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(For consideration by the Board on or about 26 October 2016)

R98-16
5 October 2016

Proposed Policy-Based Loan,
Technical Assistance Grant, and
Administration of Technical Assistance Grant
Capital Market Development Program
(Sri Lanka)

1. The Report and Recommendation of the President (RRP: SRI 49365-002) on the proposed policy-based loan, technical assistance grant, and administration of a technical assistance grant to Sri Lanka for the Capital Market Development Program is circulated herewith.
2. This Report and Recommendation should be read with *Country Partnership Strategy: Sri Lanka, 2012–2016*, which was circulated to the Board on 6 October 2011 (DOC.Sec.M57-11).

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Report and Recommendation of the President to the Board of Directors

Program Number: 49365-002
September 2016

Proposed Policy-Based Loan, Technical Assistance Grant, and Administration of Technical Assistance Grant Democratic Socialist Republic of Sri Lanka: Capital Market Development Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 12 September 2016)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.0069
\$1.00	=	SLRs145.0

ABBREVIATIONS

ADB	–	Asian Development Bank
CBSL	–	Central Bank of Sri Lanka
CSE	–	Colombo Stock Exchange
EPF	–	Employees' Provident Fund
GDP	–	gross domestic product
IBSL	–	Insurance Board of Sri Lanka
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
SEC	–	Securities and Exchange Commission
SLAASMB	–	Sri Lanka Accounting and Auditing Standards Monitoring Board
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTE

In this report, "\$" refers to US dollars.

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 49365-002	
Project Name	Capital Market Development Program	Department /Division	SARD/SAPF
Country Borrower	Sri Lanka Government of Sri Lanka	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Money and capital markets		251.50
		Total	251.50
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Client relations, network, and partnership development to partnership driver of change	No gender elements (NGE) ✓	
Knowledge solutions (KNS)	Pilot-testing innovation and learning		
Partnerships (PAR)	Implementation		
Private sector development (PSD)	Private Sector Conducive policy and institutional environment Promotion of private sector investment		
5. Poverty and SDG Targeting		Location Impact	
Project directly targets poverty and SDGs	No	Nation-wide	High
6. Risk Categorization:	Complex		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		251.50	
Sovereign Capacity development technical assistance: Financial Sector Development Partnership Special Fund		0.75	
Sovereign Capacity development technical assistance: Technical Assistance Special Fund		0.75	
Sovereign Stand-Alone Policy-Based Lending (Loan): Ordinary capital resources		250.00	
Cofinancing		0.50	
Japan Fund for Poverty Reduction - Technical Assistance		0.50	
Counterpart		0.00	
None		0.00	
Total		252.00	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to the Democratic Socialist Republic of Sri Lanka for the Capital Market Development Program. The report also describes the proposed technical assistance (TA) and the administration of TA to be provided by the Financial Sector Development Partnership Special Fund,¹ the Technical Assistance Special Fund (TASF-V) of the Asian Development Bank (ADB), and the Japan Fund for Poverty Reduction for Developing the Capital Market, and if the Board approves the proposed policy-based loan, I, acting under the authority delegated to me by the Board, approve the TA.²

2. The program will provide budget support for enhancing the role of capital markets in financial intermediation and resource mobilization by improving the allocative efficiency between savings and investment through the expansion and diversification of the investor base.³

II. THE PROGRAM

A. Rationale

3. **Slow capital market development.** Government securities, equities, and corporate bonds are the key components of Sri Lanka's capital market. The total size was approximately \$50 billion or 64% of the gross domestic product (GDP) at the end of 2015. Yet, the capital market is less developed than in other middle income countries. Government securities dominate. The market capitalization of the Colombo Stock Exchange (CSE) stagnated as a percentage of GDP at about 30% during 2006–2015, and there were just eight initial public offerings during 2013–2015. The corporate bond market is still in a nascent stage. The ratio of outstanding corporate bonds to GDP is 2%—significantly lower than those of other middle-income countries in Asia.

4. **Opening for reform.** From 2006 to 2015, government support for capital market development was limited. Governments recognized what needed to be done, but reforms were piecemeal largely due to other priorities. For example, although demutualization has been discussed for over a decade, the CSE is one of the last remaining mutualized stock exchanges in Asia. It is owned and dominated by brokers whose individual business interests take precedence over the exchange and overall market development. However, the government has become increasingly aware of the need to institute backlogged reforms so that the capital market can better intermediate savings and investments to drive future economic growth and has approached ADB and other development partners for assistance.

5. **Limited coordination between the regulators.** The opportunities for reform begin with the capital market regulators. The most important of these agencies are the Securities and Exchange Commission (SEC), the Insurance Board of Sri Lanka (IBSL), and the Central Bank of Sri Lanka (CBSL). There is no updated strategic plan for capital market development and no forum for the key agencies to coordinate their efforts. The current environment places undue pressure on the banking sector. Bank assets account for almost 60% of the country's overall

¹ Established by ADB. Financing partner: Government of Luxembourg.

² The design and monitoring framework is in Appendix 1.

³ ADB provided project preparatory technical assistance for the Capital Market Development Program.

financial assets, and the sector is not the most appropriate nor does it have the capacity to offer the long-term financing essential for private capital investments and infrastructure projects.⁴

6. **Weak governance structures.** There are also opportunities to strengthen the SEC's governance. To improve its internal governance, it will introduce term limits and adopt better qualification criteria for recruiting the SEC members. The SEC's weaknesses as an enforcement agency are demonstrated by the fact that more than a fourth of the companies listed on the CSE do not meet SEC listing requirements. The SEC's automated online market surveillance system is limited in that the data extracted from it cannot be used as evidence in court. Poor compliance by listed companies with reporting and other SEC requirements deprives investors of reliable information. This is compounded by the fact that the country's audit regulator—the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB)—does not have resources needed to properly validate the financial statements of public companies. The educational and qualification framework applied by the securities industry is inadequate and leaves the sector without the human resource capacity needed to execute and benefit fully from capital market reform initiatives. This shortfall in knowledge and skills undermines the performance of securities and insurance professionals and the level of confidence and interests of retail investors, as well as the integrity of the securities industry and insurance industry.

