SRI LANKA

1896 — Formalized share trading commenced in Colombo with the Colombo Share Brokers Association (CSBA)

1904 — CSBA renamed the Colombo Brokers Association (CBA)

1984 — CBA establishes public trading floor

1985 — Colombo Securities Exchange (GTE) Ltd formed as an amalgamation of the Stock Brokers Association (SBA) and the CBA

1987 — Securities Council Act No. 36 of 1987 passed, providing for the establishment of a regulator for the capital market

1990 — GTE name changed to the Colombo Stock Exchange (CSE); Liberalization of investment in stock market with abolition of the 100% transfer of property tax on share purchase by nonnationals

1991 — Clearinghouse of CSE automated with the establishment of a Central Depository System (CDS)

1995 — Company Takeovers and Mergers Code introduced

1996 — Marked 100 years of share trading in Sri Lanka; Introduction of two-tiered board, the Main Board and the Second Board; CSE appointed as the National Numbering Agency

1997 — Automation of trading with a screen-based trading system; Establishment of Settlement Guarantee Fund and Compensation Fund

2005 — CSE introduces Triaxial Ribbon as a part of its new logo; Settlement cycle shortened to T+3 for buyers and T+4 for sellers

2007 — CSE introduces single-tiered settlement of T+3; Corporate Governance Rules for Listed Companies introduced

SRI LANKA

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Equity Market Capitalization (USD)	12.989 Bn*	1.389 Bn*	Debt Market Capitalization (USD)
Equity Market Cap/GDP	16%*	2%*	Domestic Debt Market Cap/GDP
Equity Market Share Volume Traded	4,443 Mn*	40 Mn**	Debt Market Instrument Volume Traded
Number of Listed Companies	287*	–	Number of Issuers (Bonds)

* As of 31 July 2020
** Only corporate debt

CAPITAL MARKETS OF SRI LANKA

Sri Lanka is a USD84 billion economy with a GDP per capita of USD3,852. Its capital market consists primarily of government securities, stock, and corporate bond markets that have a combined value of USD66.3 billion. The government securities market is the dominant sector, with a value of USD52.5 billion, whereas the stock market capitalization is USD13.8 billion. Stocks trade on the Colombo Stock Exchange (CSE).

EQUITY MARKET

Trading stocks in Sri Lanka has a long history, dating back more than one hundred years. Stock trading commenced with the establishment of the Colombo Share Brokers Association (CSBA) in 1896 as a secondary market. In 1904, the CSBA was renamed the Colombo Brokers Association (CBA). Since its inception, the market has witnessed numerous transformations and has borne periods of growth and decline as a result of economic and political challenges.

The modern stock market was formed in 1985, when the Colombo Securities Exchange (GTE) Ltd was established. This was following the amalgamation of two stock brokerage associations, the Stock Brokers Association (SBA) and the CBA. The SEC was established in 1987 as the regulatory body. In 1990, the GTE was renamed the CSE.

The stock market has had its own Central Depository System (CDS) since 1991, and trading has been fully automated under the Automatic Trading System since 1997. The main securities traded on the CSE include ordinary and preference shares, closed-end funds (unit trusts), and corporate debentures. The CSE currently has two indexes, namely, the All Share Price Index and the S&P Sri Lanka 20 Index

(S&P SL 20). In 2009, the CSE was named the best performing stock market in the world, with growth of 120%.

