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SRI LANKA: SURVEY OF CAPITAL MARKETS-REVISED 1990

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INTRODUCTION

This is an updated review of the capital markets of Sri Lanka which is being submitted to the Securities Council, the Government of Sri Lanka (GSL), and has been prepared under the auspices of the Agency for International Development, Department of State, U.S. Government. This survey is based upon an earlier review of capital markets in Sri Lanka dated August 26, 1988, prepared by the International Science and Technology Institute, Washington, DC, led by Leigh M. Miller, Director, ISTI.

The Securities Council and the Colombo Securities Exchange can play a crucial role in mobilizing more investment in commercial enterprises, increasing economic benefits to Sri Lanka and creating more employment. In order to develop the market for securities on the Colombo Securities Exchange (CSE), it is necessary to review the entire capital market (debt and equity; short- and long-term) of Sri Lanka because the sale of shares on the Exchange is a part of the entire process of mobilization of capital in the country. Increased sales of equity shares on the Colombo Stock Exchange mean that more private funds are being used to finance the development of the productive capacity of Sri Lankan industry. Increased share transactions on the CSE also will help increase funds available for private investment in the equity of unlisted companies because of better anticipated returns, as a result of a more developed equity market overall. Thus, overall more funds -- both domestic and foreign --are mobilized for the development and expansion of Sri Lankan industry and commerce with the resulting increase in jobs, production and economic activity.

The report therefore focuses upon the restraints against effective mobilization of private savings for investment purposes in the private sector of Sri Lanka. In identifying and reviewing these constraints upon private investment, the report does not attempt to identify or review completely the competing or conflicting policy considerations. The Government of Sri Lanka and its people must strike an appropriate balance to achieve the optimum policy mix.

This report is based on updated review of capital markets in Sri Lanka in February, 1990. ISTI wishes to express its appreciation for the great assistance and cooperation shown by the Chairman, L. Stanley Jayawardena, the members of the Securities Council, the Colombo Securities Exchange, the many departments, units and individuals in the Government of Sri Lanka and the private sector who gave unstintingly of their time and advice, and were extremely helpful in the preparation of the original report and this update.

EXECUTIVE SUMMARY

I. The Sri Lankan Financial Markets

A. Relationship between Financial Markets and the Economy

1. Open Private Capital Markets

Open private capital markets create more economic growth and greater employment: Open markets not only allow an efficient allocation of resources through pricing, and a decentralized decision making mechanism which avoids the inefficiencies of overly centralized command decisions, but also are the only effective way to integrate a country's economy with that of the rest of the world.

2. Economic Reforms

Since 1977, the Government of Sri Lanka (GSL) has initiated a number of major reforms which have liberalized the economy and opened it to market forces. These changes have reduced government control in a number of sectors, encouraged foreign investment, fostered development in the private sector, and enhanced the free flow of capital.

These departures from previous practice have been particularly important with respect to trade: tariff reductions, custom duty rebates and exemptions, tax holidays and free trade zones have increased the investment flow to these private activities. A more open and flexible foreign exchange regime has assisted export growth and has enabled some foreign investment to come in. There is still room for improvement in the free flow of trade and related investment and foreign exchange, but much has been accomplished.

Recent monetary and fiscal policies have also contributed to more efficient capital markets. High nominal interest rates have fostered savings while dampening inflation even through some difficult periods, such as the present period of inflation and credit restriction. The growth of leasing and finance companies has assisted in this mobilization of funds, although instability in the marketplace has resulted from liquidity problems and/or financial difficulties encountered by a number of finance companies. The public auction of T-Bills has improved the capital markets' efficiency, because more participants in the market are possible, the pricing has a somewhat greater responsiveness to market forces, and such action can lead to even greater market freedom. Nevertheless, the market is still thin, prices are still significantly administered, and further progress in opening up the fixed income markets is needed.

Further corrections would lead to increased capital flows; for example, more deregulation will lead to increased investment flows to those industries which are deregulated; the public sector still includes many companies that should be in the private sector. Although sale of public companies to the private sector has begun, notably with United Motors and a textile plant, further sales by the government would assist capital flows to companies which are now in the public sector and reduce the drain on the overall government budget.

In the financial sector, government owned banks and government-dominated capital pools divert the free flow of private funds away from more efficient and profitable investments in the private sector. The GSL still maintains a guidance role in many sectors of the economy and government direction can divert capital to favored sectors and inhibit the free flow of private funds in the capital markets.

1988 and 1989 were difficult years for the Sri Lankan economy because of political turmoil and related government expenditures, inflation, poor weather, loss of agricultural output and transportation disruptions; 1990 should be better. The current government deficit has meant that considerable private savings were used to finance that gap, and private equity investment was once more crowded out. Inflation has continued high, although a contraction in credit and money supply growth has been necessary and appears to be moderating price rises, but potential private investment has again been squeezed through high, short-term government interest rates and persuasion of government owned institutions to maintain investments in government securities.

The payment of high nominal interest rates by the National Savings Bank (NSB) along with funds obtained by the Employees' Provident Fund and the Employees' Trust Fund, (which have large aggregations of capital and place most of their assets in GSL securities) which are channelled to the GSL, plus the sale of high rate Treasury Bills, and foreign aid enables the GSL to finance its deficit with only a small amount of bank borrowing.

While the high nominal interest rate policy has been effective from a funds mobilization policy point of view, such a policy discourages private investment because it is difficult to obtain higher returns from investments in the private sector. It also has, for a long time, discouraged long-term lending and borrowing because few borrowers are willing to pay such rates except for a short period. Therefore, the only long-term funds effectively available (other than those in certain GSL refinancing programs)are equity funds.

However, despite the above constraints upon the free funds flow in the capital market, it is generally agreed that investment funds remain available for good private investment projects. If constraints and impediments are removed, reasonable incentives given, and project development assisted, the amount of private funds for equity investment can be increased dramatically. At the same time, an educational effort can publicize the economic gains which accrue to the whole country. Development of the capital markets in Sri Lanka in the future should allow greater efficiency, lower capital costs and assist in the development of the entire economy through greater productivity, more jobs and larger exports.

Further reforms are needed in the following areas to achieve more effective capital markets:

- Public sector economic activity should be rationalized and reduced, and more public enterprises must be transferred to private owners;

- Financial markets for both debt and equity, and short-term as well as long-term, must be made more efficient, competitive and responsive to the needs of the Sri Lanka marketplace;

- Foreign investment should be given national treatment, i.e., restrictions solely applicable to foreigners should be removed so that foreign capital, technology and management techniques can contribute to the expansion of the Sri Lankan economy.

- Private institutions must exercise leadership in starting and expanding businesses to meet the needs of the public.

B. Financial Institutions

Sri Lanka has a relatively small number of straight-forward financial institutions which comprise the capital market of the country. The Central Bank is the major governmental agency directly affecting the capital market.

Commercial banking is dominated by The Bank of Ceylon (which had 35.1 percent of the deposit market at EOY 1988) and The People's Bank, both government owned. The remaining banks, (four private domestic banks and 19 foreign bank branches) perform a wide variety of banking functions with each bank serving one or more niches in the marketplace.

The development of finance companies has been a relatively recent phenomenon and was in response to the gaps left by the commercial banks in their lending practices. Although the problems of a number of finance companies have given concern, the safe and sound finance companies appear to have successfully served some segments of the borrowing public. In addition, leasing companies now finance an estimated 6 percent of total equipment purchases, although efforts should be made to make certain that inappropriate constraints are not placed upon leasing companies compared to other financial institutions.

The Colombo Securities Exchange (CSE), with nine operating brokerage firms, is a growing segment of the Sri Lankan capital markets; in 1987 the value of shares issued increased by 50 percent over 1986. The CSE is smaller than stock exchange in other Asian countries, but its market capitalization in relationship to GDP is larger than exchanges in Pakistan and Malaysia.

Certain specialized institutions play an increasingly important capital market role: the National Development Bank (NDB), the Development Finance Corporation of Ceylon (DFCC), the Capital Development and Investment Company Limited (CDIC), and the Merchant Bank of Sri Lanka (MBSL) are the most important quasi-governmental institutions making equity investments, and they need to expand their roles in the private sector.

Other major aggregations of savings and important investors in the Sri Lankan capital markets are: the National Savings Bank, (Savings Deposits EOY 1988: Rs. 6.3 billion), the Employees' Provident Funds, and the Employees' Trust Fund. Four insurance companies also have sufficient availabilities of funds to make significant investments.

C. Current Financial Marketplace

The current financial marketplace is characterized by high nominal rates of interest, credit restrictions to reduce inflation, a little new private equity funding, large GSL deficits, even though declining, which will continue to require sizeable funding from the private sector, and a recent decline in the rate of increase in the money supply.

II. The Securities Markets & Private Investment: Description and Constraints

A. Private Investment Mobilization

Sri Lanka has many advantages for mobilization of private resources: a propensity to save; an acceptance by the general public of the concept of investment in financial institutions resulting from the widespread practice of deposits in savings accounts; a high degree of literacy; and a liquid market. However, there are constraints: further action is needed to overcome past inhibitions towards equity investment and government crowding out of private sector funding; lack of sufficient investment opportunities; unwillingness of entrepreneurs to accept or seek outside investors; aversion to public disclosure of financial affairs; and unsettled economic and political conditions leading to investor preference for short-term, liquid investments.

In the past, a low priority for private investment has largely resulted from the crowding out of private investment by channeling savings into GSL securities and the maintenance of public sector enterprises to the exclusion of the private sector. Recently, changes have resulted from revised and proposed steps which should encourage more private investment, although more remains to be done.

B. Role of Government in Encouraging Private Investment

In order to broaden the long-term funds market, the GSL should foster medium and long-term debt issues as soon as market conditions allow, and they should be traded on the CSE.
At the same time, the GSL should encourage the NSB and other government owned institutions to invest more widely in nongovernment securities. Further training of portfolio management for those in charge of investments for such institutions would assist both the institutions involved and the overall capital market.

Government Divestment

The GSL's ownership of a significant amount of industrial production in Sri Lanka creates distortions and balloons the government budget. Many such industries are inefficient, not held to high standards of performance, are often capitalized extremely thinly, and cannot expand because of other government priorities for funds.

The GSL has announced a plan for divestment of a significant portion of such public enterprises. Such sales will provide a major increase in the shares traded on the CSE. Early implementation of peopleisation is extremely important for the Sri Lanka capital markets as well as making a contribution to the economic development of Sri Lanka.

The United Motors public sale was the first transfer. It was successfully underwritten, but the timing, structure and placement effort contributed to a lack of widespread distribution of the shares. This public transfer should be completed through restructuring and company leadership before any significant placement of other issues occurs again. In the future, a leading financial adviser who helps with careful advance structuring of the company, its finances and the placement, as well as a core group shareholder is desirable to achieve greater success.

Peopleisation can increase the number and amount of shares traded upon the CSE significantly. The GSL should continue to press ahead with this program, add more businesses to the list, restructure those businesses which need assistance prior to their sale, and also provide assistance to any personnel who might be laid off through privatization, and obtain further technical assistance where needed. Careful preparation will allow government owned businesses to sell a significant portion of their equity to employees or trade unions. An investor education program should be amplified; the program of readying target companies for sale should be speeded up; international investment bankers should be added to existing advice on public sale of government businesses on selected transactions; the list of businesses to be sold should be broadened to include banks and other businesses; a specific layoff and retraining program should be instituted.

C. Public Market for Securities

The public market for share ownership has many advantages: the size is increasing, criticism is muted, brokers have had experience, and the legal structure is in place. There are,however, significant constraints on share ownership and transfer,inadequate clearing systems for stock trades, lack of public information, and a somewhat cloudy political and economic future.

1. Types of Securities

In today's economic climate, the GSL and Securities Council should encourage new approaches to the provision of long-term capital to private businesses. The proposed education program should be undertaken, particularly in conjunction with peopleisation. Listing standards on the CSE should encourage and reward actively traded corporations. Mortgage backed securities for residential housing should be investigated.

2. Unit Trusts

Another innovative approach that should be tried is the unit trust. Open-ended trusts with a balanced and prudent investment portfolio holding both GSL securities and equities could provide income and capital gain to their shareholders. Such investment vehicles would greatly broaden the capital market in Sri Lanka and, if properly distributed, could mobilize funds throughout the country. Because of the widespread ownership potential for unit trusts, careful requirements for sponsorship, administration and portfolio management should be established by the Securities Council as planned, but it is not necessary to limit the number of qualified unit trusts because competition will help performance.

Competition between unit trusts is important in order to achieve good performance by unit trust managers (the best performance will ordinarily get more new shareholders). The Securities Council has indicated that the criterion for authorizing new unit trusts will be: portfolio management

competence, safety for shareholders and capability of performance by sponsors. Unit trusts and their sponsors which meet this criteria would be allowed; those who do not, will not be authorized. The size of the unit trusts has been under consideration. The ADB's study indicates that the optimum size should be quite large for the Sri Lankan market. However, the minimum size for a unit trust is generally determined by several factors: the fees generated by the unit trust for establishment, distribution and management, and the provision of sufficient liquidity reserve to allow safe and prudent administration. So long as these two factors are met by the sponsors and management company, the size should not be a determining factor as to authorization.

D. Incentives and Disincentives

Broadening of public ownership is the best way to improve the capital market for long-term funds.

1. Taxes

The tax policy of the GSL plays an extremely important role in investment decisions in Sri Lanka. A number of taxes should be reduced or eliminated because they: distort and reduce yields on financial instruments; add to the costs of owning and selling investment instruments unlike other forms of ownership; increase the fear of government surveillance; and constitute an inequitable tax when compared with other taxes.

Tax incentives are long-term in effect, and their ultimate incentive must be viewed from a long range perspective. Furthermore, in order to provide incentives for mobilization of private savings, tax relief should be focused upon relief for capital gains and greater trading of shares.

The report recommends the: abolition of the capital gains tax; removal of the applicability of the Business Turnover Tax to financial transactions; increase of the differential in corporate income tax as applied to private and public companies; elimination of the withholding tax upon dividend and interest payments; elimination of the valuation basis for most publicly quoted shares for any wealth tax; elimination of stamp taxes on share sales on the CSE; and elimination of the extra tax placed upon foreign investors along with permission to repatriate dividends and principal for foreign investors.

2. Disclosure

The GSL should enforce existing corporate filing and disclosure laws and augment public and private company disclosure to include timely as well as pertinent information. Timely and public information is essential to all participants in the capital markets: investors, lenders, creditors of all types, the government and the public.

3. Maximum Debt/Equity Leverage

Most businesses in Sri Lanka are now overleveraged. This is a matter of great concern to the entire country because over-reliance upon debt can lead to bankruptcy, lack of growth and severe economic disruption. Failure to require adequate long-term equity can result in loan defaults and resulting difficulties for banks, leasing companies, finance companies, and similar financial institutions extending credit. Businesses have preferred to borrow because the banks have been

willing to lend; they have not had to raise equity, and interest is deductible for income tax purposes and dividends are not.

