12 Sri Lanka

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Executive Summary

Large and persistent budget deficits are the primary cause of macroeconomic imbalance in Sri Lanka. Ongoing civil strife, the decline in foreign capital flows, and macroeconomic shocks exacerbated by the East Asian crisis have slowed down economic growth, while increases in salaries, pensions and interest payments are likely to push up government expenditure still further in the future. With no end to the war in sight, defense expenditure is unlikely to decrease, and the Government may not be able to postpone indefinitely much-needed investment in infrastructure.

Recent tax collection has fallen short of expectations, and if the present economic trend continues, revenue will not be sufficient to meet the deficit and achieve the desired level of economic growth. However, it is imperative that the deficit is brought under control to contain inflation and establish a low and stable interest rate regime in the medium term—all this in an environment of declining foreign grants and the increased welfare costs of an aging population.

A vibrant debt market is clearly crucial as a means of covering these increasing financing demands. The debt market in Sri Lanka provides financing to both the state and private sector, with the Government relying more on local than international debt markets.

The Government's medium-term plans, laid out in the budget for 2000, are designed to correct the long-standing fiscal imbalances. This is not feasible in the short term, given the commitment to not passing the cost of such a scheme on to the populace. The strategy is to raise public savings, contain the budget deficit, reduce domestic borrowing, and thereby release more resources for productive use by the private sector. This medium-term strategy, consistent with the macroeconomic policy of reducing inflation as well as interest rates, is essential to reducing poverty and unemployment, as a substantial budget deficit can have adverse implications on inflation, interest rates, and the economic growth rate.

Consistency and coordination of policies is important, as many have fiscal implications, e.g., policies regarding exchange rates, trade, and price liberalization.

Although efforts to reduce the deficit so far have not been entirely successful, progress in fiscal consolidation has proved substantial. Overall deficit stood at 8 percent in 1999, down from 10 percent in 1996, and levels of public investment rose from around 6 percent to over 7 percent—clear indications of the Government's growth-oriented fiscal policy strategy during the past five years.

The new budget's economic targets are (i) to achieve real economic growth of 7–8 percent per annum; (ii) to promote financial discipline in Government, thereby reducing the budget deficit to 4 percent in the medium term and 3 percent by 2010; (iii) to contain inflation at 3 percent; (iv) to raise national savings from 23 percent to 35 percent by 2010; and (v) to ensure growth of money supply in line with development needs and economic growth to achieve financial stability.

Several impediments remain to the development of the bond market, such as deficiencies in physical infrastructure and supporting services. A sound macroeconomic, political, and legal environment is critical. Monetary and fiscal discipline is essential to create an environment suitable for the development of viable financial institutions and markets. Sri Lanka has relatively sound monetary and fiscal policies, despite the economic disruption caused by the ongoing civil war. A sound regulatory framework has been developed in relation to financial markets and commercial transactions in general, and government and corporate securities in particular, and the Central Bank has established a diversified issue base in terms of maturities and distribution.

An effective secondary market requires a sound policy framework, as well as efficient institutional infrastructure, such as highly capitalized market makers, liquidity support, transparent trading mechanisms, and a robust clearing and settlement system.

The current lack of a proper yield curve, among other factors, creates a risk-reward anomaly between commercial bank deposit rates and government treasury bills rates. The higher interest paid for treasury bills shows there is a need for a broader investor base to create an efficient market for government securities. The dominance of the Employees' Provident Fund (EPF), Employees' Trust Fund (ETF) and National Savings Bank (NSB) have added to distortions in the market.

The present investor base thus needs to be further expanded to foster competition and reduce the impact of a small number of institutions on the market. Crucial changes are needed in pension reforms, establishment of a market-making structure, and market promotion. Moreover, the

lack of a sufficient number of issues and the relatively small size of current issues make it difficult for market participants to actively engage in secondary market trading. The continued supply of new securities and the availability of a critical mass of government securities will increase market interest and facilitate trading.

Another problem is the lack of transparency in the trading, clearing, and settlement systems of government securities, due to the lack of a scriptless central depository system. Information should be released on a timely basis to enhance efficiency. Ambiguous accounting treatment of capital gains on trading also hinders secondary market liquidity.

Finally, development of the derivatives market, interest rate risk management, short-selling, and securities borrowing and lending are also essential to facilitate market-making by enabling participants to cover their exposures.

Recommendations

Policy Environment and Management. Open market operations (OMO) should be the principal indirect instrument by which the Central Bank conducts its monetary policy. To do this it is necessary for the secondary market of both T-bills and T-bonds to be developed. Rediscounting mechanisms and repurchase (repo) or reverse repurchase (RRP) on treasury bills facilities are currently used for OMO, but a shift towards government bonds as an instrument for repo and discounting is necessary to effectively carry out monetary policy.

The development of the repo market will lead to reduction in the volatility of call market rates. Therefore the Central Bank's repo activities should be used as a tool to provide market direction on interest rates.

The issuance of government securities should be decided in light of the size and structure of existing and prospective stock of debt assessed in terms of cost, risk and consistency, as well as monetary policy.

The Government should publish an advance report on its annual debt issue program, including an auction timetable and the maturity structure of issuance for the forthcoming financial year.

A Consultative Committee on Government Bond Market Development (CCGBMD) should be set up, consisting of a wide range of market practitioners, while radical reform is proposed in the pension and provident fund sector, including the splitting of the EPF into three subfunds, all with different investment objectives.

Regulations are needed for securities lending, borrowing, and short-selling transactions, as well as definitions of legal rights, to help develop the areas of repo transactions and derivative products.

Government commitment is required in (i) facilitating the development of the secondary market infrastructure and regulatory framework; (ii) strengthening intermediaries such as primary dealers (PDs); and (iii) financial sector reforms to broaden market participation and enable independent decision making, to avoid the distortions created by captive sources.

Primary Structure. The development and regulation of the government bond market should be placed with a unit of the Department of the Superintendent of Public Debt.

Frequency of treasury bond issues with a range of maturities should be increased, so that a varying level of maturities would be available to meet investor needs at any time, and the coupon on the treasury bonds should be allowed to be stripped and traded separately.

The Government should work hard to increase market awareness and promote T-bills and T-bonds to individual investors through advertising campaigns and promotional activities.

Pension and provident funds should be reformed to allow the creation of private funds. The services of several professional fund management companies should also be obtained for the investments of EPF, NSB, and ETF.

Foreign investors should be allowed to invest in T-bills, T-bonds, and listed corporate debentures, and the number of nonbank PDs should be increased to a number at least equivalent to that of commercial bank PDs.

The share capital of PDs, particularly commercial bank PDs, should be increased, to avoid conflicts of interest arising from their deposit-taking operations The Primary Dealers' Association (PDA) should develop a code of conduct for market participants, and PDs should be subject to a comprehensive and regular performance-based review.

Proposed screen-based systems for government securities should be developed to facilitate transparency, and over-the-counter trading (OTC) should be allowed, as in most developed markets.

The present rule requiring certification by the PD of the genuineness of the endorser in a transfer of government securities should be removed.

The possibility of using the central depository system (CDS) of the Colombo Stock Exchange (CSE) for clearing and settlement should be investigated, or, if not, a dedicated clearing and settlement system should be developed, along with a detailed centralized information system to ensure a level playing field among all market participants.

Support Structure. A market surveillance division should be set up to monitor secondary market activities and transactions of PDs, to identify any market behavior that impacts on free and fair market mechanisms, or actions that may be against the interests of the investing public. The OMO Unit of the Central Bank should become actively involved in the secondary market trading of longer-term T-bonds, and the Central Bank of Sri Lanka (CBSL) should trade any maturities of T-bills or T-bonds if the market provides exploitable opportunities.

Regulations on the establishment and operation of a derivatives market should be introduced, and the legislation to remove capital gains tax from derivatives contracts, announced in the November 1998 budget, enacted.

It should be mandatory for all pension and provident funds, insurance companies, banks, merchant banks, and unit trusts to carry their investment in T-bills and T-bonds at the prevailing market value by marking-to-market. This will encourage them to monitor market trends and actively trade on the T-bills and T-bonds with a view to avoiding possible market losses.

I. Fiscal Policy and Management

In recent times, the main thrust of the Government's fiscal policy has been to correct the structural deficiencies of fiscal operations and maintain a low budget deficit over the medium term to bring about low inflation, low interest rates, productive employment opportunities, poverty reduction, higher savings and investments, and promotion of private sector-led economic growth.[1]

Proposed fiscal policy changes include widening the tax base, restructuring public debt, eliminating wasteful expenditure, and directing increased resources to education, health, environmental protection, poverty reduction, rural development, and infrastructure activities.

From 1986 to 1998, the budget deficit (before grants) was usually in double digits. Its lowest level was 7.3 percent of gross domestic product (GDP) in 1992. The aim of sustainably reducing the fiscal deficit and interest rates to encourage investments may be hindered because (i) tax revenues will be insufficient if there is lackluster economic growth and collection is not improved; (ii) increases in salaries, pensions, and interest payments are likely to increase government expenditure; (iii) defense

1. Trends in Public Finance, 1998.

expenditure is unlikely to decrease as there is no end in sight to the war; and (iv) the failure of the government's build-own-operate (BOO) and build-operate-transfer (BOT) programs may make it impossible to postpone capital expenditure for infrastructure projects any further.

The medium-term plans of the 2000 budget are designed to correct long-standing fiscal imbalances. This is not feasible in the short term given the commitment to not passing the cost of such a scheme on to the populace. The strategy is to raise public saving, contain the budget deficit, and reduce domestic borrowing, thereby releasing more resources for productive use by the private sector. This is consistent with the macroeconomic policy of reducing inflation as well as interest rates, essential to reducing poverty and unemployment.

Although efforts to reduce the deficit have not been entirely successful, progress in fiscal consolidation has proved substantial. Overall deficit stood at 8 percent in 1999, down from 10 percent in 1996, and levels of public investment rose from around 6 percent to over 7 percent—clear indications of the government's growth-oriented fiscal policy strategy during the past five years.

The budget's economic targets are (i) to achieve real economic growth of 7–8 percent per annum; (ii) to promote financial discipline in Government, thereby reducing the budget deficit to 4 percent in the medium term and 3 percent by 2010; (iii) to contain inflation at 3 percent; (iv) to raise national saving from 23 percent to 35 percent by 2010; and (v) to ensure growth of money supply in line with development needs and economic growth to achieve financial stability.

A. Government Revenue

More than 80 percent of government revenue comes from tax. Tax revenue stood at 19 percent of GDP by 1990, but then declined progressively to around 14.5 percent by 1998.

Of tax revenue, less than 20 percent is accounted for by direct taxes on net income and profits. The rest is made up of indirect taxes on domestic goods and services, particularly turnover tax and excise tax. Efforts to improve income tax collection have had only minor success, and corporate taxes as a percentage of total taxes have been reduced in recent years. Taxes on foreign trade (mainly imports) also declined, from 6.2 percent of GDP, or 35.3 percent of total taxes in 1986, to 2.8 percent of GDP, or 19.1 percent of total taxes in 1998.

B. Government Expenditure

Total government expenditure as a percentage of GDP declined from 33 percent in 1986 to 26.4 percent in 1998.

In terms of percent of total expenditure, capital expenditure declined from around 39.3 percent to 20.2 percent while in terms of percent

TABLE 1
Government Revenue 1986 and 1998
(SLRs million)

Government Revenue	1986	Percent GDP	Percent of Total Revenue	1998	Percent GDP	Percent of Total Revenue
Tax Revenue	31,272	17.4	100.0	147,368	14.5	100.0
Taxes on Foreign Trade	11,050	6.2	35.3	28,154	2.8	19.1
Exports	1,636	0.9	5.2	0	0.0	0.0
Imports	9,414	5.2	30.1	28,154	2.8	19.1
Taxes on Domestic Goods and Services	14,787	8.2	47.3	91,706	9.0	62.2
Turnover Tax/Goods and Services Tax	10,088	5.6	32.3	39,343	3.9	26.7
Excise Tax	4,414	2.5	14.1	30,293	3.0	20.6
Defense Levy	0	0.0	0.0	21,079	2.1	14.3
License Fees	285	0.2	0.9	991	0.1	0.7
Taxes on Net Income and Profits	4,787	2.7	15.3	20,429	2.0	13.9
Corporate	3,274	1.8	10.5	11,788	1.2	8.0
Noncorporate	1,513	0.8	4.8	8,099	0.8	5.5
Taxes on Property	648	0.4	2.1	7,079	0.7	4.8
Taxes on Treasury bills (CBSL)	0	0.0	0.0	0	0.0	0.0
Nontax Revenue	5,966	3.3	—	27,664	2.7	—
Total Revenue	37,238	20.7	—	175,032	17.3	—

SLRs = Sri Lanka rupees.

Source: Central Bank of Sri Lanka *Annual Report 1989* and *1998*.

of GDP, capital expenditure declined from 12.9 percent in 1986 to only 5.3 percent in 1998. However, recurrent expenditure increased from 57.4 percent to 74.4 percent, with salaries and interest payments each accounting for two fifths of total expenditure in 1998. This percentage is increasing, along with transfer payments.

Since 1988, total government revenue has not been adequate to cover such recurrent expenditure, meaning the current account has been in deficit.

C. Financing Fiscal Deficits

The primary deficit or noninterest deficit has fallen since the late 1980s and early 1990s, but interest payments have been higher since the mid-1990s. If primary deficits continue to decrease, this will take pressure off interest rates, as the overall growth in debt will be smaller.

Money financing, although used to help bridge the deficit, has never accounted for more than 30 percent of total financing since 1986. Deficit financing through foreign borrowings and grants declined from 60 percent of the total in 1986 to just 19 percent in 1998. In 1998, around 60 percent of total financing came from nonbank domestic market borrowings, mostly from captive sources, such as NSB, EPF, and ETF, state banks, state-owned insurance companies, and state-owned specialized banks, with the most commonly used instrument being the fixed rate, nonmarketable rupee loan.

TABLE 2
Government Expenditure for 1986 and 1998
(SLRs million)

Government Expenditure	1986	Percent of GDP	Percent of Total Expenditure	1998	Percent of GDP	Percent of Total Expenditure
Current Expenditure	33,967	18.9	57.4	199,648	19.7	74.4
Salaries and Wages	8,028	4.5	13.6	53,880	5.3	20.1
Other Goods and Services	7,127	4.0	12.0	43,888	4.3	16.4
Interest Payments	8,762	4.9	14.8	54,897	5.4	20.5
Transfers to Other Sectors	7,100	4.0	12.0	37,719	3.7	14.1
Pensions	2,984	1.7	5.0	19,477	1.9	7.3
Fertilizer and Food and Subsidy	2,163	1.2	3.7	2,152	0.2	0.8
Janasaviya and Samurdhi	0	0.0	0.0	8,652	0.9	3.2
Transfers to Pub. Corps and LG	2,950	1.6	5.0	9,264	0.9	3.5
Capital Expenditure	23,236	12.9	39.3	54,161	5.3	20.2
Acquisitions of Real Assets	7,788	4.3	13.2	32,246	3.2	12.0
Transfers to Pub. Corps and LG	15,448	8.6	26.1	21,915	2.2	8.2
Lending minus Repayments	1,991	1.1	3.4	14,370	1.4	5.4
Total Expenditures	59,194	33.0	100	268,179	26.4	100.0

LG = local governments; SLRs = Sri Lankan rupees.

Source: Central Bank of Sri Lanka *Annual Report 1989* and *1998*.

TABLE 3
Financing of the Budget Deficit for 1986 and 1998
(SLRs million)

Budget Deficit	1986	Percent of GDP	Percent of Total Financing	1998	Percent of GDP	Percent of Total Financing
Current Account Surplus/Deficit	3,271	1.8		(24,616)	(2.4)	
Budget Deficit/Surplus before Grants	(21,956)	(12.2)		(93,147)	(9.2)	
Budget Deficit/Surplus after Grants	(18,203)	(10.1)		(85,947)	(8.5)	
Financing the Budget Deficit	21,956	12.2	100.0	93,147	9.2	100.0
Foreign Financing	12,814	7.1	58.4	17,396	1.7	18.7
Domestic Financing (Net)	9,141	5.1	41.6	71,362	7.0	76.6
Market Borrowings	9,810	5.5	44.7	72,292	7.1	77.6
Nonbank	6,765	3.8	30.8	53,338	5.3	57.3
Bank	3,047	1.7	13.9	18,954	1.9	20.3

SLRs = Sri Lankan rupees.

Source: Central Bank of Sri Lanka *Annual Report 1989* and *1998*.

II. Monetary Policy and Management

Monetary policy includes policies that affect interest rates, money supply, and exchange rates. The Monetary Law Act (MLA), which governs Central Bank operations and the conduct of monetary policy, lists its main objectives as stabilization of the domestic value of the rupee, stabilization of the external value of the rupee, and promotion of economic growth.

A. Monetary Policy Tools

The following are the direct instruments used by CBSL.

Determination of Interest Rates. CBSL can determine the interest rates at which it provides directed credit to banks and other financial institutions, and fix the maximum rates that banks can pay on their deposits or charge for their loans. However, this practice is now rarely used.

Quantitative Restrictions on Credit. CBSL, from time to time, has used different forms of credit restrictions, such as imposing maximum maturity limits on commercial bank loans and advances, limits on expansion of new loans and advances, minimum values for ratios of capital and

surpluses to assets, and minimum margins for letters of credit. It has now moved to more market-oriented instruments, however.

