Malaysia will help highlight the importance of these markets and why the respective Governments made it a priority goal.

A. Analysis of the development of the Indian bond market

The second sub-phase (post-1996) of reforms focused mainly on the market microstructure. The emphasis was to introduce a system of PD's and satellite dealers, with underwriting or bidding commitment for 100 per cent of the issue; The benefits include an underwriting commission, permission to participate in inter bank money markets as borrower and lender, and also liquidity support from Reserve Bank of India (RBI). Expanding the players in the Repurchase Agreement (Repo) market by allowing non bank participants to borrow and lend in that market; establishing 100 per cent gilt funds to promote retail holding of government securities; and issuing long-dated securities of up to 20 years to serve as a benchmark for private debt and to elongate maturity for the government.⁸ PD's were restricted to Government securities market till

⁵ Detailed Drafting Instructions, Securitization Act, May 2007 Draft 3 Securities & Exchange Commission (www.sec.gov.lk)

⁶ Jayawardena, A.S. (2000).

⁷ Sharma, V.K. and Chandan, S. "The Corporate Debt Market in India" BIS Papers No.26 Developing Corporate Bond Markets in Asia.

⁸ Usha Torat, "India's Debt Market: A Review of Reforms" ed. Allison Harwood, *Building Local Bond Markets, Asian Perspective*, IFC Sep 2000, pg. 105.

2004 when they were permitted to make markets in corporate debt and carry inventory. The Repo markets in India were highly regulated soon after the 1993 scam. This was a set back to building liquidity in the bond market. It also highlighted weaknesses in the system that was soon that underscored the need to build the infrastructure to minimize the systemic risks in the market.

Developing the corporate bond market had its own process. Borrowing ideas from around the globe the platform was laid for a vibrant bond market. The Government has a clear policy towards development of the corporate bond market. The Securities and Exchange Board of India (SEBI) and the RBI have improved disclosure requirements namely holding securities in dematerialized form, limiting investments in unlisted paper. The private sector as the engine of growth raised its finances through the stocks and bonds. Most of the securities were raised through private placements. The secondary market development has been slow and there are some major reasons as to why. Most institutional investors buy and hold; small and issue specific size fulfilling the needs of an issuer or investor; Tax structures; mandatory investments in government bonds; lack of proper market Infrastructure. The rating agencies have been in the forefront of issuing ratings for the benefit of the public at large. Interest rates now represent the greater macro economic outlook and the market perceptions. The Government securities market is now developed well enough with the yield curve acting as a benchmark for pricing other securities. The infrastructure for a clearing and settlement system and a depository system are in place for efficiency of transaction. The regulatory framework provides for adequate disclosure, accounting standards, proper corporate governance. Laws provide for regulatory oversight and investor protection. Transparent and on-line trading systems provide better dissemination of prices in the market and narrow bid-offer spreads. Over the counter (OTC) trades are reported by brokers at the end of the day for information purposes. Unlike trading in government securities the corporate debt market has no delivery Vs payment (DVP) system in place yet. Pension and provident funds are guided on the principle of capital protection resulting in these funds investing mainly in government securities and Public Sector Undertaking bonds (PSU). The mutual fund distribution of investments across corporate securities was as follows: 53.3 per cent corporate securities 'AAA', 14.7 per cent AA and 10.8 per cent in P1+ rated securities. The investments were also mainly in shorter end of the yield curve. The funds being vulnerable to volatility in the market have limited secondary market activity.

Securitization is considered an effective way to liquefy the assets of financial intermediaries and make them marketable. The laws and regulatory aspects are being drafted and awaiting an advisory committee recommendation. In 2002 outstanding issues of asset backed securities were INR.12.9 billion and grew to INR.222.9 billion by 2005. (Increase of an average of 238 per cent per annum over a 4 year period)

Although derivatives can prove useful in risk management and in unbundling liquidity market and credit risk, market making in derivatives is possible only when there are deep and liquid cash markets to facilitate pricing. Only banks and primary dealers have been allowed to undertake market making, while others-including financial institutions and corporate' s use the products for hedging their balance sheet risk. A step towards development of a derivatives market is to develop cash markets. India now has a Forward Rate Agreement (FRA) and Interest Rate Swap (IRS) market that is quite active.

B. Analysis of the development of the Malaysian bond market

The Malaysian bond market went through a rapid transformation in the mid 1990's when the Government undertook a privatization program and encouraged private sector capital to be raised for long-term sustainability of these ventures. The first Private Debt Securities (PDS) were issued by CAGAMAS (National Mortgage Corporation) setup in 1986. This entity was established by Bank Negara Malaysia (BNM) to offer refinance bank housing loan portfolios through the securitization of housing loan receivables. Rating Agency Malaysia (RAM) was setup in 1990 to rate the various PDS issues to enhance investor confidence. In May 1992 it was made mandatory to rate all PDS issues. In 1996 a second rating agency was setup to cater to the growing demand. As an incentive all interest income from PDS and unit trust were exempt from income tax for individuals. Malaysian bond markets in the mid 90's suffered from lack of benchmark issues as the Government was not issuing medium and long-term bonds. During this period many corporate's raised capital off shore. In 1996 many reforms were announced investments in Malaysian PDS by allowing unit trusts, provident and pension funds to invest in PDS. All bonds were lodged in the trading platform (SPEEDS) along with listed debt, making transactions efficient and reducing potential systemic risks. In addition in 1996 (Fully Automated System for Tendering) FAST was launched to speed up securities tendering and RENTAS (A Real Time Gross Settlement system) for risk free securities settlement was launched in 1999. Securities borrowing and lending program was introduced in 2001. October 2004 ISCAP (Institutional Securities Custodian Program) was implemented. National Bond Market Committee (NBMC) was setup in 1999 to oversee policy direction for the development of the bond market.⁹