In order to improve the situation, the GSL should take prompt action. Although at least one other Asian country has put absolute ceilings on debt/equity ratios in order to force companies to raise long-term equity capital, such an approach would appear too sudden and radical in Sri Lanka. The Central Bank should take a leading role in supervising banks and require them to limit lending to companies with excessive debt/equity ratios. Furthermore, it should urge other financial institutions, (e.g., finance companies, etc.) also to limit credit to companies with excessive debt/equity ratios. Other governmental bodies with interests involved, e.g., Securities Council, Ministries of Finance and Industry, etc. should support such a position.

The maximum debt/equity ratio at the outset should be calculated so that it constrains only those companies with the worst ratios. It will, of course, be necessary to establish some special exceptions for specialized industries. The maximum debt/equity ratios should then be reduced over time so that all private companies will have adequate opportunity to issue more equity. At the same time, additional technical assistance should be given to banks, merchant banks, DFIs and others to help those organizations to be able to assist the companies in the equity issues.

E. Distribution

Wide distribution of shares should be encouraged. In this regard, brokers and banks should be allowed to have agents sell shares so that there is much broader country coverage. Experience demonstrates that a national network is needed to achieve sales to potential investors in the country outside of Colombo. Sales commissions should be kept under review and adjusted to allow wide coverage and adequate compensation of agents.

Also, the SC and the CSE should carefully delineate the role of underwriters while remaining flexible in their approach.

F. Development of Additional Investment Opportunities

A major restraint upon equity investment has been the lack of proposals for equity finance. The development finance institutions have done sound business overall, but they have not developed sufficient new and expanded investment proposals to widen the investment market beyond their own investments.

A new line of business activity -- either an expansion of an existing merchant bank or a new organization -- dedicated to the development of investments which are then placed with other investors would greatly enhance the mobilization of private investment. This activity should be in the private sector so that the development and placement of investments is required by the discipline of the income statement and balance sheet. Private financial institutions (other than credit institutions and insurance companies) cannot ordinarily afford to hold equity investments in an investment portfolio -- particularly if the equity investment does not yield large dividends -- because they need cash to carry out their business. (Investment companies can do this because their sole business is investment; others have to fund their new activities out of past investment business.) This new business activity needs to be managed so that it sells off or places parallel investments

as soon as possible, which would greatly augment the available investment opportunities and would serve the expanding investment demand.

This new line of business activity is similar to "private placements" in the U.S. In private placement, an investment/merchant banker identifies an entrepreneur desiring to set up or expand a business, helps him organize a financing proposal, seeks out potential investors, and obtains the financing for a fee. The fee is usually cash from the proceeds of the placement and an equity participation in the company.

G. Debt Finance

Short-Term Debt: Businessmen in Sri Lanka finance much of their business and its expansion through short-term bank debt. Although this is understandable in a climate of high liquidity, increasing inflation, and closely held companies, this tendency should be discouraged. (See above under Maximum Debt/Equity Leverage.) Lowering of interest rates should allow increased use of a term debt market in the future.

Short-Term Debt Market: The present GSL short-term securities market is significantly a direct placement market. Some progress has been made in making this market more efficient through recent development of short-term money management techniques by several financial institutions. GSL Treasury Bills have been made more readily available to private investors by several banks that now will make a two-way market for clients. The Merchant Bank of Sri Lanka has started a money management service for customers which will seek out the best risk/return for them. Technical assistance should be obtained to survey short-term markets in order to restructure this market and establish further private market makers.

Further development of a government securities market is desirable to: lower the overall effective cost of borrowing for the GSL through more efficient capital markets; allow open market operations for the Central Bank through a private secondary market in government securities; and provide further investment alternatives for Sri Lankan investors. The GSL should consider, and the Securities Council should foster, the realignment of the GSL securities issuance process into the private sector, which would assist in the development of private government securities dealers which underwrite, place and trade in GSL securities.

Refinancing Schemes: Use of GSL refinancing schemes can assist businessmen in chosen industries, and do not constitute an inappropriate method for steering financing so long as the costs and risks are carefully monitored by the GSL, but broader use of the equity market should also be supported.

Thrift Institution Investments: Thrift institutions should be encouraged to invest their funds in a broader spectrum of investments. Foremost among those investments should be additional mortgage lending for residential housing. The possibility of packaging housing mortgage financing into large mortgage packages which can be sold to various thrift institutions should be carefully reviewed.

H. Long-Term Investment Techniques

1. Project Lending Preparation and Assessment

Further assistance to financial institutions in project preparation, assessment and lending is needed to create more investment opportunities for Sri Lankan investors. Specialized short-term lending needs should be reviewed and, if possible, accommodated by private, short-term market-makers, including receivable financing and commercial paper.

2. Venture Capital Companies

Venture capital companies should be encouraged, but they should not be viewed as a substitute for development finance institutions or capital markets development, nor of other techniques for increasing the amount of investment opportunities available to investors. Venture capital companies are largely focused upon investment of their own portfolios, and they do not contribute significantly to the rapid mobilization of additional funds for the equity markets.

Venture capital companies ordinarily require a sophisticated investment manager who invests, as a portfolio investor, the capital provided, waits for the investments to mature, and sells them for a profit. Such an approach has proven to be highly risky even in the developed countries, depends upon careful and independent accounting and audit practices, requires a developed capital market to assure exit from the venture capital investment at a fair price, and depends to a large degree upon the skill and judgment of the money manager. In a country with a small capital market, limited exit opportunities, a relatively small group of portfolio investors, and a very wide range of small startup businesses with unknown markets, venture capital companies will probably do better at a later stage of development. Some of the advantages of a venture capital company can be achieved by undertaking the private placement of activities (as set forth in Development of Additional Investment Opportunities above).

I. Underground Market

There are private funds in the underground market of Sri Lanka which might be tapped for long-term investment. To some extent these have been brought into effective use through the bearer CD's being offered by banks. Innovative methods of using such instruments to capture underground funds for useful purposes should be encouraged. Furthermore, the stock market also should be employed to capture such funds, if possible. The GSL should clarify that shares may be registered in the names of nominees with minimum possibility of disclosure and a high degree of confidentiality. Such an approach should be reviewed with recommendations for regulation or legislation to assure that no disclosure will occur without carefully prescribed conditions embodying due process of law.

III. Securities Market Operations

The proposed form of stock clearance procedure through a central depository should be continued and implemented as soon as possible, and the GSL should urgently support the necessary changes to the Companies Act of 1982.

More information is necessary on stocks and the CSE. The SC and the CSE should arrange for the wide dissemination of such data, utilizing the technical assistance and advice of the USAID Capital Markets Project.

Self regulation should be vigorously adopted and cooperation between the CSE and SC redoubled. There should be a clear policy statement and enforcement of all rules and regulations which is implemented by a self contained unit within the CSE, if possible, but such an unit would ultimately be responsible to the Securities Council. The CSE should continue to obtain technical assistance and guidance through the USAID Capital Markets Project.

The Securities Council in Sri Lanka is generally viewed as the supervisory body for the public sale of securities. A review of the statute indicates that there has been some possible ambiguity in their jurisdiction. It is strongly urged that to the extent that further action needs to be taken by the GSL to make certain that all public sale of securities to the private sector is supervised by the Securities Council, that the necessary steps be undertaken.

Furthermore, the supervision of securities markets is extremely important for the economic development of Sri Lanka because a large part of new investment must be made through those markets. Such supervision must be efficient, effective and careful. The GSL must appropriate sufficient funds to allow such supervision to be professional and prompt. It would appear that the present budget of the Securities Council is the minimum possible. Future appropriations should be larger or the Securities Council will not be able to fulfil its developing responsibilities to the economy and the nation.

Another possible ambiguity in the laws of Sri Lanka also exists which, if it has not already been clarified, should be reviewed with respect to the SC, the CSE and the brokerage community. Some transactions in shares do not require the services of a broker because they do not involve a true purchase and sale of shares (e.g., certain corporate restructuring arrangements, or direct issuance of shares to employees, etc.). Under such circumstances, the transfer may not require payment of a broker's commission. Further careful definition by the GSL of the type of transactions covered by brokerage fees may be necessary to cover future situations. (When the new central depository arrangement is installed at the CSE, the transfer of such shares will be simplified even further.)

The present trading process at the CSE appears satisfactory, but the CSE should request technical assistance at timely intervals for outside experts to assess the necessity for future change.

IV. Securities Supply/Demand Analysis

A qualitative supply/demand analysis of the securities markets of Sri Lanka indicates that significant stimulus is needed for both the supply of securities and the demand for securities in order that the capital markets can make the maximum contribution to economic growth and increased employment.

CHAPTER I

THE SRI LANKAN FINANCIAL MARKETS

A. Relationship between the Financial Markets and the Economy

1. The Economy Since 1977

In 1977 the GSL began implementing major reforms which: liberalized the economy and opened it to market forces, reduced government control in several sectors, encouraged foreign investment and fostered development of the private sector. These reforms have had an important effect upon capital markets by making them more open and liquid. The reforms included:

- **Trade Policy/Foreign Investment Reform**

  The trade regime liberalized import restrictions while encouraging exports. (Sri Lankan tariffs are now among the lowest in Asia.) Exports have been encouraged through the establishment of free trade zones, custom duties rebates, exemptions from custom duties and the business turnover tax, tax holidays for up to ten years, and investment credits. As a result, foreign investment has increased -- particularly in free trade zones -- exports of manufactured goods have increased dramatically. Nevertheless, excessive protection still exists in some industries. Further reform is needed to allow foreign investment to enter and leave the country freely.

- **Exchange Rate Changes**

  There is now a more open and flexible foreign exchange regime which has fostered export growth, although contributing to some increased inflation as the rupee has devalued. The Dollar/Pound exchange rate has decreased about 30 percent since the end of 1988, but still remains somewhat constrained in fully reflecting a free exchange market and more liberal exchange policies should be undertaken.

- **Tax Reforms**

  Sri Lanka relies most heavily on indirect taxes, which include general sales and turnover taxes, and taxes on trade. Indirect taxes constitute about 85 percent of total tax revenue. Direct taxes include taxes on income, profit and capital gain and constitute the remaining 15 percent of tax revenue. A GSL Taxation Commission is presently reviewing the tax structure. Although some progress has been made in recent years to rationalize tax burdens and use fiscal policy to assist in economic growth, there remain many areas where tax policy can assist economic growth which the Tax Commission can address. The results of the Committee's reviews are not known, but provide an excellent opportunity to create incentives for private investment which will contribute to greater

economic growth. The taxes obtained from such growth should heavily outweigh any loss through the provision of tax incentives.

- **Monetary and Financial Policy Adjustments**

Since 1977 monetary policy has focused on increasing savings through maintaining high nominal interest rates and improving banking services for industrial expansion. The reforms were oriented towards deregulating the banking industry to encourage more competition and thus make capital markets more efficient. The foreign exchange regime was liberalized to expand foreign banking activity and foreign currency banking units were established. The barriers to finance companies and merchant banks were removed. One result has been the rapid growth of finance companies which were substantially unregulated. This led to a number of finance companies with severe credit problems and losses by depositors, which have destabilized financial markets and created a loss of confidence by investors.

The Central Bank introduced public auctions of T-Bills in early 1987, which has increased investment alternatives for some investors. The significant budget deficit, and its impact on inflation has put pressure on interest rates, although the IMF arrangements and credit restrictions have led to some easing recently.

- **Pricing and Market Deregulation**

Price controls in force before 1977 have been almost completely removed;deregulation in the public transit system and the insurance industry has resulted in more open markets; the transfer of several government owned businesses to private owners has started the process of reducing the government involvement in businesses.

- **Recent Economic Performances**

The current financial marketplace is characterized by high nominal interest rates, a credit squeeze to reduce inflation through the money supply, little new private equity funding, a large GSL deficit which will continue to require sizeable funding from the private sector, and a recent decline in the rate of increase in the money supply.[1]

[1]This updated survey does not attempt to reproduce the most recent data on the Sri Lankan economy. To the extent available, it uses current economic data with respect to the analysis and recommendations. For coverage of recent data, see the Survey of Capital Markets, ISTI, op. cit. pp. 3-8; the 1988 Annual Report of the Central Bank; the Economic Bulletin of the Central Bank; Socio-Economic Trends and Patterns in Sri Lanka, 1989, Statistics Department, Central Bank of Sri Lanka; and recent periodicals,including EIU Country Report, Sri Lanka, No.1, 1990, 22 January 1990.

2. Further Reforms Needed

Open private capital markets create more economic growth and greater employment. Open markets not only allow an efficient allocation of resources through pricing, and a decentralized decision making mechanism which avoids the inefficiencies of overly centralized command decisions, but also are the only effective way to integrate a country's economy with that of the rest of the world which results in participation in world economic growth.

Although much progress has been made in opening up the economy and Sri Lankan capital markets to market forces, there remain some significant areas which require further liberalization. The following outlines the general areas for consideration, and the chapters following cover these matters in detail with recommendations where appropriate.

- **Economic Strategy**

  Sri Lanka has not in the past had a sufficiently clear and agreed upon strategy for development. The overall economic lessons of the last four decades indicate that an essential element of rapid economic growth is an open market economy. A major building block for a free market is an open private capital market which mobilizes private investment funds for economically viable projects and provides economic benefits to the country and increased employment through new or expanded businesses.

  Recently, the Ministry of Industries has released "A Strategy for Industrialisation in Sri Lanka." This strong and positive statement covers a number of topics bearing upon capital markets and proposes many high priority objectives which will encourage investment. Many of its policies and prescriptions coincide with the recommendations and analysis contained in the 1988 Survey of Capital Markets which this review updates. (In some respects, however, the 1988 survey authors believe that the Strategy for Industrialization does not fully reflect all of the requirements of the capital markets, and does not cover all of the areas in which action is recommended to improve capital markets in Sri Lanka.)[2]

  The Strategy for Industrialization does, however, set forth an approach and is a significant step towards reaching an economic goal. As with any strategy, work still must be done to refine the tactics and priorities necessary to carry out the strategy, as well as continue to refine the strategic approach. It is suggested that action be taken as soon as possible on the matters set forth, including those actions which are being considered as well as those definitely recommended.

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[2]This update does not address any strategic issues except those related to capital markets. However, it should be noted that certain economic development elements related to the "Strategy for Industrialisation", e.g., agrobusiness and distribution, greater development of capital markets -- particularly debt markets, better foreign exchange markets, more rapid reduction of tariff barriers, and a need to be integrated further into an overall strategy. In other areas, it is suggested that bolder action is needed, e.g., longer tax holidays because the first 2 1/2 years is generally a time of low or no profit, and a need for greater tax relief for listed companies of at least 25 percent differential.

