

# Seminar on Capital Market Development

Organised by the

Maldives Monetary Authority

8 May 2001



## *Contents*

Introduction .....	▶ 5
Welcoming of the Guests .....	▶ 6
<i>Ms. Fathimath Shafeega, Deputy Manager- Maldives Monetary Authority</i>	
Opening by the chief guest .....	▶ 8
<i>Honourable Abdulla Yameen, Minister of Trade and Industries</i>	
An Address .....	▶ 11
<i>Honourable Mohamed Jaleel, Minister of State for Finance and Treasury and the Vice Governor of Maldives Monetary Authority</i>	
Seller’s Perspective - Why companies should consider “Going Public” .....	▶ 13
Buyer’s Perspective - Why investors should save and lend to “Listed” Public Companies .....	
<i>Professor. Peter McKenzie QC- consultant –Commonwealth Secretariat</i>	
Regulatory Framework– Stock Exchange / Regulator .....	▶ 13
<i>Mr. Makbul Rahim- Chief Legal Adviser-Commonwealth Secretariat</i>	
Developing a Capital Market / Administrative Framework / Role of Dealers .....	▶ 22
<i>Mrs. Sharda Dindoyal-Resident Adviser-Commonwealth Secretariat</i>	
Accountability to Shareholders - Role of International Credit Rating Agencies .....	▶ 29
<i>Mr. Ravi Abeysuriya- Chief executive Officer Fitch Rating Agency-Sri Lanka</i>	
Key Questions/ Answers .....	▶ 33
<i>Panel members</i>	
Appendix .....	▶ 49
I. Agenda of the seminar	
II. List of participants	



## *Introduction*

A seminar on capital market development in the Maldives organised by the Capital Market Development Section of the Maldives Monetary Authority was held on the 8<sup>th</sup> of May 2001 at the Nasandhura Palace Hotel in Male'.

The objective of the seminar was primarily to sensitize the audience on the need to develop a capital market for Maldives and discuss ways and means of its establishment in the best interests of Maldivian companies, the investing public and Government.

Participants included policy makers in the government namely: Ministers representing the key sectors of the economy, leading private companies, state owned enterprises, banks, insurance companies, accounting and audit firms, Representatives of tourist resorts, the academia and the media.

The Minister of Trade and Industries, Honorable Abdulla Yaamin opened the seminar. In his inaugural speech, the Minister conveyed important messages to the business community, the investors and the media following the trade

The Minister of State for Finance and Treasury and the Vice Governor of the Maldives Monetary Authority next addressed the seminar and emphasized that the key areas, which will receive immediate attention in the context of capital market development will be *(a) the building up of an enabling legal infrastructure and (b) capacity building and resource development and training.*

The panel of speakers comprised the senior officials of the Maldives Monetary Authority

Ms. Khadeeja Hassan, General Manager  
Mr. Abdul Ghafoor, Deputy General Manager  
Mr. Ibrahim Naeem, Assistant General Manager  
Ms. Fathimath Shafeega, Deputy Manager and  
Mr. Mohamed Ghiyas, Assistant Manager

and four eminent foreign market practitioners, namely

Ms. Sharda Dindoyal, the former Chief Executive Officer of the Stock Exchange Commission in Mauritius of the Securities and Exchange Commission  
Professor McKenzie QC, former Chairman of the Securities Commission in New Zealand,  
Mr. Makbul Rahim, Chief Programme Officer (Legal) of the Commonwealth Secretariat  
Mr. Ravi Abeysuria, the CEO of Fitch Ratings Lanka Ltd.

The above mentioned panel members played a key role in the seminar and their presentations and contributions need special mention.

The audience showed much interest and enthusiasm in the capital market project and demonstrated a willingness to participate, which was very encouraging and indicative of the future success of this venture.

## *Welcoming of Guests*

*By Ms. Fathimath Shafeega*

Minister of Trade and Industries, Honourable Abdulla Yaamin, Minister of State for Finance and Treasury and the Vice Governor of the Maldives Monetary Authority Mr. Mohamed Jaleel, Honourable Ministers, Distinguished Participants,  
*Assalamu Alaikum!*

It gives me immense pleasure to extend a warm welcome to all the participants who have taken time off from their heavy schedule to attend this seminar on the important topic of capital market development in the Maldives.

Ladies and Gentlemen!

This is the first of a series of seminars to be organized by the MMA, with a view to sensitizing members of the public, potential market participants and players, on various aspects of capital market operations.

This seminar on the development of a capital market in the Maldives with a specific focus on the eventual establishment of a Stock Exchange is taking place at a challenging time in the development of our businesses and industries.

MMA has initiated and continues to take measures to reform the financial sector of the Maldives, so as to keep abreast with financial developments and innovations that are taking place the world over and to better prepare for the challenges that lie ahead in this new millenium.

Since a Capital Market and Stock Exchange are new ideas in the Maldivian context it is felt that it would be important to present to you what is being discussed and obtain your advice as much as we can, prior to opening the doors of the proposed stock exchange.

Today, we are proud and privileged to have with us four resource persons who have extensive experience in the area of capital markets.

First of all I would like to introduce, Ms. Sharda Dindoyal, the former Chief Executive Officer of the Stock Exchange Commission of Mauritius, under whose guidance the capital market project is making headway towards a Stock Exchange for the Maldives. Ms. Dindoyal is on leave

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**MMA has initiated and continues to take measures to reform the financial sector of the Maldives**

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from the Mauritius Stock Exchange Commission, undertaking this important advisory role to the Government of Maldives under the sponsorship of the Commonwealth Fund for Technical Corporation.