Net funds raised in the private sector rose from RM.4.1 billion in 1989 to RM.188 billion by 2004¹⁰ representing 37 per cent of the countries GDP. All bond issues approved by BNM or Securities Commission (SC) are exempt from stamp duty. The Employees Provident Fund was permitted to invest in bonds, mortgage papers, commercial notes, money market papers, certificates of Deposit and promissory notes. Tax incentives for individual was on the basis debt issued was either listed or rated, interest income was tax exempt. Closed ended or open ended mutual funds that invested in listed or rated corporate debt the interest income was tax exempt.

⁹ Norashikin, A. H. (2000).

¹⁰ Bank Negara Malaysia, Monthly Statistical Bulletin

Strategic Development Initiative:

Strategy	Initiatives
Introducing an efficient and facilitative issuance process	<ul style="list-style-type: none"> > Release of Guidelines on the Offering of PDS 's – 2000 > Introduction of a shelf-registration scheme – 2000 > Release of Guidelines on the Offering of Asset-backed Securities (ABS' s) – 2001 > Release of Asset Securitization Report – 2002 > Introduction of Guidelines on the Offering of Islamic Securities – 2004
Establishing a reliable and efficient benchmark yield	<ul style="list-style-type: none"> > Introduction of an auction calendar for Malaysian Government Securities (MGS) – 2000 > Review of the principal dealers system
Widening the issuer and investor base	<ul style="list-style-type: none"> > Broadening of the investor base under the Securities Commission Act for the OTC market > Universal Brokers are allowed to trade in the OTC market – 2002 > ABS' s are introduced together with tax-neutral framework and tax deductions on issuance expenses – 2003 > Islamic PDS' s are accorded various tax incentives (ex. stamp duty waiver, tax deductions on issuance expenses) and a tax-neutral framework - 2003, 2005 > Multilateral development banks, multilateral financial institutions and multinational corporations are allowed to raise Ringgit-denominated bonds – 2004 > Removal of withholding taxes on interest income earned on investments by nonresident companies in Ringgit-denominated Islamic securities and securities issued by the Malaysian Government – 2004
Improving liquidity in the secondary market	<ul style="list-style-type: none"> > Non-financial institutions are allowed to enter into repurchase transactions – 2000 > The Securities Borrowing and Lending Program is introduced via the RENTAS system – 2001 > Institutional Securities Custodian Program (ISCAP) is put in place to encourage institutional investors to lend securities to BNM – 2004
Facilitating the introduction of risk management instruments	<ul style="list-style-type: none"> > Introduction of three-, five- and 10-year MGS futures - 2002, 2003 > Introduction of Guidelines on Regulated Short-selling of Securities – 200

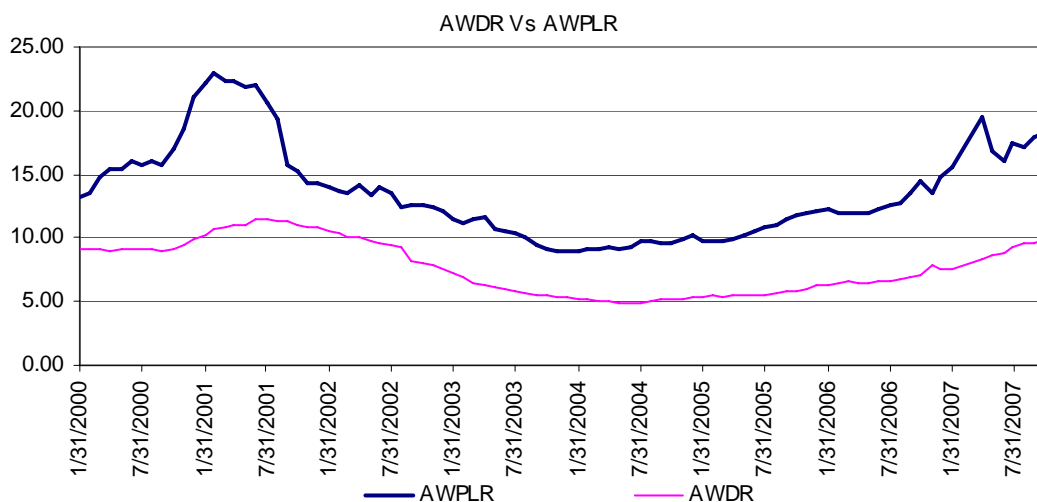
Source: Bank Negara Malaysia, Securities Commission¹¹

¹¹ Ibrahim M.B., and Wong A/ (2006). "The Corporate Bond Market in Malaysia" BIS Papers No.26 Developing Corporate Bond Markets in Asia, Feb.,pp.117)

Further development has been recognized in the following areas: deepening of the swap market, futures and forward markets (derivatives), diversification of issuer and investor base, open market to foreigners, larger issues, and credit enhancements.