Indirect instruments more commonly used today are the following.

Open Market Operations (OMO). CBSL purchases or sells government securities in the open market to control market liquidity and influence interest rates. This is the primary instrument of monetary policy in Sri Lanka[2] usually carried out by means of discount and rediscount rates at CBSL secondary window. Both these rates are based on yields of T-bills at primary auctions, and the margin between them is administratively determined. Since the sale of T-bills and T-bonds from the CBSL secondary window is at the discretion of the commercial banks, this is not so effective if commercial banks decide not to participate due to not having the T-bills or T-bonds in their portfolios. Since the secondary market for T-bills and T-bonds is not developed, carrying out OMO is not currently very effective.

CBSL also carries out OMO in the primary market at the weekly T-bill auctions. It influences T-bill yields or is able to stabilize the market by either holding a part of the maturing T-bills back from the auctions or purchasing them.

Statutory Reserve Requirements (SRR) on Commercial Bank Deposits. To control credit expansion, CBSL requires commercial banks to maintain a certain percentage of their deposit liabilities as reserves (statutory reserve requirement/SRR) with CBSL. The MLA allows CBSL to impose an SSR of 5–20 percent for time and savings deposits and 10–40 percent for demand deposits. During periods of high inflation, CBSL can impose an SSR of up to 100 percent on incremental deposits. SRR is used to make major policy changes, and was reduced in 1997, 1998, and 1999 to increase base money in the hope of boosting economic growth.

Lender of Last Resort. CBSL is legally empowered to lend to commercial banks in distress.

Moral Suasion. Though not legally binding, CBSL has used moral suasion as an effective mechanism to conduct its monetary policy.

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2. Herat, U. 1998. Recent Trends in Monetary Policy. *News Survey*, Central Bank of Sri Lanka, September/October.

Foreign Exchange Operations. CBSL has managed the external value of the rupee by deciding on the buying and selling of foreign currency with commercial banks. It also engages in external reserve management and exchange control regulation.

B. Interest Rates and OMO

The general policy on interest rates is to reduce them to boost private sector investment and economic growth. However, neither the Government nor CBSL has been able to achieve this aim in a sustainable fashion, or had any substantial control over interest rates. From 1986 to the present, T-bill rates have not fallen below double-digit levels. Nominal interest rates have been persistently high due to high fiscal deficits and debt financing, with the added problem of built-in double-digit inflation, probably caused by relaxation of monetary policy rather than money financing of the deficit, which has actually never been higher than 30 percent.

In the 1990s, the periods of highest interest rates coincided with increased credit demand in the economy. The demand for funds from both the private sector and the government was quite high, particularly in the mid-1990s. Government borrowings crowded out the private sector, pushing interest rates as high as 20 percent. The determination of these interest rates was mainly in the primary T-bill market.

In 1993, the introduction of repurchase agreements by CBSL profoundly changed the interest rate structure and interest rate determination in the money markets. In a repo agreement, CBSL sells T-bills, agreeing to repurchase them at a fixed rate after a fixed period, enabling the commercial banks to invest their excess funds in risk-free T-bills at CBSL. As long as CBSL holds a portfolio of T-bills, the repo rate functions as a floor rate to the interbank money market interest rate range, and therefore stabilizes the interbank money market. CBSL now uses the repo rate to signal its view on interest rates to the market. The repo rate is market-determined on a daily basis, but still has a large element of administrative influence. Since CBSL intention on interest rates can be conveyed through the repo rate, it can also influence long-term interest rates.[3]

The reverse repurchase agreement introduced in 1995 does the opposite of a repo, i.e., it enables commercial banks to obtain short-term liquidity from CBSL by selling their T-bills. The RRP rate acts as a ceiling to interest rates in the call money market.

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3. Hesat 1998.

Whenever CBSL wants to affect liquidity in the system, it changes the repo rate, raising it when a tight liquidity situation is desired, and lowering it to create a relaxed liquidity situation. The discount and rediscount rates, which are used to carry out transactions at CBSL secondary window, influence liquidity in the same manner. These instruments all influence liquidity in the medium term and are used to conduct OMO.

Commercial banks are now permitted to hold T-bonds as a part of their liquid assets,[4] and to use these for repo, discount and rediscount transactions at CBSL secondary window, enhancing CBSL's ability to conduct OMO.

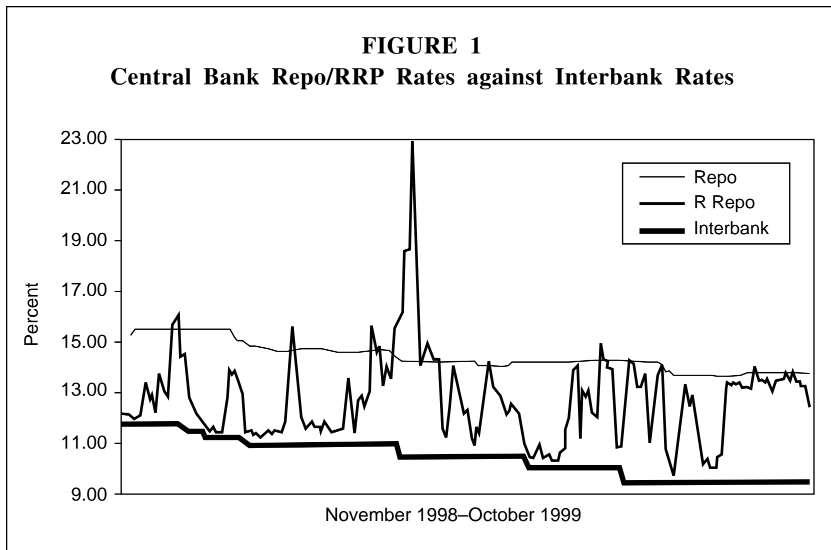


FIGURE 1
Central Bank Repo/RRP Rates against Interbank Rates

C. Impact of Financial Sector Reforms on the Bond Market

The major financial sector reforms undertaken since 1977 have been (i) freeing of interest rates; (ii) relaxation of exchange controls; (iii) implementation of institutional reforms, including authorizing the setting up of new financial institutions; (iv) market-oriented credit allocation; (v) strengthening of the legal, accounting, and regulatory framework of

4. This came into operation in May 1998.

financial institutions, and (vi) greater emphasis on market forces in monetary policy.

In terms of their impact on Sri Lanka's bond market, these reforms expanded the resource base for market-oriented borrowing and provided new instruments to the financial market. Given the expansionary fiscal policy in recent years, as well as more market-determined interest rates (due to reforms), the yields in the debt market have risen very sharply, adding a significant burden to the national debt. As a result, high interest payments have diverted a considerable portion of government revenue from more productive uses.

To comply with the capital adequacy ratio (CAR) and increase long-term funds to reduce maturity mismatch in lending and deposits, the commercial banks have issued five-year subordinated debentures. This has boosted the development of the debt market.

The autonomy given to NSB to determine its balance sheet structure and interest rates (for depositors and lenders), as well as the withdrawal of its interest rate subsidy, has forced it to invest its funds at market-determined rates, while increased autonomy in the investment decisions of the EPF and the ETF has also led to an increase in market-determined interest rates.

III. Overview of the Bond Market

CBSL is responsible for managing Sri Lanka's public debt. This function includes issuing domestic debt and servicing and repayment of domestic and external debts, all at minimum cost to the Government.

Government debt as a percentage of GDP increased from 18 percent in 1948 (when Sri Lanka obtained independence from the United Kingdom (UK) to approximately 90 percent in June 1999. On 30 June 1999, the percentages of domestic and foreign debt to GDP were 47.3 percent and 43.3 percent, respectively. Total government domestic debt increased from 117,561 million Sri Lanka rupees (SLRs) at the end of December 1989 to SLRs446,547 million at the end of December 1998, an increase of 280 percent. A major part of the domestic debt was taken up by captive sources such as NSB, the EPF, and the ETF at interest rates below market rates. By 30 June 1999, government debt outstanding stood at SLRs969,486 million, of which domestic debt was SLRs506,137 million and foreign debt SLRs463,349 million, or 52.2 percent and 47.8 percent of the total government debt respectively. Medium- and long-term borrowings of SLRs331,447 million constitute 65.5 percent of the domestic debt, while the remaining 34.5 percent, or SLRs174,690 million, is made up of short-term borrowings.

TABLE 4
Structure of Government Debt as at 30 June 1999
(SLRs million)

	Amount
Domestic Debt: SLRs506,137	
Medium and Long Term	331,447
Rupee Loans	251,863
Foreign Administrative Borrowings	64
Treasury Certificate of Deposits	11
Tax Reserve Certificates	7
Treasury Bonds	78,915
Short Term	**174,690**
Treasury Bills	123,996
Central Bank Advances	23,029
Other	27,665
Foreign Debt	**463,349**
Bilateral	235,633
Multilateral	215,542
Commercial Banks	12,174
Total	**969,486**

Source: Table 7 of *Central Bank of Sri Lanka Bulletin*, August 1999.

Domestic government debt, as a percentage of deposits of commercial banks and NSB, declined sharply between 1989 and 1999 from 167 percent to 119 percent—mainly due to very high growth in bank deposits over the last five years. The annual compound growth of the debt has been 15.9 percent, compared with 20.3 percent in bank deposits. It seems the demand created by everexpanding government borrowing in the domestic market has had little impact on the amount of bank deposits mobilized by commercial banks or NSB.

This is largely due to (i) lack of saver understanding of government securities and (ii) limited access of the saving public to primary dealers (PDs) who actively promote government securities, despite the significant premium on the yields offered by securities in comparison with bank deposits, especially short-term T-bills.

Credit to the private sector has been relatively stable at 24.8–28.2 percent of GDP from 1989 to 1998, and the volatility in government debt in the domestic market has led to the ratio of government debt to private sector credit varying from 153 percent to 177 percent. However, domestic borrowing has had no obvious impact on private sector growth during this period.

The Government raises short-term funds by issuing treasury bills, while medium- and long-term loans are raised by issuing registered stocks

and securities in the form of promissory notes, bearer bonds, and treasury bonds. Rupee loans, which are issued in the form of registered stocks, are not marketable instruments, unlike other instruments such as T-bills and T-bonds, which are transferable by endorsement and delivery.

Rupee loans accounted for SLRs54,217 million, or 46.2 percent of the total government domestic debt of SLRs117, 561 million in December 1989 (see Appendix 2 for the composition of outstanding government debt from 1989 to 1998). This increased to SLRs250,570 million, or 56.1 percent of the total government domestic debt of SLRs446,547 million at the end of December 1998. The T-bill share increased from SLRs57,246 million to SLRs119,996 million. However, this declined as a percentage of total debt from 48.7 percent to 26.8 percent. T-bonds, which were launched in March 1997, made up 11 percent (SLRs48,915 million) of total domestic debt at the end of 1998.

The privatization of the two development banks and establishment of new financial institutions have broadened the debt market. For prudential and regulatory requirements, these institutions are required to hold government securities in their balance sheets, thereby giving greater depth to the debt market.

One of the major shortcomings, however, has been the inadequate reforms in the government debt market. Large fiscal deficits have persistently crowded out the private sector, with the debt-financed deficits being mainly funded by captive sources, such as NSB, the EPF, and the ETF.

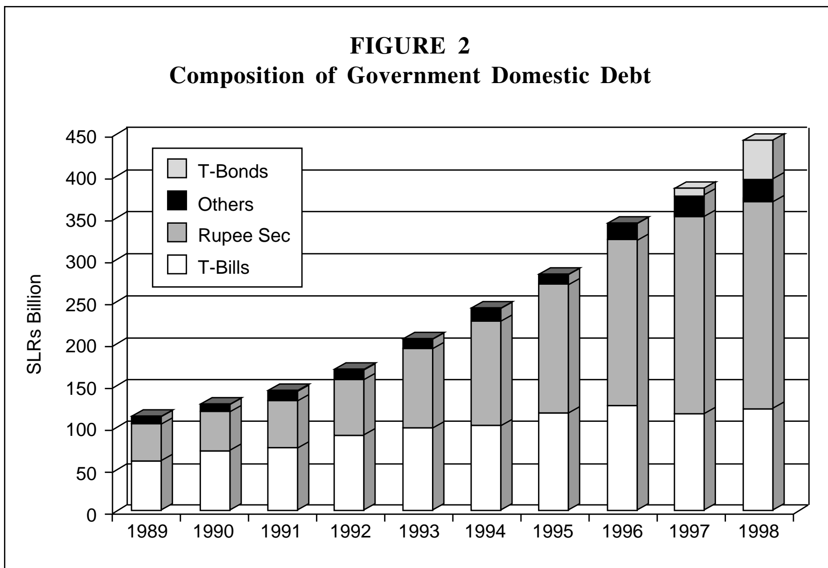
By imposing investment restrictions or high reserve requirements, the Government has been able to mobilize funds at repressed interest rates. Development has also been stifled by the Government's issuance of rupee loans, a major source of funding where yields are not market-determined. The cost of this has mainly been borne by the financial intermediaries who have kept high spreads/margins and passed on the burden to the private sector.

Market participants complain that the Government uses the captive sources, namely the EPF, NSB, and the ETF, to manipulate the government securities market, in particular primary auctions, to its own advantage. Such suspicions are based on the premise that CBSL is in a position to influence the decision making of such institutions, since the EPF is managed by a CBSL department, with the Monetary Board having ultimate authority. In addition, the Government nominates the boards of directors of NSB and the ETF, and these normally include senior officers of CBSL.

However, CBSL has taken several steps to demonstrate that primary auctions are held in a fair and competitive manner, for example, by

requiring captive sources to bid for auctions only through PDs. Captive sources may still be able to influence the primary market for T-bills and T-bonds, however, depending on the sheer size of their funds and the inflow of funds they are receiving. Due to large institutions' needs for a proportionately large investment in the government securities market, there are currently no upper limits to the amount of bids that can be made by a single PD or investor in each auction. Therefore, even if large institutions are not influenced by the Government, they will invariably have an impact on the market under current conditions, and strategies are needed to reduce such effects.

FIGURE 2
Composition of Government Domestic Debt



A. Secondary Market

CBSL introduced the secondary T-bill market in 1981 to reduce its own holdings of T-bills, while providing short-term investment opportunities in gilt-edged securities for market participants. The repo sale of T-bills was introduced in October 1993, with a view to stabilizing the lower end of the interbank call money market, and reverse repo agreement (RRP) was started in November 1995 with the aim of stabilizing the upper end of the interbank call money market interest rates.

The major constraints to the development of the T-bill secondary market are (i) the fact that major institutional investors and the general

public, who invest for a risk-free return, hold the bills until maturity; and (ii) the fact that institutional investors are unable to ride the yield curve and obtain tax-free capital gains, since PDs do not actively engage in the secondary market by making two-way quotations.

There is limited outright secondary market activity in T-bonds, but a liquid secondary market almost comparable to that in T-bills has developed in repo dealings and secondary transactions with CBSL.

For corporate securities, listed debentures are traded through brokers on the CSE, with prices dependent on market interest rates. Transactions are very few, however.

B. Corporate Market and Financing Behavior

High net worth public limited liability companies raise short-term funds by issuing commercial papers and medium-term funds by issuing debentures. However, the development of the corporate debt market in Sri Lanka has remained at an embryonic stage because of (i) the lack of a rating agency to evaluate and rate the debt instruments issued (recently resolved by the formation of Duff and Phelps Credit Rating Lanka, Ltd. as rating agency in July 1999); (ii) the lack of an acceptable benchmark yield curve for pricing corporate debt; and (iii) uncertainty in forecasting corporate performance on a medium- to long-term basis.

The issue of corporate debt has thus been confined mainly to private commercial banks and financial institutions. The first listed public debenture was issued by Vanik Incorporation, Ltd. (a merchant bank) in May 1996 for a sum of SLRs150 million with annual yield of 20 percent with three-year maturity. The debentures were unsecured, and matured in May 1999. The annual yield on subsequent debentures has declined considerably. A debenture issued by Sampath Bank in July 1999 for five years was at an annual rate of 14.2 percent, or 13.5 percent quarterly, or three-month T-bill+100 basis points. Most of the debentures issued by nonbanks were on a guaranteed basis. The market value of the debentures listed on the CSE was 151 in June 1997 and increased to SLRs4.6 billion at the end of October 1999. There have been large issues of unlisted debentures, most of which have been sold through private placement. The privatization of tea plantations was funded in part by bonds (in lieu of equity), placed with pension and provident funds. There are no data on either the number or the volume of such debenture issues. In a few instances, private debenture bonds have been issued to finance leverage buyouts (LBOs). Here, the issues have been made against the assets of a company to buy out existing shares. A few financial institutions have also issued mortgage-backed marketable securities, which transfer

illiquid assets into liquid ones in the secondary market. The country's first securitization of assets was done by Lanka Orex Leasing Co., Ltd. in November 1995.

In view of the high intermediation costs by commercial banks, there is tremendous scope for the development of the corporate debt market. There will be investor appetite for debentures issued by large companies with a strong balance sheet, and the establishment of the Duff and Phelps credit rating agency in July 1999 will also encourage the issue of debentures rated by the agency. The listing rules for corporate debt issued by the CSE are given in Appendix 5.