We are also honoured to have with us, Professor McKenzie and Mr. Makbul Rahim who are consultants with the Commonwealth Fund for Technical Cooperation.

Professor McKenzie and Mr. Makbul Rahim have traveled all the way from London to take part in this seminar and also to impart their in-depth knowledge on the subject.

Professor McKenzie was a former Chairman of the Securities Exchange Commission in New Zealand. He has carried out extensive work in the area of financial markets. He is also an avid scholar and researcher who had worked both at the international and national levels in the area of capital market.

Mr. Makbul Rahim being a lawyer and a consultant had drafted laws and regulations dealing with securities business in many countries and has extended his consultancy services to many international organisations.

Last and not least, we are greatly privileged to have Mr. Ravi Abeysuria Chief Executive Officer and Managing Director of Fitch Ratings Lanka ltd.

Mr. Ravi Abeysuria is a chartered financial analyst and a researcher in the debt market. The numerous journal articles, he had authored on various aspects of capital market speak volumes of his capabilities.

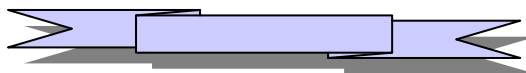
I am confident that we will all benefit from the richness of knowledge and experience brought in by these resource persons. We hope that the participants of this seminar will take full advantage of the eminent colleagues' presence by actively taking part in the discussions.

On this occasion, I am also delighted to acknowledge the work of the former Vice Governor of the Maldives Monetary Authority Honourable Arif Hilmy, whose untiring efforts, in a large measure, resulted in the birth of this project.

Ladies and Gentlemen!

We are determined to honour the confidence placed in us by you by making this session an informative and enjoyable session for everyone.

Thank you.



*Opening by chief guest,  
Hon. Abdulla Yameen*

It gives me great pleasure to have been invited to open the seminar on Capital Market Development, which is being organized under the aegis of the Maldives Monetary Authority.

Capital Market development is now a key policy objective for most Governments in developing countries, which have decided to undertake major reforms of their financial sectors to take full benefits of the internationalisation of world markets.

The objective of this seminar on Capital Market Development is primarily to sensitize this audience on the potential which the Maldives has to develop a capital market and introduce new financial products such as shares, bonds, debentures, convertible bonds, warrants and so on... as new sources of investment and savings.

I have a number of messages, which I would wish to convey to you at the wake of this new development for the Maldives.

*My first message is to the Business community.*

To succeed in today's competitive environment, there is no alternative but to adopt a new corporate culture and financing strategy which is more in tune with international trends.

What we are seeking to achieve is to alleviate concerns regarding this new development.

In fact, Capital Market Development is synonymous to Private Sector Development and you need to play a key role in this venture.

We do not pretend to come forward with a Big Bang and establish within the next few months an active and vibrant stock market. We are taking a gradualist approach. We wish to establish our market with few key market players, which eventually would grow as and when the market grows in sophistication and maturity.

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**We do not pretend to come forward with Big bang and establish within the next few months an active and vibrant stock market**

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Though our stock market will be small the need for good corporate disclosure and transparency will not be overlooked. We wish to

establish corporate governance norms for companies similar to those that are obtained in developed markets.

The Maldivian companies must, when listed on an Exchange, operate like its counterparts in any other Exchange of the world. These companies must issue financial statements and accounts, which are comparable with those of their counterparts in developed capital markets such as in Sri Lanka, India, Singapore or

the U.K. It is only then that we shall be able to make a breakthrough and form a small but well regulated Exchange and build linkages with the world capital markets.

We need the full cooperation, determination and efforts of the business community to achieve our objectives of developing small but with all the potential of becoming a financial centre for the region.

*My second message will be to the Maldivian investor.*

Your Government is doing its utmost to make you participate as equity owner either in state owned companies or private sector companies. We intend not only to privatize some of our stateowned companies but also impress on the private sector, the need to broaden ownership and create a wide shareholder base for the Maldives. You will need to be alert to this new development and take advantage of the Investor Education and Awareness Campaign program, which I understand will be undertaken by the Capital Market Section of the MMA to acquaint yourselves of the risks and rewards of investing on the Capital market.

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Government is doing its utmost to  
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companies

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As owners of companies in the Maldives I am sure you will participate more effectively in the industrial and economic life of our country. I would also encourage companies to develop share employee schemes or Management share schemes, as I believe in the active involvement of both management and employees in the companies they serve.

To establish an Exchange we would also require initiative and entrepreneurship in a new area of activity. We intend to create a new breed of financial intermediaries, which will deal on the market for their clients. These intermediaries have to be professionals with quite advanced knowledge on stock exchange operations, techniques, law and companies valuation. Investors will depend to a large extent on their professional advice when investing on the market. Furthermore, these intermediaries must be men of integrity and honesty as they would deal with clients' money Confidence of investors in these professionals is key to the success of the capital market.

*Therefore, my third message will be towards these professionals,*

Which I hope would wish to avail themselves of the new opportunities, which our Government will soon offer them, namely that of undergoing intensive training, which is being organized by the Capital Market Section of the MMA to become licensed dealers.

Diffusion of information on the market and companies traded will play a significant part in press reports.

*My fourth message is to the financial press*

Who must also be alive to this new development. We would require a lot of diligence and expertise on their part in this new field of activity so that investors are given clear and precise information on the state of the market.