C. Issuing of corporate debt

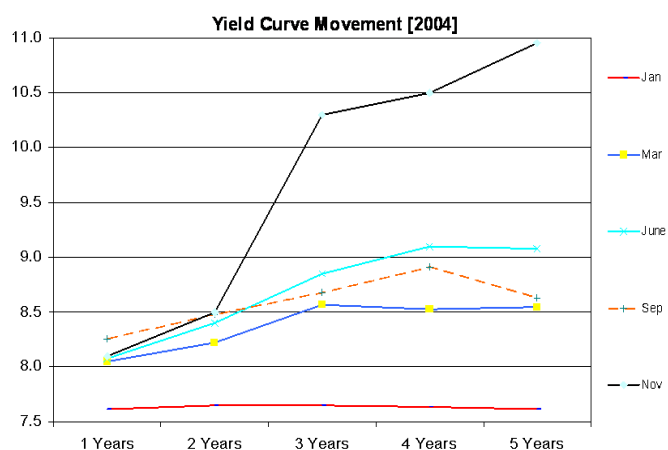
The issue of corporate debt is a disintermediation between the issuer and investor thereby lowering the spread. It would target the spread between a bank deposit and its lending rate. The bond would offer an alternative investment option to investor. This is the most effective way for corporate and other financial intermediaries such as leasing companies, finance companies and investment banks to compete with the banks. Efficient bond market will enable leasing companies to raise capital through securitizations. Most leasing companies and housing mortgage companies carry large mismatches and are exposed to high risk. It is hoped that provident funds, insurance companies, and banks-would be able to increase the return on their investment portfolios, since corporate bonds yield higher return than government bonds. Corporate bonds are more likely to give a better inflation adjusted return. A well functioning secondary market would have provided the ideal platform for a risk reward structure.



Source: CBSL website

1. Fixed versus float

In the late '90 and '00 banks issued debentures as part of their Tier 2 capital. This in effect set the moderate yield curve for other corporate's to issue medium-term debt. Essentially this constituted the only listed debt issues in the market amounting to about Rs.8 billion. If there was any euphoria at this point it soon died out as the



budget deficit grew and Government bonds yields were climbing at an alarming rate putting off any further corporate issues. In a rising rate scenario many issues are made under a floating rate option but the Treasury bill rate is increasingly coming under pressure as a reliable benchmark. In such instances Prime Lending Rate (PLR) is a widely used benchmark but the cost makes it prohibitive to raise debt for most corporate's. In such instances the market almost reduces to a trickle.

To illustrate how distorted the market is, CBSL corridor in the market is fixed at 10.50 per cent and 12.00 per cent on the overnight Repo and Reverse repo rates. The 3 month Treasury bill is issued at 17.00 per cent p.a. No corporate securities market can benchmark under these circumstances. The outstanding Treasury bill holding in Jan 2007 was LKR.40 billion and by Nov 2007 had risen to LKR.80 billion.

2. Structure/financial engineering of issues

There is a lot of scope for financial engineering in the issue of corporate debt. The issues have to be structured to suit the investor cash flow profile and/or issuer cash flow profile. The intermediaries have an important role to play in the structure of such issues. Most long-term investors such as life funds, provident funds, pension funds should be looking to invest in zero coupon bonds. CBSL could raise long-term funds through such issues at lower costs, while it affords a benchmark for long-term issues. Attempts have also been made to issue inflation indexed bonds, but wisely discontinued since.

Commercial paper (CP) and promissory note (PN) issues are now popular means of raising working capital in the money market. This market is relatively unknown, comes under no regulatory environment; there is no price discovery mechanism. This market is an important part of creating liquidity in a long-term corporate bond market. There is a serious need for 15 year issues in particular institutions in the housing mortgage market¹². These institutions lend long-term 10-15 years funds and finance loan books with 1, 2 and 3 year issues. Currently this segment of the market is under tremendous pressure. The equivalent Treasury bond issues of 10 -15 years is inadequate to be a reliable indicator for pricing. Any long-term bond holder will see the return on his bond decline dramatically when the yield to maturity (YTM) changes with the re-investment of his coupons at lower rates.

3. Over-the-counter (OTC) versus listing

Most medium- to long-term issues are OTC market. Investors tend to hold investments to maturity. Lacking transparency these issues tend to be issued at a slight premium to listed debt but investors prefer the higher rate. Ratings have given this segment of the market greater acceptance. Like the issue of commercial paper the Central Depository System (CDS) can facilitate settlement of these issues and such corporate debt should be lodged with the CDS. The CDS will act as the central depository for all corporate issues whether it is listed or unlisted. Any trades can be recorded and market data would be available on an end of day basis giving this segment of the market greater visibility and acceptance. In light of such reforms there will be wider acceptance of these issues and insurance, and provident funds should allow for a greater asset allocation for such issues. In the case of securitizations this segment of the market is extremely vital as it enables the assets to be securitized and transferred to a special purpose vehicle (SPV). The assets could be lease

¹² Abed, J.K. (1994).

or mortgage receivables and in a mature market even loans can be bundled and sold. It will be an important component of reducing risk and will have a large role to play as bank balance sheets grow in size and require more capital. The cost of securitization is prohibitive and needs to be addressed if this market is to develop.