7. **Limited coverage in mutual fund, pension, and insurance industries.** The mutual fund industry is characterized by limited subscriptions and a very small share of the economy's overall financial assets. The impediments to greater demand and growth include uneven tax treatment between unit trusts and other financial instruments. Another problem is that the mutual fund industry is largely owned by banks that perceive mutual fund subscriptions to be in competition with their savings deposits. In addition, potential clients generally lack knowledge and understanding of the investment benefits of subscribing to mutual funds. The country's two main pension funds, the Employees' Provident Fund (EPF) and the Employees' Trust Fund, both invest more than 90% of their assets in government securities. This deprives subscribers of the EPF and Employees' Trust Fund of the chance to earn better returns through diversifying into corporate securities and to intermediate savings to private enterprise. The insurance industry has made only small inroads into the economy. Its investments are spread more broadly across the segments of the capital markets, but it still needs reform. Insurance companies should adopt recapitalization measures. The incomplete legal segregation of the life and nonlife operations of Sri Lanka's largest insurance company, the Sri Lanka Insurance Corporation, undermines the credibility of the regulator. The absence of a dispute resolution panel to address the grievances of policy holders undermines the trust of subscribers.

8. **Increasing threat of fiscal dominance.** Sri Lanka is experiencing pressure that prevents the competitive auctioning of government securities based on market prices. It also hampers formulation of a credible government yield curve and a liquid bond market. The current operating framework of the primary dealer system does not promote competitive bidding. The absence of an auction calendar makes the timing of auctions and the levels of interest rates less predictable. This undermines the credibility of the primary market, as does the rejection of auction bids and the limited capital of primary dealers. Another major obstacle to the proper functioning of the primary dealer system is that no high-level committee of CBSL and Ministry of Finance (MOF) officials exists to oversee and coordinate on the issuing of government

⁴ In addition to licensed banks, nonbank financial institutions such as licensed finance companies and specialized leasing companies account for 9%, contractual savings institutions (including Employees' Provident Fund) for 19%, and CBSL for 12%. http://www.cbsl.gov.lk/htm/english/05_fss/pv/f_1.html

securities, including the determination of cutoff yields. The absence of an electronic trading system to capture all government securities trading prevents the necessary disclosure and transparency. All of these factors contribute to a deficient primary dealer system and point to financial repression. The development of a secondary government securities market is inhibited because primary pricing does not reflect market fundamentals. The development of the secondary government bond market is also held back by the frequent issuing of government securities with an average series size too small to allow the creation of liquid benchmark issues.

9. **Elements missing for stronger capital market.** Because the credible government yield curve and liquid government bond market necessary for it to function properly are lacking, the corporate bond market is underdeveloped. A market in asset-backed securities is also hindered. This is because no legislation exists to accord them bankruptcy-remote status and tax neutrality. The absence of a central counterparty system and a clearing company for exchange-listed securities prevents effective management of settlement risk. It also deters the development of derivatives because the critical market infrastructure required for netting of transactions is not available. The lack of such hedging instruments and mechanisms are an obstacle to risk management. The introduction of derivatives trading with a focus on plain vanilla instruments and under close supervision by the SEC is needed to support a more efficient and liquid capital market. Structured products, such as mortgage-backed securities and asset-backed securities, should be developed through the enactment of a securitization act to diversify the number of financial instruments available. The depth and breadth of the capital market have also been restricted in that many state-owned enterprises (SOEs) have not been listed on the CSE.

10. **Future potential.** The government knows that it must take several important steps to promote investment and achieve greater and more sustainable GDP growth. It can remove current obstacles to this growth by moving toward measured market-based structural reforms through deregulation of the financial system while laying the foundations to ensure financial stability and resilience. The crucial steps are the strengthening of the existing legal and regulatory frameworks, continuing improvements in the market's infrastructure, and empowering such institutions as the SEC, the IBSL, and the EPF. Creating an efficient, reliable capital market is a prerequisite for attracting more foreign investment. Most foreign investors require a good enabling environment and market depth before they will gain the confidence to invest. Capital market reforms will be an important complement to Sri Lanka's relatively open trade regime and to the port of Colombo, which is South Asia's largest and busiest.

11. **Thrust.** To address these constraints, the government and ADB have agreed to anchor the Capital Market Development Program to the government's long-term national capital market strategy, which ADB worked with the government to design. In addition, a crucial first tranche policy action was formulated under the program to build strong (i) ownership at the highest level on the policy front, and (ii) coordination across the agencies.

12. The program will seek to deepen and broaden Sri Lanka's capital market by (i) extending the government yield curve and thereby promoting a more liquid government bond market and eventually a more developed corporate bond market; (ii) catalyzing institutional investor demand by broadening, deepening, and diversifying the investor base; (iii) strengthening the institutional and regulatory capacity of the SEC, the IBSL, the EPF, and SLAASMB; (iv) developing important market infrastructure such as a surveillance systems, trading system, and information and communication technology systems; (v) enhancing capacity development through training and promoting financial literacy; and (vi) enhancing the supply of alternative financial instruments such as derivatives to include for commodities and securitized bonds.

13. The program will support financial inclusion by promoting financial literacy among retail investors, expanding mutual funds, and developing consumer protection in the insurance sector through its adoption of grievance mechanisms.

14. **Linkage between reform program and budget support.** The structural reforms to be taken under the program include costly measures, such as the costs of a significant enhancement in the regulatory and enforcement capacity of the SEC and the IBSL and of a short-term increase in the rates of treasury bills and government bonds to align them more with market rates. Budget support is crucial under the program to help cover the costs of implementing the reforms. Since the reforms are an integral part of the government-owned long-term national capital market strategy, the government is firmly committed to instituting the actions under the Capital Market Development Program and has the ability and political will to implement the needed reforms (Appendix 3).

15. **ADB value addition.** The government and ADB have conducted extensive policy dialogue on capital market development since the early 1990s, and this close engagement has made ADB the lead development partner in this effort.⁵ ADB's strength in supporting capital market development is its ability to take an integrated approach to helping develop, guide, and carry out policy change. The approach covers (i) policy dialogue, (ii) the structure and design of tailor-made policy reforms, (iii) policy implementation support, (iv) capacity development through TA to ensure sustainability, and (v) procurement of information technology systems to strengthen operations. ADB has the high level of credibility, the means, and the capacity to offer this comprehensive solutions-based approach, which can tailor best practices to the needs of and conditions of Sri Lanka. Given the complexities, resource and expertise requirements of such reforms, they may be further delayed, be carried out piecemeal, or not happen at all without ADB's involvement.

16. ADB's commitment to supporting capital market development in Sri Lanka is long-term, and successful implementation of this program will create an environment conducive to follow-on reforms. Demutualization of the CSE will allow for its subsequent public listing. Greater retail penetration of the insurance sector is still a priority. This program creates the preconditions for pension reforms, and a follow-on program could support their implementation. Private pension plans and the establishment of a pension regulator are needed. The reform and public listing of SOEs is a multiyear undertaking. Sri Lanka's current efforts to establish an international financial center may require external support. The derivative market will need years to develop, and the establishment of a commodities exchange would provide agricultural producers with a way to mitigate price and other risks.