A landmark in the historical development of the corporate debt market in Sri Lanka is the forthcoming public issue of unsecured redeemable debentures by Sri Lanka Telecom. The issue has been approved by the CSE and is expected to come to the market in early March 2000. The issue is unique as this is not only the largest issued in the country, but the first corporate debt rated by a rating agency in Sri Lanka. Duff and Phelps Credit Rating Lanka, Ltd. have given it AA+ rating, indicating high creditworthiness. The debentures are also underwritten by a consortium of banks up to SLRs1 billion. The successful completion of the debenture issue will give further impetus to other corporates to issue unsecured debentures.

The first commercial paper (CP) was issued in August 1993 in Sri Lanka by John Keels Holdings, Ltd. and Aitken Spence Co., Ltd. for SLRs25 million and SLRs50 million respectively, with a maturity of three months. In view of the short-term nature of the instrument and attractive interest rates, the CP has become very popular as a money market instrument and is issued by high net worth corporations to raise short-term funds direct from investors. To regulate and develop a healthy CP market, the Central Bank has issued guidelines for commercial and specialized banks, which can support the issue of the CP by investing, acting as issue and placing agents, and providing backup credit facilities. Guidelines issued by CBSL to commercial banks with regard to their participation are given in Appendix 6.

Realistic statistics are unavailable at present, as only commercial banks and merchant banks have to provide statistical returns to CBSL. Based on these returns, the value of the CP issued in 1997 was SLRs11.1 billion and SLRs16.5 billion in 1998. The CP outstanding at the end of February 1999 was SLRs4.4 billion, but the actual figure will be very much higher.

C. Types of Securities

1. Government Debt

There is a clear shift from the administrative rupee loan to market-based T-bonds as the instrument of choice in raising government finance. The importance of T-bills has also declined, and the Government has resorted to temporary borrowing from the banking sector and other domestic sources as an alternative financing source.

Treasury Bills. T-bills were first issued in Sri Lanka (then Ceylon, a British colony) in 1923 by Crown agents in the UK. However, regular issue did not start until 1941, with parliamentary approval and a ceiling of SLRs10 million.

The Government's recurrent budget deficit has necessitated continuous issuance of new T-bills. T-bills are issued by the Public Debt Department of CBSL on behalf of the Deputy Secretary to the Treasury at the Ministry of Finance.

The maximum limit for outstanding T-bills at any time is determined by Parliament, and has been increased many times to meet the Government's financing needs. The limit has been reduced only once, when part of the proceeds of the privatization of state enterprises such as Air Lanka, Ltd. and Sri Lanka Telecom was used to reduce the outstanding in T-bills by SLRs12 billion in 1997 and 1998. In an effort to impose fiscal discipline, the Government has frozen the limit for T-bill issue at SLRs125 billion since 1996.

T-bills had maturities of 3, 6, and 12 months from February 1989. Since 20 October 1999, however, they have been issued with maturities of 91 days, 182 days, and 364 days to introduce uniformity in market practices with regard to the day count. They are reissued to raise funds for meeting the repayment obligations of maturing T-bills, while fresh ones are issued to raise finance to meet unforeseen expenditures.

Treasury Bonds. The first auction for the issue of T-bonds was on 27 February 1997 for SLRs500 million with two-year maturity and coupon rate of 14 percent, and the first issue was dated 2 March 1997. The weighted average yield was 14 percent, and the auction was heavily oversubscribed. The coupon rate was reduced to 13.75 percent for the third auction and the weighted average yield was 13.71 percent. T-bonds to the value of SLRs10,000 million, and with maturities of two, three, and four years, were issued in 1997. A total of SLRs38.9 billion in T-bonds was issued in 1998, and SLRs55,785 million in the first nine months of 1999, including the reissue of maturing T-bonds. The Government plans to issue more, to the value of SLRs11,715 million, between September

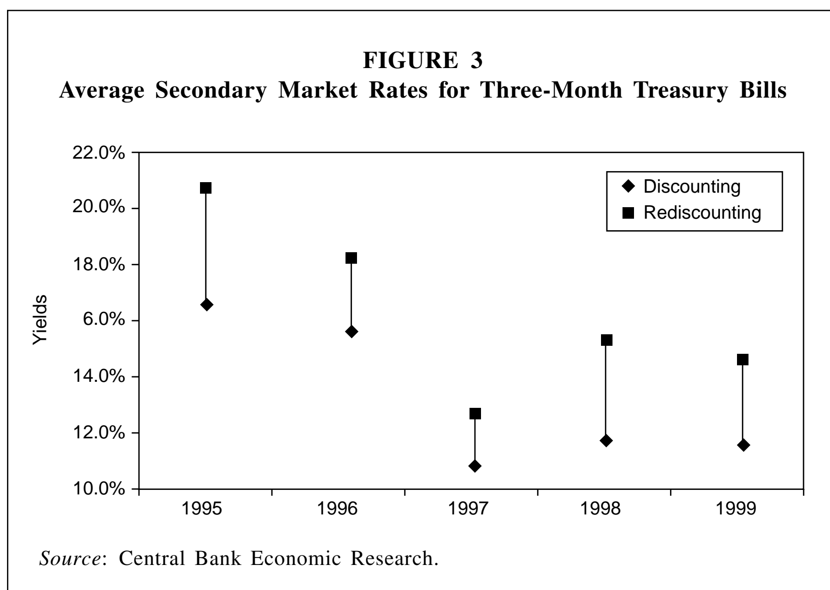


FIGURE 3
Average Secondary Market Rates for Three-Month Treasury Bills

Source: Central Bank Economic Research.

and December 1999. T-bonds have become an attractive medium-term investment instrument, and are generally oversubscribed. In view of the favorable investment response, CBSL issued the first four-year T-bond on 15 May 1997, followed by a six-year one in September 1999.

Outstanding T-bonds amounted to SLRs78,915 million at the end of June 1999. The total face values of T-bonds issued in 1997 and 1998 were SLRs10 billion and SLRs38.9 billion, respectively. The 1999 T-bond program envisaged a gross issue of SLRs67.5 billion, including reissue of matured bonds.

T-bonds are long-term instruments, issued with maturities of two up to six years. This has enabled the development of a yield curve for government securities, which could be used to price issues in the private sector debt market.

TABLE 5
Dates of Introduction of Bonds with New Maturities

Maturity of the Bond (years)	Coupon (percent)	Yield-to-Maturity (percent)	First Issued Date
2	14.00	14.00	Feb 1997
3	12.00	11.74	Oct 1997
4	12.25	12.25	Nov 1997
5	11.75	13.90	Mar 1999
6	12.00	13.68	Sep 1999

CBSL, whenever possible, has been introducing bonds with maturities one year longer than the longest previously issued to reflect market-driven, long-term treasury security. The decision to allow licensed commercial banks and other licensed specialized banks to consider treasury bonds as liquid assets also increased their popularity.

"Jumbo" issues of T-bonds (a large block of T-bonds of specified series in given maturity all issued on the same day) have also been introduced. These are offered to the public in smaller portions at several auctions over a period, depending on market appetite and government borrowing requirements. Jumbo issues that aim to ensure a significantly large amount of bonds relating to one series is issued and widely distributed to the public. Such a widely held bond issue is likely to create secondary market interest, and thus liquidity. High demand for such series in primary issues leads to lowering of government borrowing costs.

TABLE 6
Details of Jumbo Issues

Maturity	Number of Series	Number of Issues	Coupon Rate (percent)	Outstanding Amount (SLRs million)
1998				
2 years	11	29	11.00	25,065
3 years	4	14	11.50	9,450
4 years	2	9	12.00	4,400

Source: Central Bank of Sri Lanka *Annual Report 1998*.

CBSL is expected to continue to lengthen the maturities of future issues of T-bonds to at least 10 years by gradually introducing new maturities, despite the significant maturity premium needed to attract investors into unfamiliar maturities.

The issue of coupons along with T-bonds has so far acted as a deterrent to the issuance of T-bonds with longer maturities, along with the uncertainties about the movement in interest rates—but this could change with the future introduction of scriptless T-bonds.

Rupee Loans. Rupee loans constitute a major part of government debt, and have been issued as registered stocks on a tap basis at administratively determined rates of interest since 1937. They grew from SLRs54,217 million in 1989 to SLRs250,570 million in 1998, and include long-term nontransferable bonds of SLRs24,088 million and SLRs19,393 million issued by the Government for restructuring the two state banks, Bank of

Ceylon and People's Bank in 1993 and 1996, respectively. Commercial banks' holdings of SLRs44, 321 million of rupee loans in 1998 include the above two bonds issued by CBSL and held by the two state banks, and long-term bonds of SLRs4,480 million issued by the Government to recapitalize the liabilities of NSB in 1996.

They are issued on a long-term basis with maturity periods as long as 30 years, although at present the range is from 2 to 10 years to finance the development activities of the Government.

Semiannual interest warrants are issued to each subscriber for collection of interest at the stated rates. Rupee loans are transferable by registration with the Registrar of Public Debts, and therefore are not marketable instruments. In future, the Government intends to replace them with T-bonds as a means of promoting its debt market.

Interest is payable half yearly. The Government is able to issue the rupee securities at rates lower than the market rate, as the major subscribers to rupee stocks are captive sources belonging to government institutions and public sector provident funds.

Debentures. are also issued by public sector institutions, such as the State Mortgage and Investment Bank, National Housing and Development Authority, and Urban Development Authority. These are issued at interest rates lower than the market rate and therefore are not taken up by institutions other than NSB and State Provident Fund.

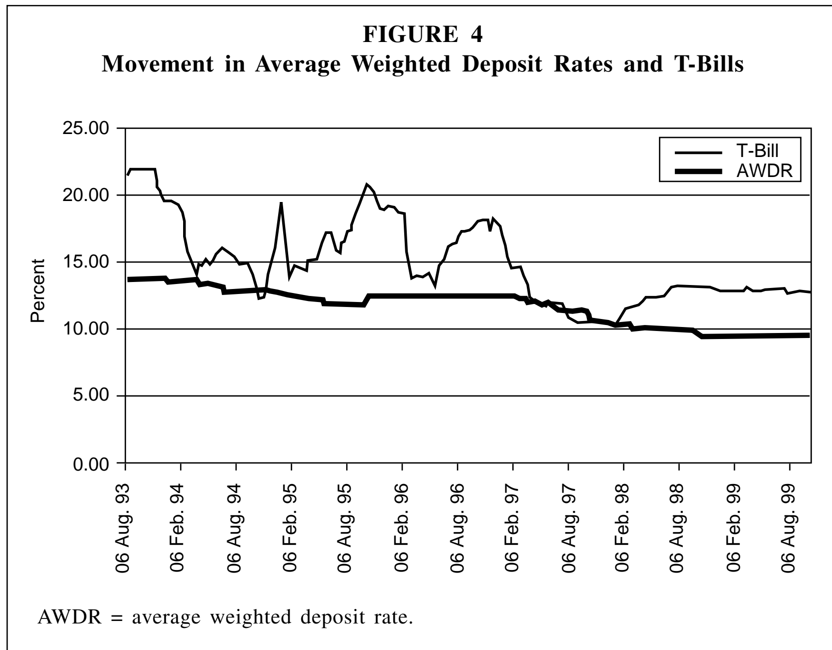
2. T-Bill Interest Rates and Yields versus Bank Savings

The average yields of T-bills in the primary market have shown a significant decline since 1997, in part due to the steady decline in market interest rates, and also CBSL's recent adoption of a prudential debt management strategy and interest rate policy.

Although the inflation rate has declined continuously from 1989, T-bill rates peaked in 1994, thereby pushing the real rate to double-digit level. This is partly explained by CBSL's policy of focusing mainly on controlling money supply, with a view to curtailing inflation. This left interest rates floating at very high levels. With inflationary pressure dying down in 1997, CBSL has been able to focus mainly on the interest rate, and the real T-bill rate declined to 3.2 percent by the end of 1998. CBSL reduced the SRR in 1997 from 15 percent to 12 percent in two steps, and in 1999 it was brought down to 11 percent. This released approximately SLRs8 billion of liquidity to the banking sector, which greatly helped bring down the T-bill rate in 1997.

NSB was able to maintain its savings rate at approximately 5 percent

FIGURE 4
Movement in Average Weighted Deposit Rates and T-Bills



AWDR = average weighted deposit rate.

below the 12-month T-bill rate until 1997, when the deep discount in the rate was reversed. It stabilized at 2.2 percent in 1998. Analysis of the prime lending rate shows how the Government had to offer rates comparable to the borrowing rates of prime corporate customers of commercial banks to attract the funds. However, in 1998 the prime lending rate was above the T-bill rate, although the 2.5 percent premium does not adequately reflect the inherent risk in corporate, compared with government, borrowing.

The interest cost on the Government's market borrowings seems to be far above the market rate that would compensate the low risk profile of the Government. This reflects a considerable anomaly in the interest structure of the local market, arising from prolonged market inefficiencies over the past decade.

One of the factors that led to commercial banks' ability to offer significantly lower interest to savers has been the wide network of branches maintained island-wide, greatly contributing to the commercial banks' and NSB's rapid deposit growth. There is evidence that the changes in NSB savings rates have had a tremendous effect on the interest rates offered by commercial banks. Retail customer segments are so sensitive to the rates offered by NSB that they act as a kind of benchmark, which

commercial banks follow in setting their deposit rates. The branches, located in rural towns, have been able not only to provide customers ease of investing excess funds, but also withdrawing them at short notice in case of emergency. Savers would thus have to make significant sacrifices to be attracted to higher T-bill rates. The T-bill, or any other security invested through PDs, who are located far away from rural savers, combined with the illiquid secondary market, has not helped PDs to provide investors with reasonable assurance as to the ability to meet possible withdrawal demands.

Bank deposit rates are maintained significantly below the T-bill rate due to banks' preference to mobilize deposits at a lower rate and channel them to T-bills in the absence of adequate credit demand, rather than giving savers the opportunity to directly invest in T-bills. Meanwhile, PDs that are not banks lack the resources to build up a wide distribution network to effectively compete with the well-established bank branch network to channel such funds towards high-yielding treasury bills.

The significant average real return of over 5 percent has certainly drawn a large amount of even long-term funds towards short-term T-bill investment, as the 2.2 percent risk premium provided by listed equity has not been adequate to compensate for the risk inherent in the equity market.

3. Corporate Securities

Debentures. The listed medium-term corporate debenture market grew rapidly from 1997. A large number of issuers have been banking and other financial institutions, who could raise funds through unsecured papers, while a few others have preferred to enhance credit quality by obtaining the guarantees of banks or international agencies. Some debentures carry fixed interest and others have floating rates payable, anything from monthly to annually. It is interesting to examine the pricing of such debt, which carries a fixed coupon, in relation to government papers of comparable maturities.

The debenture issuers (Table 7) can be categorized into three fairly homogenous (in terms of issuer's credit quality) broad areas: (i) unsecured nonbanks, (ii) unsecured banks, and (iii) issuers guaranteed by banks and international agencies.

The unsecured nonbank issuer has a risk premium of approximately 6.46 percent, which cannot be compared with any other debenture issues in the absence of comparable issues.

Four commercial banks have issued unsecured subordinated debentures with five-year maturity. The premia over the T-bond yield on comparable maturities have varied considerably from 42 bps to 160 bps.

Although the credit quality of the four banks cannot be identified in the absence of credit rating, it is unlikely that the difference in premia can be explained by varying credit quality. However, an interesting feature is that the yield-to-maturity offered by all debentures has been at 14.20 percent, except in one case where it has been around 14.37 percent. This indicates that, for the purposes of pricing, debenture issues have been benchmarked to the yields of previously issued debentures of commercial banks with the same maturity, rather than T-bond yields.

TABLE 7
Pricing of Corporate Debenture Carrying Fixed Coupon

Issuer and Security	Date of Issue	Yields-to-Term (years)	Treasury Maturity (percent)	Yield (percent)	Spread (percent)
Unsecured Nonbank					
Ceylinco Securities Unsecured	Mar 98	4	18.26	11.80[a]	6.46
Unsecured Banks					
HNB Unsecured/Subordinated	Jun 98	5	14.20	12.60[a]	1.60
Commercial Bank Unsecured/Subordinated	Jul 98	5	14.20	12.85[a]	1.35
Seylan Bank Unsecured/Subordinated	Sep 98	5	14.37	13.58[a]	0.79
Sampath Bank Unsecured/Subordinated	Jul 99	5	14.20	13.78[a]	0.42
Guaranteed					
Ceylon Glass Co Guaranteed by DFCC	Jul 98	3	13.95	12.27[a]	1.68
Vanik Inc Guaranteed by USAID/People bank	Dec 98	5	15.00	13.90[a]	1.10
Mercantile Leasing Guaranteed by IFC/NDB	Mar 99	5	14.75	13.84	0.91
People Merch. Bank Guaranteed by DFCC/People B/HNB	Apr 99	4	14.20	14.00	0.20

[a] Estimated on the closest yield on treasury bond based on selling bid on secondary market.

Source: Market information.

Further, in the case of the four guaranteed debentures, the credit premia varied from 20 bps to 168 bps, although this cannot be explained by the credit quality of the issuers in reference to the guarantors. The examination of the yield-to-maturity of the guaranteed debentures reveals that there was some attempt to price them based on the yield offered by bank debentures.