As the regulator for the securities market the SEC should recognize the OTC markets and help facilitate these markets while safeguarding the investor Interest. There is a general fear that if this segment of the market is also regulated that it will stifle the issue of securities. The Sec will have to setup a mechanism by which approvals for issue of debt can be fast tracked.

4. Taxes/intermediary costs

In view of liberalizing and promoting the issue of corporate debt, stamp duty and Withholding Tax (WHT) was abolished. WHT was re-introduced in 2004. There is no capital gains tax on corporate securities trading for the investor. In a hold to maturity environ the capital gain has made not made any significant contribution to the market, however the withholding tax has. This needs to be addressed on an urgent basis. At present the primary market investor claims the entire WHT Certificate that is paid on behalf by the issuer. Inland Revenue Department (IRD) requires that a WHT certificate is produced to be eligible for the tax credit. This is irrespective of whether the security is with the investor or not through the tenure of the security.

D. Investing in corporate debt

The WHT structure is now uniform across all investments whether it is a bank deposit, CP, PN or Treasury bond investment. Several factors that have affected the demand for corporate bonds in the recent past are the restrictions placed on contractual savings having to invest almost 95 to 97 per cent in Treasury bonds. Most investments are through private placements and the entire market has been distorted. The pension reform program has been scrapped. No new mutual funds have been launched in the past 5 years. The market lacks long ~ medium-term investors. There are no dedicated dealer brokers that take positions in corporate debt. This would enable market making opportunities and thereby increasing liquidity. Some fundamental improvements will have to be made along the way, such as improve the secondary market for bonds that would enable better pricing of corporate debt and facilitating corporate debt portfolio trading in turn. The OTC market is very active purely on the basis of entrepreneur efforts of a few institutions. These efforts need to be better facilitated. Any improvements in the Treasury bond markets will without doubt have spin-off benefits in the corporate bond market too. However there are a few areas in the corporate debt securities that can be improved as of now and need that urgent attention.

1. Information/disclosure

There is no information or transparency about issue specific or secondary markets when it comes to OTC markets. Intermediaries will not mind this. However for the greater efficiency of the market it is important that it operates on a structure than belies the risks and the rewards. There are institutional investors that make investments without fully well understanding the risks. In the foreseeable future any default in this market will kill any progress made so far. The result is that the long-term investors that should be looking

out for higher investment returns have little or no asset allocation. Market makers and price discovery are virtually non-existent. The listed debt securities market has virtually no trading. In an order driven system the bids are likely to be in the region of the current market yield curve and the spread between the offer and the expected return would be extremely wide. In a high interest rate environment new issues dry up.

There is no published research on debt instruments. The primary issues in some instances have a prospectus while being issued on a private placement basis. This is also detrimental in making an informed investment. Investing in debt requires a good understanding of the market, issuer and the structure of the security. Many investors have not quite understood the role of the Rating Agency. Constant awareness is a key to addressing this issue. The mechanism of bond pricing and yield is also poor. The OTC market has seen many different standards being adopted. This is also not an ideal way the market should develop. This can be easily addressed in a regulatory environment where consistent standards are adopted. Many investors have made uninformed decisions that have led to them withdrawing from the market altogether. The only way is to constantly create an awareness of this market and here the participation of issuer, intermediaries and investors are paramount. It is clear that no mark to market is made when it comes to corporate securities and hence a financial report may not carry the true position of the current status of the investor. Any portfolio investment marked to market in the current scenario will result in heavy provisioning for losses, that too in an environment where there is virtually no exit mechanism. As a result, an investor will ask for a higher liquidity premium to hold the security to maturity and that is prohibitive to an issuer in terms of costs. The market cannot develop under these circumstances.