17. **Development coordination.** ADB has worked to closely coordinate its capital market development activities with those of other development partners and to complement their efforts. ADB's program is part of an umbrella operation to support economic recovery led by the International Monetary Fund (IMF). In June 2016, the IMF approved an extended fund facility of

⁵ Since 1993, ADB has approved 15 technical assistance projects supporting capital market development in Sri Lanka and two major programs, one in 2000 and the second in 2004. This support helped build the reform momentum that has led to the Capital Market Development Program. Under the last program, ADB provided a \$65 million loan to Sri Lanka in 2004 for (i) increasing the financial products and services available to capital markets, (ii) enhancing corporate governance in the financial markets, and (iii) improving regulations of the insurance industry. (ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Financial Markets Program for Private Sector Development*. Manila).

\$1.5 billion for Sri Lanka that aims to restore macroeconomic stability.⁶ The World Bank approved a \$100 million development policy loan in July 2016, with the Japan International Cooperation Agency providing another \$100 million of parallel financing.⁷ The World Bank's policy effort focuses on private sector competitiveness, governance, and macro fiscal stability. In December 2016, the World Bank is expected to approve a second policy loan for \$75 million that will operationalize key recommendations formulated under an IMF–World Bank financial sector assessment program concluded in June 2016. Along with the World Bank and the IMF, the United States Treasury and International Organization of Securities Commissions are providing important advisory support that will complement ADB's program; ADB has been closely coordinating with these organizations.

18. Alignment with ADB's strategy and lessons learned. ADB's finance sector strategy for Sri Lanka, which is part of its country partnership strategy and country operations business plan, is based on the government's emphasis on private sector development, lessons from ADB's previous finance sector interventions, and coordination with other development partners.⁸ Capital and bond market development is in line with the priorities of ADB's Strategy 2020 midterm review and its financial sector operational plan. Both aim to facilitate private sector development and infrastructure development by helping increase the availability of long-term local currency funds for viable financial structures.⁹

19. The program will build on lessons from findings of a 2008 study by ADB's Independent Evaluation Department.¹⁰ In line with the evaluation study report's key recommendations, its prospects for achieving maximum efficiency and effectiveness have been improved by (i) limiting the number of policy actions to allow for effective monitoring; (ii) formulating a long-term capital market strategy as a first tranche policy action to ensure that the program is an integral part of a government-owned, long-term development strategy; (iii) adopting a holistic approach including the inclusion of insurance and pension areas; and (iv) consulting comprehensively with stakeholders through a national workshop to effectively diagnose the issues and build greater ownership for the development of a strong, relevant proposed policy matrix.¹¹

B. Impact and Outcome

20. The impact will be that basic capital and investment needs, as well as Sri Lanka's longer-term economic objectives, are supported. The outcome will be enhanced size, depth, and capacity of the capital market. The program has 13 first tranche policy actions and 17 second tranche policy actions.

⁶ International Monetary Fund. 2016. *Staff Report for the 2016 Article IV Consultation and Request for a Three-Year Extended Arrangement under the Extended Fund Facility—Press Release; Staff Report; Staff Statement, and Statement by the Executive Director for Sri Lanka*. <http://www.imf.org/external/pubs/ft/scr/2016/cr16150.pdf>.

⁷ World Bank. 2016. *Sri Lanka Competitiveness, Transparency and Fiscal Sustainability Development Policy Financing*. <http://www.worldbank.org/projects/P157804?lang=en>; the Japan International Cooperation Agency's parallel financing is expected to be approved in October 2016.

⁸ ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka, 2015–2016*. Manila; ADB. 2015. *Country Operations Business Plan: Sri Lanka, 2016–2018*. Manila.

⁹ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila; ADB. 2011. *Financial Sector Operational Plan*. Manila.

¹⁰ Independent Evaluation Department. 2008. *Special Evaluation Study: ADB Assistance for Domestic Capital Market Development*. Manila: ADB.

¹¹ A national stakeholder and dissemination workshop held during program formulation was attended by 100 registered participants from 30 organizations.

C. Outputs

21. **Market facilitation enhanced.** Enhancing market facilitation will support more efficient mobilization and allocation of resources in the economy. The program will help develop a long-term vision for the capital market by formulating a cabinet-approved Capital Market Strategy (Appendix 5), institutionalizing interagency coordination, enhancing the SEC's role in developing and monitoring the market, strengthening regulatory measures, developing a clearing and settlement system, pursuing demutualization of the CSE, strengthening enforcement of listing requirements at the CSE, and enhancing financial literacy.¹²

22. A Capital Market Advisory Council at the strategic level and the Capital Market Development Division at the SEC will ensure the successful implementation of the government's multifaceted Capital Market Strategy. The development of a real-time market surveillance system will help the SEC detect trading irregularities and market abuse as they occur. This system will make market transactions more transparent and enhance investor confidence. Improving the operational and financial efficiency of the SLAASMB will strengthen compliance with auditing standards. This too will build market confidence by making reliable public company information available on which potential investors can base their investment decisions.

23. Issuing risk-based capital rules for intermediaries and the subsequent implementation of a recapitalization plan will consolidate the number of intermediaries in the industry and ensure that those remaining will be adequately capitalized. The CSE's demutualization will segregate its ownership and management and convert the exchange into a commercial and more professionally run organization that can pursue market development with more vigor. Establishing a clearing and settlement system for SEC-listed securities will eventually enable a central counterparty entity to guarantee the settlement of these securities. The SEC will enhance its educational and qualification framework. This will include changes to enable qualified market intermediaries to deal with a variety of asset classes, as well as to enhance financial literacy and outreach to retail investors for mutual funds.

24. **Demand measures enhanced.** The policy actions linked to this output will support the mobilization of capital market financing by developing liquid bond markets, expanding institutional investor demand, and promoting mutual funds. To develop a liquid bond market and a reliable yield curve, the government will become a price taker by issuing treasury bills and bonds at market rates. The CBSL will publish a rolling 12-month quarterly Treasury auction calendar and will execute a strategy to create liquid benchmark issues by reducing the number of issues as well as increasing the average size of issues. Creation of liquid benchmark issues will facilitate secondary bond market activity. To support a resilient primary government securities market, the CBSL will ensure compliance with capital adequacy requirements for primary dealers. A committee chaired by the MOF and comprising representatives from the MOF and the CBSL will be established to oversee government securities issuance procedures.