I wish to take this opportunity to thank the Commonwealth Secretariat for their efforts to ensure that this project meets with success. To day we have the presence of two representatives from the Commonwealth Secretariat who have agreed to come and participate in this seminar. They are men of experience and have been with us since 1995 to look into all the legal implications and infrastructure, which we in the Maldives need to build to place our capital market on solid and healthy conditions. The Commonwealth Secretariat has also sent us a Resident Adviser who is currently assisting us on the project.

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**We intend to create a new breed of financial intermediaries, which will deal on the market for their clients**

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in this seminar.

I also wish to acknowledge the presence among us of a distinguished practitioner from the neighboring island of Sri Lanka who has also come to the Maldives to participate

Last but not least I wish to place on record the efforts that the Maldives Monetary Authority has put together to organize this seminar which demonstrates a real sense of purpose and commitment towards attaining an objective which they have since 1995 been promoting.

Finally, as I said before and I repeat it now, though we would encounter a number of constraints we are keen to go ahead and develop the Maldives Capital Market and its Stock Exchange. The Government has placed capital market as a priority on its agenda for development.

With your cooperation and determination we shall make this challenging task a success and I have much pleasure to declare this seminar open.

Thank you.



*Address by Hon. Mohamed Jaleel*

Honourable Minister of Trade and Industries, Distinguished Ministers, Participants, Good Morning and Welcome to the seminar.

I do not intend to make a long statement. The Honourable Minister of Trade and Industries who is also one of the Members of the Coordinating Committee for the development and establishment of the capital market, has very ably explained the developments that have taken place so far and the Government's goals and objectives to ensure that a capital market functions in this country.

I would wish to use this opportunity to, first of all thank the Honourable Minister of Trade and Industries for having made time available during these very early hours of the morning to make his inaugural speech for this important workshop. I thank you Mr. Minister. This certainly bears witness to the fact of your great commitment to this project.

I, also wish to emphasize that we are gathered today to confront the realities of a world economy where changes are accelerating.

We are witnessing increasing momentum towards regionalisation in trading arrangements and the enlargement of world markets. This workshop is held at a especially opportune time and I think, we are here, to reap the maximum benefits of these developments.

An efficient capital market is needed to mobilize domestic resources and to allocate relatively scarce capital to productive uses. We have been hearing for many years the kind of difficulties that the business community in the country has been facing in their developmental efforts.

The Governor of the Maldives Monetary Authority, His Excellency the President, has placed a high priority as noted by the Honourable Minister of Trade to the development of the financial sector and in particular the development of the capital market in this country. Let me take this opportunity to convey my very special thanks to His Excellency the President for his unflinching support and efforts towards the national development of this country.

As was noted earlier, by Ms. Fathimath Shafeega, who has been working very hard in making this project a success, my predecessor Honourable Arif Hilmy's efforts must be commended. Since 1995, he has been committed to make this project a success. He has laid the foundations and set the stage for us to follow. When I say us I am including the general business community and the staff of the Maldives Monetary Authority. We however deeply regret the absence of Mr. Arif Hilmy in this seminar today.

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**An efficient capital market is needed to mobilize domestic resources and to allocate relatively scarce capital to productive uses**

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I would like to join Minister Yaamin and the previous speaker here in very warmly

welcoming the guest speakers particularly from the Commonwealth Secretariat from whom we have been getting continuous assistance since 1995. I would also like to convey special thanks to the distinguished experts who are here today.

In this context let me emphasise the efforts made by Ms. Sharda Dindoyal, The Resident Adviser from the Commonwealth Secretariat. She is always knocking on my door to get something done as quickly as possible to get this project off the ground. Her untiring efforts, I think are highly commendable and I wish her very special thanks.

Finally I would not wish to omit the participants in my list of thanks. It is only the collective efforts of the community as well as the general citizens of this country, which will make things happen. They represent the two sides of a coin: people who save at household level and businesses, which then utilize these savings as investment finance. Collective effort is I reiterate again, what will make the project a success.

I hope that this sensitization program, the series of programs that we are beginning today will be taken over to the general community at the grass root level. The small investor has to be explained the kind of benefits that we can reap together if we establish this new venture.

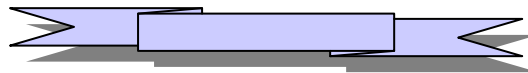
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**It is only the collective efforts of the community as well as the general citizens of this country, which will make things happen**

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To conclude, I would like to thank the staff of the Maldives Monetary Authority and in particular the staff of the Capital Market Development Section (CMDS) for their very hard

work for a long time. However this is not the end of this work. The challenges ahead are much more daunting than what we have experienced so far and I have absolutely no doubt that the staff of the CMDS are dedicated and highly committed to making capital market activities a success in Maldives and I thank you very much.



*Seller's perspective – Buyer's Perspective*  
*by Prof. Peter McKenzie*

Mr. Peter McKenzie expressed the pleasure he felt to be back in Male'. When he was given the invitation to come from New Zealand to intervene in the seminar he did not expect to encounter so much interest. He was very much encouraged by the response and the number of participants in the seminar.

The video, which was presented to seminar participants, raised a number of questions, prominent among which were

*What were the advantages of establishing a Stock Exchange for the Maldives?*

*What are the advantages for investors?*

*What advantages were there for companies to list their companies on an Exchange?*

It was helpful before looking at the particular topic of the session to outline some of the basics.