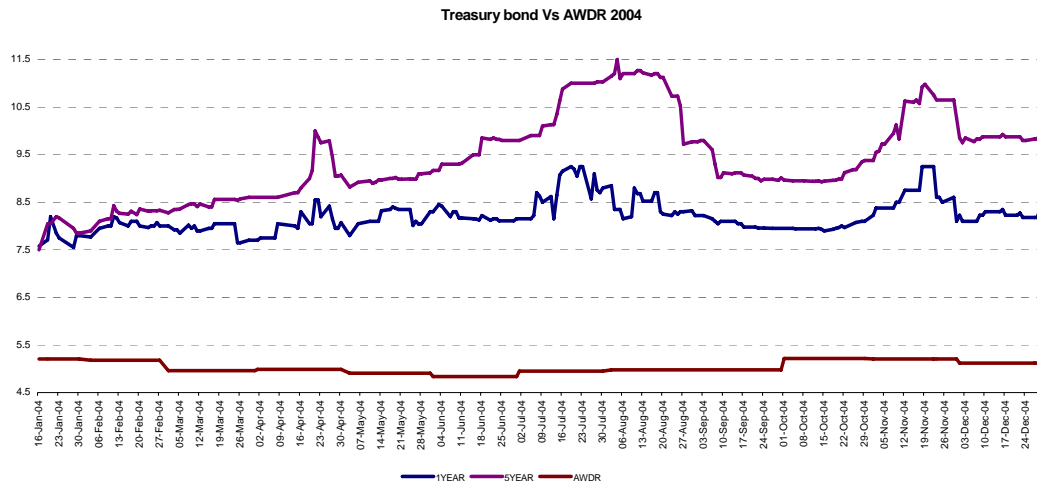
2. Rating agency

There are two credit ratings operating in Sri Lanka, namely Fitch Rating Lanka Ltd. (FRL) and Lanka Rating Agency Ltd. (LRA) There was a stage when one of the rating agencies considered pulling out of Sri Lanka. It is now mandatory for banks, insurance and finance companies to carry ratings. While mandatory laws are needed to protect and create investor confidence market development must also follow. While ratings have helped the OTC market by virtue of the awareness it has created the ratings must be used to greater effect. This is encouraging in light of debt markets having to compete with the banks. It must also be noted that there are restrictions placed on investing in rated securities when it comes to provident, pension funds and insurance funds. Ratings are available but not compulsory and awareness is poor. Regulator and rating agency together with market participants alike have to create awareness as an ongoing effort in the market. The OTC market, not under any form of regulation does not have any champion for the cause, either in government, CBSL or at SEC. Result the market has been left to their own vices. The purpose of ratings was to make the credit worthiness of an issuer more standardized, transparent and it eliminates the need for credit enhancements such as bank guarantees. Unless there is greater awareness about ratings and the confidence that should go with it asset allocation to corporate securities will remain poor.

3. Medium- to long-term investments

An important means to raising short- to medium-term capital in the retail market is through mutual funds. The earliest mutual funds focused on the stock market with most of the 'Unit Trusts' being equity funds. This is an important entity that offers a saver

alternative investment options by creating an array of funds that will target the higher revenue sectors of the economy. It is believed that a modern highway into the remote areas of the country will open up opportunities for trade and spawn development. If products such as mutual funds can reach the remote parts of the country, savers will get better than inflation returns on their investments that will in turn be an incentive to save more, much before the highway reaches his/her doorstep. Examples of these markets taking off could be found in both India and Malaysia.



Demand for long-term investments come from pension funds and life funds in insurance companies. Most of these funds invest in short- to medium-term assets and carry long-term liabilities with short to medium-term assets. This is a result of the volatility we have seen in the bond markets.

4. Hedging

A fund manager carrying a portfolio of securities has no effective hedging mechanism. The repo will provide some cover but to negate the sort of volatility one has witnessed in the Sri Lankan market, a more effective hedging mechanism must prevail. A financial futures and a swap market could facilitate this. The swap market has been somewhat active where borrowers have been able to switch from floating to fixed rate with fund managers looking to increase their portfolio returns where long-term investments have been made at lower returns. Unfortunately the participants in this market have been mainly private sector companies, provident funds and mutual funds. The largest funds such as the Employees Provident Fund (EPF) and Employees Trust Fund (ETF) can play a dramatic role in this market without changing the composition of their portfolio and affecting their cash flow.

E. Intermediaries

1. Financial market brokers/intermediaries

Among the numerous intermediaries of the capital market, the stock brokers have been asked to promote debt securities actively in the provinces. While acknowledging the good of the cause one must understand that the two markets operate in completely contrasting environments. The investors in these markets look for such investments for very different

reasons. There are 11 primary dealers, 20 stock brokers along,¹³ eight money brokers and 53 insurance brokers that can be used effectively to make a market in corporate debt and contribute to a price discovery mechanism. Sri Lanka has primary dealers (Licensed by CBSL), stock brokers (Licensed by CSE) and eight money brokers. In the Sri Lankan capital market, the brokerage services offered by numerous companies are fragmented. These companies provide an important service to the market and that is the price discovery mechanism. The broker will provide the best bid and best offer in the market. While brokerage services have been compartmentalized and minimum capital requirement specified, their role is very limited. Most countries have adopted the approach of universal brokerage under one roof. A broker's role is to find a buyer and a seller and show his bid and offer in the market be it stocks, bonds, money, foreign exchange, commodity, derivatives or real estate.

About 32 finance companies, 14 specialized banks,¹⁴ 10 merchant banks and an equal number of investment banks have not been able to form a cohesive group of participants in corporate debt markets. Brokerage on listed securities trading is fixed by the CSE in consultancy with the SEC, and is 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 revenue. At these spreads most probably it will 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, 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 future¹⁵.

2. Fund managers

Fund/investment management companies are now required to register with the SEC (16 registered companies) and must have a minimum capital of Rs.7.5 million. As different sectors of the economy open up for investment it would be prudent to recognize that the fund manager as an intermediary has a large role to play and will be a major growth segment. The SEC will need to develop reporting formats while giving recognition to the registered fund management companies. With reforms in the areas of pension funds and mutual funds what follows would be the required expertise of fund managers and regulations to safeguard the investor.