25. A robust mutual fund industry will be promoted under the program by adoption of a legislative amendment to remove tax distortions. The amendment will allow unit trusts to become tax neutral. The EPF's capital market participation will be spurred by implementation of its new information and communication technology system. Insurance industry participation in the capital market will be enhanced through measures to promote the industry's growth and stability. These will include enforcement of compliance with the minimum capital requirements,

¹² Sri Lanka Capital Market Strategy (accessible from the list of linked documents in Appendix 2).

establishment of a dispute resolution panel to hear policyholders' grievances, the legal segregation of the life and nonlife operations of Sri Lanka's largest insurance company, and the formulation and implementation of a comprehensive strategy for retail education. These steps will in turn enhance investor demand.

26. **Supply measures enhanced.** The changes tied to this output will increase the supply of quality bonds and alternative financial instruments. Partial listing of SOEs on the CSE will broaden and deepen the capital market. The corporate bond market will be catalyzed through the implementation of quotes for corporate securities citing yield to maturity, which is a more useful indicator to investors than bond prices. Alternative financial instruments such as derivatives will be promoted to develop a deeper and broader capital market by focusing on the enabling regulatory framework. The introduction of regulations for issuing derivatives and the enactment of a securitization act will together encourage the development of such instruments as interest rate swaps, currency swaps, and asset-backed securities.

D. Development Financing Needs

27. The program loan will be \$250 million, which will be made available in two equal tranches. Tranche 2 will be released about 18 months after disbursement of tranche 1. The tranche amounts reflect the materiality of policy actions required for release of each tranche with tranche 1 having fewer but more pivotal policy actions such as the submission of an SEC and a demutualization bill to parliament. The first tranche will be available upon loan effectiveness.

28. ADB's financial support addresses the development financing needs. In particular, the counterpart fund generated out of the loan proceeds will finance development expenditures in the form of the costs of the adjustments involved in undertaking the reforms agreed for implementation under the program and necessary to achieve the intended outputs. The estimated cost of these adjustments is \$260 million, and the government has requested a loan of \$250 million from ADB's ordinary capital resources to help finance these costs.¹³ The loan will have a 15-year term, including a grace period of 3 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions set forth in the draft loan and program agreements. Based on this, the average loan maturity is 9.25 years, and no maturity premium is payable to ADB.

E. Implementation Arrangements

29. The executing agency will be the MOF. The implementing agencies will be the SEC, the MOF, the CBSL, the IBSL, the SLAASMB, the EPF, the Ministry of Public Enterprise Development, and the Ministry of Labor. The SEC's Capital Market Development Division has been tasked as the program management unit. A Capital Markets Advisory Council chaired by the senior advisor to the prime minister and established as a first tranche policy action will monitor the program. The deputy secretary to the Treasury will be the executing director. The program will be implemented over 3 years from January 2016 to December 2018.

30. **Tranches, disbursement, and counterpart funds.** The loan will be provided in two tranches and disbursed upon fulfillment of the related program policy actions (Appendix 4). The proceeds of the loan will be disbursed in accordance with ADB's *Loan Disbursement Handbook*

¹³ Financial Analysis (accessible from the list of linked documents in Appendix 2).

(2015, as amended from time to time) and detailed arrangements agreed with the government.¹⁴ The proceeds will be used to finance the foreign exchange cost of items, excluding items included in a list of ineligible items and imports financed by other bilateral and multilateral sources.¹⁵ ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the government's certification.

III. TECHNICAL ASSISTANCE

31. The attached TA for Developing the Capital Market will support the implementation of key reforms under the program.¹⁶ The outputs to be supported through the TA activities will be the (i) facilitation of the demutualization of the CSE; (ii) development of a multilayered, multiproduct financial certification framework for brokers; (iii) enhancement of financial literacy and outreach for unit trusts; (iv) support of a legal review of the unit trust code and related legislation; (v) support of a legal review and the drafting of a securitization act; (vi) support of the establishment of a derivatives market; (vii) formulation of a strategy for the development of a commodities exchange; (viii) assessment of the options for reforming the current system for retirement savings; (ix) enhancement of the EPF's capacity for managing risk in alternative investments and foreign equities; (x) support of the establishment of a dispute resolution panel for insurance cases; and (xi) deepening of financial literacy regarding insurance products.

32. The TA is estimated to cost \$2,000,000, of which \$750,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-V), \$750,000 will be financed on a grant basis by the Financial Sector Development Partnership Special Fund (footnote 1), and \$500,000 will be financed on a grant basis by the Japan Fund for Poverty Reduction and administered by ADB. The executing agency for the TA will be the MOF. The SEC, the Ministry of Labor, the CBSL, the IBSL, and the EPF will be the implementing agencies. The TA will be implemented over 2.5 years starting in December 2016. ADB will engage consultants through a consulting firm in accordance with its Guidelines on the Use of Consultants (2013, as amended from time to time). Disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time). The government will provide counterpart support in the form of counterpart staff, office, office supplies, secretarial assistance, and other in-kind contributions.

IV. DUE DILIGENCE

A. Economic and Financial

33. The program will facilitate the mobilization of financial resources for productive investment and employment generation by supporting the development of the capital market. By strengthening the capital market, it will reduce systemic vulnerabilities in the bank-dominated financial system. By promoting the development of the corporate securities market, mutual funds, and institutional investors such as insurance companies and the public pension funds, the program will diversify the financial instruments available and broaden the investor base. This will reduce market volatility and improve the resilience of the finance sector to external shocks. In addition, by strengthening governance of the capital markets, the program will enhance market efficiency and transparency and improve investor protection.

¹⁴ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

¹⁵ List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

¹⁶ Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

B. Governance

34. Public financial management governance systems are adequate. The MOF has been modernizing its management and operations, including its administration of the national budget. The program will advance these efforts by publishing rules for primary auctions, developing an auction calendar for government securities, and establishing a committee for the strategic management of public debt under MOF. The government has national guidelines on selection and employment of consultants that were issued in 2007. In the absence of a codified public procurement statute, these guidelines have the force of law. The guidelines are comprehensive and broadly aligned with those of multilateral agencies. Sri Lanka signed the United Nations Convention against Corruption and is part of the ADB–Organisation for Economic Co-operation and Development anticorruption initiative. Its legal framework for bribery and corruption is fairly comprehensive, but there are implementation gaps, and the country ranks 83rd in the perception of corruption. In 2009, the Institute of Chartered Accountants of Sri Lanka issued the Sri Lanka Public Sector Accounting Standards. These were based on the standards of the International Federation of Accountants and introduced accrual accounting. The program will strengthen Sri Lanka's policy and legal framework by helping to prepare and submit a proposed SEC bill to Parliament. It will strengthen regulatory capacity through the attached TA. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and implementing agencies. Implementation of the program will adhere to ADB's Guidelines for Implementing the Second Governance and Anticorruption Action Plan.¹⁷

C. Poverty and Social

35. Financial crises disproportionately harm those in society with the fewest resources to mitigate their impact. Capital market reforms under the program will help provide investors with additional investment opportunities and mitigate the risk of financial market instability. Diversification away from a predominantly bank-based system of financial intermediation will expand alternative sources of credit, helping to limit the systemic impacts of economic shocks. Capital markets can stimulate healthy competition with the banking sector that results in lower borrowing costs. The capital market reforms to be pursued through the program will help Sri Lanka diversify its financial system so that the country can realize its broad-based economic growth and socioeconomic development objectives, including poverty reduction.