Securities Markets will function only if three groups of people are active:

**(a) Sellers:** namely companies, which are going public and selling their shares or debentures to investors. Companies in the Maldives must examine the advantages and opportunities that there are in the capital market in the Maldives. It was important however for seminar participants to realize that there are two kinds of market involved in the capital market.

The **primary Market**, where companies put their shares on the market make them available to the public

The **secondary market** where once the shares issued are in hands of those who have decided to put their money in the public companies wish to liquidate, or transfer their shares to some one else (that is where the Stock Exchange has a particular role to play by bringing buyers and sellers together).

**(b) Buyers:** namely investors, who have money to put in the share market, and purchase shares of listed companies

**(c) Market intermediaries;** namely

(1) a group of brokers, who will bring buyers and sellers together and match deals.

(2) investment advisers professionals who have studied the market, the individual securities that are available and are in a position to advise members of the public as to the desirability or otherwise of investing in public companies

Of these groups of people, it is the first two( buyers and sellers) on which emphasis will be placed during this session.

"What is the point of going public? some companies might ask .Capital can be raised from the bank and control can be retained within the family. Going public will mean allowing some other persons in a company. However there are advantages and these will now be elaborated

### **Advantages to Issuers**

- *Access to equity capital.*

Equity is one of those words that appear in English law and refer to the owners of the underlying entitlement of the surplus in a company. Shareholders who own ordinary shares are entitled to the surplus in the company, in the growth or the capital increase. These are equity shareholders. The advantage of having equity shareholders is to find people who are willing to become partners in a company.

Equity shareholders are not lending money. They are not like a bank where there is a requirement to pay a fixed rate

Companies in the Maldives must examine the advantages and opportunities that there are in the capital market in the Maldives

of interest on the money that is borrowed for a fixed term and to be repaid in time. In the case of equity capital, people are willing to join as if on a partnership type of basis, to share in the growth and returns of the company.

Equity shareholders are not in a position at any time to ask from the company their money back. They can only get their money back if they sell their shares on the stock market to somebody who is willing to invest in the company.

. With equity Capital, there is no fixed return. In the good years and in times when the company wants to attract new shareholders, it will be advantageous for the company to pay the shareholders a healthy and good return on their shares. However, in a lean year, there will be no requirement for the company to pay the 14%, which it has to pay in the case of bank loan, for example.

The only problem would be to face the music at the annual meeting of shareholders. Shareholders are long suffering bodies who do well in the good years but suffer in the

A number of share markets have been able to take off though Government offering tax incentives to companies going public

bad years and they are not in a position to do anything other than complain. Thus equity capital is cheaper and there is no interest burden. It is permanent and not repayable and there is no debt

burden for the company.

- *The company is able to issue debentures.*

Debentures are a form of loan capital, units by way of debt that are offered to members of the public. Members of the public are willing to lend money to the company usually through a trustee and the terms at which the public may be prepared

to lend may be more flexible than what is obtained from a bank. So there are specific advantages in issuing debentures rather than borrowing from the bank. It is also a cheaper and more flexible source of loan capital which a Central Bank is often interested in as it introduces a great deal of financial flexibility in the market. It is a private source of loan capital.

- *Increase in the lease period*

There is another advantage, which is available to one industry sector in the Maldives and specific to the Maldives. A number of stock markets have been able to take off through Government offering tax incentives to companies going public. As there are no corporate taxes in the Maldives, this is a carrot, which cannot be offered in this tax haven paradise.

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Leading companies in the Maldives have already adopted International standards and as such it would not be an increased burden for effectively administrated companies

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But in the tourism sector, there is an incentive being presently offered by Government as through legislation there is an increased term in the lease period of a resort, a longer term of 50 years to companies which are willing to go public and offer at least 50% of their shares to the public with not one shareholder holding more than 1% to ensure diversity and spread of shareholding. The public must be Maldivian citizens. For those companies, which are already in existence, there is an extension of the existing lease if they are willing to go public.

### ***Obligations of Issuers***

Having mentioned the advantages to issuers one however needs to get the full picture as going public also carries with it certain obligations

- *The first obligation is that of sharing profits with new shareholders*

In a family structure there is no need to share profits. Ordinary shareholders are entitled to a proportionate part of the surplus capital and income generated by the company as well the founding proprietors. Preference shareholders, holders of preference shares are given a preference as to payment of dividends and repayment of capital in the case of winding up of the company.

A company is able to structure itself in such a way that it can issue a group of preference shares which would grant certain preference as to payment of dividend and on winding up but with all the remaining surplus going to ordinary shareholders. Family proprietors can structure their company in such a way that they can still maintain a reasonably significant stake on the ongoing surplus.

- *The other obligation is that there is the important responsibility of increased disclosure, transparency and improved principles of corporate governance*

A sound administered company must for the benefit of its shareholders prepare proper financial accounts, otherwise directors will not be in a position to effectively operate the company if the ongoing financial position is not known. In a number of jurisdictions, financial accounts are prepared on the basis of International Accounting Standards, set up by an International Body.

The standards of this widely recognized body, if adopted, in the Maldives will give international banks and investors confidence in the companies in the Maldives. It is understood that leading companies in the Maldives have already adopted international standards and as such it would not be an increased burden for effectively administered companies.

Some closely held family companies may find it less attractive to disclose the financial affairs of their companies to new shareholders that are brought in which they may regard as outsiders. However, this is an important aspect of the financial market. If companies are attracting new capital, along with it is the responsibility to be transparent and to disclose to shareholders the financial status of the company.