- **Oversized Public Sector/Promotion of Competition**

  The oversized public sector still claims a majority share of resources without adequate economic return.

  The pressure to keep unprofitable public enterprises afloat has contributed to the GSL deficit and discouraged competition. The peopleisation program, and the direct sales of GSL government companies and other enterprises will address these inefficiencies and lay the groundwork for privately owned operations that can survive and prosper in a competitive environment.

- **Financial Markets**

  Competition and efficiency are still restricted even though the reforms have improved conditions considerably in both debt and equity markets. In debt markets, banking competition has been overshadowed by the dominance of two state-owned commercial banks and the difficulty in recovering delinquent loans, although action is projected on loan recoveries which will be very helpful. Positive high real interest rates have made short term debt more attractive than long term financing in today's marketplace.

- **Institutional Rigidities**

  There are still many institutional rigidities that prohibit private sector development (e.g., GSL use of savings institutions to purchase government debt even though the institutions are allowed to make other investments). Even private sector representatives look to the state for inspiration, leadership, and cheap funds in financing private transactions. To redress this imbalance, more broadly based private sector institutions will have to become much more active in shaping and effectively representing their memberships' views on economic policy issues (e.g., the agro-industry sector needs greater efficiency and competition and less public intervention).

3. Monetary Policy and Capital Markets

The GSL exercises overall influence upon the allocation of credit through a number of mechanisms and through the interest rate structure.

The Central Bank (CB) plays a dominant role in establishing interest rates, significantly through its sales of Treasury Securities to the National Savings Bank (NSB) (which is by far the largest savings institution in the country and has 26 percent of the total savings deposits of the country, December 31, 1988), the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF). Interest on deposits in the NSB has a tax free element, thus increasing the tax equivalent rate paid by the GSL even further.

For some time the banking sector has been liquid and has more lending funds available than were needed for loan demand. This may partly reflect the traditional saving preference for secure deposits rather than other investment alternatives, but it also reflects high nominal interest rates which the GSL has supported. With credit restrictions, the main commercial banks should continue to be liquid.

The interest rate and structure have supported the GSL need to mobilize private savings to cover the public sector borrowing requirement and have tended to crowd out funds for private sector investment.[3] Furthermore, inflation is high, monetary policy has tightened and interest rates are high. Therefore, equity investment is lower because of short term high rates of interest. Crowding out, therefore, is not just applicable to Sri Lankan domestic credit; it also applies to equity investment.

There has been effectively no long term funding in the market place in recent times. There has been some indication that some medium term funding (e.g., 2-3 years) to avoid constant rollovers by borrowers might be floated in the market place at market rates, but nothing has occurred recently. Some continue to believe that medium term debt is possible, provided that the issues include some escape valves for investors (e.g., redemption privileges for at least a portion of the issue). Although there is no inhibition on the issue of bonds by private companies, there has been at least a psychological barrier to such issue -- largely because companies prefer to borrow upon more flexible and less onerous terms from banks and banks continue to lend even though companies are often over-leveraged.

4. Other Credit Allocation Mechanisms

The GSL also has influenced credit allocation through several other mechanisms:

- The National Credit Plan and moral suasion. The Central Bank has used discussion and persuasion to arrive at agreement concerning credit allocation.
- Operation of monetary policy and reserve requirements on financial institutions.
- Refinancing programmes for preferred sectors of the economy. These programs have targeted specific economic sectors (e.g., export, small industry) for loans at subsidized interest rates to induce growth in those areas.
- Tax holidays encourage investment and lending to certain favored sectors.

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[3]The Central Bank's publication, "Socio-Economic Trends and Patterns in Sri Lanka, 1989, p.43, maintains that ". . . a crowding out effect is not evident in Sri Lanka"; however, although the proportion of private credit and public credit to the GSL and government corporations has remained roughly equivalent in recent years (private credit has declined as a proportion from 54 percent to 51 percent in the last five years), the private sector has grown much more rapidly and it would be expected that private credit should have increased proportionally.

B. Financial Institutions

1. Major Financial Institutions

The major financial institutions are:

- **Central Bank of Ceylon**: The Central Bank plays a central role in government financial policy, and it is also instrumental in a number of credit and refinancing programs concentrated on export, small industry and the rural sector.

- **Six commercial banks**: Two dominant Government-owned banks, the Bank of Ceylon and the People's Bank (The Bank of Ceylon alone having 35.1 percent of the deposits in the commercial banking system); and four private banks. The commercial banks play an extremely important financial role because they contain about 70 percent of the total savings and fixed deposits in the country (about Rs. 43 billion at end of 1988).

- **Nineteen foreign banks**: Nineteen foreign banks have branches; and 24 foreign currency banking units which are owned by other financial institutions in Sri Lanka, predominantly by the banks, undertake operations, which contracted in size by about 1.4 percent during 1988.

- **Finance companies**: Finance companies have been able to take fixed deposits for short- to medium-terms and have issued Certificates of Deposit for longer periods. Several troubled finance companies required refinancing facilities or have not been able to repay depositors fully in order to remain afloat and there has been a rapid loss of confidence in this financial sector area.

- **Development banks**: The National Development Bank (NDB), which is owned, inter alia, by the Government Banks (11 percent), GSL (67 percent) and CB (17 percent), and the Development Finance Corporation of Ceylon (DFCC), which is owned by: government banks (40 percent), the public (27.5 percent), foreign assistance institutions (10 percent: DEG - German; 12.5 percent: FMO - Dutch) and IFC (10 percent).

- **Special purpose financial institutions**: Includes the National Savings Bank (NSB), the State Mortgage & Investment Bank (SM&IB) and the Capital Development and Investment Company Limited (CDIC). The NSB blankets the country with about 8 million accounts, which is nearly 50 percent of the total population and several thousand branches, most of which are through the GSL's post offices. At the end of 1988 the NSB had about 30 percent of the total deposits (savings and fixed) in the country. The CDIC had about Rs. 300 million in assets, March 31, 1989, of which about 45 percent is invested in equity and quasi-equity securities. Its objective is to stimulate economic development through provision of equity or quasi-equity capital.

- **The Colombo Securities Exchange Limited:** The Colombo Securities Exchange Limited (CSE) operates the stock exchange in Colombo. The Securities Council oversees the performance of the CSE and public issue of securities.

- **Nine Securities brokers:** Members and owners of the stock exchange.

- **Four insurance companies:** Two state owned companies, Insurance Corporation of Sri Lanka and National Insurance Corporation, and the privately owned Union Assurance Limited and Eagle Insurance Corporation, which have recently issued shares.

- **Two major funds for employees:** The Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF) provide thrift institutions into which employees place sums which they may withdraw upon specified events.

- **Several money brokers:** These money brokers broker call deposits. Some broker intermediate Eurodollar deposits from Asian and European Markets.

- **Two merchant banks**

- **Rural banks**

2. Colombo Securities Exchange

The Colombo Securities Exchange (CSE) the successor to the Colombo Brokers' Association founded almost 100 years ago, was established in 1984. The CSE is small by any of the conventional measures of a securities market.

The growth in the share prices is measured by two indices, the CSE all share price index and the CSE sensitive price index. The all share price index grew 23.5 percent, 13.5 percent, 34.9 percent respectively in 1985, 1986, and 1987. It is not as representative of a measure as the sensitive price index, which includes only the stocks ("blue chip") which are most actively traded.

The Sri Lankan stock market is the smallest among other Southeast Asian markets in absolute terms, but in relation to its GDP it is larger than Pakistan and Malaysia, as indicated in Appendix D of the 1988 Survey of Capital Markets. The CSE is the only completely privately owned stock exchange of those Asian exchanges cited.

C. Current Financial Marketplace

The current financial markets are liquid, but there has been very little testing of the long term markets. The following discussion notes a number of aspects of the money markets and outlines some possible steps.

1. Interest Rate\Liquidity

Current short term, nominal interest rates are high. (This review does not attempt to analyze or make recommendations concerning the level of interest rates because the role of a capital market is to accommodate free flows of capital under various rates of interest so long as there is a reasonably free capital market). The comparative level of interest rates on deposits indicates that there is sufficient liquidity in the banking system so that the commercial banks do not have to compete on interest rates fully with the NSB for deposits in order to maintain sufficient liquidity. (They must maintain high enough interest rates on deposits to pull in enough deposits to satisfy their requirements.)

Finance companies do have to compete more fully with the NSB and have to pay a nominal interest rate premium to obtain funds. (If the NSB depositor is a taxpayer, the nominal premium for finance companies is substantially reduced on a tax equivalent basis.) Finance companies have had greater difficulty in obtaining deposits because of their well-publicized financial difficulties.

Finance companies have played a role in providing short term financing in areas where banks have refused to lend. However, their lending practices have embodied considerable risk.

Recommendation:

Potential investors in finance companies need to be fully informed about their activities before making investments because a number of these companies have been taking funds from the public. Under such circumstances, the GSL needs to make certain that full information is given in a form which potential investors will understand. Furthermore, at least to the extent refinancing arrangements are or may be involved, the GSL should continue to maintain supervision over the finance companies.

2. Leasing Companies

Leasing companies have provided a useful financing role in Sri Lanka. These companies provide financial leases at rates generally higher than bank financing, but provide single purpose financing with better service. Often, the leasing rates may not be so much higher than bank financing if the true costs of the bank financing are factored in, e.g., compensating balances, service charges, etc. (Commercial banks typically have charges which they collect from their customers or require maintenance of cash balances by their borrowers; these costs to the borrower are hidden from the actual interest rate charged on a loan, but should be factored into the interest charge to get the actual rate being received from the borrower.) In Sri Lanka, however, the leasing companies are subject to some costs or charges that some other financial institutions are not.

Recommendation:

To make leasing capital market more efficient, all financial institutions which undertake leasing should be subject to the same tax regime and subject to similar charges by the GSL.

3. Call Money Market

Banks generally are liquid, and there are limited investment opportunities at competitive rates for banks with excess deposits. For this reason commercial banks often do not reach out aggressively to obtain deposits. Furthermore, because of reserve requirements they curtail deposits and adjust their balance sheets conservatively and use the call market only to meet short-term deposit needs.

Recommendation:

The Central Bank should be urged to keep the call markets in Sri Lanka under careful supervision to see if they can be made more efficient.

4. GSL Debt Securities

There is only a small investment market for medium- and long-term funds. The GSL has avoided issuing long-term securities except at sub-market rates for specific purposes. High short-term rates have meant that investors are unwilling to invest longer term unless the premium is high.

CHAPTER II

SECURITIES MARKET AND PRIVATE INVESTMENT: DESCRIPTION AND CONSTRAINTS

A. Private Investment Mobilization

Although Sri Lanka is a very poor country, it still has advantages for private investment mobilization:

- The citizens' propensity to save, particularly for housing, even in unsettled times;
- A basic understanding of saving through an investment instrument: almost all adult Sri Lankans have an NSB Savings Account even though many are very poor;
- A relatively high degree of literacy, and a willingness to save through financial institutions and accept a bank book as evidence of investment; and
- A highly liquid market place with surplus investment funds.

However, there are many conditions in Sri Lanka that have restricted private investment:

- Generally low priority accorded to investment in private companies and government crowding out of private investment;
- Lack of sufficient sound, well worked out investment opportunities being presented to potential investors;
- Unwillingness of entrepreneurs to bring in outside partners or investors because of fear of loss of control and desire for secrecy;
- Reluctance to have public disclosure for fear of governmental interference, particularly in the tax field; and
- Unsettled conditions which lead to investor choice of short-term, liquid investments.

The reduction or removal of these general restraints upon private investment in Sri Lanka will assist capital markets, increase private investment in useful projects, and increase development and employment in the country.

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B. Role of Government in Encouraging Private Investment

A persistent constraint upon private investment for private projects in Sri Lanka has been the low, overall priority given to such investment. The private industrial sector has had a checkered history over the past three decades, and only recently has private investment received any real priority. The low priority given to private investment is manifested at this time in several ways:

- Private investment funds are mobilized for public investment as the highest priority through various subsidized or government directed schemes which crowd out use of such funds for private investment; and

- Government has taken over many private companies in the past and through its agencies and government organizations performs many activities traditionally found in the private sector.

1. Government Crowding Out

The GSL has been running a sizeable budget deficit, and, in order to fund the deficit, has had to attract funds by payment of high nominal interest rates. Such high rates also serve to restrict investment in private companies because they cannot compete for such funds. This action by the GSL has the effect of crowding out considerable private investment that might otherwise be made. (See above discussion under IA3.)

2. Government Divestment

The GSL owns or controls a significant proportion of the total industrial production of the country through Government Owned Business Units (GOBUs) or other entities owned or controlled by the GSL as a result of past policies. However, the GSL has announced a policy of privatisation ("peopleisation") of selected GOBUs or controlled companies and has established an organizational framework to carry out this action. Two entities have been privatised under this policy which is extremely important for the capital markets of Sri Lanka.

GOBUs are protected from competition by state support and many firms are not as efficient as those which must compete in the open market place. In order to increase the efficiency and to allow increases in capital when needed without increasing the GSL budget deficit, such companies should be transferred to the private sector at the earliest possible time.

The GSL can realize significant funds from the floatation of securities issued in connection with the full or partial privatisation of such public entities. The capital realized from the public sale of stock in such government owned organizations can be used for capital expenditures in other high priority GSL programs.

Early implementation of the privatisation of public corporations or similar entities is a high priority for improving the capital markets of Sri Lanka. No other action will have such an immediate and positive effect upon the growth of the CSE, as well as upon the general industrial sector of Sri Lanka.

The GSL should seek to expand the number of government owned businesses which are to be privatised. Some businesses could be privatised without sacrifice of essential governmental control in certain crucial aspects of a business (e.g., commercial banks can be private and the government can still control monetary policy). Other businesses may be restructured so that essential parts are maintained by the government but some potentially profitable portions can be sold (e.g., in agriculture, transportation, etc.). Furthermore, it is possible to sell off minority shares of some businesses to the public which would buy the minority investment based on high expected returns.

A major concern has been the amount of investment by foreigners in Sri Lankan businesses being sold because: a) foreign owners may not be concerned about maintaining and expanding production in Sri Lanka to the same degree as Sri Lankans, and b) foreigners have greater resources and might be able to buy up Sri Lankan businesses cheaply.

These legitimate concerns should be dealt with directly upon the basis of stated principles. The principles should be general, but the application should be on a case by case basis because circumstances surrounding the transfers of publicly owned businesses vary. Certain key types of businesses which may be monopolies may not lend themselves to private or foreign control, e.g., ports, airports, harbors, public utilities, unless a proper and effective governmental regulatory body is in place. Others may give rise to sensitivity over foreign control, e.g., plantations.