This shows that the T-bond yield has not been used by the market in pricing medium-term yields. The main reason for this has been the lack of liquidity in the T-bond market, particularly in the secondary market, from which the market yields are derived. Lack of a transparent market-driven interest rate in the T-bond market may not provide enough confidence in the market to allow T-bonds to be used as a benchmark in pricing medium-term debentures.

Asset-Backed Notes. There are a few asset-backed securities transactions in Sri Lanka, which mainly focus on the securitization of leasing assets by leasing companies and merchant banks. The first asset securitization was done by LOLC in November 1995, issuing asset-backed notes for four years for a value of SLRs366 million, and carrying a yield of 17.5 percent when the one-year T-bill rate was 19.5 percent. Recent securitization transactions show a series of "trust receipts" with varying maturities. Yields of such receipts backed by assets are directly based on the T-bill or T-bond rate, with an approximate premium of 1.5–2 percent depending on tenor. Therefore, the pricing of asset-backed securities seems to rely to a large extent on T-bills or T-bonds.

Commercial Paper. The CP has become a popular instrument for raising funds, particularly by listed companies needing to meet short-term working capital requirements. The last few years have seen a rapid growth in the CP issues, and it is estimated that the outstanding CP at present amounts to SLRs7 billion, from more than 40 issuers.

The CP now also takes a significant share of the institutional portfolios due to its ability to enhance yield over the short-term deposit or T-bill rates. Generally, commercial banks are involved in the issue and placement of the CP by providing a standby credit facility to meet the maturities of the papers and endorsing or guaranteeing the papers for credit enhancement, in accordance with CBSL guidelines. Banks, after keeping a spread to meet the cost of guaranteeing, sell the papers by placement and management to a wide range of institutions, based on market interest rates. Due to the high liquidity accumulated in commercial banks in recent times, banks sometimes prefer to hold on to CP they have structured in their own portfolio, without passing it on to outside investors.

Although the cost of funding CP issues can be quite high to issuers, depending on their credit standing, they can be suitable for even very conservative investors once the papers are guaranteed or endorsed by a commercial bank. CP with three- to six-month maturity should reflect the prevailing risk-free rate with appropriate premia for credit risk.

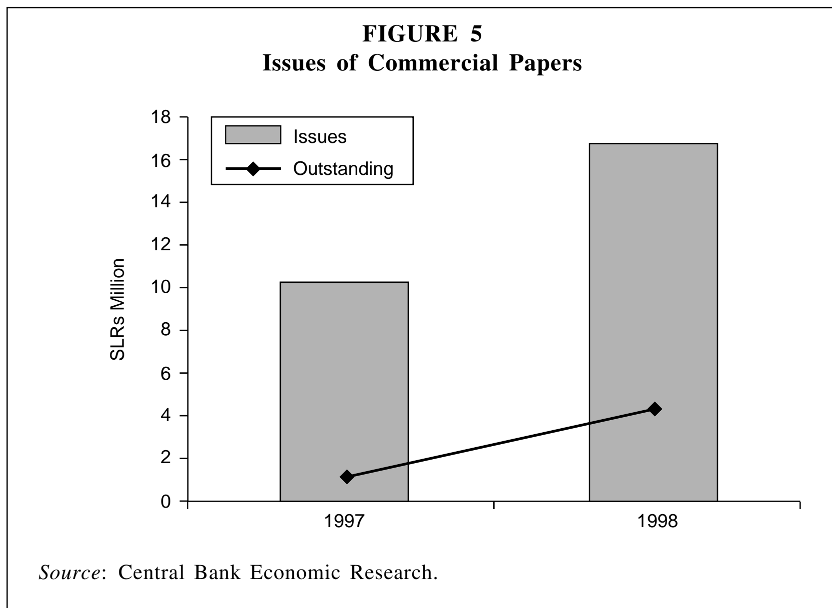
Based on the analysis of 25 randomly selected CP issues compared

with government securities issued at the same time, T-bill and CP yield rates showed a strong correlation of 79 percent, indicating that the T-bill rate acts as a benchmark in pricing bank-guaranteed or endorsed CP in the market.

D. Investor Base

Treasury Securities. Until 1983, the demand for T-bills by commercial banks and the general public was very slack, due to the nonmarket-

FIGURE 5
Issues of Commercial Papers



Source: Central Bank Economic Research.

related return. CBSL was thus forced to subscribe a substantial portion of the T-bill issues, and was the major holder of T-bills in the country, with 99 percent of outstanding bills in 1983. However, this changed when it issued T-bills at market-related interest rates.

There is a significant concentration of government securities in the hands of three institutions under government ownership or control. In 1989, these institutions—NSB, the EPF, and the ETF—held securities to the value of approximately SLRs52.4 billion, accounting for 45 percent of total domestic debt. Their share grew to 62 percent of total outstanding in 1998. CBSL holdings have declined in absolute terms from SLRs40 billion to SLRs29.2 billion, or from 34 percent to 8 percent of domestic

debt over the same period. Commercial banks' holdings of government securities grew steadily from 5.7 percent to 7.8 percent in 1993, but have since declined, with a shift to the nonbanking sector.

T-bills and T-bonds, which are marketable instruments, have a different holding pattern from rupee securities. While CBSL holdings of T-bills declined steadily from SLRs34.1 billion to SLRs9 billion over 10 years, the holdings of NSB, the EPF, and the ETF have grown from 9 percent of the total outstanding to 32 percent over the same period. Most noteworthy is the private sector holding of T-bills and bonds, accounting for 48.3 percent of the total outstanding in 1998, compared with just 1.2 percent 10 years ago.

TABLE 8
Ownership of the Government Domestic Debt Market at 31 December 1998
(SLRs million)

	Amount
Banks	**100,903**
Central Bank (by debt instrument)	**29,150**
Rupee Loans	—
Treasury Bills	8,958
Provisional Advances	**20,192**
Commercial Banks (by debt instrument)	**71,753**
Rupee Loans	44,321
Treasury Bills	14,850
Treasury Bonds	5,808
Other	6,774
By Institutions	**71,753**
State Banks	63,443
Others	8,310
Sinking Fund	**100**
Nonbank Sector (by debt instrument)	**345,544**
Rupee Loans	206,149
Treasury Bills	96,188
Treasury Bonds	43,107
Treasury Certificate of Deposit	12
Tax Reserve Certificate	6
Other	82
By Institutions	**345,544**
National Savings Bank	67,260
Savings Institutions and Individuals	84,102
Employees' Provident Fund	157,711
Insurance Institutions	13,053
Finance Companies	7,060
Other	16,359
Total	**446,547**

Source: Table 72 of Central Bank of Sri Lanka *Annual Report 1998.*

Rupee Loans. The government-controlled EPF and NSB continue to hold the major share of the rupee loans, while CBSL holdings of rupee loans were nil in 1998, down from SLRs27 million in 1989. Rupee loans are not attractive to the private sector because of (i) the interest rates on them being lower than market rates; (ii) their long-term maturity structure; (iii) the lack of a secondary market; and (iv) uncertainty resulting from high volatility in inflation rates.

The major reasons for the fall in CBSL's holdings were (i) commercial banks being allowed to keep up to 5 percent of their total deposits in T-bills to meet their statutory reserve requirement with effect from 16 September 1988 (rescinded since 11 January 1991); (ii) commercial banks' holdings in unencumbered T-bills being counted as liquid assets for meeting CBSL statutory liquid assets requirement; (iii) the banks being able to use T-bills to enter into repo agreements and raise short-term funds in the money market without keeping statutory reserves on such funds, thus enabling them to reduce the effective cost of mobilizing funds; (iv) the banks being able to participate in the OMO of CBSL by using T-bills to raise short-term funds under repo agreements; (v) the withdrawal of withholding tax on the interest earned on T-bills in the secondary market; (vi) the abolition of capital gains tax on trading in T-bills; and (vii) the abolition of stamp duty on T-bills.

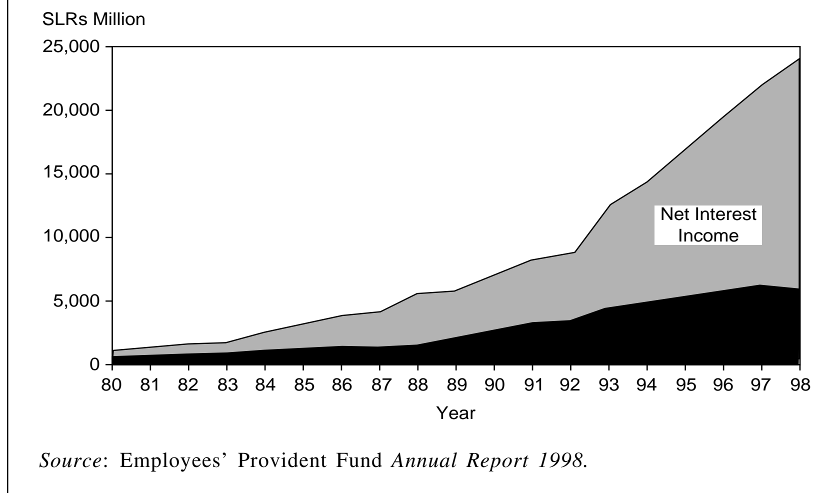
1. Employees' Provident Fund

The EPF was established in 1958 as a compulsory savings scheme for individuals in the private sector, providing superannuating benefits. Monthly contributions of a minimum 20 percent of total earnings, with 8 percent contributed by the employee and 12 percent by the employer, are remitted to the fund. The fund is administered by the Department of Labor, while investment decisions are made by CBSL's Monetary Board. Each member's account is maintained separately and credited with interest and contributions by the member, his or her employer. The Government guarantees a yearly minimum investment return of 2.5 percent to the members of the fund.

The EPF was estimated to have 7.6 million member accounts at the end of 1998, of which 24 percent were active and 76 percent inactive (i.e., contributions had stopped for more than one year). Some members have more than one account due to the opening of a new account when changing jobs.

In addition to the net contribution of SLRs5.6 billion in 1998, EPF also received a net interest income of SLRs18.7 billion, totaling net growth of SLRs24.3 billion. This accounted for 17.7 percent growth of the EPF balance of SLRs137.3 billion outstanding at the beginning of 1998. The annual inflow of funds to EPF is very substantial, and one of

FIGURE 6
Growth in EPF Funds



Source: Employees' Provident Fund *Annual Report 1998*.

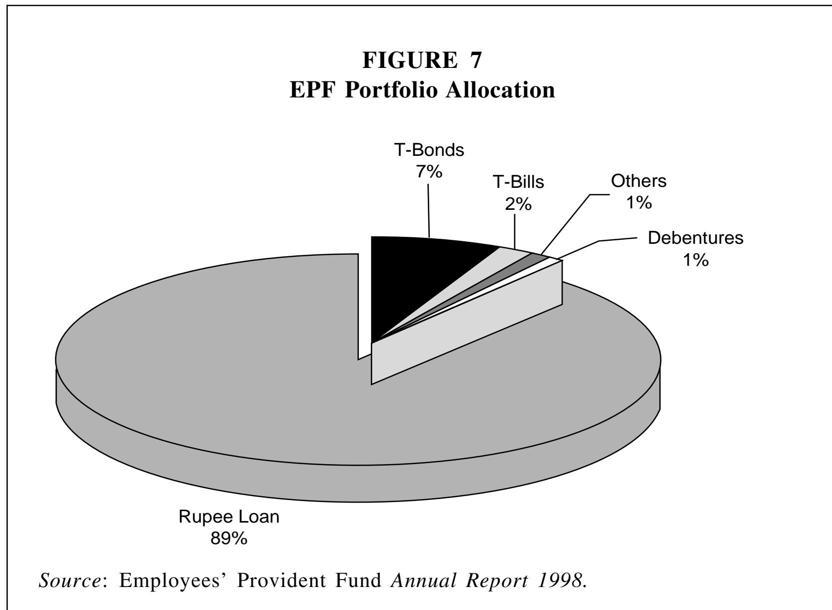
the challenges for managers of EPF funds is to find destinations for these funds. The rise in government debt due to the spiraling budget deficit gives them their only hope of investing such proceeds risk-free.

EPF thus invests most of its portfolio in government securities. These have been mainly in rupee loans and 12-month T-bills and T-bonds. In addition, EPF has invested in debentures issued by development banks and plantation companies, and commenced investing in listed equities in 1998. The fund has occasionally invested in short-term money market instruments. However, it has not exploited this sector to maximize the return on liquid funds awaiting investment.

The fund has invested only in government-backed securities, limiting the potential for higher returns from other investments. The average yield of the portfolio at the end of 1998 amounted to approximately 13.9 percent per annum, showing a continuous decline, reflecting the recent decline in yields of government securities. The asset allocation in rupee loans, T-bills, and T-bonds stood at 89 percent, 7 percent, and 2 percent, respectively, at the end of 1998.

The investment portfolio of EPF at the end of 1998 had an average life of four and a half years, showing a maturity mismatch due to the absence of long-term government securities or other fixed income investments in Sri Lanka. The maturities of the investment do not fall due

FIGURE 7
EPF Portfolio Allocation



Source: Employees' Provident Fund *Annual Report 1998*.

according to a smoothly planned schedule, exposing the fund to a very high reinvestment risk.

The EPF, due to the significant amounts it manages, has a significant influence on the domestic borrowings of the government. At present, the government relies heavily on the EPF for its growing borrowing requirements. A mechanism is necessary to avoid the concentration of so much power in one organization and to help increase competition in the government securities market.

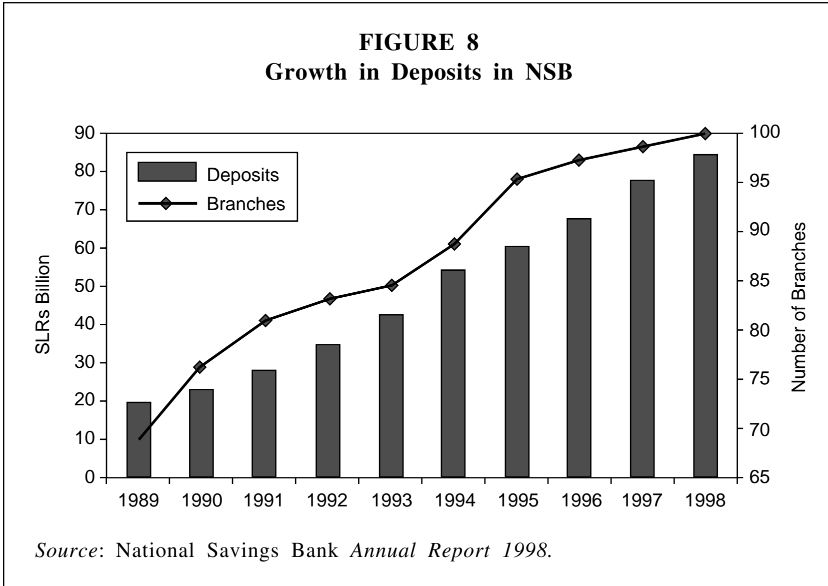
2. National Savings Bank

NSB was incorporated in 1972 through the amalgamation of the Post Office Savings Bank, Ceylon Savings Bank, National Savings Movement, and Savings Certificate Section of the (GPO). It is fully state-owned.

By the end of 1998, it had mobilized approximately SLRs87.1 billion in deposits, of which 37 percent was made up of savings deposits and the balance of fixed and other deposits. The net assets of NSB at the end of 1998 amounted to SLRs90.7 billion, around 76 percent of which were invested in government securities.

NSB mobilizes saving through its 100 branches and 4,032 post offices and subpost offices spread island-wide. It serves 12.4 million account holders, much above the membership of the EPF, although the average account balance is significantly lower.

FIGURE 8
Growth in Deposits in NSB



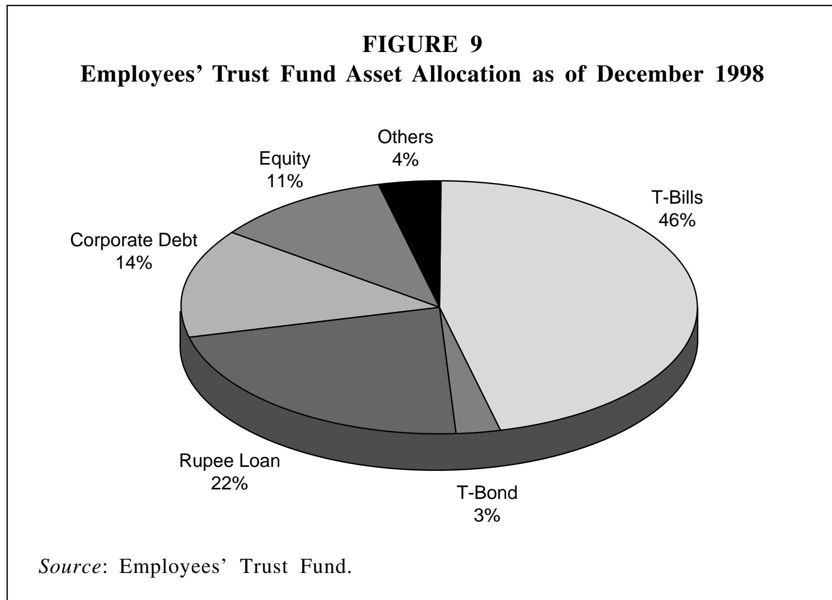
Source: National Savings Bank *Annual Report 1998.*

NSB has diversified its activities into provision of housing loans and investment in debentures and loans to licensed commercial banks and specialized banks, with a view to enhancing returns. The deposits of NSB have shown compound annual growth of 15.5 percent for the last 10 years. Although NSB holds most of its assets in government securities, their yield has been much lower than the cost of funds it has mobilized. As a means of attracting such funds to these securities, the Treasury paid the interest differential on the yield of government securities and the cost of funds to NSB on a yearly basis, but this subsidy was withdrawn in 1997, leaving the bank to improve the viability of its operations alone.