- *There is also the obligation to disclose to the Regulator and to ensure good and sound practice when a company goes public.*

These are issues that will be developed by other intervenants of the seminar. In brief though there are advantages for companies to go public but there are obligations and new responsibilities that have to be taken on board by companies raising equity.

### **Advantages for Investors**

The question that might be raised is what does one do if one has some savings? The savings can be placed in the bank at a rate of interest of 6% or under the bed. However if a share market is established and there is a significant number of public companies involved in important areas of the economic life of the country, then

*investors will have an avenue for their savings*

Investors have the opportunity to share in the growth of the tourism, retail, construction, public sector companies, in short, in the capital growth of the Maldives.

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**The individual investor does not have to make an individual decision where to place his savings**

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This gives investors of the Maldives more investment opportunities than depositing their money in the bank.

*It also provides opportunities to foreign investors to participate in the future growth of the Maldivian economy.*

Once there are a number of investors exchanging their investment in a number of companies on the share market, it brings opportunities for a balanced portfolio of investments.

*Investors have a choice instead of placing their money in only one company they can pick areas of growth and move their money, buying and selling and placing it where it is going to be most profitable.*

This of course serves an economic purpose because it enables funds to go to those sectors of the economy which are growing. The stock market is very important in an economy as it is the channel in which money is flowing in directions in which it is needed. It also brings with it the opportunities to establish mutual funds or unit trusts as vehicles to handle a portfolio of investments in different companies. The individual investor does not have to make an individual decision where to place his savings. These decisions are made by an expert fund manager within a mutual fund, which would spread the risk by spreading the investments across different sectors of the economy.

*Investors are in a position to invest in the Maldives.*

In New Zealand for example, a lot of money is going offshore because the stock market has not been performing so well. A lot more would have gone abroad, however if the stock market in New Zealand did not exist. Until the Maldives develops a stock market, those who have savings and are not content only to place these in the bank will seek for opportunities abroad. A stock market in the Maldives will provide people with the opportunity to see their savings grow within their own economy and within their own country.

A public company needs to proceed on the basis that the majority of the voting shares will be in a position to remove the directors

### **Features of a Company going public**

If a market in shares of public companies is to be established, these shares must be freely transferable. Investors must be free to trade these shares without the directors of the company being in a position to refuse to accept them as shareholders

*. So the public share market gives the ability for shareholders to gain access into a company regardless of the views of directors of that company as to their suitability and to freely exit and enter the company.*

Within management itself, there is a distinction between executive management decision made within the executive body of the company and the decisions relating to corporate governance of the company, which are made by a board comprising executive directors working for the company and non-executive directors with input from outside.

In the case of a public company it is not necessary for all shareholders to serve on the Board of Directors.

*One of the advantages of a public company is that it enables shareholders to entrust to those who have expertise to manage the company and take management decisions.*

*A feature of a public company is limited liability .Shareholders do not stand any risk*

*of losing money except what they have put in the company as fully paid shares*

*Another feature is that the Board of Directors is accountable to the majority of ordinary shareholders.*

Public companies proceed on the basis of one share one vote, but this is attributable to ordinary shares only.

Companies can of course structure their capital and issue preference shares, which do not carry a vote. These shares have a fixed return and are not "growth shares" as in the case of ordinary shares. A public company needs to proceed on the basis that the majority of the voting shares will be in a position to remove the directors.

However, companies can structure their capital in such a way that they have debenture loan capital, preference share capital and so on. In brief, a capital structure, which is most appropriate for them.

There, could of course, be some restrictions, which could be imposed through legislation in the interest of the economy in relation to the percentage of shares to be held by local shareholders or overseas shareholders. Through statute a number of restrictions could be imposed on companies if thought appropriate.

*There is a fear often expressed by family and closely held families regarding the loss of control of the company if they go public.*

However in developing share market takeovers is generally not a feature of that market. For example, in Mauritius, there are very few takeovers. Economists agree

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Economists agree that a healthy share market is one where control can pass in a number of companies but this is unlikely to develop for sometime in the Maldives

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that a healthy share market is one where control can pass in a number of companies but this is unlikely to develop for sometime in the Maldives. Companies may not offer in the Maldives more than 25%, 30% or 40% of their shares to

the public except in the tourism sector where there is an incentive to offer 50%. However even with 50% the control is still in the hands of the founding proprietors as the remainder is spread amongst a number of different shareholders. The only obligation is that there needs to be independent directors to represent the other shareholders. It is to be expected that the majority of Directors will be drawn from the family group of shareholders and a take over can only take place if the majority shareholders give their consent. Therefore, the fear of losing control when going public is minimal, the more so when the capital structure can also be formed in such a way so that the initial group of shareholders retain majority control

## *Regulatory Framework – Stock Exchange/Regulator by Mr. Makbul Rahim*

Mr. Makbul Rahim, in his opening remarks, conveyed the appreciation and great honour, which the Commonwealth Secretariat including himself, Professor McKenzie and the Resident Adviser had to be associated with the capital market project of the Maldives, which he believed, was a worthwhile challenge. The challenge was worthwhile as developing a stock exchange is not necessarily an easy task. Many countries are trying to establish stock exchanges and experiences vary in the time taken to achieve the overall objective. Whatever the case may be it is a task that was worth pursuing to the maximum of one's ability.