The government of Sri Lanka is committed to a substantial privatisation effort which has been estimated at as much as Rs. 3 billion over the next five years. If this program is to be financially successful, both the size and efficiency of the Sri Lanka equity market must be increased in order to absorb the stock issues. If the program is to be politically successful, not only must the securities be sold by the government, but also a portion should be bought by the general public and not just the relatively narrow group of individuals and institutions centered largely around Colombo. From a capital markets point of view, the broad distribution of the securities is desirable because such distribution mobilizes new investment funds and leads to a more active secondary market.

Peopleisation will provide a significant increase in the shares traded on the Colombo Securities Exchange. If the estimated Rs. 3 billion amount of equity is distributed to the public and listed on the CSE, the total market capitalization of shares listed on the CSE would increase about 20 percent over year end 1989 total market capitalization. Such distribution will also contribute enormously to mobilization of additional private savings for productive investment. Early implementation of the transfer of such public entities to the private sector is a very high priority for improving the capital markets of Sri Lanka. No other action will have such an immediate and positive effect upon the growth of the industrial sector of Sri Lanka.

As we noted in our earlier survey, the placement of the securities of privatised companies and the after market are extremely important. A failure of one of the early offerings would endanger the entire program. Furthermore, were an issue to be distributed to the public and then to fall drastically in price afterwards, such an event would create major problems. The placement of such issues in permanent or final investors' hands upon a widespread basis at the outset is essential to avoid leaving a large amount of loose stock in the hands of underwriters or speculators.

Recommendations:

It is recommended that the GSL:

- Continue its investor education program on peopleisation. keep the public informed through announcements that such efforts are continuing, and provide estimated time-tables for these actions. Coordinate this with the Securities Council program;

- Continue technical assistance to provide leadership in restructuring businesses to put them into share for privatisation;

- Continue technical assistance to design a program for retraining and compensating laid-off or other adversely affected employees resulting from privatisation;

- Broaden the list of companies which will be privatised or partially privatised;

- Pinpoint responsibility and authority for carrying out each transaction so that the government agency responsible for transfer of a public enterprise knows who has implementation responsibility; develop accountability requirements for performance;

- Structure the transactions to enhance the new shareholders' value;

- Obtain further technical advice upon techniques of widespread placement of privatised securities from international advisers; and

- Establish rules concerning any limitation of foreign ownership in special cases.

C. Public Market for Securities – General

1. Advantages

The public market for securities in Sri Lanka has a number of advantages:

- The size of the present market with respect to the number of transactions is increasing. Moreover, it has grown during a difficult period for the country which was not conducive to long-term investment.

- There is a strong feeling in the financial community that, while the Exchange could be improved, it should be supported and could play a key role in the development of Sri Lanka's capital markets.

- The CSE has the advantage of being owned by nine firms who collectively appear to have the resources and influence to provide the financial capital necessary for the Exchange as it grows. The "parent" firms of these brokerage units are owned by well-known and respected members of the Colombo

business community, people who could make available corporate and personnel support to their brokerage units should it be attractive to do so. Their collective experience in other types of brokerage and trading activities will be of service to the CSE. They should be encouraged to broaden their support and to increase their sales efforts.

- The legal structure necessary for the regulation of a securities market has been put in place by the government under Securities Council Act No. 36 of 1987. This act created the Securities Council and provides an adequate framework for necessary legal and administrative procedures to regulate and promote equity capital markets generally. Certain amendments are in process and will be continuing as the market develops.

- There have been some large issues of shares that have demonstrated a broader share market is possible. However, although the United Motors Lanka Limited (UML) offering was successfully underwritten, it experienced some difficulties. While the shares sold to public investors (approximately 13 percent of the total) were broadly distributed geographically, only approximately 33 percent was sold to final investors. The balance, 67 percent, is substantially held by the underwriters and constitutes a significant market overhang as well as an impediment to further underwritten issues by the same underwriters. Fortunately, the shares have traded at a premium to the offering price to date (5-10 percent).

  Recommendation:

  That prior to the next privatisation, the UML common stock position on the underwriters' books be reduced and the market value of the shares be enhanced by a leveraged recapitalization. (Other aspects of the UML offering which should be noted were the suboptimal timing of the issue and ineffective marketing.)

2. Constraints

However, while the future of Sri Lanka equity markets would appear to have great potential, several factors, acting individually and in conjunction with one another, have combined to restrict the market's development:

- Sri Lankans are reluctant to share knowledge of their affairs outside of an immediate circle of friends and trusted family, or to give outsiders even the slightest opportunity to exercise control or criticize. Such an attitude severely inhibits raising equity ownership -- particularly of publicly quoted shares -- if it is seen to carry with it a loss of some control and the duty to give some information on business affairs. There is also a fear of sharing information that might cause the government to review a business's operation or cause tax authorities to review the personal tax position of shareholders which might not be the case for ownership of other types of assets.

- Sri Lankans in need of capital in a business enterprise consistently borrow funds rather than raise equity; sometimes even preferring to turn to the underground market, if bank credit is not available, rather than raising equity. Until recently, banking and tradition favored the rights of borrowers -- particularly with respect to loan collection. Although some progress appears to be possible with respect to loan collection, raising capital on the public market has been viewed as the least attractive alternative, tantamount to taking in a large group of partners over whose selection there would be little or no control. Turning to the public market is sometimes viewed as a sign of corporate or personal weakness in Sri Lanka, in sharp contrast to Western business standards. Given these attitudes, it is hardly surprising that minority shareholders are avoided by corporate management or that their rights as "owners" are not given firm support.

- The tax burdens imposed on various transactions affecting securities and the capital markets (e.g., wealth tax, dividend withholding tax, transfer tax) are onerous and in a broader sense may reflect an antipathy towards business and free capital markets. Recently, moves have been made to rectify a number of these deficiencies, but further action is required to overcome roadblocks to increased equity share issue.

- The securities clearing and settlement process presently in place is inadequate for any anticipated increases in volume. A post trade automation system is being implemented to address this problem.

- There appears to be a certain amount of insider trading taking place. Partly this occurs because of the lack of timely information to the public. Public dissemination of material information on public companies should be intensified and further education of companies' responsibilities as well as existing law enforcement should occur. While such conduct is a problem even on such mature exchanges as New York and London, the CSE has only recently installed basic surveillance and compliance procedures. The procedure for aggrieved shareholders to seek redress needs to be improved and initial steps have been made. Enforcement of effective rules is important, but the rules should be equitable and reflect the current state of the market.

- In the past many businessmen expressed anxiety over potentially broad changes in the future stemming from political or economic changes. Repeated references were made to past expropriation and anti-business actions by former governments, and many potential investors indicated they might be reluctant to sacrifice liquidity or make extended commitments. In addition, the broader political problems create reluctance to make long-term investments -- particularly by potential foreign investors. However, some indicated that they believed that many investors who voiced concerns were merely giving reasons for actions they would not take anyway. Sophisticated foreign investors have indicated that potential adverse political developments would not affect their willingness to invest, but it would probably affect the level of their monetary commitment.

Obviously, long-term capital markets can develop in Sri Lanka only in an atmosphere of reasonable stability and public confidence. The new industrialization policy recently announced by the Minister of Industries, if implemented consistently over a reasonable period, should address many of these constraints and permit the private sector to contribute significantly to the economic development of Sri Lanka.

The economy has paid a price for the past lack of equity investment. Growth has certainly been inhibited. Individual business enterprises at the margin probably have not had the ability to expand into attractive new ventures, to upgrade their present plant and equipment, nor to compete effectively in some instances with better financed foreign competitors.

The above factors have encouraged individuals and companies to manage their businesses so that growth is financed only from retained cash flow supplemented by short-term borrowings, which in today's market are at very high cost. Reduction in the constraints to private investment and the provision of positive benefits for private equity investment can benefit the Sri Lankan economy significantly.

3. Types of Securities Used in Sri Lanka

a. Equity

The most common form of equity issued today is the class A-voting share. The value of the shares issued on the CSE increased in 1989, but the overall use of equity when compared with bank financing is still very small. In order for a company to qualify for the corporate tax reduction its shares must be listed on the CSE and sell at least 25 percent of the total offering to the public via the CSE.

b. Other Financial Instruments

There are only a few cases in recent years where other financial instruments have been used. Debentures have not been an attractive alternative to equity since nominal interest rates have been relatively high. In one instance, however a company issued debenture stock with a 16 percent dividend for four years with a "put" attached. This issue indicates that there may be some demand for other more flexible financial instruments.

One type of debt security that could mobilize additional private funds is a mortgage-backed security. This type of security would be a direct outgrowth of the residential mortgage packaging suggested in paragraph IIC above. An originator of residential mortgages (e.g. NM&IB) groups a large number of individual mortgages together, often in a trust. The trustee finances the purchase of the mortgages by issuing debt securities collateralized by the mortgages placed in the trust pool. The interest and principal of those debt securities issued by the trust are serviced by the mortgage payments. Such an arrangement would allow additional mortgage lending to be undertaken by the mortgage lenders because they have sold some of their mortgage loans. (To the extent that the mortgage lender gives subsidized rates to home buyers, the interest differential can be paid by the GSL without its having to provide the principal.)

Recommendations:

- Listing standards and fiscal incentives should be modified to encourage and reward actively traded companies. In this context, emphasis should be placed on increasing the number of shareholders rather than limiting concentration of ownership or specifying a minimum percentage distribution. Consideration should be given to a tiered mould structure to distinguish between active and non-actively traded securities.

- Innovative financial instruments should be encouraged by the Securities Council and the CSE so as to give investors and issuers more flexibility, provided that such instruments are in accord with principles of a sound security. Such new securities should be subject to the registration process for listed securities under the Securities Council Act of 1987.

- The Securities Council and the CSE should enhance its education of companies about, as well as indicate a desire to entertain, medium-term, fixed rate debt proposals for listing which are flexible and used for funding medium-term assets or similar types of needs.

- The Securities Council should review the potential for mortgage-backed securities in Sri Lanka in the future.

4. Unit Trusts

It appears that substantial potential exists for unit trusts in Sri Lanka. Many equity investors in Sri Lanka -- especially those reached by widespread distribution arrangements -- would be investing in equities for the first time. A unit trust providing portfolio and professional investment management, would be most appropriate for such investors. In addition, an open ended unit trust would provide liquidity to the individual investor. This liquidity feature is vital if small, unsophisticated investors used to short- or medium-term deposits are to have confidence in an equity market. A unit trust having a portion of its portfolio in interest bearing securities can also provide immediate and periodic income to its investors, whereas shares in many companies will not pay dividends until surplus cash is obtained and the yield may be quite small.

A unit trust fund, if open ended, could grow over time as the Sri Lankan market matures as well as provide a reasonable return to investors. To compensate for the lack of liquidity in the equity markets at the present time and to provide an acceptable yield, the fund should be invested substantially in government securities or similarly high yielding, secure debt investments as well as publicly quoted companies. Over time the fund should also consider broadening its investments, purchasing loans from commercial banks and investing in other investment instruments. In a country with a stock market which is restricted as it is in Sri Lanka and a government securities market limited to short-term securities, a unit trust should carefully broaden its investment portfolio to include a wide range of investment vehicles, so long as they are prudent and sound, e.g.,

purchase seasoned bank loans, short-term promissory notes of major Sri Lankan companies, foreign exchange deposits, etc.

A unit trust broadly distributed across the nation would also be of great support to the peopleisation effort. Not only could the fund be a large buyer of stock on an initial offering but it would represent an appropriate way of putting ownership of a newly-privatised company into many and diverse, but firm hands. Company managements concerned about the danger of public ownership opening the door to incompatible shareholders should find a relatively passive intermediary, such as a unit trust, to be a desirable shareholder.

Lastly, the currently proposed unit trust could serve as a device for educating the investing public. Brokers should be encouraged not to sell the fund solely on the basis of its fixed return; to do so would be misleading and would waste a valuable opportunity to introduce investors in Sri Lanka more broadly to the idea of capital gain risk and growth. Such an educational campaign would also aid in the development of the stock market itself.

Recommendations:

- Unit trusts meeting prudent criteria should be authorized and all enabling laws and rules established as soon as possible.

- The SC and CSE should continue and expand an investor educational effort which includes unit trusts because the market in listed securities would benefit from an increase in the total number of investors and augmented share transaction volume. Brokerage commissions and industry profitability would be expected to increase proportionately.

- We believe that it would be beneficial to investors to have more than one unit trust. In particular, a private sector managed alternative to any public sector managed unit trust should provide a competitive environment to stimulate managerial efficiency and investor service.

a. Unit Trust Authorization Criteria

The unit trust would be a new approach for investing in Sri Lanka. Although there are existing closed end investment trusts in Sri Lanka, the establishment of an open ended unit trust involves new investment policies, different accountability, continuous stewardship to the shareholders, new legal relationships and shareholders who are probably much less sophisticated than normal for Sri Lanka. Under these circumstances, the Securities Council and the CSE should establish prudent and cautious criteria for registration of new unit trusts.

Recommendations:

In addition to the usual criteria for registration of a new share issue for public trading upon the exchange, the reviewing authorities should only authorize the issue of shares for a unit trust that meets extremely high standards which should include:

- Sponsorship by companies and individuals having excellent credentials in the investment field and considerable experience in managing investments;

- The sponsors must have high credit ratings and meet the highest standards of financial responsibility and be prepared to provide assurance to fund against loss due to negligence or misconduct on their part or the investment manager;

- Chartered accountants and a custodian bank or trust company of the highest reputation must review and manage the books of the unit trust, provide audited statements upon a frequent basis to the shareholders and the public, and review and hold the investment instruments; and

- Review and approval of proposed unit trusts by an international consultant or investment bank acceptable to the Securities Council that has had direct experience in organizing international investment funds or unit trusts with particular reference to the Asian market; the firm involved or similar organization should be asked to give its specific views on the adequacy of the unit trust's organization and administration as well as on the marketing techniques proposed and the depth of the market for the shares, including whether or not the proposed unit trust can be successful.

b. Competition

Competition between unit trusts is important in order to achieve good performance by unit trust managers (the best performance will ordinarily get more new shareholders). The Securities Council has indicated that the criteria for authorizing new unit trusts will be: portfolio management competence, safety for shareholders, and capability of performance by sponsors, which may include a minimum size to allow viability. Unit trusts and their sponsors which meet this criteria would be allowed; those who do not, will not be authorized.

The size of the unit trusts has been under consideration. The ADB's study indicates that the optimum size should be quite large for the Sri Lankan market. However, the minimum size for a unit trust is generally determined by several factors: the fees generated by the unit trust for establishment, distribution and management, and the provision of sufficient liquidity reserve to allow safe and prudent administration.

Recommendation:

So long as any unit trust meets the authorization and administrative criteria for the sponsors and management company, its size should not be a determining factor and, this study believes, could be lower than the optimum size mentioned by the ADB report.