3. Pension funds

Provident funds, pension funds are by far very much in the control of the state and very little private capital has been invested in this area. The entire pension reform program is on hold. The Employees Provident Fund (Special Provisions) Law No.6 of 1975 came into effect from 1996. This law prohibits the establishment of new private pension and provident funds. The program undertaken to segment the EPF and ETF and build their own fund management capabilities has been disbanded. The idea of private pension plans under a pension authority has been widely spoken of but is an unlikely starter. In effect contractual savings is almost entirely being invested in government securities and the

¹³ Registered market intermediaries, Securities and Exchange Commission (www.sec.gov.lk)

¹⁴ Institutions regulated by the Central bank of Sri Lanka (www.cbsl.gov.lk)

¹⁵ Lennart, K. and Nystrand, M. (2000).

returns are well below inflation, thereby reducing the value of their saving in the long-term. It is clear that the contributors are arbitraging the market by borrowing against their provident fund and investing such asset classes as land and buildings.

4. Mutual funds

Mutual funds and pension funds are the long-term players of the capital market and have an important role as an intermediary to facilitate investment into corporate debt markets. This is the only capital market instrument that can effectively compete with the bank deposit, can deliver economies of scale, offer diversification to a small investor and is the vehicle for direct access to the capital market. As a market becomes more sophisticated demand for securitized loan receivables and other cash flows will be traded very much in the market. Asset Management companies will have a catalytic role to play in retailing these securities.

5. Investment banks/financial services

Financial intermediaries such as investment banks/financial services companies are very few and most of them do leasing, trade bill discounting and some corporate finance work. The two leading investment banks in the late 1990s are no more. From their dizzy heyday these entities have all but stopped any investment banking activity. Structured financing, mergers and acquisitions (M&A) activities, IPO's, underwriting are associated with investment banking and these sectors of the financial market have suffered immensely with the fluctuating fortunes of the capital market. It must be noted that finance companies, financial services companies, fund managers, insurance companies and investment/merchant banks have an important role to play in the capital market as non-bank intermediaries. There are five companies registered as underwriters with the SEC. They will form an integral part of the resource pool of the capital market and should be in constant touch with institutions such as CBSL, SEC and Insurance Board of Sri Lanka (IBSL). CBSL has been trying to liberalize the role of the primary dealer, allowing them to deal in corporate debt and fund management activities in addition to bond trading. Although this idea was first mooted with the multilateral agencies and subsequently with CBSL the implementation has been slow to get off the ground. The government in the past has tried to encourage private investment into the capital market having provided incentives to the sectors of mutual funds, primary dealers, venture capital companies, stock brokers, leasing companies and insurance companies. While some of the incentives have been timely, the capital market reform program and policy changes that should have been effected are held up.

F. Secondary market

There are no intermediaries to carry portfolios and make a market in corporate debt. The SEC for example can provide an incentive to institutions that bring a minimum amount of capital and function as dealer brokers in corporate debt. The stock broker can still provide brokerage services for debt. This will facilitate price discovery and underwriting in corporate debt. Finance companies, insurance companies, fund managers, primary dealers, leasing companies could operate in this market. For underwriting to be effective a corporate debt 'repo' market has to be facilitated. This is an important mechanism by way a market can build liquidity. The secondary market is an important tool in providing an exit mechanism for securities thereby making investment more acceptable and will trade

with smaller spreads. At present though there are secondary market trades it is very limited and there is no visibility or transparency. A repo market in corporate securities, encourage intermediaries to build portfolios and dealers to make markets in corporate debt. Any corporate debt market liquidity will depend on how liquid the money market is. The commercial paper market is small and is vastly unregulated, yet operational. This market has to be improved as a stepping stone to the development of the corporate debt market.

With a volatile market and the kind of yield curve movement we have seen pricing securities and trading in secondary markets will dry up. No short selling is permitted and the investor/portfolio manager will end up holding securities till maturity. A derivative market could facilitate liquidity and hedging particularly where the asset is in short supply. Knowledge of the derivative market will have to expand while the idea is being mooted. As bond traders taxation, tax treatment and policy must be viewed on the basis that the spreads are very narrow and trading is on volume. The tax treatment cannot be on the basis of what is applied to banks.

Short selling, borrowing and lending of securities are the way to improve liquidity in the market. This is sadly lacking in the Treasury bond market as well. With the securities in dematerialized form the CDS can facilitate this. It should be possible to borrow/lend securities while swapping government securities for corporate securities. This will create a vibrant trading environment and facilitate portfolio financing.

1. Payment and settlement systems

The infrastructure to facilitate corporate bond trading is available; it is only a matter of opening it up to the wider segment of the market. Even in developed markets the OTC markets tend to be much larger and are wholesale in nature, as opposed to exchange traded securities. High value transactions need to be facilitated to enable securities trading and at present operates in a highly restrictive environment through the banking system. As participants in the CDS, all listed securities settlement has to be through a stock broker or debt broker. The transactions of the listed securities thus have been reduced to a trickle or are virtually non-existing. OTC markets have no access to the CDS at present. The trading mechanism has the likelihood of transaction failure. It could also explain why very little trading happens in the listed debt securities market. The settlement guarantee fund in effect is to cover equity and debt settlement. The stock market could boast of moderate liquidity and hence unwinding a transaction maybe possible, but in an illiquid bond market the transacted volumes are much higher and therefore settlement failure could be higher too. During the late 90's and early '00 the banks issued 5 year debentures as part of their Tier 2 capital. This was at the time when Central Bank of Sri Lanka adopted capital adequacy requirements under the Basel Agreement and directed all banks to comply. Some insurance and telecommunications companies were the other entities to issue medium-term debt.