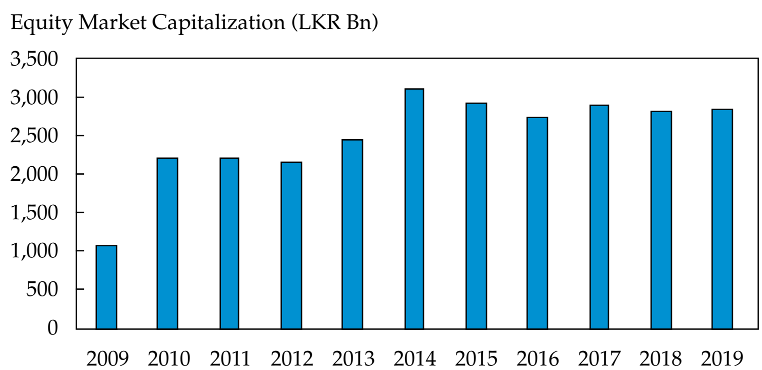
The activities of the exchange are driven primarily by 15 members and 14 trading members, who are licensed as stockbrokers for equity and debt (three of whom work exclusively in the debt market). The policy-making body of the CSE is the board of directors (BOD), comprising nine members: Five are elected by the members, and four are appointed by the government on the recommendation of the SEC. The BOD is responsible for appointing subcommittees and delegates with the required authority to convey recommendations on daily operations. The subcommittees comprise capital issues, rules and by-laws, disciplinary and arbitration, research and development, finance, and listings.

CSE market turnover was recorded at LKR171 billion during 2019, of which LKR62 billion was attributed to foreign investors. Market capitalization stood at LKR2,851 billion by the end of 2019 (see **Figure 1**). CSE is a limited-by-guarantee company and a mutual exchange. A company limited by guarantee usually refers to a public company that is formed with the intention to benefit the community. This type of company does not have share capital or shareholders. Instead, the members of such companies act as guarantors and agree to contribute a set amount of capital toward the company each year. The SEC has been taking measures to demutualize the CSE, and such measures are expected to materialize in the coming years.

GOVERNMENT SECURITIES MARKET

The Public Debt Department (PDD) of the Central Bank of Sri Lanka (CBSL) is in charge of the issuance of government securities and public debt management on behalf of the government treasury. Government securities are issued in both rupee-denominated and foreign currency–denominated securities. Rupee-denominated securities include Treasury bills and Treasury bonds, and foreign currency–denominated securities include Treasury-denominated bonds, such as Sri Lanka Development Bonds (SLDB) and Sri Lanka International Sovereign Bonds. Since 2007, Sri Lanka has been issuing sovereign bonds. Sri Lanka has made 14 international sovereign bond issues with maturity periods of 5 and 10 years, for a total of USD15,050 million. Sovereign bonds are listed on the Singapore and Berlin Stock Exchanges.

FIGURE 1. CSE MARKET CAPITALIZATION FROM 2009 TO 2019



Treasury bills are zero-coupon, short-term securities with 3-, 6-, and 12-month maturities. Treasury bonds have been issued within the range of 2- to 30-year maturities. Treasury bonds carry a fixed rate of interest. SLDB have been issued with short-term maturities of 3–12 months and with longer-term maturities of two years, with both fixed and floating interest rates.

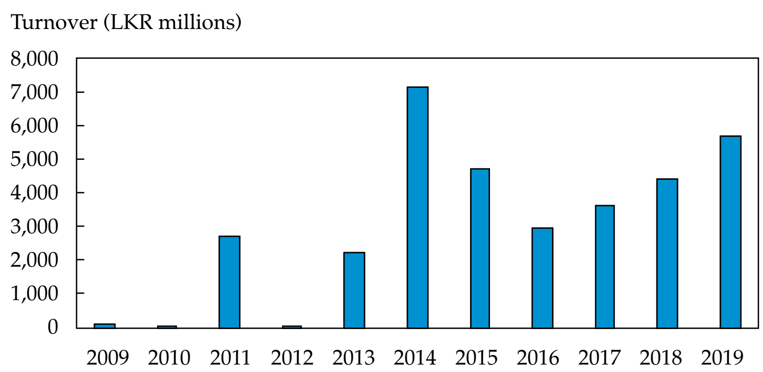
Government securities are sold by the PDD through multiple-price competitive auctions on the primary market. The participants of the primary auction are approved primary dealers, and currently, 15 primary dealers exist, consisting of eight bank primary dealers and seven non-bank primary dealers. Each primary dealer is required to bid for at least 10% of the value of securities offered at the primary auction. Sri Lanka has relied primarily on short-term funds for financing the government's cash flow requirements.