D. Incentives and Disincentives for Ownership of Publicly Traded Shares

This study of the capital markets of Sri Lanka is for the purpose of outlining various ways to enlarge the size of the capital markets and increase the amount of private investment that is mobilized in Sri Lanka.

A major technique of augmenting private investment is by broadening the investing public. Existing evidence suggests that there is an investor group which is centered in Colombo which is already investing in equity shares. However, the relatively low turnover on the CSE and the small proportion of listed shares which is traded each year indicates that most shares are held (vs. traded) by a small number of large shareholders. A key element in generating a more active market is to increase and broaden the total number of shareholders as well as providing incentives for investors to trade. Widening share ownership requires both a country-wide stock sales effort as well as an increase of the supply of equity shares for sale. An expansion of investment opportunities will also assist in mobilizing additional investments from existing investors, although other methods of expansion are also extremely desirable. (See discussion elsewhere on increasing investment opportunities.)

Equity shares in publicly held companies provide the best vehicle for mobilizing broadly based investment funds. However, there are many perceived disadvantages in investing in publicly held companies (see above). In order to overcome those perceived disadvantages, incentives must be given for individual ownership of publicly issued shares. Fiscal incentives should be given even though there may be some short-term revenue losses to the GSL. In order to reduce such losses, it may be desirable to limit fiscal incentives to a period of time, e.g., 10 years. At the same time, increased equity investment will also cause greater economic activity in Sri Lanka which will increase tax revenues and probably more than compensate for any initial loss of revenue.

There are also perceived disadvantages to public companies and the stockholders of publicly held corporations which cause them to be reluctant to "take the company public". In order to make certain that these disadvantages accruing to publicly held companies are compensated for, it is necessary to recommend some actions which will result in incentives to go public.

The following outlines some incentives and disincentives which can assist in expanding the market for publicly issued securities in this field.

1. Taxes

Tax policy is of crucial importance in providing incentives for stock ownership. Throughout the world, countries have found that tax incentives are paramount in mobilizing private investment. However, experience has also been that the amount of tax relief required in developing countries to induce investment in favored targets is large.

For example, in the area of tax policy, this report makes a number of recommendations which should improve the desirability of ownership of publicly quoted shares and remove some of the disadvantages to such ownership. At the same time the report does not attempt to indicate the relative strength of counterbalancing policy objectives against certain types of tax relief, nor does it attempt to indicate alternative sources of tax resources except to note that increased economic growth more than compensates for many types of tax relief.

Some have argued that certain taxes were not imposed on shares and share transfer in the past (e.g., capital gains taxes were suspended for a period), but such action did not increase the trading of shares significantly, and therefore the incentives should not be applied. This view fails to take into consideration the longer term effect of tax incentives; investors must have confidence that the tax structure will remain stable and will facilitate capital markets if they are to be influenced by fiscal measures. For example, eliminating the capital gains tax may not have an immediate effect upon investment in a small market such as Sri Lanka because it operates best in conjunction with an increased supply of investment alternatives. Reduced capital gains taxes are the most powerful incentive when investors believe they have a better alternative investment for the funds. Otherwise, investors are less likely to sell, but also no tax revenue loss on capital gains is incurred if investors do not sell.

Certain adjustments in existing tax system can assist in the further development of wider and better capital markets.

Recommendations:

Taxes affecting individuals

- Capital Gains Tax:

  Abolition of the capital gains tax with respect to private investors will encourage wider individual share ownership. Capital gains cannot be equated with other income. Share owners are not assured of a dividend return, and must look for a capital gain to compensate for investment risks. If the capital gain is taxed the same way that other income is taxed, the total gain to the investor is reduced accordingly and the incentive to take the risk is reduced. Furthermore, inflation erodes investments and capital gains are necessary to maintain principal and should not be taxed. Interest rates upon deposits reflect inflationary expectations; capital gains from shares ordinarily do not. A sliding scale of capital gains taxation is designed mainly to protect companies with family or other long standing owners who maintain ownership; the scale does not provide any incentive to passive private investors who desire to provide investment capital for a period of time and be compensated for the risk involved. Total abolition of capital gains taxes would apparently not result in any large loss of tax revenue, and it would provide a powerful incentive for new investors.

- Withholding tax:

  The withholding tax on dividend payments should be rescinded because it constitutes an unfair practice of tax collection: First, as share ownership becomes wider, many shareholders will be exempt from income tax and refund processing is difficult, expensive and slow. Second, a withholding tax constitutes an unfair collection of tax

because the withholding tax is deducted from the dividend before the income tax is actually due to be paid to the GSL. Because of this advance payment feature, the owners of shares are penalized for owning shares when compared with other forms of investment income. Although taxpayers making quarterly income tax payments do not suffer significant loss, those who are entitled to a rebate do suffer greatly. (Appropriate taxes on dividend income will still be levied in accordance with other provisions of the tax law.)

- Tax on Foreigners' Investment in Sri Lankan Shares:

  We understand that this tax is in the process of being repealed and urge that it be repealed completely. It has been suggested that the tax on foreign shareholding be repealed only with respect to a minority shareholding in order to protect Sri Lankan businesses from takeover by foreigners. A tax on foreign investment is not the way to prohibit foreign takeovers. Any laws pertaining to foreign ownership and takeovers should be direct and not through the guise of taxes. To the extent the tax on foreign investment is not repealed entirely, it should apply only to a majority purchase by a related foreign group in order to prevent a two-tiered stock market from developing.

- Wealth Tax and Stamp Tax on Publicly Quoted Shares:

  We understand that various recommendations have been made to the President's Commission on Taxation recommending removal of the Wealth Tax and Stamp Tax on listed incentives. Such removal will encourage wider share ownership significantly.

  The application of the Wealth Tax is particularly burdensome to shareholders. Not only does it create problems because it applies to full share market price, unlike other forms of ownership, and it applies even though there may be little or no actual cash income, but it indicates government surveillance of stock ownership with the resulting reluctance of investors to invest.

Taxes affecting corporations

- Corporate income tax:

  The differential in corporate income tax for private and public companies should be widened significantly and corporate income tax for publicly quoted companies should be not more than one half that of other private companies.

  This action would be a major incentive for public quotation of shares, which would greatly expand the investment opportunities for the public.

The existing income tax differential between publicly quoted companies (40 percent) and private companies (50 percent) is not large enough to cause private companies to consider public registration seriously. A larger incentive is needed and a differential of 25 percent is recommended at present tax rates (25 percent compared with 50 percent). As suggested elsewhere, although perhaps overly complicated, it would be possible to link a tiered market structure with such a fiscal incentive so that companies having more than a predetermined number of shareholders, say 100, would receive the benefit. Purchases by institutions having multiple owners (e.g., unit trusts, pension funds, insurance companies) should not be counted as single shareholders. In this way the more widely held companies would benefit.

The tax effect of this reduction of corporate income tax should be much less than might be projected from existing data because evidence from other countries indicates that those private companies which go public may not have been declaring the same income as they would when they are held to the test of a public company. Thus, collections at 25 percent per annum may be proportionally larger than the 50 percent tax yield on private companies. When these tax revenues over a number of years are balanced against the loss of tax revenue from existing public companies, the actual deficit should be considerably less than anticipated.

-- Business Turnover Tax on Financial Transactions:

Business Turnover Tax (BTT) should not apply to financial transactions. For example, such tax results in a double taxation of the physical turnover (the principal amount) in a leasing transaction and raises interest rates and makes the transaction more costly without compensating economic advantage.

-- Double Taxation of Dividends:

Under current tax law, dividends are subject to double taxation. We recommend removal of the double taxation effect either by exempting dividend income from withholding tax at the recipient's level or by permitting deductibility at the corporate level. (See above under taxes affecting individuals for discussion of effect of dividend withholding tax.)

-- Limitation on deductibility of interest payments:

As a possible supplement to, or in conjunction with, a limit on the gearing ratio, we recommend examining the feasibility of limiting the deductibility of interest payments by all entities other than financial institutions (e.g., banks, leasing companies and other approved credit

institutions) based on target capitalization ratios of total liabilities to equity. Since equity issuance would be stimulated because corporate debt and equity would be equally costly, the supply of equity securities would increase. Over the medium-term, corporations would become less leveraged, financially stronger and would show increased taxable income. Bank loan quality would improve over time, and fiscal revenues would be increased in the long-term.

-- Consolidated Tax Returns:

Current tax law does not permit consolidation of a subsidiary's tax return with that of the parent company. Thus, tax losses of a subsidiary company cannot be utilized to affect taxable income of a parent. In order to create a fiscal incentive for healthy companies to take over sick ones, we recommend permitting a healthy parent company which acquires a sick company (for example, as a result of a bank foreclosure and sale) to consolidate its tax return with the sick company, which could still be held as a separate subsidiary, and utilize the tax losses of the sick company against the healthy company's taxable income.

- NSB deposits and term rate structure:

In order to create a more competitive financial environment, as between the public sector and the private sector, it is recommended that the fiscal subsidy to NSB depositors be removed and a realistic term debt structure for longer term lending institutions be created.

2. Disclosure

Corporate information disclosure requirements are important for the investing public. The GSL, via the Securities Council and Registrar of Companies, should require all corporations to comply more fully with the present laws on corporate disclosure. Information that should be filed annually with the Registrar is often not provided in timely fashion, if at all, thus encouraging the natural preference of company owners for staying private and concealing their affairs. Furthermore, the disclosure law should be applied so that corporate information on file is easily available to the general public.

Recommendation:

The GSL should establish clear responsibility for enforcement of corporate disclosure laws, the laws should be enforced and the public should have available timely corporate information on all companies -- public or private. The proposed new rules of the CSE are going in the right direction. The accounting community should be asked to participate in the process and concern itself with the particular problems of establishing standards for public and private companies. Vigorous enforcement of existing laws and more effective corporate disclosure by private companies might prove very important for encouraging public ownership.

3. Maximum Debt/Equity Leverage

Most businesses in Sri Lanka are now over leveraged. This is a matter of great concern to the entire country because overreliance upon debt can lead to bankruptcy, lack of growth and severe economic disruption. Failure to require adequate long-term equity can result in loan defaults and resulting difficulties for banks, leasing companies, finance companies and similar financial institutions. Businesses have preferred to borrow because the banks have been willing to lend; they have not had to raise equity; and interest is deductible for income tax purposes and dividends are not.

This grave situation also means that there is little margin for businesses to expand and business opportunities which cannot be financed from cash flow are not undertaken. Companies which have avoided raising equity funds are not contributing sufficiently to economic growth.

In order to improve the situation, the GSL should take prompt action. Although some countries have put absolute ceilings on debt/equity ratios in order to force companies to raise long-term equity capital such an approach would appear too sudden and radical in Sri Lanka. The Central Bank should take a leading role in supervising banks and require them to limit lending to companies with excessive debt/equity ratios. Furthermore, it should urge other financial institutions (e.g., finance companies, etc.) also to limit credit to companies with excessive debt/equity ratios. (Although occasionally secured lending may be prudent, generally it simply exacerbates other lenders' problems in a highly leveraged company.) Other governmental bodies with interests involved, e.g., Securities Council, Ministries of Finance, and Industry, etc. should support such a position.

Any establishment of maximum debt/equity ratios should be phased in over a period of years and should gradually reduce the maximum over such time. It will be necessary to make exceptions or at least establish separate maximum ratios for different types of businesses. The maximum leverage allowed should provide plenty of room for businesses to operate reasonably, because this approach is designed to provide additional safeguards for banks in order to avoid bad loans and provide a small safety margin for businesses in times of difficulty. A more stringent requirement should be established at the outset for new businesses. Although the matter needs to be studied further, there seems to be a consensus of Sri Lankan informed observers that maximum total liabilities to equity ratio of perhaps 5 to 1 would be an appropriate target at the outset. Study also needs to be made of incentives and disincentives for adhering to the debt/equity ratio limits. The Central Bank can inform banks of lending limits. Other limitations might be imposed, e.g., no deductibility of interest payments for borrowings beyond the limit; reduced taxes on corporate income for a period of time when equity is raised to meet a debt/equity limit, etc.

Although this approach is likely to be complicated in application, it is extremely important to the economic well being of Sri Lanka.

Recommendation:

That the Securities Council obtain technical assistance in the form of a study of debt/equity ratios and forms of leveraging by companies in Sri Lanka which will lead to the establishment of regulations by the Central Bank, which will place outside borrowing limits based upon maximum

debt/equity ratios, for existing and new businesses in Sri Lanka, and also study the types of penalties that might be imposed for failure to adhere to the maximum ratio for individual businesses.

E. Distribution

1. Wide Distribution and Use of Agents to Place Shares

Shares have been distributed in Sri Lanka in two distinct ways; the more traditional approach is one where shares are sold primarily in Colombo through the established brokerage houses; the other approach is innovative and places shares throughout the island through the use of branches or offices of the group issuing the shares. The Union Assurance Ltd. issue (UAL) is an example of the first approach, and Sampath Bank and Seylan Trust has used the second more broad based approach.

The UAL issue (June-July 1988) offered Rs. 20 million to the public (total issue: Rs. 100 million) through a syndicate. In spite of the syndicate, foreign investment, technical support and strong management, the issue encountered some difficulty because it apparently did not achieve the broad based distribution that is needed to sell new issues in Sri Lanka.

However, Sampath Bank, which began operations in 1987 with two successful share issues, conducted an extensive marketing campaign throughout the country to educate and prepare the public for the issue. The major purchasers of shares appear to have been the average middle class public (median income: Rs. 3,000 month) who viewed the investment as an alternative saving instrument. Very few investors had consulted with a broker or financial adviser. The investment decision was mostly based on the information, motivation and reassurance provided by an imaginative marketing advertising campaign. (Towards a Shareholding Democracy Sampath Bank Share Marketing Experience, November 10, 1987.) The Sampath Bank appears to have utilized the entire resources of the group throughout Sri Lanka to place the shares successfully.

While the widespread use of branches and offices of the selling group has been very imaginative and successful, this technique, if used more widely, might be considered an unauthorized distribution of shares in developed country markets and raises problems for the capital markets of Sri Lanka.

Use of selling agents in Sri Lanka is essential for a broad distribution of shares. The existing brokerage firms do not have a wide sales capability, and others must be mobilized to assist in the selling effort. At the same time the Securities Council and the CSE must be assured that sales agents do not violate laws and regulations governing the sale of equity shares and that selling practices conform to the norms required for brokers. Failure to regulate sales agents could lead to high pressure sales techniques and "bucket shop" operations with consequent false or misleading sales.

Recommendation:

Because the use of sales agents is desirable, the Securities Council and the CSE need to establish clear rules governing them and fix responsibility for their conduct -- probably the sales agents

should operate through established brokers or banks who are responsible for the actions of their agents.