D. Safeguards

36. ADB's evaluation of the program-supported capital market reforms showed that they will have no direct or indirect environmental impacts, will not cause involuntary resettlement, and will have no impacts on indigenous peoples. The program is classified as category C for environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

37. The program's overall risk rating is *medium*. This is because (i) ADB has solid experience in the sector in Sri Lanka; (ii) the MOF, which will be the executing agency, has a good performance record in project implementation; and (iii) the program is unlikely to have any impact on safeguards. Major risks and mitigating measures are summarized in the following

¹⁷ ADB. 2014. *Guidelines for Implementing the Second Governance and Anticorruption Action Plan*. Manila.

table and described in detail in the risk assessment and risk management plan.¹⁸ The integrated benefits and impacts of the program are expected to outweigh the costs.

Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Vested interests provide resistance to program reforms.	The chairperson of the program steering committee and the executing director have the institutional authority to resolve disputes among stakeholders.
Weak implementation capacity at government agencies delays the implementation of reforms.	The technical assistance attached to the program loan will facilitate the implementation of key second tranche actions by government agencies.
Coordination between government agencies and multilateral agencies is inadequate.	A program steering committee, the Capital Market Advisory Council, will provide coordination. The Asian Development Bank (ADB) will coordinate closely with the World Bank, whose financing, and with the United States Treasury, whose advisor, are expected to support some of the policy actions in the second tranche.
Weaknesses in public financial management result in delayed or ineffective implementation of policy actions.	Public financial management reform will continue under the support programs of several development partners, and ADB will work closely with the government to ensure that this program loan's policy actions have adequate funding.
Key legislation is not adopted by Parliament in a timely manner.	The SEC bill and demutualization bill, whose submissions to parliament are first tranche policy actions, have undergone stakeholder consultation to ease their eventual passage. Similar consultation is envisioned for legislation under the second tranche.

Source: Asian Development Bank.

V. ASSURANCES AND CONDITIONS

38. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan agreement. No disbursement shall be made for a tranche unless ADB is satisfied that the government has completed the relevant policy actions specified in the program's policy matrix.

VI. RECOMMENDATION

39. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$250,000,000 to the Democratic Socialist Republic of Sri Lanka for the Capital Market Development Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and program agreements presented to the Board.

Takehiko Nakao
President

30 September 2016

¹⁸ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impact the Program is Aligned With Basic capital and investment needs, as well as Sri Lanka's longer-term economic objectives supported. (Capital Market Development Master Plan) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome Size, depth, and capacity of the capital market enhanced	By 2019: a. Stock market capitalization as percentage of gross domestic product increased to 25% (March 2016 baseline: 23%) b. Total value of annual corporate bonds issuance increased to SLRs75.5 billion (2013–2015 baseline: annual average of SLRs68.6 billion) c. Total investment portfolio of EPF, ETF and insurance companies in nongovernment securities increased to SLRs302.9 billion (2015 baseline: SLRs275.1 billion)	a. CBSL monthly bulletin b. CSE annual reports c. CBSL and IBSL annual reports	The economy experiences a macroeconomic downturn. Tax amendments discourage corporations to issue bonds.
Outputs 1. Market facilitation enhanced	(All baselines: Not applicable) 1a. Capital Market Strategy approved by the cabinet by Q4 2016 1b. New SEC bill submitted to Parliament by Q4 2016 1c. CSE approved to become a demutualized exchange by SEC by Q2 2018 1d. Rules issued and implementation of capital restructuring plans for intermediaries initiated by SEC by Q2 2018 1e. Installation of a central counterparty system started and clearing company for exchange-listed securities established by SEC by Q2 2018 1f. Installation of a new electronic market surveillance system by SEC started by Q2 2018 1g. Companies not compliant with listing requirements with regards to financial statements, unqualified audit opinions, corporate governance, and	For all indicators: Executing and implementing agencies' progress reports For 1a-1g and 1i: SEC and CSE rules and regulation For 1h: Sri Lanka Accounting and Auditing Standards rules and regulation	Vested interests provide resistance to reforms. The implementation and coordination capacity of government agencies is weak. Weak budget preparation by the government and insufficient funding for ICT systems from development partners result in delayed or ineffective implementation of policy actions. Key legislation is not adopted by

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	<p>related party transactions delisted or have the trading of their shares suspended by SEC by Q2 2018</p> <p>1h. An amendment to the Sri Lanka Accounting and Auditing Standards Act No.15 of 1995 submitted to Parliament by Q2 2018</p> <p>1i. Educational and qualification framework of SEC enhanced by Q2 2018</p>		Parliament in a timely manner.
2. Demand measures enhanced	<p>2a. Rules on the primary auction market for government securities published by CBSL by Q4 2016</p> <p>2b. Operational manual to concentrate issuances across benchmark securities at key points along yield curve and consolidate the number of issuances approved by Q4 2016.</p> <p>2c. Installation of an electronic trading system to capture all government securities trading begun by Q2 2018</p> <p>2d. MOF committee with strategic responsibility for debt issuance with representation from CBSL established by Q4 2016</p> <p>2e. Maturity and series of bonds to be auctioned during the upcoming year published by MOF by Q2 2018</p> <p>2f. Inland Tax Revenue Act amendment submitted to Parliament by Q2 2018</p> <p>2g. Capital plan acceptable to IBSL submitted by insurance companies not in compliance with regulatory capital minimum by Q4 2016</p> <p>2h. A comprehensive strategy for retail education to strengthen financial literacy prepared and staff to implement the strategy engaged by Q2 2018</p> <p>2i. Legal segregation of its life and nonlife operations approved by Sri Lanka Insurance Corporation's board by Q2 2018</p>	<p>For all indicators: Executing and implementing agencies' progress reports</p> <p>For 2a-2c: CBSL rules and regulation</p> <p>For 2d-2e: MOF rules and regulation</p> <p>For 2f: IRD rules and regulation</p> <p>For 2g-2i: IBSL rules and regulation</p> <p>For 2j: MOL rules and regulation</p> <p>For 2k: EPF rules and regulation</p>	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	<p>2j. A white paper on retirement savings reform prepared by Q2 2018</p> <p>2k. Installation of new information and communication technology system begun and training on portfolio management completed for EPF by Q2 2018</p>		
3. Supply measures enhanced	<p>3a. Partial listing of at least three state-owned enterprises by Q2 2018</p> <p>3b. CSE instructed to quote corporate securities using yield to maturity by SEC by Q4 2016</p> <p>3c. Rules for derivatives issued by SEC by Q2 2018</p> <p>3d. Securitization bill that provides for bankruptcy-remote vehicles and tax neutrality submitted to Parliament by Q2 2018</p>	<p>For all indicators: Executing and implementing agencies' progress reports</p> <p>For 3a: Ministry of Public Enterprise Development rules and regulation</p> <p>For 3b-d: SEC and CSE rules and regulation</p>	
Key Activities with Milestones Not applicable			
Inputs Asian Development Bank program loan: Ordinary capital resources: \$250 million Technical assistance: Financial Sector Development Partnership Special Fund: \$0.75 million Technical Assistance Special Fund (TASF-V): \$0.75 million Japan Fund for Poverty Reduction: \$0.50 million			
Assumptions for Partner Financing Not applicable			