### *Scope and Content of Regulation*

Stock Exchange activities, he said, are generally private sector led and in many cases the regulation of securities market have originated from the market itself. Self-regulation is what makes the managers of the market formulate rules of conduct for their members and in fact, operate the market. The degree of self-regulation has to be qualified, however, with external supervision to ensure public interest. Basically therefore the regulatory framework is one where a private sector led activity operates within the supervision or under the supervision of a Regulator. One of the main instruments of Regulation is the licensing regime for the stock exchange and the market intermediaries. The licensing regime will ensure that the market intermediaries have proper standards of probity and professional conduct and a proper stock exchange has been authorised.

### *The Functions of the Regulator*

The Regulator in the case of Maldives will be the Capital Market Authority and its role will be an overwhelming, important role, as it must first and foremost promote the development of the Capital Market. The Authority would need to have facilitation

Many countries are trying to establish Stock Exchanges and experiences vary in the time taken to achieve the overall objective

as well as a promotional role. It must create the right environment (legal, institutional and market) to stimulate market activities.

Further to this role of facilitator, the Authority has the basic core role of surveillance and regulation of the securities market which in fact is: (1) the Regulation of Market Intermediaries and (2) the Regulation of the Stock Exchange.

The Authority performs this role through its powers, the various powers entrusted under the legislation and there is, if necessary, direct regulation over the Stock Exchange. The Regulator can give directions to Stock Exchanges to take certain specific actions to protect public interest. A very important role of the Regulator is investor protection. Without confidence in the integrity of the market, the market intermediaries, it will not be possible for a Stock Market to function.

Investors must be satisfied that the intermediaries would deal honestly, professionally and efficiently. This is a very important consideration and therefore in the legislation, which has been drafted, there would be many provisions highlighting investor protection.

*To ensure investor protection*

The Regulator is entrusted with the responsibility of monitoring insolvency, among market intermediaries and the right to step in to protect the interest of the customer where the solvency of the licensee is in doubt. In addition the Regulator must of course monitor, prevent and stamp out abusive practices, which could exist. In fact, in the statement of principles for the guidance of the securities industry generally, the Regulator develops various standards of probity and professionalism. Codes of conduct are developed for various market intermediaries relating to how they have to carry out their activities and what financial standards they should have. The Regulator has besides the role of advising and regulating take-overs, mergers and acquisitions of public companies.

*The Regulatory framework*

In brief therefore the Regulator has got functions over the Stock Exchange, the market intermediaries and the securities industry. The approved Stock Exchange is permitted to regulate itself and its members but this is subject to the supervisory control of the Regulator. It is the licensing control of the Regulator over the Stock Exchange and the market intermediaries that enables efficient operations to take place. Indeed there are many statutory obligations, which are levied on the market intermediaries, which are part of the plank of the Regulation.

*The Stock Exchanges*

The Stock Exchange will be a body corporate under the Company's law and will have to meet the requirements of a company. However, this company will have to meet the conditions of approval of the Regulator, which may comprise the fact that there must be a minimum of dealers, which will be acting independently and in competition with each other.

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**The regulator is entrusted with the responsibility of monitoring insolvency, among market intermediaries and the right to step in to protect the interest of the customer where the solvency of the license is in doubt**

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The shareholders of the company, the Members must comply with the Membership criteria set by the Regulation with regard to good character and high business integrity. Other conditions for the approval of the company as a

Stock Exchange may include the fact that there must be a fair representation of dealers, issuers, members of the public, investors in the Governing council of the Stock Exchange.

The Regulator would also require the Exchange to have satisfactory listing, trading, clearing and settlement rules and appropriate compensation fund arrangements. These rules would have to be approved by the Regulator as well any amendments thereto. The Regulator is also in a position to initiate various changes to the Stock Exchange rules and impose amendments to the rules themselves. The Regulator can review the disciplinary powers, which the Stock Exchange has over its members to ensure compliance with standards of conducts which will foster more investor confidence.

#### *Powers of the Regulator Cooperation*

The powers of the Regulator consists of its ability to (1) require the production of books, copies and extracts and explanations from dealers, (2) require disclosure (3) to investigate and apply for search warrants where there is no corporation from dealers (4) to inspect and (5) issue standards of principle and (6) make application to the court where there is a case of non compliance.

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**Members must comply with the membership criteria set by the Regulation with regard to good character**

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The Regulator has also the power to (i) register a prospectus of a publicly floated company, (ii) to cancel and suspend the registration of prospectuses where there is false and misleading information and (iii) to prohibit advertisements relating to securities which are likely to deceive or mislead.

#### *Licensing of the Market Intermediaries.*

Licensing of market intermediaries provides an idea of the breadth of the possible licensing regime, which could be available for the Maldives. Under the regime dealers, dealer's representatives, investment, advisers, investment representatives underwriters, custodians could be licensed. There would be a provision for other activities that may require a license and as such there would be no need to amend the law to provide for any new license. Licenses are granted to fit and proper persons, which have to be properly qualified and trained.

It is the duty of the Authority to ensure that they are fit and proper. Dealers would have to be trained, to succeed in examinations and be granted certificates to show proficiency in all aspects of the dealership business in which they wish to operate. They must be able to deal with the public on the basis of confidence. This confidence is ensured to a large extent by the fact that the dealers have been able to pass the relevant examinations and meet the minimum financial requirements to ensure that there is no problem of insolvency, which could affect the business and the clients' funds.