2. Underwriting

The role of the underwriter in the Sri Lankan share market is more limited than in most markets. The relative size of share issues to be placed in the Sri Lankan share market varies enormously. In large issues, it is doubtful if the underwriter/brokers have sufficient financial strength to undertake firm underwritings. The firm placement of such large issues must be negotiated directly with the major pools of Sri Lankan capital as well as through a wide selling effort.

The role of underwriters should not be confused with the role of investors. In the United Motor offering, the use of some inexperienced firms as underwriters and possible investors resulted in confusion and lack of selling. In the distribution of smaller issues of stock, the underwriter can play a more usual role.

Recommendation:

The Securities Council and the CSE should carefully examine the role of underwriters, but should remain flexible in considering the role of underwriters in the widespread placement of issues, and should foster actions which will help assure the successful placement of newly issued shares at fair prices.

3. Commissions

Stocks and bonds must be sold; they do not sell themselves. Sales commissions should reflect such effort. At the present time, the brokerage commissions are 1.5 percent for the selling broker and 1.5 percent for the buying broker. In new issues, there is now a precedent for a selling brokers commission of 3 percent which was paid to the insurance agents in the UML issue. This fee level should be adequate incentive for a broker.

In transactions taking place on the CSE, the total sales commission should probably be on a sliding scale; larger transactions should be at a lesser rate than smaller transactions reflecting economies of scale. However, until the industry starts generating profits, we recommend not implementing a sliding scale adjustment.

Recommendation:

That the CSE and SC keep brokerage commissions for the sale of shares under careful review, particularly with respect to agents' commissions, to make certain that the commissions adequately reflect the level of sales effort necessary.

F. Development of Additional Investment Opportunities

1. Existing Sri Lankan Equity Investment Development

A major constriction upon expansion of equity investment through mobilization of private resources in Sri Lanka is the lack of sound equity investment proposals. Businessmen, bankers, brokers and investors stated that there were more long-term investment funds available than there were good projects in which to invest.

This situation has resulted from multiple constraints which have been outlined elsewhere in the report: entrepreneurs unwilling to expand through injection of new equity from outside sources; government crowding out of private investment through capture of savings to cover the government deficit; lack of use of the stock market which will mobilize private savings for equity investments; failure of existing banks, merchant banks, development banks and other financial institutions to develop and package equity investments which are sold to others.

The existing commercial banks in Sri Lanka do not have a strong focus upon equity development. Although the Bank of Ceylon has been developing some project finance capability and is on the lookout for investment opportunities, new equity investment is not a major business objective of any of the commercial banks.

The main institutions which have been established to provide long-term financing for projects are the DFCC and the NDB along with CDIC. However, organizations have been able to generate a surplus of investment opportunities which they have sold to a broader section of the public. The NDB had Rs. 64 million (less than 2 percent of its total assets) invested in equities on December 31, 1987 (in fact so small that it is only about 3 times total staff loans). This amount is insufficient to enable it to sell off any equity investments to other investors. The CDIC owned shares valued at Rs. 89 million at the end of fiscal year 1988, but only sold Rs. 1.25 million during FY 1989; in FY 1988 about five times that amount was sold, but the proportion remains small for a company with footings of Rs. 300 million. The DFCC had as much invested in equities (FY 1989: Rs. 94 million), but sold only Rs. 1 million in FY 1989, and Rs. 2.4 million in FY 1988 of such equities to other investors. (DFCC, among others, is now contemplating a new unit trust, which could help distribute equity holdings more widely.)

The nature of the development finance objectives of DFCC, CDIC and NDB imposes significant constraints upon their ability to distribute their equity holdings broadly. The shareholding of each of the institutions is broadly governmental and they do not have the constraints imposed upon them by private investors. Their shareholders are willing to take a very long range view and do not require a return on the equity capital commensurate with the private marketplace. These institutions also view their long-term advances as part of a continuing relationship: they make long-term developmental loans and the equity taken in the project is often only a part of the total financing package. They are reluctant to part with the shares obtained because: they may wish to retain the close working relationship which a shareholder position gives during the duration of any loan they may have made, their clients do not want any wider distribution of shares, they wish to retain successful investments because they will lead to more business, and these DFIs do not have to satisfy private shareholders by taking shorter term profits.

These financial institutions indicate that they are working more and more closely to their capacities. They state that the investment proposal process in Sri Lanka is complicated by the lack of knowledge upon the part of potential entrepreneurs on how to prepare and present a project proposal. It is necessary for DFIs not only to react to proposals brought before them for financing, but they must also do some preliminary work to identify proposals, shape those proposals as they are being presented so that they become reasonable investment project documents, and then assist in the financial engineering which will result in the presentation of a viable project to the DFI.

As a result, the existing DFIs do not engage in significant equity sales, and are not required by the drive for prompt profits to turn their investments over, nor to act as a placer of equity investment with others. Most DFIs shareholders are major financial institutions or governments who can afford to wait for returns on their investments over a long term. Thus, there is little pressure for investment turnover.

2. New Approach to Equity Investment Placement in Sri Lanka

There are numerous possibilities for new or expanded investments in Sri Lanka. Many entrepreneurs do not have any real idea about how to go about preparing a new project. Others need additional capital, but do not know how to overcome the perceived obstacles to obtaining long-term funding at a cost which the company can bear without risking certain disadvantages (e.g., loss of control or excessive outside influence). A financial organization with financial engineering experience can often accommodate all of the competing demands and obtain additional capital upon acceptable terms, so that a new or expanded business can go forward.

A private financial company with a main line of business which is the development and transfer of investment opportunities would be able to tap new sources of private capital in Sri Lanka. This business activity is commonly called a "private placement," i.e., the equity is placed with private investors directly by a financial institution. Such a private company would have as its objective the identification of new or expanded private businesses, preparation of investment proposals for obtaining equity and perhaps additional debt from other sources, and sale of the investment to other investors for a fee. The advantage of such an organization is that it becomes part of a process which is perpetually developing and placing new investments. Thus, this type of financial institution has an enormous multiplier effect upon the economy because it is actually selling all or a part of the investments it develops, rather than making an investment from its own capital, it is using other investors' capital for its business.

"Private placements" are common in developed countries where many investment bankers assist entrepreneurs in developing and "packaging" new or expanded investments for direct placement with investors. There have not been many institutions in developing countries which perform this role. However, many other developing countries have more active entrepreneurs seeking outside equity investment. Sri Lanka needs to develop new institutions to perform this role or expand existing financial institutions through increased equity and technical assistance.

A significant proportion of such an organization's income would come from actual placement of the debt and equity for new or expanded projects with private investors so that its success depends upon continual placement of such proposals. Generally speaking, its income would come from two sources: a front end cash fee for placement of securities, and another front end fee in the form of

an equity interest in the project (sometimes called an "equity kicker"). If the organization failed to place investments with investors, it would not have sufficient income to sustain itself. This discipline would concentrate the efforts of such an organization upon finding viable investment opportunities and selling them as fast as possible. In this way it would use investors' money to achieve the overall objectives of expansion of investment opportunities in Sri Lanka and mobilization of additional private resources for productive long-term investment.

Such an organization is highly desirable in the Sri Lankan investment climate. The expansion of the stock market, the development of unit trusts, the possible arrival of foreign investment funds, the new incentives for equity ownership, and increased activity of the development finance institutions, all should contribute to the expansion of investment funds searching for good investments. The supply of investment opportunities must also be expanded to meet that demand.

There are a few existing private organizations which could be expanded to undertake this type of activity, which is closely related to merchant banking (e.g., The Merchant Bank of Ceylon). But such organizations require institutional assistance to get started. Such financial institutional assistance is needed because:

- It would be a new venture and there will have been little applicable experience in Sri Lanka. Therefore, the start-up time will take longer than the usual financial institution and some assistance from abroad will probably need to be obtained.

- The profitability of this type of activity will be delayed longer than that of more usual financial businesses, and financial institutions, particularly international institutions, can afford to wait longer than individuals. Its early cash income will come largely from the actual placement of investments, which only occurs after a great deal of time has elapsed from the beginning of work on the project. Its greatest profits will come from capital gains from the equity interest taken in projects as a part of the fee. These capital gains will only come after some years.

- The identification and development of investments is time consuming. Many potential investments must be reviewed prior to identifying one that looks as though it might be successful. The financial institution must fund this activity while waiting returns, and assistance from another larger institution would be extremely helpful in surviving this period, particularly an international financial institution. Such an organization would have the best resources available to provide technical assistance as well as arrange for any equity injection needed from abroad because local investors have a shorter time frame.

Recommendation:

That GSL should arrange for technical assistance to review the feasibility of one or more new or existing private financial institutions developing a business which would identify, develop and place new and expanded investments with other investors. (An international aid institution may be willing to fund such a feasibility study.)

G. Debt Finance

1. GSL Debt Securities: Primary and Secondary Markets

The GSL places the largest amount of its securities through the primary market to the savings institutions: NSB, EPF and ETF. Under its charter, the NSB must hold not less than 60 percent of its portfolio in the form of GSL securities. Despite this provision allowing alternative investments, the NSB still maintains much more than this in the form of GSL securities because of GSL instructions.

Because it places such securities through the primary market to savings institutions that have no alternative, there has not been a true secondary market in GSL short-term debt issues. Even though the CB does rediscount its Treasury Bills as a service to purchasers, this is not an independent, two-way market maker.

Further development of both primary and secondary markets in GSL securities is needed and would improve capital markets because:

- More efficient capital markets will lower the effective GSL overall cost of borrowing;
- Open market operations in a two-way market will allow an interest rate yield curve which will assist in mobilizing further private sector investment; and
- Investment alternatives will be provided to private and institutional investors.

Public Sector Securities: The CSE provides an excellent vehicle for trading GSL long-term debt securities. The GSL should be encouraged to issue long-term debt securities as soon as market conditions allow. The market for such securities is more efficient if they are registered and traded on the CSE at market prices.

Furthermore, from a capital markets point of view, it is also desirable if other government entities with separate income and balance sheets issue their own long-term debt securities registered on the CSE. (No opinions are expressed on this subject from a debt management point of view.)

Private financial institutions with sufficient capital to engage in full scale, two-way market-making in GSL short-term securities, as well as other types of short-term securities, greatly enhance the effectiveness of the short-term money markets in Sri Lanka. Although such financial institutions would not participate directly in the CSE, they would complement its securities trading because:

- They foster additional investment activity which increases the market for all types of securities; and
- They improve the efficiency of short-term capital markets through provision of investment alternatives, and thus provide a better choice for investors in either long-term or short-term capital markets.

Longer term securities, when they arrive in the market place,should be registered and traded on the CSE.

Recommendations:

The GSL should consider, and the Securities Council should foster, the realignment of the GSL securities issuance process to assist in the development of private government securities dealers which underwrite, place and trade in GSL securities. Technical assistance should be obtained to study and develop recommendations to accomplish such a result.

However, some progress has been made in making this market more efficient and professional through recent development of short-term money management techniques by several financial institutions. For example, GSL Treasury Bills have been made more readily available to private investors by several banks that now will make a two-way market for clients. And the Merchant Bank of Sri Lanka has started a money management service for customers which will seek out the optimum risk/return for them.

2. Short-Term Debt

NSB, EPF and ETF are the largest private fund mobilizers and they invest almost entirely in government securities. Payment of high nominal savings rates by these government institutions makes it extremely difficult for private companies and entrepreneurs to obtain investment funds without paying insupportable rates of return for the funds. An extremely useful way of helping with this problem is to "free up" the money markets -- particularly for the shorter term money markets. Short-term money rates are the foundation upon which all other money rates are built. If the short-term markets can be made more efficient so that rates reflect economic realities, private entrepreneurs will be able to compete effectively for funds at the lowest possible cost.

Development of short-term capital markets for new types of short-term debt instruments is extremely important to allow competition by the private sector for funds. Existing financial institutions have had to develop along specialized lines to provide short- and medium-term funds, e.g., leasing companies, finance companies, etc. One or more centralized market making organizations in short and medium-term financial paper (commercial paper, promissory notes, bankers' acceptances, etc.) would provide cheaper funds at more effective rates for appropriate credits. To be fully effective, such financial institutions would have to operate in conjunction with a more open money market for GSL securities; otherwise they may be effectively crowded out.

Many kinds of private short-term financial instruments exist which could effectively use a borrowing base, but private companies have not used these extensively in Sri Lanka.

- Receivable financing:

  There is little capability for sellers of consumer durables and similar items to discount their receivables from instalment sales contracts or hire purchase contracts with a financial institution. These receivables are capable of being

packaged, their credit assessed, and the package of receivables might be discounted with a bank, finance company or other investor.

- Commercial paper:

  Some of the largest Sri Lankan companies need funds for varying short periods of time, and others may have excess funds for such times. When the credit risks on both sides are excellent, there is a real opportunity for commercial paper operations. In such an operation, a market-maker intermediates promissory notes from a borrower and an investor. The market-maker thus avoids making a direct loan for the short period of time involved, but collects a commission on the sale. Particularly in times of high liquidity, this is a cheaper way for companies to borrow short-term funds, and it is a way for short-term investors to achieve a higher return than on a bank deposit.

Recommendation:

The Securities Council should arrange for a technical expert from an international private financial institution who will survey the short-term money markets in detail and prepare studies which would enable private sector money market makers to be established.

3. Term Debt

This report proposes actions which would make equity funding more attractive. Because long-term bank lending or other debt funding is ordinarily not available except at very high rates, few businessmen will be willing to be locked in at such rates for any period of time. For this reason most balance sheet restructuring or expansion in the near future will take place through equity or quasi-equity transactions. Emphasis should be placed upon making equity financing more attractive.

However, certain aspects of term debt should be noted. Medium- and long-term funds also have been limited because they have not been sought after by businesses at competitive rates. They have been mainly available through the DFIs, some commercial banks (notably the Bank of Ceylon) and the refinancing programs of the GSL for selected industries. Greater amount of term debt is needed to provide adequate capital bases for private enterprises.

a. Short-Term Rollover Debt

Many private companies substitute short-term finance on a rollover basis for long-term borrowing. This practice should be discouraged because of the business hazards involved. Although Sri Lanka businesses are used to having short-term debt rolled over, a repayment of principal can often be required whenever there is a dip in revenues or a significant increase in interest rates. Furthermore, there is little room for an increase in working capital loans to support new business, if the short-term borrowing capacity is already used up. Businesses should be encouraged to obtain long-term loans or equity for their long-term needs. The financial, monetary and fiscal authorities should discourage substitution of short-term debt for long-term requirements. (See recommendation on debt/equity ceilings.)

b. Private Term Debt

Nevertheless, most businesses believe there is a shortage of long-term loans available because they are alleged to be too expensive in nominal terms. In an inflationary environment, businesses should be able to support some medium-term lending even at high nominal rates. Pricing policies in an inflationary environment should be able to compensate in some degree for the high interest rates, e.g., leasing companies would be ill advised not to match their income maturities with medium-term funding for a significant portion of their portfolio, because, otherwise, disaster will occur if short-term rates increase radically. Businesses should, of course, avoid taking on any foreign currency liabilities even though foreign interest rates are nominally cheaper, unless they have foreign exchange earnings.