3. Employees' Trust Fund

The ETF was set up in 1980 to provide noncontributory benefits to employees on retirement, and to promote employee ownership and welfare through participation in financing and investments within the model of the trust fund plan. Accordingly, it has a larger allocation for investment in corporate and fixed-income securities. Over the last 10 years, however, the investment in government securities has increased from 60 percent to 71 percent of ETF's gross assets. The major portion of its allocation is in short-term T-bills.

FIGURE 9
Employees' Trust Fund Asset Allocation as of December 1998



Source: Employees' Trust Fund.

At the end of 1998, assets under ETF management amounted to SLRs21.9 billion, much smaller than those of the EPF and NSB. Its exposure to government securities is also lower. The asset allocation of the ETF at the end of 1998 is given in the following graph.

4. Insurance and Finance Companies

Insurance companies are required to hold a minimum of 50 percent of life insurance funds and 30 percent of general insurance funds in government securities. The insurance industry has experienced rapid growth in premium income, creating a significant inflow to government securities. There were seven insurance companies operating at the end of 1998, including two state-owned insurers and two specialized companies. The demand for T-bonds by the insurance industry is likely to be high, considering the long duration of liabilities and the conservative nature of the industry.

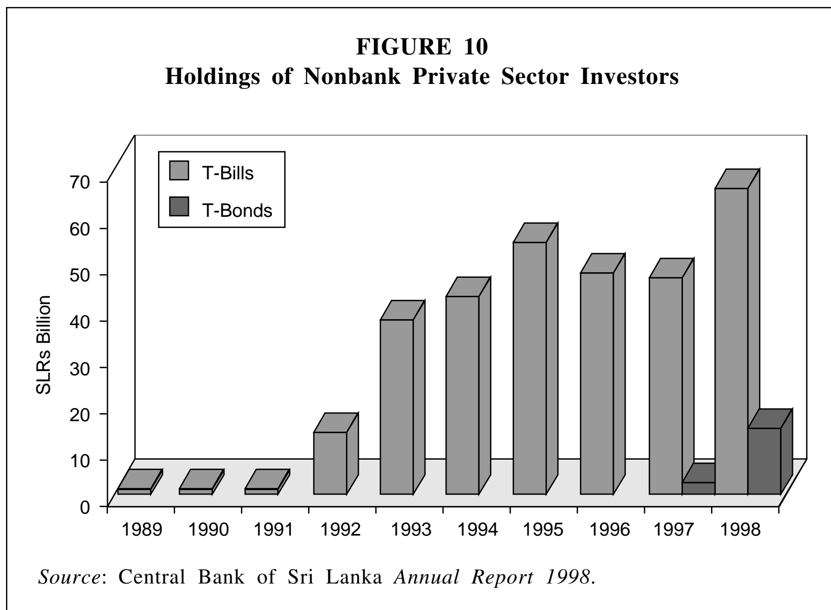
There were 25 finance companies operating at the end of 1998, accounting for an asset value of SLRs26.1 billion. Finance companies are required to maintain 10 percent of their assets in liquid investments, and T-bills are permitted as these, resulting in high demand among finance companies. Their T-bill holdings at the end of 1998 amounted to SLRs1.95 billion, or 7.5 percent of total assets.

5. Other Nonbank Private Sector Investors

The holdings of the nonbank private sector in T-bills and T-bonds have grown significantly in recent years, and in 1998 accounted for 48.3 percent of aggregate T-bills and bonds outstanding—even surpassing the holdings of EPF, NSB, and ETF (31.9 percent in the same year).

These investors comprise a wide range of individual and institutional investors with excess liquid funds requiring short- to medium-term placement. This segment has been attracted by T-bill investment since 1993, due mainly to the high real rate of return, and has not shown any interest in rupee securities. Holdings of rupee securities reached only SLRs64 million outstanding in 1998. Institutional investors in this sector comprise private provident and pension funds, unit trusts and investment companies, merchant banks, regional rural development banks, development banks, government corporations and nongovernment organizations (NGOs).

FIGURE 10
Holdings of Nonbank Private Sector Investors



Source: Central Bank of Sri Lanka *Annual Report 1998.*

IV. Bond Market Infrastructure

A. Primary Dealer System

CBSL appointed 11 accredited PDs in June 1992, consisting of eight commercial banks and three nonbank dealers. This rose to 18 by 1994, consisting of 11 commercial banks and seven nonbank dealers in 1997.

The Primary Dealers Association was formed in June 1997 with the active support of CBSL to promote the development of the government debt security market. Access to auction of government securities was restricted only to PDs and designated nondealer bidders appointed on the basis of specific market-making requirements.

Previously, commercial banks and other nonbank financial institutions had been appointed but these have other primary duties and functions. A survey showed most commercial banks were not interested in actively marketing T-bills in the primary and secondary markets, and most had applied for primary dealer status as a matter of prestige rather than as a market-developing business venture.

CBSL thus felt that a separate legal entity, possibly a wholly owned subsidiary of a commercial bank or other financial institution, was necessary to strengthen the institutional framework and to separate the primary dealership and treasury functions carried out by the commercial banks and other financial institutions. This would (i) facilitate better management of government debt; (ii) strengthen monetary and fiscal management; (iii) make dealer surveillance easier and more meaningful; (iv) improve incentives for PD activities; (v) provide a level playing field by a uniform set of institutions; and (vi) eliminate conflict of interests within organizations.

The Monetary Board of CBSL has decided in principle that one of the major appointment criteria for PDs should be that they are a public limited liability company with dedicated capital initially of SLRs150 million.

As an initial step, CBSL proposes to reduce the number of PDs from 18 to 9, consisting of 7 commercial banks and 2 nonbank financial institutions in January 2000. It has approved in principle the applications of eight PDs, with one still pending. The new PDs are expected to commence business on 1 March 2000.

PDs are expected to (i) bid for and purchase T-bills, T-bonds, and instruments issued by the Government and CBSL at primary markets, and promote and develop a secondary market in T-bills and T-bonds and other government and CBSL securities; (ii) maintain a minimum capital

as determined by the Monetary Board; and (iii) not have on their board of directors a director or an employee of another PD or, except for the chief executive officer, an employee of the company.

Their duties and privileges include (i) the right to deal with CBSL as a counterparty in the primary and secondary markets; (ii) compliance with CBSL-determined minimum levels for maintenance of stocks of securities, collection and payment of maturity proceeds and interest, maintenance of books, submission of periodic reports, charges levied by the PD and qualifications required of its senior executive officers; (iii) the right to engage in transactions relating to securities for their own accounts and for the accounts of their customers; and (iv) maintaining minimum standards of competence, confidentiality, and infrastructure facilities.

CBSL may supervise and examine a PD to ensure its business conduct is not prejudicial to customers, and also evaluate its auction performance and ability to create and maintain a secondary market, and the Monetary Board may suspend a PD or cancel its appointment if it fails to fulfil its functions.

1. Problems with the PD System

The requirements for all PDs to have capital of SLRs150 million and be regularly evaluated on their performance are intended to ensure that they carry an adequate inventory of securities. However, the lack of access to broad segments of the retail market means PD opportunity for high spread business on the primary market is very small.

Bank PDs are at an advantage in that they can utilize a large part of the capital requirement in banking activities rather than in carrying the inventory of government securities, and can participate at primary auctions due to the demand for treasury securities from their day-to-day liquidity requirements. However, for nonbank PDs, the lack of a retail network for distribution means they have to mainly concentrate on the institutional sector which attracts, at best, a very thin margin.

The consistently high spread of T-bill rates over the interest rates offered by commercial banks during the last five years, much higher than the banks' statutory reserve costs, means PDs involved in commercial banking operations are not motivated to directly place T-bills or T-bonds among their investor segments, as this would reduce their customer deposits. They prefer to take such funds through low-cost deposits and invest in T-bills to earn a margin. Further, they lose the flexibility to remobilize their customers' funds in the bank lending operation when there is a greater demand for lending that provides much higher spreads.

TABLE 9
Treasury Bill Rates Compared with Deposit Rates
(percent)

	1994	1995	1996	1997	1998
Treasury Bill 12m	19.4	18.9	17.4	10.2	12.6
AWDR	12.5	12.4	12.3	10.4	9.2
AWFDR					10.7
NSB – Savings	14.0	12.0	12.0	10.8	10.5

Source: Central Bank of Sri Lanka.

One of PD's main functions is to make market in outstanding T-bond issues by quoting bid and offer rates to the market, based on inventories. However, in the absence of a well-structured secondary market for government securities, these bids and offers are only indicated by PDs to potential investors upon formal inquiry. These are collated by CBSL on a weekly basis, and the average is published for information. Very few trades are transacted at the published rates.

The very high volatility of the implied yields derived from the bid and offer rates indicated by PDs shows the market's very inefficient price discovery mechanism. The implied short-term yields seem to differ considerably from the expected rates, reflected by the historical volatility of the short-term interest rates. Potential investors cannot identify the yields of a specific PD. In a transparent secondary market mechanism, the bid and offer quoted by a dealer are immediately known to all market participants.

The very few secondary market transactions, if any, are motivated by the sale of securities due to an immediate need for cash, or purchase of securities due to failure in the primary bids (especially when there is a very large cash balance and low short-term rates). The lack of liquidity means these transactions take place at rates that differ significantly from prevailing market rates. Therefore, current investors in primary auctions tend to hold securities until maturity.

2. *PDs in the Repo Market*

A PD's profitability depends to a large extent on his or her ability to offer competitive rates for investors. To satisfy customers' varying demands, it is necessary to carry a large inventory of T-bills and T-bonds with varying maturities. PDs in the banking business generally carry a large inventory of government securities as part of their liquid assets. If they carry a level marginally higher than that required for

liquidity, they will be able to meet the needs of the customers when there is a demand for investment. Nonbank PDs, with limited capital, can only pay to build up an inventory through raising short-term funds by entering into repo agreements.

The yield of the T-bills and T-bonds of up to six years maturity shows very steep upward-sloping curves. The short-term rates in the market and the implied yields of the T-bonds indicate very high maturity premia. PDs are extensively involved in extracting these high premia by investing in T-bonds with long maturities and borrowing to finance such inventories by way of repo agreements. They carry significant interest rate risk due to the maturity mismatch, but in the long run they earn a positive yield over the borrowing cost.

B. Issuance Methods and Procedures

The primary issue of T-bills and bonds is through auction by CBSL's Department of Public Debt (DPD). Only PDs and designated nondealer bidders can bid for the securities, and tenders are called for from them through notices in the national newspapers on Fridays, which indicates the amount offered and other particulars.

T-bill auctions are held every Wednesday, with settlements scheduled on the following Friday, and T-bond auctions are held twice a month on a Monday, with settlement on the following Wednesday.

The total of T-bond and T-bill issues planned for the year and the total amount remaining to be issued during the rest of the year are published in the notice calling for tender, for public information. CBSL tries to keep to these programs, unless there are changes to government borrowing requirements.

PDs are informed about the forthcoming issues with regard to bonds and bills at least a week in advance. There are plans for CBSL to announce the amounts planned for issue during the quarter in advance to PDs.

T-bills are issued in the form of zero coupon bills on a discounted value basis. The money is collected from PDs at a discounted value at the point of issue of the primary bill. At maturity, the face value of the T-bill is paid to PDs. The minimum bid value a PD can offer at a primary auction is SLRs5 million, and in multiples of SLRs1 million thereafter, although it may request different denominations. The lowest denomination is SLRs10,000 and the highest SLRs200 million.

For T-bonds, the minimum bid amount is SLRs5 million, with additional amounts in multiples of SLRs1 million, and are issued for a principal sum with interest payable semiannually.

T-bonds are issued on the first and fifteenth of each month, while auctions may be held on different dates. Unlike T-bills, which are issued on a discounted basis, T-bonds are issued in the form of coupon bonds. The coupon rate is announced for each series of T-bonds.

Bids at the primary auction may be made at par, discount, or premium. The cutoff time for bids in T-bonds is 10:00 a.m. on Mondays. Auction results are announced by the Tender Board in the afternoon. Settlement takes place on Wednesday of the same week.

At present T-bills and bonds are issued as written certificates. However, there is legal provision to issue them in scriptless form, which would facilitate record-keeping.

For rupee bonds, CBSL's DPD invites subscriptions from the public by notices published in the national press, giving details as to the amount available, maturity dates, interest rates, and interest payable.

1. Allotment of Securities and Cutoff Rates

On the morning of an auction, CBSL's Superintendent of Public Debt (SPD) comprehensively researches the availability of funds among institutional investors, the money market conditions, and the outlook of the bidding process, based on the responses of PDs. A paper called Forecast of Treasury Bill Auction is prepared based on these factors, and submitted to the Governor of CBSL before the closure of tender.

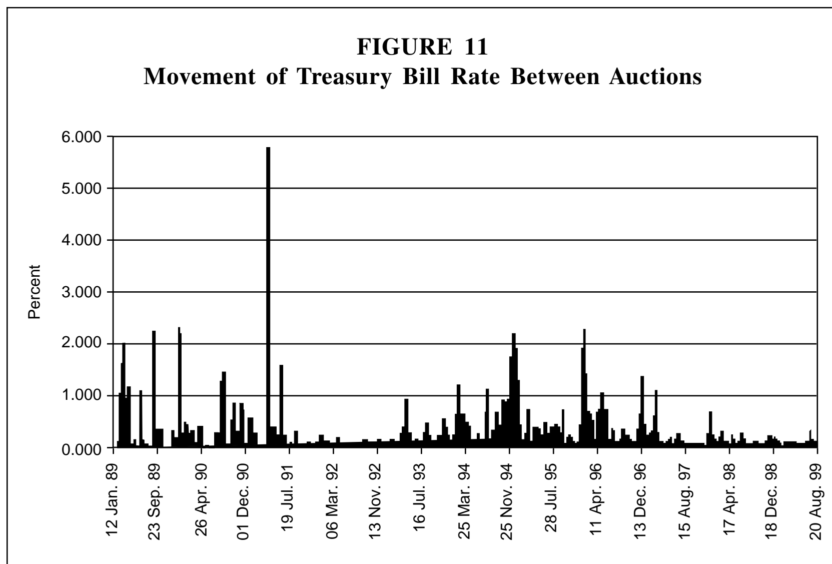


FIGURE 11
Movement of Treasury Bill Rate Between Auctions

Once the tender is closed, the Department of Public Debt analyzes the bids received and prepares a memorandum detailing (i) the weighted average and cutoff rates of the previous auction; (ii) CBSL holding of the securities, its investment in previous auctions, and its capacity to intervene in the current auction by taking part of the issue; (iii) amount bid by major institutions, and at what rates; and (iv) scenario analysis of the yield outcome compared with previous auctions, assuming varying allotments to CBSL and different mixes of allotments to different maturities, etc. This is forwarded to the Tender Board, which meets at 3:00 p.m. on auction day, and decides the cutoff rate based on the memorandum information and prevailing monetary and economic conditions.

2. Pricing

To minimize the cost of government borrowing while maintaining interest rate stability in the domestic money market, CBSL adopts the following strategies in managing the pricing of issues: (i) plan issues well in advance, based on the Government's annual and monthly cash flow forecast; (ii) advise the Treasury with regard to market conditions affecting the success of treasury issue; (iii) intervene in the money market through repo operations, by either introducing liquidity in tight market conditions or mopping up excess liquidity, thereby indirectly influencing bidding behavior for Treasury issues; (iv) change the composition of 3, 6, and 12-month T-bill issue; (v) vary the amount on offer, particularly in T-bill issues, compared with the amount maturing on the same week that are intended for reinvestment; (vi) increase or decrease the amount of the issue taken up by CBSL; (vii) vary the amount of T-bills of specific maturity allotted against the amount offered up to 25 percent of the value offered; and (viii) closely coordinate with major institutions such as NSB, the EPF, and the ETF.

The EPF is managed by the Monetary Board, and some CBSL officers are represented in large government corporations with a very large appetite for treasury issues, so CBSL can make well-informed decisions.

CBSL's ability to adopt the above strategies may be limited to some extent by the (i) steady increase in budget deficit over and above planned levels; (ii) demand from private sector credit growth, requiring higher interest rates to attract funds; (iii) inadequate holding, at times, of treasury securities by CBSL for repo; and (iv) short-term money market conditions and speculative pressure on currencies, leading to tight money market conditions.

3. Electronic System

There are plans to develop an automated system to replace the present system of bidding at primary auctions, as well as secondary market trading, clearing, and settlement. Please see the section on Clearing and Settlement at the end of this chapter for a full description.

C. Secondary Trading Systems

Unlike in most market systems, secondary trading outside the system is not practiced in Sri Lanka.

CBSL introduced the secondary T-bill market in 1981 to reduce its own holdings of T-bills, while providing short-term investment opportunities in gilt-edged securities for market participants. CBSL discounts and rediscounts T-bills for OMO through the T-bill open market window, with interest rates dependent on market conditions, and also engages in repo and RRP whenever liquidity needs to be injected or mopped up. T-bills are also used by commercial banks for repo and RRP in the interbank market, and with customers.