CBSL = Central Bank of Sri Lanka, CSE = Colombo Stock Exchange, EPF = Employees' Provident Fund, ETF = Employee Trust Fund, IBSL = Insurance Board of Sri Lanka, ICT = information and communication technology, IRD = Inland Revenue Department, MOF = Ministry of Finance, Q = quarter, SEC = Securities and Exchange Commission, SLR = Sri Lanka rupee.

^a Government of Sri Lanka, Securities and Exchange Commission. 2012. *Capital Market Development Master Plan*. Colombo.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=49365-002-3>

1. Loan Agreement
2. Program Agreement
3. Sector Assessment (Summary): Finance (Capital Market)
4. Contribution to the ADB Results Framework
5. Development Coordination
6. Attached Technical Assistance
7. Financial Analysis
8. Country Economic Indicators
9. International Monetary Fund Assessment Letter
10. Summary Poverty Reduction and Social Strategy
11. Risk Assessment and Risk Management Plan
12. List of Ineligible Items

Supplementary Documents

13. Outline Terms of Reference for Consultants Under the Attached Technical Assistance
14. Governance Risk Assessment
15. Sri Lanka Capital Market Strategy

DEVELOPMENT POLICY LETTER



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MINISTRY OF FINANCE

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திகதி } 6th Sept. 2016
Date }

DEVELOPMENT POLICY LETTER

Mr. Takehiko Nakao
President
Asian Development Bank

Dear Mr. President,

The current government of the Democratic Socialist Republic of Sri Lanka (the Government) was sworn into office in January 2015 on a strong commitment to pursue the reform of the economy of Sri Lanka. This Capital Market Development Program to develop the domestic capital market with the support of the Asian Development Bank (ADB) is a concrete manifestation of that commitment.

A. Background to Reforms

Sri Lanka has been actively pursuing capital market reforms for many years. These efforts have sometimes been done in coordination with its development partners, such as ADB's Private Sector Development Program of 2000 and Financial Markets Program for Private Sector Development of 2004, and sometimes independently, such as the 2013 reforms to promote the primary market for corporate debt.

Although many components of the capital market are in place, Sri Lanka still needs to undertake substantial and challenging structural and policy reforms in order to establish a well-functioning financial system with more broad-based, efficient, and stable capital markets and to fully leverage its potential to achieve long-term economic objectives.

The absence of a developed capital market reduces the range of viable options for companies and borrowers seeking finance for growth and places undue pressure on the banking sector. An efficient and reliable capital market is a critical prerequisite to attract foreign direct and portfolio investment since most foreign investors require a good enabling environment and market depth. Capital market reforms will also complement Sri Lanka's relatively open trade regime and the Colombo port, which is the largest and busiest port in South Asia.

B. Rationale for the Program

Across Sri Lanka's capital market, there are opportunities to strengthen existing market infrastructure and increase the supply of and demand for capital market instruments. The cornerstone of these reforms is the submission of a new SEC bill to parliament. Although periodically amended, the existing Act was passed in 1987, and the passage of a new Act will strengthen the SEC, provide a legal basis for derivatives and other new products, enable market making, and develop the framework for collective investment schemes, such as mutual funds.

The Colombo Stock Exchange is one of the last remaining mutualized stock exchanges in Asia. It is owned and dominated by brokers whose businesses take precedence over market development. This mutual governance structure creates potential conflicts of interest and limits the expansion of the market, development of new products, and introduction of latest technologies.

The equity market is hampered by inadequate compliance of listed companies with reporting and other listing requirements, which prevents informed investment decisions. The limited enforcement effectiveness is evidenced by the non-compliance of over 60 companies with the Colombo Stock Exchange's listing requirements.

The limited resources of the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) hamper its ability to validate the financial statements of public companies.

Unit trusts have limited market share. Impediments to their growth include uneven tax treatment, competition with bank deposits, limited dissemination channels, and poor understanding among some potential subscribers.

The primary dealer system lacks transparency. Secondary trades are often not recorded, which inhibits the development of the risk-free yield curve. The secondary government bond market is also hindered by too many issues of government securities with the average size of each issue being too small, which prevents the creation of liquid benchmark issues.

The corporate bond market remains at a nascent stage. Despite rapid growth since 2013, outstanding corporate bonds account for only 2% of GDP, which is significantly less than in other middle-income Asian countries.

C. The Program

The program seeks to create a policy environment conducive to capital market development. The program aims to develop a fair, transparent and efficient capital market to strengthen public confidence and promote and facilitate investments. The key objectives of the program, set forth in greater detail in the attached Policy Matrix, are discussed below.

1. Market Facilitation

The program will support more effective and efficient mobilization and allocation of resources in the economy through introducing an updated capital market development strategy to guide the various reform initiatives, strengthening the market's legal foundation, enhancing the capacity of regulators, and supporting the operationalization of new electronic systems.

2. Demand Measures

The program will support mobilization of capital market financing. The project outputs will strengthen the functioning of the primary debt market and risk-free yield curve, which are key inputs to investors' decision making. It will also support the development of EPF, which is the single key domestic investor, and of the insurance sector.

3. Supply Measures

The program will increase the supply of bonds, equities, and alternative financial instruments. A greater supply of instruments and issuances will increase market capitalization and liquidity and make the market more attractive to outside investors. Supply measures include both new instruments, such as derivatives and asset-backed securities, and bringing new issuers to market, particularly nonstrategic state-owned enterprises.