4. Refinancing Schemes

The GSL refinancing schemes are well known. Little evidence has been obtained that they are crowding out other long-term funding for worthy projects. Although it might be better policy to use other methods for achieving the same end (e.g., a freer exchange rate), the refinancing schemes appear to be reasonable exceptions for projects the GSL deems worthy. Although the refinancing programs might be subject to criticism, these objections do not appear sufficiently persuasive or relevant in today's capital markets.

The important criterion from the GSL's point of view is that the refinancing schemes are carefully tailored to achieve the result desired. These programs bring longer term money to favored industries, and the banks generally obtain ancillary business which will compensate them for any extra administrative expenses involved. However, the GSL should continuously evaluate whether or not the refinancing schemes are serving the national interest and they should be terminated promptly, if they do not do so (e.g., in hindsight it would appear that programs fostering hotel investment should have been terminated earlier).

5. Thrift Institutions' Term Lending

Because of the nature of their deposit structure, it is difficult for commercial banks to undertake significant long-term loans. However, thrift institutions can undertake a reasonable amount of medium- and long-term loans because of the greater stability in their deposit base and interest rate payments.

In addition to greater equity investment breadth, the NSB and other thrift institutions should also increase their term lending to the private sector. In view of their client base, the movement towards residential mortgage lending should particularly be encouraged. A large segment of the population of Sri Lanka is saving for the purchase of a residence. The thrift institutions should reflect these objectives and enlarge their lending and residential mortgage financing facilities.

At present, a large part of the house and mortgage financing is undertaken by the State Mortgage and Investment Bank. However, demand for mortgage and house lending appears to outstrip the present supply of funds. Under such circumstances there still should be a demand for house

lending and mortgages even though the rates may be somewhat higher. It may be necessary to stretch out principal repayments to make such loans more competitive, because in most countries it is the monthly payment amount that is critical -- not the actual interest rate.

The NSB should increase its residential mortgage lending, but it should not necessarily build up its mortgage lending staff upon an equivalent basis. There already are existing institutions which originate residential loans and mortgages. The NSB (and any other thrift institution) should build up its capability for reviewing such loans originated by others and should buy them as a package. The existing loan originators would thus have additional funds to lend and could add incrementally to their existing mortgage origination capability at a much smaller cost than building up a duplicating facility at the NSB (or other thrifts).

Recommendation:

Technical assistance in housing loan and mortgage review and packaging should be given to the NSB or other thrift institutions. Technical assistance in loan packaging and augmented origination techniques should be given to the mortgage originator (i.e., SM&IB).

H. Long-Term Investment Techniques

1. Project Lending Preparation and Assessment

In order to increase investment opportunities, project preparation, appraisal, and lending capabilities need further upgrading in connection with long-term lending to projects within prudent limits by commercial banks and project arrangement by merchant banks. Further training for bankers, merchant bankers and development bankers in project lending should be given.

Recommendation:

Technical assistance should be provided for further training of project lenders in Sri Lanka in public and private financial institutions.

2. Venture Capital Companies

A number of institutions have been reviewing the establishment of venture capital companies (VCCs). These are useful tools for providing long-term capital for new businesses because VCCs accept larger risks for larger gains. However, it should be appreciated that they turn their investments over for capital gains extremely slowly -- particularly in an environment where there are few exit opportunities. Although helpful in identifying new investments, they are not a substitute for DFIs or a private institution whose business is to identify, develop, and then place new investments with private investors (see discussion above).

I. Underground Market

Significant funds exist underground in Sri Lanka, but the funds have not been as effectively employed in development of the economy as is desirable. Although it is not known how big the underground market is, on occasion it provides alternatives to bank financing, generally at high rates. Although some underground market funds are apparently loaned at competitive rates

because the income tax avoidance is passed to borrowers, it appears that most of the rates are extremely high (e.g., 60-235 percent per annum).

GSL has tried to mobilize these funds through allowing non-withholding tax, bearer CDs to be issued by banks, but subject to limits. Other debt techniques might be used.

However, a free market in equity shares, with considerable anonymity in the purchase of the shares through brokers, should provide an even better method of bringing some of the underground money back into the market place. Equity shares can have a high return through capital gains if an investor selects carefully, and this may cause underground funds to go into the market if anonymity is preserved. Confidentiality might be attained through a study of the type of regulation or legislation which would give maximum assurance that no disclosures will occur without carefully prescribed conditions embodying due process of law.

Recommendation:

That the CSE and Securities Council allow all shares to be registered in the name of a nominee and clarify that the anonymity will be preserved under carefully drawn rules, and the GSL and others will not be allowed to obtain the names of the owners except under circumscribed conditions.

CHAPTER III

SECURITIES MARKET OPERATIONS

A. Stock Clearance, Settlement and Share Transfer

The 1988 survey of Capital Markets of ISTI made recommendations concerning the clearance, settlement and share transfer system of the CSE. The CSE has taken numerous steps over the past year to impose a stringent operating process on the present manual, paper based clearance, settlement and share transfer process. These rules and operational guidelines have enabled the CSE to reduce greatly the number of unsettled share trades. However, because of the intensive paper based share transfer process presently employed in Sri Lanka, there are frequently long delays -- often of several months -- before a new stock certificate is delivered to a new shareowner.

There is a project, presently underway with the CSE under the auspices of the USAID Capital Market Development Project, to automate the clearance, settlement, and share transfer process for trades in stocks of CSE listed companies. The key to this process is the establishment of a book entry, central share depository system. This system, when operational at the CSE, will mirror similar developments in markets throughout the world. In order that the CSE be able to co-ordinate its processes and procedures with other stock exchanges -- particularly in Asia -- and maintain minimum safety procedures, it will be imperative to have an acceptable and efficient clearance, settlement and depository system for the Sri Lanka capital market.

A separate report on the details of this automation project, called Post Trade Automation, is being submitted simultaneously. This report details the operational, procedural, organizational and legal changes and considerations that are being addressed to implement successfully a central depository concept in Sri Lanka for share transactions.

Recommendations:

That the CSE and the Securities Council:

- Obtain all the support necessary to make the required changes quickly to the Companies Act of 1982 to enable the central depository system to be effective.

- Continue to utilize the technical advice they are receiving on the automation of the clearance and settlement process for the CSE.

B. Market Information

There is a very narrow and limited distribution of market data information on the daily activity of the stock market in Sri Lanka. The CSE has a reasonably sophisticated computer data base which forms the basis for daily stock reports which are distributed to brokers, the media and other subscribers. These reports contain price and volume information, stock under movement from the previous day, and certain key information about listed companies.

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The basic problem is not the quality of the information but the scope of distribution and ease of access to the information. If the Sri Lanka secondary stock market is to become a more active market, data and information must be available more quickly in electronic and useable form to a much broader audience than it is today.

In developed capital markets the wide and fast distribution of stock market activity, prices, volumes and trends is usually done to satisfy a huge pent-up demand by the professionals in the market as well as the average market information consumer. Sri Lanka is in the early stages of both broadly promoting the market and preparing various ways to support this promotion with information.

The USAID Capital Market Development Project has a plan to expand the present CSE computer data base system. Conceptually this plan will provide the basis for an "on-line" market data retrieval and distribution system that will enable:

- Stock market professionals and regulators to access market activity on a "real-time" basis;
- Electronic dissemination of such market data as prices, quotes, highs and lows of prices, volume statistics of individually listed companies and the several CSE stock indexes.
- Improved graphic display of stock market performance for consumption by the general public.

In addition, there is a broad public awareness and education program presently being devised which will assist present and prospective investors throughout Sri Lanka to receive and digest all of the information about the stock market, its benefits and its performance. This program is also a part of the USAID Capital Market Development Project and is being coordinated via the Securities Council.

Recommendation:

That the Securities Council and the CSE continue to utilize whatever means become available, both advisory and technical, to encourage the distribution of timely and accurate market information to the broadest possible audience, particularly island-wide. Additionally, this market data information base is usually a good source of income to a participating stock exchange because some of it can be sold on a subscription basis.

C. Regulation and Enforcement

1. Self Regulation

A strong sense of government regulation and stock exchange self regulation has developed in Sri Lanka over the past two years. The Securities Council has organized itself and the Secretariat has published rules and guidelines for the market and it has formulated substantive and creative amendments to the Securities Council Act of 1987. The continuing evolution and development of this body as a regulator of last resort will be a continuous positive support for the broadening of the capital market in Sri Lanka. It sometimes takes decades to evolve a proper regulatory

framework. The Securities Council has done an excellent job of creatively developing its role since its inception in 1987.

The CSE has also recognized its role as a regulator in this new framework. This is very important if investors, both institutional and individual, are to become comfortable with the supervision and governance structure of the stock market. Self regulation is a most important precept for a capital market in a private sector oriented business society. Therefore, it is vital that the CSE continue to develop its self regulatory and enforcement capabilities.

Recommendations :

- The Securities Council should:
  - Continue to refine the regulatory relationships and responsibilities for itself and the CSE based upon its experience, discussions with the CSE, and observations of how other markets are regulated.
  - Continue to assess critically the Act and its own rules and guidelines as to their correctness.
- The Securities Council and CSE should maintain an active formal dialogue on all important capital market development and regulatory issues. In all developed markets this is a healthy and vitally creative method for refinement and improvement.
- The CSE should take advantage of all the technical assistance which is available under the USAID Capital Market Development Project to assist in the establishment of a proper regulatory, surveillance and enforcement process at the exchange. The contractor has available some of the world's leading experts for the benefit of the CSE and the Sri Lanka capital market in this important area.

2. Jurisdiction

The Securities Council in Sri Lanka is generally viewed as the supervising body for the public sale of securities. A review of the statute indicates that there is some ambiguity in their jurisdiction.

Recommendation:

It is strongly urged that action be taken by the GSL to make certain that all public sale of securities to the private sector in Sri Lanka is supervised by the Securities Council.

3. Funding of Securities Council

The supervision of securities markets is extremely important for the economic development of Sri Lanka because a large part of new investment must be made through those markets. Such supervision must be efficient, effective and careful.

Recommendation:

The GSL should appropriate sufficient funds to allow overall supervision of securities' markets to be professional and efficient, and it would appear that the present budget of the Securities Council is the minimum possible to achieve these goals, and more will be needed in the future. Future appropriations should be larger or the Securities Council will not be able to fulfill its responsibilities to the economy of the nation.

4. Ambiguity in Law

Another possible ambiguity in the laws of Sri Lanka also exists which should be reviewed with respect to the SC, the CSE and the brokerage community.

Many transactions in shares do not require the services of a broker because they do not involve a true purchase and sale of shares (e.g., certain corporate restructuring sales, or direct issuance of shares to employees, etc.). Under such circumstances the transfer should not require a broker's commission.

Recommendation:

Careful definitions by the SC and the GSL of the type of transactions covered by brokerage fees should be established over time. When the new central depository arrangement is installed at the CSE, the transfer of shares will be simplified and the stock transfer arrangements clarified more easily.

D. Trading Floor Operations

The present stock trading process at the CSE is on an open outcry basis with trades consummated through a trading floor manager. There are presently nine CSE member firms represented on the trading floor by two or three representatives licensed brokers or traders. The CSE members may only trade on an agency basis representing firm client interests to buy and sell.

The CSE has a well developed set of trading rules and practices which are under review on a continuing basis.

This stock trading procedure is more than adequate for a developing stock market. There are however, numerous initiatives presently underway to increase the scope and breadth of the stock market in Sri Lanka. The CSE and the Securities Council should continually monitor the capabilities of the present trading methodology for enforcement and change in accordance with the advice given under the USAID project, which has made excellent progress.

Recommendation :

That the CSE should request technical assistance at regular intervals for one to three months for experts in stock market operations to assess the necessity for change including the prospect of electronic trading support systems.

CHAPTER IV

SECURITIES SUPPLY/DEMAND ANALYSIS FOR SRI LANKA

A. Introduction

In order to have an overview of the capital market of Sri Lanka, a supply/demand analysis can help state succinctly the factors affecting the sale of securities within the country. In developed countries, it is possible to make sophisticated quantitative analyses of the pools of funds, the number and characteristics of investors available for the purchase of securities, and the supply of securities available to meet that demand. In developing countries, this is impossible. The statistics available are not refined, and estimates are unreliable. The size of the pool of savings theoretically available is often so much larger than the supply of securities that any supply/demand analysis rests on qualitative, not a quantitative, factors. (The study done by Sampath Bank gives some indications concerning the potential funds-available pool, but replication on a sufficiently large scale to be reasonably useful would be an enormous task; the Sampath study is mainly useful for qualitative analysis.)

This portion of the updated survey of capital markets is largely a qualitative analysis of the factors that can affect the demand for and supply of securities in Sri Lanka. These factors have, to a large extent, already been discussed under the various capital sub-markets' headings set forth elsewhere in the survey. A few additional steps have been added which could have a positive effect upon supply or demand, but arise indirectly out of the previous Sri Lankan capital market review. This section will recapitulate these factors with some estimate of their effect upon future markets.

Any capital market requires an appropriate supply of securities with a parallel supply of funds available for purchase of such securities. Development of demand helps create a favorable climate for issuers of securities to offer greater amounts. Development of the supply of securities stimulates additional investors to put more money into the new securities. The relationship between supply and demand is mutual dependence. This will discuss the qualitative factors that have been set forth previously and help develop each side of the equation.

B. Demand for Securities in Sri Lanka

1. Primary Element in Demand: Liquidity

The first element in securities demand is a secondary market to give investors liquidity. Most investors require the ability to sell or otherwise liquidate their investments because they only wish to invest so long as they do not have a more advantageous use of the funds represented by the investment. Some investors have other reasons for investment, such as control of an enterprise so that the capability of selling the investment is secondary. But, the ability to exit from the investment at the time chosen by the investor remains paramount for most investors.

In Sri Lanka, the CSE provides this basic element, but it is limited to a small number of investors and relatively few issuers. Other than the CSE, there are unfortunately no real two-way capital markets where investments can be bought and sold. The lack of an informal or "over-the-counter" market for unregistered securities inhibits investors from investing in non-CSE registered securities.

Development of the CSE into a more broadly based market is one of the keys to success in enlarging demand for securities; this has been embraced by the SC and the CSE, and the current status of the technical development of the CSE is described in Chapter III.