The repo sale of T-bills was introduced in October 1993, with a view to stabilizing the lower end of the interbank call money market. The repo rate was determined daily by CBSL, taking into consideration factors such as the primary and secondary market rates, interbank call market rates, liquidity, and market position. The RRP scheme of the CBSL was introduced in November 1995 with the aim of stabilizing the upper end of the inter-bank call money market interest rates. The secondary market in T-bills is confined mainly to repo and RRP agreements.

The major constraints for the development of the T-bill secondary market are (i) the fact that major institutional investors and the general public, who invest for a risk-free return, hold the bills until maturity; and (ii) institutional investors who are conversant with market conditions are unable to take advantage of the volatility in the interest rates to ride the yield curve and obtain tax-free capital gains, since PDs do not actively engage in the secondary market by making two-way quotations.

There is limited outright secondary market activity in T-bonds. However, they have become very popular, and a liquid secondary market almost comparable to that in T-bills has developed in repo dealings and secondary transactions with CBSL.

For corporate securities, listed debentures are traded through brokers on the CSE, and the price depends on market interest rates. Transactions are very few, however.

1. Repo Market

There is a large market for repo and RRP on T-bills and bonds in Sri Lanka, with an estimated volume of over SLRs1,118 billion and transactions of SLRs632 billion in 1998. The secondary market's appetite for treasury securities has been largely met by the vibrant repo market. CBSL is also actively involved, although only overnight, as a part of its OMO designed to maintain short-term interest rate stability.

There are several reasons for the growth in the repo market: (i) the ability to meet the exact needs of investors in terms of the maturity period and investment value in comparison with the secondary market sale, which depends on the terms of the security and denominations; (ii) the ability for even a conservative investor to place funds with an institution with lower credit quality, due to the high quality of the underlying asset; (iii) the steep yield curve generating high profits; (iv) the simplicity and flexibility of the repo agreement; (v) the fact that repo transactions are tax neutral, with low stamp duty and no withholding tax on the profit arising from the difference between selling price; and repo price; and (vi) the high interest given to investors by commercial banks, since repos are not subject to statutory reserve.

Transactions are mostly done on an overnight basis up to three months. However, cumbersome administrative procedures in delivery of physical securities (necessary with nonbank counter-parties) and a tedious settlement system have an adverse impact.

2. Stripping the Coupon

T-bonds are currently issued with detachable coupons, which can be transferred by endorsement and delivery. Although the coupon payment necessitates the bearer to forward it through a PD, the payment procedure of CBSL requires the PD to ensure the coupon is attached to the bond until it is forwarded for payment, to enter the customer's name on the reverse of the bond, and certify that the named customer is the holder of the bond. This prevents the coupon being detached from the bond before the payment date for trading in the secondary market, which may lead to the holder of the coupon being different to the holder of the bond on the coupon's payment date.

D. Clearing and Settlement

CBSL, in consultation with the PDA, is planning to develop an automated system to replace the present system of bidding on the pri-

TABLE 10
Underlying Factors that May Impact on Development of Repo and Outright Markets

	Repo Market	Outright Transaction
• Meeting the needs of counterparties in terms of amount and maturities	Easy	Difficult
• Physical delivery of securities	Mostly tedious	Always cumbersome
• Extent of maturity/term	Mostly short, and therefore flexible	Depends on the maturity of security, mostly long
• Tax on intermediary	Only on the spread	Only on the spread
– Turnover tax and Defense	Only on the spread	Only on the spread
– Corporate tax	Not applicable	Exempt
– Capital gain	Leveraging impact on the balance sheet	No leveraging impact
• Accounting effects	High credit risk if the delivery of the security does not take place	Low due to the delivery security
• Risk on counter party/investor	Varies from 50 to 200 bps	5 to 10 bps
	Very high interest rate risk due to mismatch in duration	Liquidity risk and very low interest rate risk during the time of holding inventory
• Spread to intermediary		
• Risk	Nonexistent	Nonexistent
• Instruments to manage risk		

mary issues of treasury securities, secondary market trading, clearing, and settlement. This system is still at the conceptual stage, but as an interim measure CBSL's Information Technology Department has developed an internal system to automate the PDs' primary issues bidding process, which is currently in being tested.

The proposed system will connect the terminals of all PDs and the CBSL's DPD. Accounts will be opened for each investor in treasury securities under their respective PDs. Only the PDs and CBSL will be able to enter, edit information, or gain access to information on deals. CBSL will only maintain accounts for the PDs.

Treasury securities will no longer be issued in physical form, but transferred to investors in scriptless form by electronic entry in their depository account.

When CBSL announces the tender on T-bills or T-bonds, the PDs will receive bids from their customers up to a specified time before closing the tender, either by writing or telephone. The PD will enter this information through the PD terminal, indicating the amount bid, price, interest rate, and specified maturity. PDs can also enter this information in their own accounts on behalf of their clients.

Once the cutoff rate is determined by CBSL, it will identify each participant's successful bids and inform the respective PDs, with the allocation of bids automatically processed to the relevant investors. PDs may require the funds to be cleared in their banks before the settlement day, so these funds will be transferred to their settlement accounts at CBSL.

On the relevant settlement date, the gross payment due is debited from the settlement account of the respective PDs and transferred to CBSL. The PDs' depository accounts will immediately show the treasury securities allocated on the successful bids received through them. Only investors in the PDs' master accounts will be debited the face value amount of the securities issued. Once the PDs' depository accounts are credited with the amount of issues allotted after settlement, this will automatically be transferred to the respective investors' accounts, or the PDs' own accounts in the case of securities bought on their own account.

1. Secondary Market Transactions

All secondary market transactions will be exclusively carried out by PDs through the automated trading system, making it obligatory for them to give a bid and offer quotation on all outstanding securities issues. This will be displayed in the system, giving several quotations in order of competitiveness, starting from the most competitive bid. A potential investor's intended price will be automatically matched with the most competitive bid quoted on the trading system. The securities will be transferred from the seller's depository account of one PD to the buyer's depository account of another PD. The respective PD bank accounts at CBSL will be debited and credited. It is the PD's responsibility to obtain or facilitate the corresponding settlement.

Once a deal is done, a deal slip is generated in the PD's back office, and a corresponding contract note, giving transaction and settlement information, will be given to the relevant customer, which may also carry the commission chargeable. The system will also facilitate the movement of securities among the depository accounts of the customer, based on repo and RRP agreements, securities lending and borrowing agreements, and short-selling of securities.

2. The Present CSE Infrastructure

Colombo Stock Exchange (CSE) has a fully automated system of screen-based trading, clearance, and settlement with regard to listed equity and corporate debt issues. It facilitates placement of orders in the offices of 18 brokers, which are matched on a best price basis in executing transactions. Once the transaction data are finalized, they are inputted in the CDS, which clears the securities between buyers' and sellers' accounts either through a licensed broker or custodial bank. Fund settlement is carried out on a T+5 and T+7 basis for sale and purchase of equity securities and T+1 for debt securities. Investors can decide whether to have the physical share or debenture certificate of the securities lodged directly at CDS. However, securities must be lodged at CDS if they are to be traded in the secondary market, and the transfer of securities is not allowed outside the exchange except in very exceptional cases. The system at CSE is well tested, and meets international standards.

CSE has been actively lobbying the PDA and CBSL to consider using its system for the trading and settlement of government securities. CSE is presently in the process of making sweeping changes in the area of the listing and trading of debt, and only a few minor changes would be needed in its system for government securities to be traded on it. The PDs, who would act as intermediaries, would have a special seat to deal only in government securities, which should be allotted to the respective accounts of investors electronically through the PDs at the conclusion of the primary auction. Once the securities are in the respective investor's account, they will be used in the secondary market on a scriptless basis.

E. Other Aspects

1. Tax Treatment

Capital gains arising from the sale on or after November 1997 by any person of any bond, debenture, or other debt instrument issued by any company and held by such a person, which at the time of such sale is quoted on the CSE, is exempt from income tax. Withholding tax of 10 percent payable on interest on listed debentures and debt securities has been withdrawn. Issue of listed debt instruments such as debentures and promissory notes is exempt from stamp duty, as is trading of bonds and other debt securities of companies that are quoted on the CSE.

In the case of intermediaries involved in repo transaction, the spread between the income from security and the interest expense paid is subject to turnover tax and defense levies, while the net income after

TABLE 11
Relative Advantages of a New Automated System vs. CSE System

Developing a New System	Using CSE System
Advantages • Ability to develop tailor-made system to suit Government securities needs • Integration with the primary issue mechanism • Able to incorporate market-monitoring and surveillance system based on the specific needs of Government securities market **Disadvantages** • Long lag time for implementation • Very high investment cost	**Advantages** • Use of well-tested systems • Ability to be amended in a short period to meet the requirements of Government securities • Minimal investment value • Economies of scale in systems maintenance **Disadvantages** • Demand by equity trading volume may slow down the system and necessitate upgrading • Need to retrain exchange staff who are focused on equity in the requirements of the Government securities market • Overlap in SEC jurisdiction over the regulatory framework of Central Bank

deducting operating expenses is taxed at the normal corporate tax rate. In the case of the outright sale of treasury securities, the difference between the purchase price and the sale price (spread) can be divided into the interest income generated during the period of holding at the yield of original investment and the capital gain. Only the interest income is subject to turnover tax and the defense levy, while the capital gain, which may be a minor portion of the spread, is not. The interest income is subject to tax at the normal corporate tax rate, and the capital gain, which is a very insignificant portion, is not. Therefore, except for a very insignificant portion of income from an outright sale not being subject to turnover tax and defense levy (5.5 percent in total), the two transactions are subject to the same tax.

2. Benchmark Yield Curve

Since the first issue of T-bonds with two-year maturity in March 1997, CBSL has extended maturities up to six years The market-determined yields on medium-term T-bonds help to develop a yield curve extending up to six years against a background of a monetary policy aiming to stabilize interest rates.

There are several advantages to the market due to the development of the yield curve. For a start it has made it possible to estimate future interest rates based on the implied yields underlying the yield curve, thereby reducing the uncertainty of interest rates. Meanwhile, market participants have been able to value bond inventories based on market-determined quotations that may indicate potential profit or loss in a trading transaction, and the pricing of corporate debt papers has been facilitated by identifying benchmark yields at respective maturities, and assigning the appropriate risk premia.

However, yields have been derived from the average selling bids indicated by PDs rather than actual transactions on treasury securities, and therefore may not be realistic.

For a yield on any instrument to be used by the market as a benchmark, it should win the confidence of the market as a market-determined yield with adequate liquidity, which is not influenced by the behavior of one or a few buyers or sellers. It should also be a rate at which interested parties can execute transactions. T-bill and T-bond rates, which are indicative of risk-free yields, have been commonly used as a base rate in deriving the pricing of short- and long-term corporate papers.

However, there is evidence of efforts to price medium-term guaranteed debentures based on the yield of bank debentures rather than T-bonds. The main reason for this has been the lack of liquidity in the T-bond market, particularly in the secondary market, from which the market yields are derived. Lack of a transparent market-driven interest rate in the T-bond market may not provide enough confidence in the market to allow T-bonds to be used as a benchmark in pricing medium-term debentures.

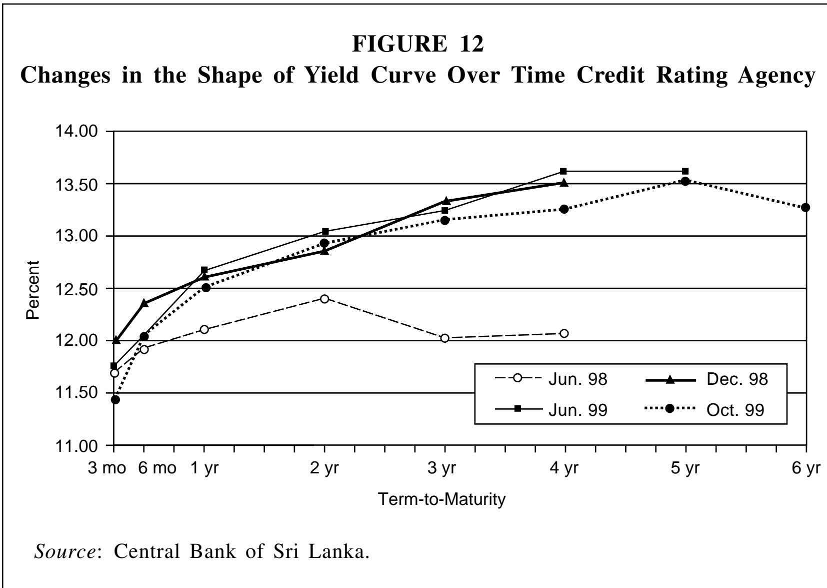
The lack of a credit rating agency inhibited the development of the corporate market for many years, preventing realistic evaluation and rating of debt instruments issued. However, the formation of Duff and Phelps Credit Rating Lanka, Ltd. In July 1999 should resolve many of these problems.

V. Regulatory Structure

Currently the Superintendent of Public Debt of CBSL regulates all market intermediaries and operations.

Planning the issue of treasury securities commences at budget time, announced in November of the previous year. The Treasury of the Ministry of Finance prepares the Government's annual cash flow statement, a rolling budget that specifies the aggregate cash inflow and outflow for the next 12 months, giving the net deficit or surplus for each month. The SPD of CBSL then prepares the annual Treasury Bill Issue Program,

FIGURE 12
Changes in the Shape of Yield Curve Over Time Credit Rating Agency



Source: Central Bank of Sri Lanka.

including the Annual Rupee Loan Program, indicating the issue of different securities of government debt needed to meet cash flow requirements. The Monetary Board of CBSL approves it with any necessary modifications for implementation by the SPD. A monthly Treasury Security Issuance Program is planned in the same way.

The Domestic Debt Market Committee (DDMC) is responsible for determining the amount of T-bills, T-bonds, and rupee securities to be issued for the whole year, broken down into specific maturities, and meets weekly to determine its plans on the T-bill or T-bond issues scheduled during the week.

VI. Major Policy Issues and Recommendations

Sri Lanka has reasonably sound monetary and fiscal policies, despite the constraints of economic imbalance created by the ongoing civil war. Over time, a sound regulatory framework has developed in relation to financial markets and commercial transactions in general, and the government securities market in particular. CBSL has made significant progress in establishing a diversified issue base in terms of maturities, distribution, etc. However, the present investor base needs to be further broadened to foster competition and reduce the impact of a few large institutions on the market. Further government commitment is essential in areas such as pension reform, establishing market-making structures,

and market promotion. The proposed development of the trading, clearing, and settlement systems of government securities should be expedited, while more information on money market and secondary market activities should be released on a timely basis to enhance efficiency. Accounting methods that have an impact on the secondary market must be considered, while development of a derivatives market for interest rate risk management, short-selling, securities borrowing, and lending are essential for facilitating market-making, and to enable investors to cover their exposures.

A. Policy Environment and Management

Debt management requires macroeconomic stability, financial sector reforms, the establishment of regulatory framework, and most essentially, the continued commitment of the Government. Sound monetary and fiscal policies are essential to contain inflation, maintain the stability of interest rates, and create an environment in which sound financial institutions and intermediaries can be developed to foster an efficient market for government securities.

B. Macroeconomic Policies

OMO should be the principal indirect instrument by which CBSL conducts its monetary policy. For this, the secondary market for both T-bills and T-bonds must be developed. Currently, re-discounting mechanisms and repo or RRP facilities on T-bills are used for OMO, but a shift towards government bonds is necessary for the effective application of monetary policy.

Since repo and RRP rates stabilize the call money market rates, the development of the repo market will lead to reduction in the volatility of these rates. Therefore, CBSL repo activities should be used as a tool to provide market direction on interest rates.

The issuance pattern of government securities should be decided in light of the size and structure of the existing and prospective stock of debt, assessed against cost, risk, and consistency with monetary policy.

The Government should publish in advance a report on its annual debt issuance program, and send it to CBSL, setting out program details, including an auction timetable and maturity structure of issuance for the forthcoming financial year.

CBSL should introduce a formal consultation process to enable it to ascertain the views of market participants on strategic debt management policy issues.

A Consultative Committee on Government Bond Market Development should be set up, consisting of a wide range of market practitioners such as PDs, institutional investors, commercial and development bankers, market makers in corporate debt, the stock exchange, and regulators to arrive at a consensus on issues relating to market development.

At a later stage, when macroeconomic stability is attained, opening up the capital account of the balance of payment should be seriously considered. If there are reservations about completely opening the capital account, partial opening with due safeguards should be considered as far as the government securities market is concerned.

C. Financial Sector Reform

The mandatory requirement for employers to contribute to their workers' pensions and virtual monopoly status of the EPF have led to rapid growth in assets of state provident funds. The creation of private pension funds is not allowed, and existing pension schemes are limited to state-funded pensions for government sector employees and a few pension funds established by private banks.

The enormous size of the state provident funds has resulted in potential market distortion, as well as misallocation of resources when management of such funds is not driven by basic economic fundamentals.