CORPORATE BOND MARKET

The primary market for listed corporate debt became active in 2013 as a result of incentives introduced for corporate debt listing by the CSE. One such measure was the enactment of new listing rules for corporate debt in 2013. Further, tax incentives were provided by the government for investing in listed debt securities. Such incentives included the exemption from income and withholding taxes of interest income received from listed debt. Such action prompted the rise in debt issues in 2013—where 28 debt issues raised LKR68 billion, representing 72% of all the capital raised through the CSE that year. The CSE also changed the maximum tick size to LKR10,000 in 2013 to improve liquidity among listed debt instruments. Entities that sought a listing managed to raise LKR55.9 billion in 2018 and LKR57.9 billion in 2019 through listed debt instruments. In 2019, debt issues represented 55% of the total capital raised through the CSE.

The listed corporate debt market in Sri Lanka began in 1997. The turnover in the corporate debt market has witnessed a considerable increase, from LKR75 million in 2012 to LKR5,677 million in 2019 (see **Figure 2**). However, the corporate debt market turnover was only approximately 3% of the stock market turnover in 2019. The market capitalization of the listed corporate debt market was LKR257.9 billion in July 2020, compared with the stock market size of LKR2,412 billion. The corporate bond market in Sri Lanka is only approximately 8% of the size of the stock

FIGURE 2. CSE DEBT MARKET TURNOVER FROM 2009 TO 2019



market. This is mainly due to the preference of entities to resort to bank-based financing for their capital needs. Another reason is the lack of familiarity with capital markets in Sri Lanka.

FOREIGN INVESTMENT IN THE CSE

Both the CSE and SEC aim to strongly encourage foreign investment in companies listed on the CSE. Such investments are unrestricted to any particular entity but are subject to certain ownership restrictions in entities of certain industries. Foreign ownership is permitted up to 100% in all listed entities of the CSE, except for a cap of 40% on plantation stocks. A 10% restriction exists for banking sector stocks for any single local or foreign accountholder or accountholders acting in concert. However, with the approval of the Monetary Board of the CBSL, ownership can be extended up to 15%. No specific restrictions are in place on the ownership of debt instruments listed on the CSE. In terms of government securities, the threshold limit on foreign ownership of Treasury bills and bonds is 5%.

THE WAY FORWARD

The SEC has developed a master plan for the CSE. The aim of the set strategies is to develop the CSE in line with global exchanges. A few of the key challenges emphasized include enticing new listings from both the private and public sectors locally and attracting new global investors, such as investment funds. Attention has also been given to developing new financial instruments for the exchange in an effort to expand the investment options available.

With the view of expanding market operations, consideration has been given to the development of capital market–related infrastructure and the implementation of a risk management system, delivery versus payment, and central counterparty. The SEC has now facilitated the introduction of a real estate investment trust (REIT) framework, and the proposed initiative provides real estate developers and owners the option to convert fully completed properties into REITs. This new product, REIT, will be the first product introduced to the CSE after a lapse of 23 years, following the introduction of corporate bonds to the capital market in Sri Lanka in 1997.

Equity Market

The equity market has limited attractiveness for large-scale investments because it is small in size relative to the economy and regional nations. The size of the market also limits diversification and growth, with many listed firms having a smaller public free float that impedes active trading.

Compared with regional counterparts and emerging markets, the equity market is less liquid. The lack of market making can be considered one aspect that severely limits liquidity. Transaction costs on stock trades in Sri Lanka are high. Too many intermediaries are involved in Sri Lanka's stock market, and the presence of specialized brokers for different capital market products is not economically feasible. Stockbrokers lack adequate technical skills required to provide investor advice on alternative instrument products.

Over the years, many suggestions have been made on policy initiatives and incentives to expand and grow the CSE. One such measure was to encourage the listing of large, privately owned enterprises, given that most of the well-known entities, some of which are public, continue to remain unlisted. Other suggested initiatives have included creating a national policy framework for public enterprise reforms linked to capital market development and implementing such public enterprise reforms to restructure state-owned enterprises (SOEs) to make them profitable and financially robust. An initial measure would be to list at least a minority stake of some SOEs on the stock market.