Other capital markets also play a role: a more active, informal market for unlisted securities, and a private sector market for short-term debt instruments would also help provide overall liquidity and increase demand for securities in Sri Lanka. The development of each segment of the financial market helps every other segment because it means that investors know that they can sell one security and buy another of a different type at their discretion. At the present time, only CSE registered securities have a formal, two-way (both selling and buying) market, but the establishment of participants in other types of markets contributes to the ability of investors to keep their funds fully employed and provides necessary confidence for investors.

2. Pool of Funds Estimate

At the same time, it is necessary to stimulate demand even though the existing market supply of securities is not large. The total private funds available in Sri Lanka for investment is not known, but some rough estimates can be made which demonstrate that they are vastly in excess of the present market demand for equity issues. The turnover in 1989 on the CSE was approximately Rs. 300 million. The total funds theoretically available for investment[4] at only the following institutions are Rs. 60 billion.[5]

	Rs. Million
NSB	18,000
DFCC	2,500
Commercial Banks	40,000
CDIC	300
	60,800

The CSE turnover is less than 1/2 percent of this total, and the CSE figure is for **turnover**, not investment.

[4] Savings or similar accounts at selected financial institutions.

[5] Dates of availability vary during 1989 but do not affect the result.

The pool of funds actually available for equity investment at this time is, of course, quite small. As the above figures indicate, the smallness of the pool is not because there is an absence of liquid funds available. Rather, it is because Sri Lankans with savings choose to place them in investment vehicles which are available and familiar.

Furthermore, the institutional funds theoretically available for equity investment is also much larger than the supply of securities. The Employees' Provident Fund, the Employees' Trust Fund, the National Savings Bank, the development banks (NDB, DFCC, CDIC), the insurance companies (Insurance Corporation of Sri Lanka, National Insurance Corporation, Union Assurance, Ltd., and Eagle Insurance Corporation), plus other financial institutions are huge aggregations of savings, but they invest in equities only to a very minor degree. Again, the main reasons for such failure to invest has to do with lack of understanding of real investment returns, reliance upon a few traditional types of investment, and GSL need to finance the governmental deficit.

3. Investor Requirements for Securities

Savings by individuals, rather than consumption, indicate that the saver is sufficiently knowledgeable to be willing to incur a present sacrifice to achieve future benefits. The savings rate in Sri Lanka, although not high, is certainly ample. When coupled with the relatively high literacy rate, and the size of the population, it allows the establishment of a reasonable capital base for capital markets, as indicated by the above figures. If new liquid and reasonably secure financial instruments are developed, the savings base can be mobilized for more effective use through the expanded capital market.

It is particularly important that financial institutions be developed who will invest the funds of others. The development of such financial managers allows intelligent investment decisions to be made as a result of information gathering and analysis. Professional money managers can assist both individuals and other institutions in investing their money wisely. Many of the recommendations are made to assist in the development of such money managers because they will increase the demand enormously, and they should be able to obtain a higher rate of return on the invested funds than individuals who make independent investment decisions.

The main investment vehicle in Sri Lanka is bank deposits. Alternative investments, e.g., real estate, or gold, do not apparently rank highly in Sri Lanka (except home owning, and among sophisticated investors, off-shore bank accounts).

Most investors, both institutional and individual and including many investors in listed securities on the CSE, do not give much weight in making investment selections to capital gain. Recent calculations indicate that the total gain (dividends plus capital gains) for a broad range of securities on the CSE over a five year period was about 40 percent per annum. However, investors do not ordinarily make such calculations, and most continue to measure success by the dividend received rather than earnings growth and forecasts. And many investors measure success by the size of the dividend when measured against par, rather than other more current measures.

Under these circumstances, a successful stock will continue to be one which carries a dividend. Even if cash is not available, a stock dividend will give Sri Lankan investors the type of direct tangible return that they require.

New stock issues desiring diversified ownership must take this investor attitude/requirement into account. Not only must these be the usual, careful advance prospectus and sales education campaign, but companies must structure their stock issue so that dividends compete with savings deposit rates. It is probable that the dividends do not have to be exactly comparable, because investors will accord some premium for share price increase, although not very much. But issuers should take great care to be sure that an attractive future dividend policy is announced at the time of placement of a new issue in order to increase investors interest.

With an appropriate dividend policy, a new issue will attract more interest and the pool of investment funds available for investment will increase significantly.

Furthermore, use of the unit trust which investors in Treasury securities and similar high rate instruments, as well as equity shares, would allow payment of a cash dividend equal to or greater than a savings bank deposit rate and can also achieve capital appreciation, should provide an investment which would attract significant new funds from the large pool available.

4. Demand Stimulation

Although only a small proportion of the above mentioned large pool of funds would be actually available for equity investment, it does show that additional demand can be developed. The following lists potential new sources of demand for securities in Sri Lanka:

- The DFIs, e.g., NDB, CDIC, DFCC, should invest more of their funds in equity issues including investing liquidity in CSE-listed shares. At the same time they should sell issues being held in their own portfolio sooner even though this may not provide optimum gain, because this will enhance the supply of securities. Selling out of portfolio will allow them to reinvest the proceeds of the sales in more equity. Furthermore, a more vigorous equity investment program should be undertaken by the DFIs. As with DFIs in other countries, they may be somewhat reluctant to take equity positions. The DFIs should request use of convertible debentures, loans with warrants, convertible preferred stock, and similar financial instruments which offer opportunities for the DFIs to receive a market rate of return for their investment and create a larger demand for equity or quasi-equity securities.

- Merchant banks and other financial institutions should develop the business of identifying, developing, and making equity investments, and then placing with other investors all, or a portion of, the equity securities purchased. They will need technical assistance to establish such a line of business and invest in, and inventory, securities.

- The savings institutions (e.g., NSB, EPF, ETF) should become larger portfolio investors in equity securities and need GSL encouragement and technical assistance in portfolio management. Although these financial institutions are government controlled, the GSL should allow them to achieve equity rates of return for at least a portion of their assets in order that the individuals whose savings are used will achieve a better overall return. Although such an approach will make it a little more difficult for the GSL to finance the deficit, it will mean that it will pay a rate slightly closer to the real market for the funds rather than forcing savers to subsidize the GSL.

- Offshore individuals and funds should be encouraged to invest in Sri Lankan equities, particularly overseas Sri Lankans, but they require the same treatment on securities transactions as nationals of Sri Lanka (e.g., no extra taxes) and reasonable foreign exchange repatriation arrangements.

- Commercial banks should require equity participation when they make loans that have an equity risk component (i.e., when the borrower is highly leveraged); and should be encouraged to underwrite and sell securities, although it is recommended that such activities be concentrated in a separate subsidiary to provide assurance that they are properly monitored as well as allow building up a skilled staff.

- Unit trusts should be established to purchase both debt and equity securities, and unit trust shareholders should not be subject to Withholding Tax and should have an Income Tax credit for the first Rs. 5,000 of unit trusts purchased.

- Begin development of a system for loans against stock as collateral ("margin" loans). Although it is probable that a full margin loan system would be premature, it would be desirable to study the possibilities of margin loans in Sri Lanka because they are employed widely in securities markets around the world.

- Insurance companies should be encouraged to invest a modest portion of their assets in equities which are liquid and prudent. Modern insurance companies should make investment profits as well as underwriting profits. To fail to make the maximum investment return means that the insurance companies charge higher rates than they would otherwise have to charge in order to meet the target return.

- Employees of companies should be enabled to purchase company securities at discounts and on a time payment basis as a part of peopleisation, and should have an Income Tax credit for the first Rs. 5,000 in shares purchased and no Withholding Tax. The peopleisation program envisions widespread ownership which should include employees. Employees generally require some assistance in purchasing securities at the time the company's stock is sold to the public. Incentives for direct employee ownership should be given, but the employees should be able to sell their shares without restriction in order to obtain funds

when they need them after a reasonable holding period. Certain types of employee ownership plans, such as those familiar in the U.S. known as Employee Stock Ownership Plans (ESOPs) contribute little to the demand for equity shares if the stock is locked up in a trust fund.

- Educational campaigns should be undertaken to educate:
  - The public about the values of share ownership;
  - Specialized groups: e.g., potential investors on how to invest; the financial community on stock analysis; and agents and brokers on specific selling techniques.
- The following set of fiscal incentives should be enacted:
  - Exempt the holding of listed securities from Wealth Tax;
  - Remove dividend withholding tax;
  - Eliminate capital gains taxes on transactions in listed securities;
  - Repeal 100 percent transfer tax on foreigners on purchases of Sri Lankan shares and allow free repatriation of dividends and principal; if there is a valid concern about foreign equity ownership in certain types of situations, the regulation should be direct and deal only with the specific problem;
  - Remove stamp duty on transactions in listed securities;
  - Exempt Unit Trusts from income and turnover taxes; in addition, specific Unit Trust legislation will be required as well as modifications of regulations pertaining to certain investments, e.g., interbank money market.
- Develop capabilities of commercial banks, merchants banks and investment advisers as money managers largely through technical assistance.

Many are concerned that an increase in demand will simply cause prices of existing securities to rise rapidly. If the demand increases suddenly, prices will undoubtedly rise. However, by world standards, the stock market in Sri Lanka is somewhat undervalued because of the lack of demand. A portion of any increase may merely rectify the present under-valuation. Nevertheless, stimulation of the supply of securities should go hand in hand with increased demand in order to reduce the danger of over-valuation. In any event, a rise in prices on a free market means that at some price the supply will meet the demand because it is profitable enough for entrepreneurs to take advantage of the opportunity.

C. Supply of Securities in Sri Lanka

There are two main types of securities; equity and debt. The equity market suffers most from lack of supply. An increase in attractive equity securities will generate considerably greater investor interest and demand. But the securities must be considered desirable by the potential investors and there must be an increase in such supply over the amounts presently available.

The usual measure of attractiveness to investors in the price/earnings ratio for a share of stock. This measures the investor's cost of a share compared with its earnings potential. In some booming economies, the price/earnings ratios are very high because investors believe that the possibility of large increases in earnings are good (e.g., in Japan, the ratios are sky high). In Sri Lanka, the price/earnings ratios remain reasonable. This could indicate that stock prices still can rise and reflect sound values. However, significant increase in demand will require an increase in supply to maintain proper balance.

The debt market in Sri Lanka continues to develop, but it now needs greater structure to increase a supply that is attractive to private investors which will mobilize increased private investment in Sri Lanka.

1. Equity Shares

The following steps would increase the supply of equity securities:

- Trade existing share issues more widely, and apply general incentives (indicated below) to their trading and holding.

- Increase sales of government-owned businesses. The sale of government owned firms is advantageous to the GSL because it can bring in new funds and reduce the need to subsidize or provide capital for such commercial businesses as well as make the businesses more efficient through competition. Such sales of government businesses are of two basic types: businesses that are sold privately to one or a few purchasers, and businesses that are sold in whole or in part to the public. The latter public type of sale has the additional advantages that it increases the supply of securities, provides a broader segment of the public with a stake in the country's commercial life, and helps avoid overconcentration of ownership. However, the public sale of securities is more difficult in LDCs and requires skilled financial engineers (not just those who can sell a company) to provide maximum opportunity for success. The difficulties stem from the sale in a thin market of securities issued by a newly formed company without a previous public record of performance. In fact, this has been done only infrequently in developing countries, although it has been done many times in developed countries (e.g., in France and Great Britain in recent years). These public sales should be accomplished by relying to a greater or lesser extent upon the following elements:

- Broad sale of shares to the public ("peopleisation"); a broad sale of shares helps assure a greater supply of shares being bought and sold because more people will be making investment decisions about holding or selling shares as they determine the desirability of alternative uses of the funds.

- Seeking and establishing core groups of investors in the specific government-owned business to be sold who can provide leadership for the business to be sold and can assist in broad sale to public of balance of shares;

- Allowing securities swaps from existing businesses in Sri Lanka to pay for purchase of a government business and government then sells securities received; this approach can be useful in some cases because it would allow a Sri Lankan company to issue its own shares to the GSL to pay for the purchase of the new company without having to borrow, and the GSL could then sell the shares publicly under a mutually agreed upon arrangement over a period of time, or place the shares in the portfolio of a GSL entity to be sold when appropriate.

- Authorizing more government businesses for sale to the public, in whole or in part, including banks. Sale of more shares allows greater market diversity and increases demand because investors have a greater chance to fill their particular needs.

- Impose ceiling on leverage of private companies through debt which will create additional supply of equity to reduce debt/equity ratios. Initially, the regulation of debt/equity ratios should be through restriction of lending by commercial banks to companies which have an excessive debt burden. The debt burden should be defined through the promulgation of an outside maximum debt/equity ratio which would be reduced over time to a target of a reasonable debt/equity ratio. Such an approach would allow overly indebted companies to prepare an appropriate strategy to satisfy fiscally prudent standards which will reduce gradually the debt equity ratios allowed borrowers.

- Require increased sales of equity securities by Development Finance Institutions. Such equity sales should probably not be mandatory, because circumstances surrounding investments vary. Nevertheless, the DFIs should be urged to sell their equity holdings as soon as possible, and should be asked to justify publicly any failure to sell equity securities held in a company that has been profitable for some period, e.g., three years.

- Provide technical assistance and financing to merchant banks to allow them to identify, develop and privately place new and expanded equity investments.

- Provide additional fiscal incentives to issuers, including:

  - Reduce corporate income tax for listed issuers to 25 percent which will expand listed companies issuing securities for public sale;

  - Abolish any turnover and stamp taxes related to stock issuance, sale or investment;

  - Provide income tax deduction for five years equal to dividends paid on newly issued shares, so long as there is no corporate income tax deduction for all dividends.

- Require adequate information disclosure for all corporations and enforce law and regulations in a timely fashion, including for private companies.

2. Debt Securities

Debt is the most usual form of financing for private businesses in developing countries, and this is certainly true in Sri Lanka. (In fact, debt is used almost exclusively for private financing and should be discouraged for those companies which are overleveraged; see above.) The GSL is, of course, the main issuer of debt securities because of the GSL deficit. However, other conditions favor issuance of short-term debt by corporations: interest paid on loans is tax deductible for corporations and therefore, the GSL is subsidizing this type of finance; there is no loss of management control; and inflation means that long-term debt is too expensive. Nevertheless, the debt market needs restructuring to provide a larger supply of debt securities which will, in turn, help create a larger demand.

The following steps would increase the supply of debt securities in Sri Lanka:

- Reorganize existing GSL debt issuance procedures to develop a private, government debt brokerage community which also would establish a market for private short-term debt instruments, e.g., short-term promissory notes of prime issuers.

- Foster development of new debt instruments, e.g., mortgage-backed securities.

- Encourage commercial banks to sell prime term loans to financial institutions.

D. Conclusion

The above analysis outlines methods of increasing the supply of and demand for securities in Sri Lanka. The development of each side of the equation is necessary in order to have a successful, fair market with securities sold at a reasonable equilibrium price.