D. Program Implementation

The Government is fully aware that the success of the program depends upon the ability of the executing agency to implement the program. The executing agency will be the Ministry of Finance. The implementing agencies will be the SEC, Ministry of Finance, Central Bank of Sri Lanka, Insurance Board of Sri Lanka, Sri Lanka Accounting and Auditing Standards Monitoring Board, EPF, Colombo Stock Exchange, Ministry of Public Enterprise Development, and Ministry of Labor. The program will be implemented over a period of 3 years. A capital markets advisory council chaired by the senior advisor to the prime minister will be shortly established and monitor the program. Additionally, the Deputy Secretary to the Treasury has been identified as the program director. The Government will dedicate counterpart funds generated out of the loan proceeds to meet the costs of adjustment arising from the proposed reforms.

To ensure program quality, the Government will seek and consider the views of all parties to be affected by reforms and consult with as wide a segment as possible of the capital market, prior to implementation of specific reform actions. Specific problems will be brought to the attention of the ADB at an early stage. TA resources will also be central to ensure successful program implementation, and the Government is committed to making effective use of TA resources.

E. Government's Request

The Government considers the development of the domestic capital market to be critical to its overall domestic resource mobilization effort vital for the future growth and development of the country's economy. The Government's ownership of the program is strong as highlighted by the Cabinet approval of the Capital Market Development Strategy. The Government is also acutely aware that as part of its comprehensive economic recovery reforms, the capital market program supported by ADB will be critical to enhance investors' confidence in Sri Lanka and attract greater investments into the country. The Government is also aware that the Program to reform and develop the country's capital market represents a crucial test of the Government's political will to carry out more far-reaching reforms in the financial sector and the overall economy.

The Government is, therefore, dedicating its best staff and resources to undertake the implementation of these reforms. It is confident that it can implement the proposed reforms within the time frame agreed upon and achieve the objectives of the program. The Government would, therefore, like to seek ADB's favorable consideration of its request for a program loan of \$250 million equivalent in support of its policy reform program. The Government will collaborate closely with the ADB in the implementation of the proposed reforms both to facilitate the process and ensure that the reforms carried out meet the requirements of the program. Based on the suggested implementation of the program, and recognizing the long-term nature of reforms to capital market, the Government may consider a follow-up program to deepen reforms included under the program.

The Government believes that successful implementation of the program will facilitate further reforms of the financial sector and more urgently, help meet the immediate and pressing needs of the real sector. The envisioned reforms will complement other ongoing reforms focused on achieving a faster pace of economic growth and raising the living standards of the people of Sri Lanka. We welcome and look forward to ADB's participation in our reform efforts.



Yours sincerely,

Minister of Finance

POLICY MATRIX

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
A. Market Facilitation Objective: To support more effective and efficient mobilization and allocation of resources in the economy.		
1. Promote capital market development through a long-term vision for the capital markets and inter-agency coordination	(1) Cabinet will have approved the Capital Market Strategy to include the following elements: (i) Capital Market Advisory Council at the strategic level to facilitate the inter-agency policy coordination and the implementation of the Capital Market Strategy; and (ii) Capital Market Development Division at SEC to spearhead the implementation of the Capital Market Strategy. (Cabinet) (Documents Required: Letter confirming Cabinet's approval of the Capital Market Strategy, and copy of the Capital Market Strategy, both from Cabinet Secretary's office)	
2. Enhance SEC's role to develop and monitor the market	(2) A new SEC bill to include the following elements will have been submitted to Parliament: (i) enhancing the SEC's governance by requiring the provision of cause for the dismissal, introducing term limits, and including qualification criteria in the appointment of Commission members and transferring the power to appoint and remove the director general of the SEC to the Commission; (ii) enabling the regulatory framework to introduce derivatives, including commodities	

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
	derivatives; (iii) enabling market making and securities borrowing and lending; and (iv) enhance the framework for collective investment schemes (mutual funds). (MNPEA and SEC) (Documents required: Letter confirming submission of SEC bill, and certified copy of the bill, both from Secretary General of Parliament)	
3. Improve regulation, governance, and operation of stock exchange	(3) A Demutualization bill will have been submitted to Parliament. (MNPEA and SEC) (Documents required: Letter confirming submission of demutualization bill, and certified copy of the bill, both from Secretary General of Parliament)	(1) A license will have been issued approving CSE as a demutualized exchange. (SEC) (Document required: Copy of the license, certified by SEC Director General or officer-in-charge)
4. Strengthen regulatory measures		(2) SEC will have: (i) issued risk-based capital rules for intermediaries; and (ii) adopted and initiated the implementation of capital restructuring plans for intermediaries. (SEC) (Documents required: Copy of risk-based capital rules certified by SEC Director General or officer-in-charge, and letter from same confirming that implementation of capital restructuring plans for intermediaries has been initiated)
5. Strengthen market infrastructure	(4) A clearing company for exchange-listed securities will have been incorporated. (SEC)	(3) A central counter party system will have begun to be installed. (SEC)

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
	(Document required: Certificate of Incorporate from the Registrar-General of Companies)	(Document required: Letter from SEC Director General or officer-in-charge confirming that the central counterparty system has begun to be installed)
		(4) A new SEC electronic market surveillance system will have begun to be installed. (SEC) (Document required: Letter from SEC Director General or officer-in-charge confirming that the electronic market surveillance system has begun to be installed)
6. Expedite enforcement actions	(5) CSE will have coordinated with the SEC and issued a circular requiring all listed companies to comply with continuous listing requirements on timely submission of financial statements, unqualified audit opinions, corporate governance, and related party transactions or otherwise have their trading suspended or be delisted. (SEC) (Document required: Copy of the circular, certified by SEC Director General or officer-in-charge)	(5) Companies that are not compliant with listing requirements as of issuance of the circular under Tranche 1 will have had their trading suspended or be delisted. (SEC) (Document required: Letter from SEC Director General or officer-in-charge confirming that trading of non-compliant companies have been suspended)
7. Strengthen auditing		(6) An amendment to the Sri Lanka Accounting and Auditing Standards Act No.15 of 1995 will have been submitted to Parliament on a priority basis that reconstitutes SLAASMB as an independent body and allows it to; (i) Fund itself through contributions from listed exchanges, regulatory agencies, and the central government; (ii) Determine its own staffing needs and pay