Capital markets can also help raise funds for infrastructure development corporations and infrastructure development projects. One such measure included the proposal to establish the Small and Medium Enterprises (SMEs) Board for listing SMEs. This proposal became a reality in 2019. In addition, consideration can be given to establishing listing boards for companies approved by the Board of Investment of Sri Lanka (BOI). The BOI is the main institution entrusted to encourage and promote investment, specifically foreign direct investment, in Sri Lanka. Most entities that obtain BOI approval receive tax concessions and are primarily export-oriented industries (i.e., driven predominantly by foreign investment).

Several regulatory measures are currently being considered to implement higher public float requirements to increase liquidity. The main reason for the low public float has been that the major shareholders of local enterprises have preferred to retain majority shareholding and continue to do so.

An important requirement is the establishment of a market-making mechanism to ensure a continuously liquid market for listed equities. To reduce transaction costs, the introduction of negotiated brokerage could be considered. The design and implementation of a brokerage industry consolidation plan to create a financially strong and competitive brokerage industry is also paramount. A universal brokerage model can be adopted to allow market intermediaries to deal in all capital market products, such as equity, debt, mutual funds, and derivatives.

Government Securities Market

A majority of bond issues have been of short-to-medium maturity, resulting in lower liquidity at long maturities and higher refinancing risk. The secondary market trading in government bonds is illiquid at longer maturities, hindering the dependability of the Treasury yield curve. The lack of an auction calendar makes auctions and interest rates less predictable and undermines the auctions' credibility.

Measures must be taken to establish an evenly distributed maturity structure that spans both medium-term and long-term divisions. A mechanism must also be in place to develop a reliable benchmark yield curve by issuing relatively more benchmark securities at key points along the yield curve. The CBSL must publish a quarterly Treasury auction calendar in advance containing security type, term to maturity, coupon rate, volume, announcement date, auction date, and settlement date to provide credibility and predictability to auctions. Steps must also be taken to increase the competition in the primary market by creating a more diversified range of investors in government securities.

Corporate Bond Market

The supply of corporate debt securities is related primarily to bank, finance, and insurance sectors. At present, one key concern is that the secondary market for listed corporate debt remains highly inactive and illiquid. And a market-making mechanism for corporate bonds is lacking. Transaction costs on large debt trades are high, and unlisted corporate debt (including bonds, debentures, commercial paper, and promissory notes) remains unregulated. Moreover, stockbrokers have an insufficient level of knowledge and skills with respect to investing and trading in debt securities.

The immediate development and implementation of policy reforms must be undertaken to increase institutional investor participation in the listed corporate debt market, thereby creating a strong investor base for corporate debt. In addition, conditions must be established to make debt financing through the capital market more beneficial to companies than bank-based financing to increase debt security issuance by a wider range of industries.

Measures can also be established to develop the necessary framework for introducing corporate bond derivatives and to develop market fundamentals that are suitable for bond derivatives. A formal market-making mechanism for listed debt securities should be introduced, and measures must also be taken to lower transaction costs for trading debt securities and to bring unlisted corporate debt under SEC regulation. Unlisted corporate debt includes debt instruments (e.g., debentures) issued by both public and private entities that do not trade on the debt board of the CSE. Training must be conducted to enhance the technical capacity of stockbrokers and other market professionals on debt instruments and trading, which will strengthen the existing financial industry education and qualification framework.

A new government was elected to office in August 2020, and the foreign ownership restrictions just mentioned can be subject to amendment if the foreign investment policy is modified. However, no indication of a dramatic change has been made public up to this point. Amendments to the existing SEC Act of 1987 are expected to take place to attract more foreign investors to the CSE. In addition, the development of the corporate bond market, as well as of the unit trust industry, is at the forefront of the financial instruments that come within the SEC's strategic plan to attract more overseas investment.