#### *Regulation of code of conduct.*

The above is an important area of regulation. The code of conduct provision would prohibit a dealer for example to hold the position that as a license holder he already meets all the requirements with respect to qualifications and ability and as such has no other obligations. Independently of the fact that he is qualified for a license, he must

be able to demonstrate that he can perform his duties on an on going basis. For example, he has a duty to issue a contract note as soon he executes a transaction for his client. He has an obligation to disclosure when he is acting on his own account that is as a principal and when he is acting on behalf of a client. The important duty of investment advisers is to be able to show that they had a reasonable basis for making that recommendation.

This reasonable basis for making recommendations has to be objectively monitored so that they would be able to pay damages to persons who were relying on their recommendations, if it is shown that there was no reasonable basis to make that particular recommendation.

#### *Register of Interests in Securities*

A register of interests has to be maintained by the licensee. The licensee must enter in the register all the securities that he owns himself and any exchanges must also be recorded as and when they occur. The Register can be inspected and called upon for inspection by the Authority at any time. There are also accounts and audit requirements, which are very important. Since the dealers are dealing with clients fund, he has to keep a separate account for the purpose of his clients which he cannot use for his own purpose. This separate account is insulated even in cases of Court actions against the dealers in case of personal debts.

Since there is a separate clients account that has to be maintained there needs to be proper accounts and audits in relation to these accounts. There are very detailed provisions how these accounts are to be kept in many jurisdictions. In this respect the Auditor has a special role. The appointment of an Auditor has to be notified to the Authority and if the auditor is removed by the dealer, the consent of the Authority must be sought.

The Auditor is obliged under law to make certain reports to the Authority or to the Stock Exchange where it applies stating that he has encountered in the course of its audit non compliance with the provisions of the law e.g. short selling. All matters that

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The licensee must enter in the register all the securities that he owns himself and any exchanges must also be recorded as and when they occur

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affect the ability of the dealer to meet its obligations or are a breach of the conditions of the license to be notified. Therefore, the Auditor of a dealer has a very important role.

#### *Register of substantial shareholders*

A register of substantial shareholders has to be kept by a public company for shares entitling any one holder to exercise 5% or more of the aggregate voting power at general meetings. This register must be made publicly available so that investors know who are the people who hold 5% or more of the companies share and who can influence decision at general meetings. In this way, there is transparency.

In fact there are many detailed provisions in the legislation which will apply in cases of prohibited dealings, for example, insider dealing, fraudulent inducement to invest,

making false statements and transactions misleading documents, market manipulation. These are provisions normally found in many jurisdictions to ensure that there is proper conduct and integrity by the dealer and that the market is not influenced by insider information or other manipulative practices as a vast number of investors are relying on market transparency, integrity and equal and free flow of information to one and all. With the above tough provisions, which are offences in the law, the Regulator has power on the Stock Exchange and over market intermediaries.

### *Conclusion*

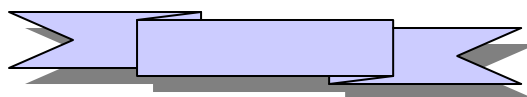
To conclude, what has to be borne in mind is that the regulatory framework must provide the right environment for the development and the growth of the market. To attain this type of enabling environment, the participation of all concerned; the issuers, the market intermediaries, the investors, the dealers, is essential. High standards of probity and professional conduct have to be maintained and reach world class standards. There is no

**There is no way any market either small or big would operate if standards are undermined and there is a compromise in relation to these standards**

way any market either small or big would operate if standards are undermined and there is a compromise in relation to these standards. Integrity is very important as well confidence. The development of a proper free flow of information and disclosure will help investors to make informed investment decisions. All the provisions that are contained in the draft law and regulations, which are being developed, go in that direction. Disclosure and continuous disclosure many seem cumbersome and even draconian.

But the market must have a free supply of information and it is important that this information is not perceived as being withheld and put to advantage for certain players and issuers in the market.

There are appropriate powers in the law to ensure that all these obligations are met. Further Maldives must develop International Accounting Standards. These standards will allow measuring the worth of a company on the basis of worldwide standards. This seminar was but an initial laws and there will be opportunities to look at detailed provisions in the draft Securities and all relevant legislation once they have been finalised in subsequent seminars.



## *Developing a Capital Market / Administrative Framework / Role of Dealers by Sharda Dindoyal*

### Agenda

- History of Capital Market Development
- Definition of the capital market
- The Maldives financial system
- Objectives of Capital Market Development
- Constraints
- Action

### History of Capital Market Development

- The National Development Plan 1994-96 already called for the development of a Capital Market in the Maldives.
- In October 96, however, this move was discouraged because of the constraints that were identified and advice was given to establish an informal trading market for securities which could afford a measure of price transparency.
- Today in 2001 we want to convince you that this development is a feasible proposition with the establishment of a full-fledged Stock Exchange for the Maldives.

**Before going further I need first to situate what we actually mean by Capital Market and I am going to take the most commonly used definition.**

### *Capital Market Definition*

#### Broad and Commonly used definition

☞ *Market where agents can raise funds with long term maturity by issuing marketable securities*

#### Definitions

#### Marketable Securities; Securities are;

- Debentures, bills or bonds issued or proposed to be issued by a government;
- Debentures stocks, shares, bonds or notes issued or proposed to be issued by a body corporate or unincorporated;
- Any other instruments as the Minister may prescribe to be securities for the purposes of the Act.
- And these become marketable when they are freely transferable and are priced regularly.