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
		<p>salaries competitive with market rates; (iii) Determine the work scope to focus on entities that are likely to propose a risk to the public interest or to the viability or stability of the public markets; (iv) Recover, for cases decided in its favor, the costs of investigation and prosecution; and (v) Permit SLAASMB to conduct qualitative reviews of audit firms.</p> <p>(SLAASMB and MOF) (Documents required: Letter confirming submission of amendment to Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, and certified copy of the amendment, both from Secretary General of Parliament)</p>
8. Education, training, and certification		<p>(7) SEC's educational and qualification framework will have been enhanced to include the following elements: (i) enabling qualified market intermediaries to deal with different asset classes; (ii) enhancing financial literacy and outreach for unit trusts; and (iii) developing continuous securities-related education programs.</p> <p>(SEC) (Document required: Copy of enhancements, certified by SEC Director General or officer-in-charge)</p>
B. Demand Measures		

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
Objective: Support mobilization of capital market financing.		
1. Develop liquid bond markets	(6) Two representatives from MOF will have been appointed to CBSL's Auction Tender Board Committee. (MOF and CBSL) (Document required: Letter from CBSL Assistant Governor or Superintendent, Department of Public Debt, confirming that MOF representatives have been appointed)	(8) MOF will have established a committee with strategic responsibility for debt issuance and its membership will include senior representation from CBSL. (MOF) (Document required: Letter from MOF Deputy Secretary to the Treasury, or officer-in-charge confirming that the committee has been established)
	(7) CBSL will have (i) published rules that primary auctions of government securities will follow in terms of transparency and predictability and (ii) completed an inspection of all non-bank primary dealers for compliance with the October 2015 capital adequacy directive. (CBSL) (Documents required: Copy of the rules, certified by CBSL Assistant Governor or Superintendent, Department of Public Debt, and report from CBSL indicating the results of the inspection)	
	(8) CBSL will have approved revisions to the Public Debt Department's operational manual resulting in concentration of issuances across benchmark securities at key points along the yield curve and consolidation of the number of issuances. (CBSL) (Document required: Copy of the approved revisions, certified by CBSL Assistant Governor or Superintendent, Department of Public Debt)	
	(9) A circular will have been issued requiring all	(9) An electronic trading system to capture all

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
	secondary market trading to be reported to CBSL via Bloomberg. (CBSL) (Document required: Copy of the circular, certified by CBSL Assistant Governor or Superintendent, Department of Public Debt)	government securities trading will have begun to be installed. (CBSL) (Document required: Letter from CBSL Assistant Governor or Superintendent, Department of Public Debt confirming that the electronic trading system has begun to be installed)
	(10) The maturity and series of bonds to be auctioned during the upcoming quarter beginning with October-December 2016 will have been published on a website. (MOF, CBSL) (Document required: Copy of the website extract showing the bond auction quarterly schedule, certified by, as applicable, either CBSL Assistant Governor or Superintendent, Department of Public Debt, or Director General, Department of Treasury Operations or officer-in-charge)	(10) The maturity and series of bonds to be auctioned during the upcoming year will have been published on a website. (MOF, CBSL) (Document required: Copy of the website extract showing the bond auction annual schedule, certified by, as applicable, CBSL Assistant Governor or Superintendent, Department of Public Debt, or Director General, Department of Treasury Operations or officer-in-charge)
		(11) An amendment to the Inland Tax Revenue Act will have been submitted to Parliament so that unit trusts will become tax pass-through vehicles. (MOF) (Document required: Letter confirming submission of amendment to Inland Revenue Act, and certified copy of the amendment, both from Secretary General of Parliament)
2. Enhance institutional investor demand by developing the insurance	(11) Any insurance company not in compliance as of 31 March 2016 with regulatory capital requirements will have submitted a capital plan that is acceptable	

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
and pension sectors.	to IBSL, or IBSL will have taken regulatory action against such company. (IBSL) (Document required: Letter from IBSL Director General or officer-in-charge confirming that non-compliant insurance companies have submitted capital plans acceptable to IBSL or that regulatory action has been taken)	
		(12) IBSL will have (i) established and staffed a dispute-resolution panel for the insurance sector that submits its recommendations to IBSL's board and (ii) commenced implementation of a comprehensive strategy for retail education to strengthen financial literacy, and (iii) caused Sri Lanka Insurance Corporation to have secured its board's approval of the legal segregation of its life and non-life operations as undertaken by the Chairman of SLIC's board. (IBSL) (Document required: Letter from IBSL Director General or officer-in-charge confirming that the dispute-resolution panel has been established and staffed, implementation of the comprehensive strategy for retail education has commenced, and SLIC's board has approved the legal segregation of its life and non-life operations)
	(12) EPF's investment policy statement will have been amended to allow investments in foreign equities. (EPF)	

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
	(Document required: Copy of amendment to investment policy statement, certified by Superintendent, EPF or officer-in-charge)	
		(13) A white paper on retirement savings reform to include establishing professional fund managers will have been submitted to the cabinet. (MNPEA) (Document required: Letter confirming submission of the white paper, and certified copy of the white paper, both from Cabinet Secretary's office)
		(14) A new EPF ICT system to integrate member data with the general ledger will have begun to be installed. (EPF) (Document required: Letter from Superintendent, EPF, confirming that the ICT system has begun to be installed)
C. Supply Measures Objective: To increase the supply of bonds and alternative financial instruments through the capital markets.		
1. Promote SOE listing on the CSE		(15) At least three SOEs will have been partially listed on the CSE. (MOF, MPED and SEC) (Document required: Letter from Secretary, MPED or officer-in-charge confirming partial listings)
2. Enhance supply of bonds (including promotion of alternative	(13) SEC will have instructed the CSE to make the necessary system change to quote the prices of corporate securities using yield to maturity.	

Objectives and Policy Actions	1 st Tranche Policy Action (by Q4 2016)	2 nd Tranche Policy Action (18 months after T1)
sources of bond financing)	(SEC) (Document required: Letter from SEC Director General or officer-in-charge confirming that instruction has been given)	
3. Promote derivatives		(16) Rules for derivatives will have been issued. (SEC) (Document required: Copy of rules for derivatives, certified by SEC Director General or officer-in-charge)
4. Promote asset securitization		(17) A Securitization bill will have been submitted to Parliament that provides for bankruptcy remote vehicles and tax neutrality. (SEC) (Document required: Letter confirming submission of Securitization bill, and certified copy of the bill, both from Secretary General to Parliament)

CBSL = Central Bank of Sri Lanka; EPF = Employee Provident Fund; IBSL = Insurance Board of Sri Lanka; SEC = Securities and Exchange Commission of Sri Lanka; MOF = Ministry of Finance; MNPEA = Ministry of National Policy and Economic Affairs; MPED = Ministry of Public Enterprise Development, SLAASMB = Sri Lanka Accounting and Auditing Standards Monitoring Board, SLIC = Sri Lanka Insurance Corporation, SOE = state-owned enterprise.