There is no payment and settlement system to facilitate OTC corporate debt at present. No market price is available, no market data on outstanding issues of debt nor volumes of trade. Debt Exchange (DEX) was considered the answer to all of this market but was a total failure in its implementation. An order driven market will have to have constant issues of debt and a stable yield curve to facilitate trading and market intermediaries. None of these functions happened for some obvious reasons. The members of the

exchange were stock brokers. They do not carry inventory. The intermediaries that carried inventory were the investment banks/financial services companies who were not members of DEX. DEX also did not facilitate trading of non-listed securities, such as OTC market securities of debentures, securitized paper and commercial paper. The OTC market raised far more debt than the listed securities market, and this is true even in the most developed markets. There is only one settlement bank for entire market of stocks and bonds, while there are many other major banks with an integrated banking solution and a host of other banks competing.

G. Regulator

Facilitating trading in a system based environment will help with the regulatory effort and dissemination of information. It would be pertinent to observe that there is no regulator of any sort in the OTC market for corporate debt. Government debt comes under the regulations of the Central Bank of Sri Lanka and listed debt comes under the regulations of SEC and CSE. There is no price discovery mechanism for OTC market debt traded and any available information on amount of debt outstanding, structures or tenures of issued debt. Dual jurisdiction between CBSL and SEC has not been identified. OTC corporate debt markets are not subject to any regulation at present. By virtue of corporate debt being securities, the issue of debt should come under the jurisdiction of the SEC. CBSL regulate some of the non-bank institutions and coordinating the regulatory effort will be very useful in the future development.

Transparency and governance structures and systems must be devised by the regulator. CBSL, SEC and IBSL must have a constant dialogue. In time to come they will have overlapping areas of jurisdiction. The securities market by virtue of what the Securities and Exchange Commission was set up for should be regulating or establishing some disclosure requirements for securities issued and traded and also for the derivative market. For the capital market a Chapter 11 type bankruptcy law was being suggested sometime ago. These types of laws must be studied with a view to implementing similar laws so that companies do not have to be at the receiving end of a bad market, but will have the ability to restructure and get back into business, delivering shareholder value. There are plenty of examples of the benefits of such laws as a capital market matures in the long-term.

H. Recommendations

1. Issuing of corporate debt

The CDS and SEC have a roll to play in facilitating this market. Companies that issue commercial paper should lodge such securities with the CDS. The CDS can facilitate the settlement and transfer title of the securities to an eventual buyer. Brokers in the market both money and stock brokers can facilitate a price discovery mechanism and traded prices can be recorded at the end of the day. Repo financing can also be facilitated in this way and thereby creating much needed liquidity for eventual portfolio management of corporate debt. CP's being short-term in nature and liquid the SEC can derive a mechanism for disclosure rather than regulate. At present this market has no regulatory mechanism at all.

Issues of debt greater than one year and less than five years are predominantly now trust receipts issued by trustees under securitization of lease receivables. This segment of the market has been active and suffers immensely when interest rates increase and transaction costs by way of fees, trustee fees, stamp fees and withholding tax is concerned. Costs of intermediation must be addressed if this market is to make any headway in the future. Securitized markets are likely to be the biggest issuer of corporate debt in time to come.

2. Tax treatment

Tax claim allowed only for the holding period and IRD recognize concept of notional tax. A secondary market buyer can also claim notional tax for the period the bond was held. Currently Government bonds the concept of notional tax is accepted on the basis of the auditor's statement. In the same way audit can be the basis for corporate debt notional tax. IRD can prepare a note on the tax treatment for corporate debt and provide the same to auditors. An issuer sets off interest income from interest payable and pays corporate tax only on the net interest income.

3. Mutual funds

The SEC should look at all possible means to reduce costs of intermediation. The combine cost of infrastructure, retail marketing, trustee fee, custodian fee and taxes has put paid to any development of this market. Apart from equity funds, there are a scattering of money market funds. The market for launching RIETS (Real Estate Investment Trusts, infrastructure funds, bond funds, Gilt funds, sector funds etc. can form an array of funds. The mutual fund market is the only mechanism that can effectively bring retail investment directly to the capital market. The funds will offer the diversification of investment to an investor and the economies of scale. Most importantly it will offer better than inflation returns and provide the access to invest in the more lucrative sectors of the economy. This mutual fund market must be given as many incentives as possible to form an array of funds, to distribute and market the products country wide.

4. Pension reforms

With a law prohibiting the formation of private pension funds the contribution to contractual savings is compulsory. In Sri Lanka they are fondly known as captive sources. With a looming prospect of a dramatically ageing population by 2020 reforms in the area of retirement benefits will need urgent attention. Can the state bear the burden of an ageing population? Are the present provident funds providing a better than inflation return? A fund such as EPF will have 30 year liabilities and the modified duration of its invested securities portfolio is most likely in the region of 3.5 years. Even in the developed countries the state pension schemes came under tremendous pressure and Government's had to intervene to bail them out. The only mechanism for these funds to increase their returns would be to authorize larger asset allocation into corporate securities and equity. Pension plans and provident fund asset allocation for corporate debt is minimal. As an example 97.5 per cent of the total funds of the EPF are invested in Government securities. 95 per cent of the total funds of the ETF are invested in Government securities. Ninety per cent of National Savings Bank (NSB) funds are invested in Government securities. These three funds together can account for about 75 per cent of the funds for investment into the securities market. As at present all

government and semi government funds are diverted to the control of the treasury and are totally invested in Government securities as non-competitive bids or by private placement. This has more or less dried up the market place and any liquidity left.