Radical reform in these sectors would have a dramatic effect on the government bond market, and the following are suggested: (i) a Commission for Pension Funds to be established to issue licenses to new pension and provident funds and regulate their activities; (ii) the establishment of new pension and provident funds based on predetermined criteria to ensure prudential management and protection of members' interests; (iii) splitting the EPF into three subfunds (a government securities fund, a corporate fixed-income securities fund, and an equity fund) with different investment objectives, allowing members to move their balances among subfunds from time to time; (iv) the ETF to be dissolved, allowing members to transfer their balances to the three subfunds of the EPF; and (v) obtaining the services of several organizations providing professional portfolio management to manage the subfunds on a competitive basis along with in-house management.

It is proposed that the above recommendations be implemented over the medium term, with a target horizon of five to seven years.

D. Regulatory Framework

Regulations should be introduced for (i) securities lending, borrowing and short-selling transactions; (ii) defining legal rights of securities and entitlements with regard to the parties involved in repo transactions; and (iii) formulating, selling, trading, and settlement of derivative products.

E. Government Commitment

It is essential that that the Government is committed to developing an efficient market for its own securities, not only to reduce its borrowing costs, but also to develop accurate and reliable benchmark interest rates for pricing corporate securities. This also will enable the development of an efficient mechanism for CBSL to effectively conduct OMO to create monetary stability.

Commitment is required broadly in (i) facilitating the development of secondary market infrastructure and an efficient regulatory framework; (ii) strengthening intermediaries such as PDs, so that they can compete with the retail commercial bank network; and (iii) continued financial sector reforms aimed at broadening market participation and ensuring independent decision making, thereby removing market distortions due to captive sources.

The Government has already ensured that T-bills and T-bonds maintain tax neutrality compared with other instruments, so no other significant effort is required in the fiscal area.

Schemes to support PDs in setting up a retail network to effectively compete with commercial banks could involve the following.

Loan Scheme for Branch Expansion. Such a scheme, offered by CBSL, would enable PDs to obtain funding to meet 80 percent of the capital cost of opening branches across the island. The requirement to fund an additional 20 percent capital requirement would ensure that PDs carry out the planned expansion to recover their investment. Considering the narrow range of products that can be offered in the branches, and thin spread likely to generate in the business, it is essential that funding should not carry an interest cost of more than 6 percent during a minimum 12-month grace period for repayment.

Government Securities Windows. CBSL should build these in major cities, providing a central location for investors around the island to obtain necessary information on T-bills and T-bonds. CBSL should permit

any PD to maintain a desk at one of these windows, at an attractive monthly rental rate. The windows should be electronically linked to market information systems for government securities trading, while providing security and logistics on fund-clearing facilities in real time with PDs' Colombo offices. A similar model has been successfully implemented by the CSE to provide access to investors outside Colombo.

Provide Fiscal Incentives to Invest in Expanding the Retail Network. Further relief should be provided if the PDs engage in capital expenditure in expanding their retail network, by deducting 100 percent of the amount spent against the assessable income of the company over and above the general capital allowance available, depending on the nature of the assets. Expenditure qualifying for such relief should include office equipment, and initial costs of telephone connections and advertising.

Liquidity support by CBSL. One of the key factors determining the success of a market maker is ability to carry a reasonable size of inventory, with a range of issues and maturities in order to meet investor demand. If the cost of carrying the inventory of government securities is excessive, the size of the inventory will decrease, leading to lack of competition among PDs, and widening the spread offered in the market.

Under this scheme, the amount of funds available to each PD would be limited to 25 percent of the government securities it buys in the primary auction, irrespective of whether the securities are bought in its books or not. However, to discourage PDs from obtaining this funding and financing their inventory up to the maturity, thereby earning the spread arising from subsidized funding, the funding should be short-term only, and related to the maturity of the securities bought in the primary market. For example, 25 percent of the funds obtained should be paid within a twentieth of the maturity period of the security, another 25 percent before the second twentieth of the maturity period, and the balance within the fourth twentieth.

This type of arrangement will ensure that the amount of finance available depends on a PD's level of activities in the market and the timing of repayment—linked to the maturity of the securities bought—and will encourage them into higher turnover of the inventory, while not discouraging them from focusing on shorter maturities. The concessionary interest rate should be varied by CBSL, taking into account prevailing market conditions.

The Government should also fund and carry out market awareness campaigns to promote retail investments, and avoid the use of captive sources for funding the budget deficit. Government-controlled institu-

tions should be allowed to compete on an equal footing to earn market-related returns.

F. Primary Market Structure

Presently, SPD Department of CBSL plays an active role in facilitating the development of the government securities market and regulating the intermediaries and market operations, apart from acting as banker to the Government. However, there are situations where measures useful for reducing the cost of borrowing to the Government may not necessarily be consistent with policy objectives targeting bond market development.

Therefore, it is recommended that an independent unit be established for the role of market development and regulation of the government bond market separate from the SPD Department. This unit may be called the Government Bond Market Unit (GBMU), staffed by CBSL employees, and headed by an officer who is at least equal in hierarchy to the SPD, and responsible to the Governor. At a later stage, if necessary, the Unit can be totally separated from CBSL.

CBSL's OMO should be strengthened by getting actively involved in secondary market and repo activities with PDs.

Issue Base. The liquidity of government securities in the secondary market is critically important to derive an accurate and reliable benchmark yield curve. This requires the provision of an adequate volume of securities at appropriately spaced benchmark maturities along the entire yield curve, i.e. at one, two, three, four, and five years, to create an active secondary market for government securities. However, the lack of a sufficient number of issues and the relatively small issue size make it difficult for market participants to actively engage in secondary market trading. The maturities should be reasonably spaced to avoid uncertainty of the yields during intermediate maturities, but reducing the space between maturities should not be done if this means reducing the volume of securities available at each maturity.

The Government should further increase the size of issues, even in distanced maturities, by re-opening the benchmark lines, particularly issues with lower volume. Further, reissues should not be limited to the same year of initial issue, but be able to be reopened after several years to enhance liquidity compared with the volume available in other issues. Accordingly, if the issue maturities are appropriately planned over time, the recent maturities can only come from reopening previous issues in the primary market, and CBSL will be able to concentrate on new issues of only distanced maturities.

Frequency of T-bond issues with distanced maturities should be increased so that varying levels of maturities are available to meet investor needs at any time. One way to increase the amount of T-bonds outstanding is by gradually converting rupee loan maturities to T-bonds.

Also, the coupon on the T-bonds should be allowed to be stripped and traded separately, independent of the underlying security. Every T-bond issue includes coupons with the cash flow for every six months up to the maturity of the bonds. If such coupons can be detached from the bonds, it not only creates securities with several different maturities, but also creates zero coupon bonds, which do not carry any reinvestment risk. Stripping coupons is one means of eliminating anomalies and disparities in the yield curve by encouraging arbitrage activities. It further increases the attraction of government securities by targeting those investor segments generally averse to reinvestment risk.

Investor Base. The higher interest paid for T-bills compared to bank deposits indicates the lack of a broad investor base to create an efficient market for government securities. In addition, the dominance of the PF and NSB has created an anomaly in the market. Institutional investors with diverse investment needs in terms of investment horizon and transaction needs will eliminate these anomalies. Reforms in the pension and provident funds sector should thus aim to increase competition and provide wider choices to investors.

The Government should engage in increasing market awareness by promoting T-bills and T-bonds to individual investors outside Colombo, funding advertising campaigns, and carrying out promotional activities at village level.

Reforms in the pension and provident funds sector would allow the creation of private provident and pension funds. The services of several professional fund management companies should also be obtained to take charge of the investments of the EPF, NSB, and ETF, and increase the autonomy of in-house management in investment decision making.

Foreign investors should be allowed to invest in T-bills and T-bonds, and listed corporate debentures, if necessary with built-in safeguards.

Strengthening Intermediaries such as Primary Dealers. The basic foundation for any efficient financial market is competitive, professional, well-capitalized, and regulated intermediaries, capable of making active markets in designated securities. Therefore, it is important to create a level playing field for all operators The main recommendations are to (i) increase the number of nonbank PDs; (ii) broaden the share capital of PDs, particularly commercial bank PDs, in line with the Banking Act

provision to avoid any conflict of interest arising from their deposit-taking operations; (iii) allow PDs to carry out specified business activities relating to dealing in government securities, e.g., market-making in corporate debt, guaranteeing short-term papers, and fixed income portfolio management; (iv) the PDA to develop a Code of Conduct for market participants; (v) CBSL to provide assistance in creating a PD distribution network, with financing at a concessionary rate, as already described.

Unless systems are put in place to ensure that PDs meet expectations, it is unlikely the development target will be met. The proposed GBMU should be the ideal point from which to supervise the performance of PDs on a quarterly basis, based on the following targets: (i) participation at primary auctions, (ii) secondary market volumes, (iii) target level of securities inventory and its quality, (iv) turnover ratio on the inventory, and (v) growth targets on the volume of retail or individual investors.

The licenses of PDs should be reviewed annually, and six months' grace period given to achieve the desired level of performance to retain the license.

Transparent Trading Mechanism. The issues arising from the distortion with regard to yields quoted by PDs, lack of a liquid secondary market, difficulties in delivery of physical scripts, and absence of a market-monitoring mechanism, can be effectively resolved by developing a screen-based trading and settlement system as soon as possible. The trading mechanism should not restrict or discourage small investors located far from Colombo from trading in government securities. This can be achieved only by providing the flexibility, if investors wish it, to withdraw scripts of government securities from the electronic-based system for the purpose of OTC transaction through a dealer, by way of endorsement and delivery. Further, it is necessary to remove the present rule requiring PDs' certification of the genuineness of the endorser for transfer of government securities. This is cumbersome, and increasingly difficult, given the widen-ing of the retail base.

Dealing outside the system, but with strict reporting of the transaction, should be allowed, however, as most developed markets have seen rapid growth in the OTC market, exceeding the trading in the exchange, due to the greater flexibility at less cost.

Robust Clearing and Settlement System. The possibility should be explored of using the CDS of CSE for the development of the clearing and settlement function linked to the primary dealing and screen-based trading. If that is not feasible, the development of a dedicated clearing and settlement system should be expedited by contracting an external software developer.

Central Information System. The availability of a centralized information system to all market participants will ensure a level playing field, and an advance calendar for the issue of government securities should also be published a year ahead so that market participants can plan their investment strategies, along with frequent, extensive information with regard to auction cutoff rates, CBSL holdings, and secondary market statistics.

G. Supporting Market Infrastructure

Market Monitoring. The GBMU should be responsible for licensing intermediaries, monitoring the market for possible irregularities, ensuring PDs' performance and compliance with regulations, and providing the necessary leadership for initiatives on market development.

A Market Surveillance Division should be set up within the GBMU to monitor the secondary market activities and transactions of PDs and evaluate their compliance with regulations, any market behavior that may impact on the free and fair mechanism of the market, or actions that may violate the interests of the investing public.

Market Support. The bid and offer prices indicated by PDs to CBSL, which are then averaged for weekly publication, show significant disparities in terms of prevailing yields, particularly of distanced maturities. This is clear evidence of an inefficient secondary market mechanism, because PDs offers/bids are indicated to CBSL, but are not simultaneously available to other dealers or market participants.

The disparities can only be eliminated by introducing a transparent screen-based trading system, where the quotations of all securities traded are shown for all maturities, and matched to smooth the curve on the quoted yields. However, such developments are unlikely to be achieved quickly, so there should be an alternative mechanism to remove market disparities within the short term.

CBSL's OMO Unit should get involved actively in the secondary market activities of T-bonds for longer duration. One possibility is that CBSL's OMO Unit, independent of the GBMU or SPD, should be involved in the trading of any maturities of T-bills or T-bonds if the market provides suitable opportunities. This would require CBSL to build up an inventory of T-bonds, which it does not carry at present, to represent all possible maturity categories. A system should be devised for the OMO Unit to have easy access to PDs' quotations on a daily basis.

Risk Management and Hedging Opportunities. Regulations should be introduced to establish and operate a derivatives market by legalizing

the structure of contract, the role of exchange, and obligation of intermediaries, etc., and the exemption on capital gains on derivative contracts announced in the budget presented in November 1998 should be put into effect.

Accounting Standards. It should be made mandatory for all pension and provident funds, insurance companies, banks, merchant banks, and unit trusts to carry the investment in T-bills and T-bonds at the prevailing market value by marking-to-market, thereby requiring them to charge the resulting gain or loss in the income statement of the relevant year. This will encourage the institutional investors to monitor market trends and actively trade on T-bills and T-bonds with a view to exploiting opportunities and avoiding possible market losses.

Integrated Government Bond Management Program. The proposed strategies for development of the government securities market require the effective coordination of the Government, CBSL, multilateral agencies, private sector market intermediaries, and other participants. The different strategies proposed are very closely interrelated, and the whole development program should be planned and managed as one process. The proposed GBMU of CBSL needs to play an active role in providing leadership to the market development program in consultation with the CCGBMD. A specialist in bond market development should be appointed as a consultant to the GBMU.

The Integrated Government Bond Management Program has been broadly identified in terms of three time frames of short-, medium- and long-term targets, and summarized as follows.

TABLE 12
Three Phases of Integrated Government Bond Management Program

	Strategy	Deliverables
	Short-Term Target — 1–2 years	
A-1	Set up a “Consultative Committee on Government Bond Market	Draft the terms of reference and appoint members
A-2	Set up an independent Government Bond Market Unit at Central Bank	Issue circular formalizing the unit and appointing head of the unit
A-3	Open Market Operation Unit to commence trading on Government bonds on distance maturities	Issue guidelines to OMO unit and build up an inventory of government bonds
A-4	Publish Annual Debt Issuance Program	Publication of the program
A-5	Development of screen-based trading and settlement system	Issue scriptless securities and commence trading

A-6	Announce fiscal incentives for expanding retail network for PDs	Inland Revenue Amendment Act
A-7	Provide liquidity support to PDs	Set up a fund for liquidity support and formalize the rules
A-8	Launch a market awareness campaign for government securities	Award campaign implementation to advertising agency
A-9	Increase the frequency of treasury bonds on distance maturities	New treasury bond issues
A-10	Reopen treasury bond issues to build up volume of existing securities and increase jumbo issues	Reissue existing bond lines
A-11	Obtain the services of more than four portfolio managers for the management of EPF, NSB, and ETF	Enter into portfolio management agreements
A-12	Introduce regulations on repo transactions	Issue rules regarding repo transactions
A-13	Increase non-bank primary dealers	Issue license to non-bank PDs
	Medium-Term Target — 2–4 years	
B-1	Implement pension and provident fund reforms	Set up Pension Commission, license first provident/pension fund and split the EPF into three subfunds
B-2	Convert all outstanding rupee loans to treasury bonds	Stop issuing rupee loans and settle all outstanding rupee loans at maturity
B-3	Introduce regulations on securities lending and short-selling transactions	Obtain Parliamentary approval for Securities Lending and Short-Selling Act
B-4	Introduce loan scheme for branch expansion by PDs	Issue rules and guidelines of the loan scheme
B-5	Set up government securities windows	Commence the operation of first government securities windows
B-6	Allow coupon on treasury bonds to be detached	Amend the relevant rules
B-7	Allow PDs to engage in other related activities	Amend the rules on PDs
B-8	Introduce a page on Internet to publish weekly data on money market and secondary market activities on government securities	Open the web page
	Long-Term Target — 4–8 years	
C-1	Introduce and establish derivative markets	
C-2	Open up capital account, thereby permitting government securities market to foreign Investors	Amend Foreign Exchange Act
C-3	Broadbase the share capital of PDs	List PDs

Appendix 1

Limit for the Issue of Treasury Bills Approved by Parliament
(SLRs million)

Date	Change	Limit
29 Jul 1941	10	10
01 Jun 1948	15	25
15 Jul 1949	25	50
28 Jul 1950	50	100
26 Feb 1953	100	200
23 Apr 1959	150	350
29 Oct 1959	100	450
23 Aug 1960	200	650
08 Jun 1961	100	750
14 Dec 1961	250	1,000
21 Mar 1963	150	1,150
01 Oct 1963	100	1,250
22 Aug 1964	250	1,500
27 Jan 1968	250	1,750
18 Aug 1969	200	1,950
25 Sep 1970	100	2,050
21 Jul 1972	500	2,550
26 Nov 1976	450	3,000
06 Mar 1980	1,000	4,000
10 Jul 1980	2,000	6,000
17 Oct 1980	2,000	8,000
01 Dec 1980	2,000	10,000
08 Jul 1981	3,000	13,000
24 Nov 1981	5,000	18,000
02 Nov 1982	5,000	23,000
10 Nov 1985	2,000	25,000
13 Nov 1986	10,000	35,000
11 Aug 1988	5,000	40,000
28 Oct 1988	5,000	45,000
07 Dec 1988	10,000	55,000
11 Apr 1989	10,000	65,000
29 Oct 1990	25,000	90,000
16 Dec 1992	35,000	125,000
05 Nov 1997	−10,000	115,000
1999 to date		125,000

Source: Central Bank of Sri Lanka. 1998. *Economic Progress of Independent Sri Lanka*. Box 4.6.2, p. 232.

Appendix 2

TABLE A2.1
Composition of Outstanding Government Debt
(SLRs billion)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Rupee Loans	54.2	54.7	66.8	69.2	105.7	137.5	157.9	205.9	239.5	250.6
Treasury Bills	57.2	67.9	73.0	87.1	97.2	98.9	113.8	125.0	115.0	120.0
Treasury Bonds	–	–	–	–	–	–	–	–	10.0	48.9
Treasury CDs	–	0.1	0. 1	0.1	0.1	0.1	0.2	0 .2	0 .1	–
Tax Reserve Cert.	–									
National Defense Bonds	– 4.5	4.5	4.5	–						
Central Bank Advances	5.9	6.4	7.4	8.9	10.5	12.4	13,7	17.7	18.3	20.2
Other	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0 .1	0.1	6.9
Total	117.6	133.8	152.0	170.0	213.7	249.1	285.8	349.0	382.9	446.6

Source: Central Bank of Sri Lanka *Annual Report 1998*.

TABLE A2.2
Treasury Bills Outstanding
(as at end October 1999)

Period	Amount (SLRs million)	Percent
91 days	17,612	14.09
182 days	17,390	13.91
364 days	66,306	53.05
others	23,668	18.95
Total	**124,996**	**100.00**

Source: Central Bank of Sri Lanka.

TABLE A2.3
Treasury Bonds Outstanding
(as at end October 1999)

Year	Amount (SLRs million)
2	34,465
3	35,778
4	23,150
5	5,300
6	1,000
Total	**99,693**

Source: Central Bank of Sri Lanka.

Appendix 3

Primary Dealers of Government Securities

Ceybank Securities (Pvt) Ltd. 7th Floor, Bank of Ceylon Head Office Bank of Ceylon Mawatha Colombo 1	Subsidiary of Bank of Ceylon
Commercial Bank Primary Dealer Ltd. 21 Bristol Street Colombo 1	Subsidiary of Commercial Bank of Ceylon
HNB Securities (Pvt) Ltd. 21 Janadhipathi Mawatha Colombo 1	Subsidiary of Hatton National Bank
MB Financial Services Ltd. 28-12/1 St Michael Road Colombo 3	
NSB Fund Management Co., Ltd. 225 Galle Road Colombo 3	Subsidiary of National Savings Bank
People's Securities Ltd. 38 D R Wijewardena Mawatha Colombo 10	Subsidiary of People's Bank
Sampath Surakum Ltd. 110 Sir James Peiris Mawatha Colombo 2	Subsidiary of Sampath Bank Ltd.
Seylan Bank Asset Management Ltd. Level 3, Ceylinco Seylan Tower Galle Road Colombo 3	Subsidiary of Seylan Bank Ltd.
Vanik Securities Ltd. Seva Mandiraya 46/38 3rd Floor Navam Mawatha Colombo 2	Subsidiary of Vanik Inc. Ltd.

Appendix 4

National Housing Development Authority Debentures as at 9 February 2000

Ser No.	Debenture Certificate	Date Issued	Name of Holder	Program	Interest Rate (percent)	Period	Date of Redemption
01	001	10 Nov 88	Mr. P P Edward	Manning Town	14	5 yrs	09 Nov 93
02	002	30 Nov 88	Employees Trust	Manning Town	14	5 yrs	29 Nov 93
03	003	29 Dec 88	Employees Trust	Manning Town	14	5 yrs	28 Dec 93
04	004	16 Jan 89	Employees Trust	Manning Town	14	5 yrs	15 Jan 94
05	005	20 Jan 89	Employees Trust	Manning Town	14	5 yrs	19 Jan 94
06	006	30 Mar 89	Employees Trust	Manning Town	14	5 yrs	29 Mar 94
07	007	06 Oct 89	National Savings	R D F C Loan	15	6 yrs	05 Oct 95
08	008	23 May 91	Employees Trust	5000 Houses	18	1 yr	23 May 92
09	009	23 Jun 91	Employees Trust	5000 Houses	16	2 yrs	22 Apr 93
10	010	24 Jun 91	Employees Trust	5000 Houses	15	6 yrs	22 Apr 97
11	011	14 Nov 91	Employees Trust	F T Z Houses	5	6 yrs	14 Nov 97
12	012	26 Dec 91	Employees Trust	F T Z Houses	5	6 yrs	26 Dec 97
13	013	15 May 92	Employees Trust	5000 Houses	18	1 yr	22 Apr 93
14	014	21 May 92	Employees Trust	5000 Houses	18	1 yr	22 Apr 93
15	015	10 Dec 92	Employees Trust	F T Z Housing	5	6 yrs	09 Dec 98
16	016	29 Dec 92	Employees Trust	F T Z Housing	5	6 yrs	28 Dec 98
17	017	16 Mar 93	Employees Trust	Wanni Dist	16.5	7 yrs	28 Dec 00
18	018	10 Aug 93	Employees Trust	F T Z Housing	5	6 yrs	09 Aug 99
19	019	23 Sep 93	Employees Trust	F T Z Housing	5	6 yrs	22 Sep 99
20	020	16 Dec 93	Employees Trust	F T Z Housing	5	6 yrs	15 Dec 99

Appendix 5

Colombo Stock Exchange (CSE)

Corporate Debt Listing Rules

A. New Companies Seeking Listings by Obtaining a Quotation only for their Debt Securities

In recent times the amount of funds raised from debt offerings has exceeded the amount of funds raised from equity offerings. To give an impetus for further development of the listed debt securities market, new rules have been made to make it possible for companies to seek listings by obtaining a quotation only for their debt securities without the need to have their equity quoted. (Hitherto a company that wanted to have its debt quoted on the Colombo Stock Exchange was required to obtain a quotation for their equity in the first instance.)

A company seeking a listing by obtaining a quotation for a debt security may do so by choosing one of several options available to such a company. The options available have been included in a new listing rule which will be numbered as 1.1-7, quoted below.

Debt Securities

A company applying for a quotation of debt may, as a general rule, be considered for admission to the official list (Debt Securities Board) if the debt securities comply with the following:

1. Have a guarantee (from a bank licensed by the Central Bank of Sri Lanka or a multilateral lending agency acceptable to the CSE) for the repayment of capital and interest.

or

2. Be secured against collateral. For the purpose of this rule "collateral" shall mean land and building or security acceptable for purposes of asset securitization.

or

3. Have obtained for the security a rating acceptable to the Exchange from a rating agency registered with the SEC.

or

4. The securities are issued by companies which conform to the following.
   a. Have a debt/shareholders funds ratio of at most 2:1 following the issue of debt securities for which a quotation is sought. For the purpose of calculating the debt/shareholders funds ratio as required by this rule, debt includes all forms of borrowing and bank overdrafts but excludes trade creditors

and

b. Have at least a 7.5 percent return on investment (shareholders funds) on an average in the three immediately preceding years

and

c. Which will create a reserve fund for the redemption of the debt securities. Appropriation of profits should be made to the reserve fund in equal annual installments during the tenure of the debenture so that on the date of maturity of the debenture the total amount required for repayment of capital would have been appropriated. The reserve fund need not be a sinking fund. Following the redemption of debentures the reserve fund may be extinguished.

and

5. A minimum of 50 percent of the debt securities for which a quotation is sought is in the hands of the public following a public offering of securities. Underwriting of the public offering is mandatory. The minimum size of the public offering is SLRs50 million.

   In complying with this requirement the following are to be excluded.

   a. Holdings by parent, subsidiary, or associate companies.
   b. Holdings by group companies (subsidiaries or associates of the parent company).
   c. Holdings by directors, members of their families (spouses and children under 18 years of age), and/or their nominees.
   d. Holdings by a company in which a director has a controlling interest. A controlling interest prevails where the director owns at least 51 percent of the equity of the company or can control the composition of the Board of Directors of such company.

B. Granting Quotations for Debt Securities of Existing Listed Companies

Hitherto there have been no rules governing the issue of debt securities by companies which are already listed in the Colombo Stock Exchange. With the number of debt offerings increasing, it has been thought necessary to regulate the issuance of debt securities even when the issuer is an existing listed company.

The rules applicable to existing listed companies are very similar to the rules applicable for new listings but with one exception. The debt/equity ratio is not a requirement which has to be adhered to by a company which chooses the last option. Such a company will however have to meet the other two criteria namely, average return on investment should exceed 7.5 percent over a three year period and the need for a creation of a redemption fund.

The text of the relevant rule which will be numbered as 4.8 (the existing rule 4.8 will be renumbered as 4.9) is as follows.

An existing listed company may seek a quotation for debt securities if such securities conform with the following.

1. Have a guarantee from a bank licensed by the Central Bank of Sri Lanka or a multilateral lending agency acceptable to the CSE for the repayment of capital and interest.

or

2. Be secured against collateral. For the purpose of this rule "collateral" shall mean land and building or security acceptable for purposes of asset securitization.

   or

3. Have obtained for the security a rating acceptable to the Exchange from a rating agency registered with the SEC.

   or

4. Securities issued by companies which conform to the following.
   a. Have at least a 7.5 percent return on investment (shareholders funds) on an average in the three immediately preceding years

      and

   b. Which will create a reserve fund for the redemption of the debt securities. Appropriation of profits should be made to the reserve fund in equal annual installments during the tenure of the debenture so that on the date of maturity of the debenture the total amount required for repayment of capital would have been appropriated. The reserve fund need not be a sinking fund. Following the redemption of debentures the reserve fund may be extinguished.

      and

5. A minimum of 50 percent of the debt securities for which a quotation is sought is in the hands of the public following a public offering of securities. The minimum size of the public offering is SLRs50 million.
   In complying with this requirement the following are to be excluded.
   a. Holdings by parent, subsidiary, or associate companies.
   b. Holdings by group companies (subsidiaries or associates of the parent company).
   c. Holdings by directors, members of their families (spouses and children under 18 years of age), and/or their nominees.
   d. Holdings by a company in which a director has a controlling interest. A controlling interest prevails where the Director owns at least 51 percent of the equity of the company or can control the composition of the Board of Directors of such company.

C. Continuing Listing Requirements

Companies that have obtained a quotation for debt securities are required to circulate to all holders of debt securities a profit and loss account and a balance sheet within two months of the end of each half year (financial year).

There are also ratios which have to be calculated and disclosed in such half yearly accounts. The text of the relevant rule which has been numbered as rule 3.1.17 is as follows.

Companies listed on the debt securities board and companies that have obtained quotations for debt securities shall make available to the Exchange and to all holders of debt securities a profit and loss account and balance sheet before the expiry of two months from the end of each half year. If a company circulates to the Exchange and to all holders of debt securities the audited

accounts before the expiry of three months from the end of the financial year it will be exempted from circulating the accounts for the second half year.

Half-yearly accounts should be similar in format to the audited accounts. Detailed notes as given in the audited accounts are not deemed necessary. However, the following minimum requirements, explanatory notes and ratios should be adhered to and included in the case of half yearly accounts.

Minimum Requirements

A balance sheet and a profit and loss account. The profit and loss account should be prepared on a cumulative basis for the second half year.

Figures for the previous corresponding period for comparison.

Where the company is a holding/parent company, disclosure of results separately for the holding/parent company and of the group as a whole.

An additional column to be included in the profit and loss account indicating the variance, calculated against the results of the previous comparative period.

Explanatory Notes

A statement that the same accounting policies and methods of computation are followed in the half-yearly accounts as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature of the change and the effect of the change.

Material events subsequent to the half year period that have not been reflected in the accounts for the half year.

The effect of changes in the composition of the assets and liabilities of the enterprise during the half year period, including business combinations, acquisition or disposal of subsidiaries and long-term investments, restructuring and discontinuing operations, changes in contingent liabilities of a material nature since the last annual audited balance sheet date.

Liability for management fees or any other similar expenditure not provided for in the half yearly accounts.

Any material change in the use of funds raised through an IPO/Rights/Debt Issue.

Ratios

The following ratios should be included in the half-yearly accounts.

	Current Period	Previous Comparative Period
Interest rate of comparable Government security	X	X
Debt/equity ratio	X	X
Interest cover	X	X
Quick asset ratio	X	X
The market prices during the year/half year (ex interest)		
Highest price	X	X
Lowest price	X	X
Last traded price (as at dd/mm/yy)	X	X
Interest yield as at date of last Trade (dd/mm/yy)	X	X
Yield to maturity of trade done on (dd/mm/yy)	X	X

In deciding how to recognize, measure, classify, or disclose an item in the half-yearly accounts, materiality should be assessed in relation to the half-yearly financial data. In making assessments of materiality, it should be recognized that half-yearly measurements may rely on estimates to a greater extent than measurements of annual financial data.

Twenty-five copies of the half-yearly accounts should be made available to the CSE at the same time that the accounts are circulated or published.

Appendix 6

BS/21/93 05.06.1995

Central Bank of Sri Lanka
Bank Supervision Department

Guidelines to Licensed Commercial Banks in Sri Lanka on the Grant of Facilities for the Issue of Commercial Paper

All licensed commercial banks are hereby required to observe the following guidelines when they support the issue of Commercial Paper by their Corporate customers by acting as issuing/paying agents, dealers, by authenticating signatures of the issuers, in the provision of accommodation, by endorsing or guaranteeing and by investing or underwriting.

The Commercial Paper shall be in the form of an usance promissory note negotiable by delivery or endorsement and delivery complying with the Bills of Exchange Ordinance.

(1) Eligibility Criteria - Banks shall, in supporting the issue of Commercial Paper referred to above, do so only for companies that meet with the following criteria:

- 1.1. They should be listed on the Colombo Stock Exchange.
- 1.2. They should have a tangible net worth of not less than SLRs100 million as per the audited balance sheet for the financial year immediately preceding the proposed date of issue of Commercial Paper.
- 1.3. They should be institutions that are not permitted to accept public deposits.
- 1.4. All existing credit facilities enjoyed by the issuing company with any banking institution in the country should be "current" in terms of the Central Bank's Guidelines on Non-Performing Advances dated 13th February 1991.
- 1.5. They should possess a standby credit line to the full face value of the issue which should be specifically reserved for the purposes of redemption of Commercial Paper under the issue.

Licensed commercial banks should also ensure that:

(2) Maximum and minimum period of Commercial Paper

- 2.1. No Commercial Paper shall be issued for a period less than three months or more than six months from the date of issue.

(3) Minimum amount of Commercial Paper to be issued

- 3.1. Every issue of Commercial Paper to be issued shall not be less than SLRs25 million.

(4) Denomination and Size of Commercial Paper

- 4.1. Commercial Paper may be issued in multiples of SLRs100,000.
- 4.2. The minimum amount invested by a single investor shall not be less than SLRs100,000.

(5) Procedure - Supporting the issue of Commercial Paper by licensed commercial banks does not require the prior approval of the Central Bank of Sri Lanka. However, in supporting the issue of Commercial Paper, licensed commercial banks shall ensure that:

5.1. The Company issuing Commercial Paper submits an application in respect of each issue containing comprehensive disclosure including company profiles and financial data, value of Commercial Paper already issued and outstanding to the commercial bank supporting the issue. The licensed commercial bank should also ensure that these information is made available to investors upon request.

5.2. Security printing features are embodied and that Commercial Paper is printed on good quality security paper and necessary precautions have been taken to guard against tampering with the document.

5.3. Commercial Paper is raised within a period of 14 calendar days from the date of issue. Commercial Paper under each issue should have the same maturity date. Any unsold portion of the issue after the 14th day cannot be issued.

5.4. No grace period shall be given to the issuer for meeting the obligations in arriving at the due date of the Commercial Paper.

5.5. The Commercial Paper contains the following minimum information/ features:

a) The word "Commercial Paper" should be clearly printed on it;
b) Name of the issuing company;
c) Serial number;
d) Place of issue;
e) Date of issue;
f) Amount (in words and figures);
g) Date of maturity;
h) Name of the issuing and paying agent;
i) Signatures of authorized signatories of the issuing company; and
j) Signatures of the issuer authenticated by the issuing/paying agent.

5.6. a) Counterfoil of Commercial Paper contains the information at 5.5 other than (i) and (j).

b) Adequate space is provided for endorsement on reverse of Commercial Paper.

5.7. a) The licensed commercial bank's engagements relating to Commercial Paper are appropriately recorded in the monthly assets and liabilities statements furnished to the Central Bank of Sri Lanka.

b) The Bank Supervision Department of the Central Bank of Sri Lanka is informed all details pertaining to the issue of Commercial Paper including the name of the company, its tangible net worth, the amount and tenure of the issue, outstanding amounts of Commercial Paper already issued, Commercial Paper not subscribed and the nature of the bank's support etc. within two weeks from the date of closing subscriptions.

5.8. Endorsement of Commercial Paper by commercial banks should be reported as an off balance sheet item.

5.9. The licensed commercial banks supporting the issue of Commercial Paper are required to conform with other applicable legal requirements.

(6) Prudential requirements of the Central Bank

6.1. All credit facilities extended and commitments made by licensed commercial banks relating to the issue of Commercial Paper will be treated as accommodation granted to the issuing company and shall be subject to directions issued from time to time under the Banking Act and to all prudential guidelines issued by the Department of Bank Supervision. However, when the licensed commercial banks lends its name to the issue of Commercial Paper "without recourse"' it is obligatory on the part of the licensed commercial bank in such an event to make it known to the public of its "without recourse" status.

6.2. Premature withdrawal of credit facilities, if any, referred to at 6.1 should be reported immediately to the Bank Supervision Department of Central Bank of Sri Lanka.

(7) "Tangible Net worth" is defined as "the paid-up capital plus free reserves (including balance in share premium account, capital and debenture redemption reserves and any other reserve not being one created for repayment of any future liability or for depreciation in assets or for bad debts or a reserve created by revaluation of assets) less accumulated balance of loss, balance of deferred revenue expenditure, as also other intangible assets."