Revive the pension reform program. The long-term savings will develop only through this mechanism. The lower returns in contractual savings will be a disincentive to save. Pension funds could form a nucleus where investment into infrastructure is required with a long-term capital commitment and a steady revenue generator. This will create a competitive environment and also offer a choice to the contributor.

5. National Mortgage Association of Sri Lanka NMASL (proposed)

Setup an institution to finance purchase and insure mortgages and finance such purchases by issuance and sale of long-term securities collateralized by aggregation. The second major function of such an institution is to create a secondary market for mortgages, by providing originators with liquidity. This will significantly reduce liquidity, interest rate and credit risk for the originators of long-term housing loans¹⁶. In the United States of America the Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) and in Malaysia, National Mortgage Corporation (CAGAMAS) would be examples of such an institution. HDFC, SMIB, NSB and BOC will account for a significantly large pool of home loans and these institutions will be able to increase their capacity to offer more home loans at a lower margin. Such an institution can be set up as a public private partnership initiative. As a long-term player in the market such an institution will need the backing of the government, but can operate under private sector type management. NMASL will significantly contribute to the development of corporate debt markets with the primary issuance of long-term securities.

6. Other market intermediaries

Permit universal brokerage and liberalize the service. The market will have greater access that would lead to a better price formation. Dealer brokers may require higher capital. Being fee based activity the risks they carry are limited. Universal brokerage will provide the diversification a brokerage needs to be a multi product company. Ex, the role of the money broker could expand into bonds, stocks, corporate bonds, derivatives etc. These markets will find better bids and offers and facilitate secondary trades.

7. Market hedging

IRS market also operates on an ad-hoc basis lacks transparency and a price discovery mechanism. The SEC needs to recognize the derivative market and facilitate standards, regulations and derivative traders who can enable price formation. The way the market can be created is to structure debt and create a conducive environ between borrowers and portfolio managers to swap the interest differential. Looking at the average returns of the two largest funds namely EPF and ETF who carry large amounts of bonds with low yields can increase their portfolio returns very effectively. Corporates can use their credit ratings to be able to build confidence about capacity to pay the interest differential. This market will have a significant step to building a hedging mechanism in an otherwise ill-liquid market.

¹⁶ Abed, J.K. (1994).

With greater transparency and transaction information a corporate bond index can be developed. With this an exchange traded index futures market can be developed. Typically in an ill liquid market where the debt issue size is not significantly large the futures market trading will offer an effective hedge as opposed to trading in the underlying asset itself.

8. Payment and settlement systems

Open up the market for lodging OTC market debt in the CDS. Permit any financial institution registered with the SEC or CBSL to open a CDS account. The Intermediary/broker maintains two accounts with CDS; Broker account and customer aggregate account. The CDS is linked to the RTGS of CBSL. For securities settlement CDS can transfer securities in 'demat' form and funds can be facilitated through the RTGS system that in turn is linked to all the banks and 'Lankaclear' the automated clearing house for cheques. CDS can facilitate outright sell and buy of securities as well as 'Repo' transactions. The securities that can be lodged with CDS could be short-term money market instruments, medium-term securitized paper and long-term debentures. This will open up the market and there will be an end of day reporting of all outstanding volumes of trade, prices traded at and possible a very liquid market with greater transparency and visibility. All this using existing technology and no extra costs involved. DEX, CDS, SEC and CBSL will have to discuss modalities and the regulatory environ. For greater accountability and transparency CDS should be a widely held de-mutualized entity like most exchanges the world over. Trades should carry a minimum fill of Rs.500,000 or Rs.1,000,000. The mechanism for retail investors must be through the mutual fund market for the reasons explained earlier. Settlement must be value date T+1 or T+2. Although there is a settlement guarantee fund it is woefully inadequate to cover a default transaction. The settlement guarantee fund needs to be built up and risks associated with default can be minimized provided DVP settlement can be facilitated.

X. Conclusion

A well developed bond market could supplement the banking system in meeting the requirements of the corporate sector for long-term capital investment and asset creation. It could provide a stable source of finance; especially when the equity market is volatile and resource requirements of the corporate entities are large. Most of the infrastructure and laws are in place and will probably require only a fresh approach and some amendments to any legal impediments. It is evident that financing economic development only through the banking system is high risk for any economy. De-regulation and opening up market infrastructure to intermediaries to transact is the way forward.

For greater confidence and financial stability, a disclosure based market is the way forward as opposed to 'overkill' of a highly regulated regime. The cost of intermediation can come down dramatically and greater volumes of trade can make the corporate debt market extremely vibrant or it can remain in the 'grey' market as a small insignificant segment of the capital market where higher margins can be made but among fewer market participants.

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