## **Why do we wish to develop a Capital Market in the Maldives?**

### *The Maldives Financial System*

- Bank dominated and comprising four state owned commercial banks , three of them branches of foreign state owned banks.
- There is no money or inter bank market.
- Development banking is limited though there is some effort in this direction by the Bank of Maldives.
- One government Employee Provident Fund.
- One Ministry of Finance and Treasury (MOFT) - non-funded pension plan for Government Employees only.

### *Presently the Financial Sector may be considered as:*

- Narrow and lacking depth.
- Lacks dynamism and competition.
- Opportunities for financial inter mediation are limited.

### *Why develop the Financial Sector?*

- Pillar on which rests the growth of other sectors of the economy.
- Study has shown that there is a positive correlation between economic development and growth and the degree of sophistication of an economy's financial sector.

Maldives needs an efficient and healthy financial sector to face the significant developments that are confronting the country

### *Objectives of Capital Market Development for the Maldives.*

- Make it possible for private sector companies to broaden ownership and enable a larger part of Maldivians to participate in the economic and industrial life of this country.
- Meet the shortages in the supply of long-term capital to finance capital investments both for Government and private sector.
- Provide a new channel to mobilize savings.
- Improve efficiency in the allocation of such savings to productive ventures.

- Catalyze the development of other capital market institutions (mutual funds, unit trusts, portfolio management, custody service and credit rating), which is a source of employment for highly skilled Maldivian University school leavers.
- Generally strengthen the financial system and make it more efficient and competitive and less vulnerable to external shocks.

There are constraints and the purpose of this seminar is to think together and develop a business plan/an action program on how such constraints are to be eliminated.

**Constraint No 1:**

*The legal infrastructure*

- No capital market will develop if there is no legal infrastructure which will set down the parameters, the ground rules so that the Maldivian public or foreign investors know that they are protected and secure when they place their savings in shares, debentures, and other financial instruments.

**Action No: 1**

- The legal infrastructure, under which the capital market will evolve, is being worked on;
- A review of the Companies Act is being undertaken to facilitate private companies to float their shares or debentures in the public and to enhance good governance norms by companies.
- A review of the Tourism Act is also under discussion.

**Constraint No:2**

Absence of Capital Market Institutions

Institutions to support the development of a capital market are essential such as:-

- The Capital Market Regulatory Authority
- The market operator (Stock Exchange)
- Intermediaries which will deal on the market (dealers, investment advisers, portfolio managers) and so on . . .

**Action No. 2**

Steps have been taken to set up the Capital Market Development Section at the Maldives Monetary Authority.

### *Role of the Capital Market Development Authority*

Endowed with two distinct and separate activities namely;

- To develop and expand the capital market by placing emphasis on the supply and demand for securities
- To train regulate and supervise the activities of market participants

It is believed that the Authority must be granted as much autonomy as possible to ensure immediate and effective enforcement of the Securities Act and regulations made there under.

- Once the Securities Act is passed by the Parliament, the Maldives Stock Exchange Company will be formed as a private company under the Companies Act.

### *Role of a Stock Exchange*

- A Stock Exchange is a Secondary Market for securities and typically consists of dealers and brokers in communication with one another.
- Where the organization is loose and communication is mainly over the telephone (or over a computer network) the market is called an over the counter (OTC) market.
- Where the organization is more structured and communication is centralized and as in the past face to face the market is known as an Exchange.

### **Functions of an Exchange**

- Sets price for the securities it trades and makes it easy for people to trade them.
- Facilitate the sale and resale of transferable securities. The market in which new securities are sold is called the primary market, the market in which the existing securities are resold is called a secondary market. In fact a secondary market is essential for the functioning of primary market and enable such investment to become liquid as and when the investor wishes to realize them.
- Intermediaries (dealers, investment advisers) will be licensed by the Capital Market Development Authority,
- Such dealers will be licensed upon satisfying the Capital Market Development Authority of "dealing expertise"
- The Capital Market Authority is currently mounting a training program for dealers, details of which will be communicated in due course.

### *Role of dealing houses*

- Intermediate between buyers and sellers of securities and execute transactions on the Exchange.
- Provide advice to sellers and buyers of securities.
- Manage portfolio of clients (Individual, Corporate).
- Sponsor listing of companies on the Exchange.
- Advise Companies on takeovers, mergers and other corporate reorganizations

### **Constraint no: 3**

- Any Capital Market requires a steady supply of securities (shares, debentures, Government bonds, convertible debentures)
- Such a supply must come either from state owned companies or private sector companies.

### **Action no: 3**

- Our challenge today is to convince both Government and the private sector to float shares on the Stock Exchange that will be established as a National Market.

### **Implications of a Listing**

#### *Some Drawbacks*

Listing your companies on a Stock Exchange may present some drawbacks

E.g.

- I. Requirement to produce annual audited accounts in compliance with international standards and to submit them to the Exchange and the Authority.
- II. Requirement to submit six monthly statements to the Exchange and the Authority.
- III. Requirement to disclose the dates of dividend payments.
- IV. Requirement to notify and obtain the approval of the Authority and the Exchange when you wish to undertake a bonus or a rights issue.
- V. Requirements to notify the Exchange and the Authority whenever you engage in any operation which will have an impact on the price of your shares.

All what I have said could be perceived as major threats to your freedom of operation and in some cases you may even think that you will be giving inside information to your competitor.

But it has to be borne in mind that we are now confronting an increasingly global economy where exchange control barriers are non-existent and computer technology has dismantled geographical boundaries.

#### *Advantages of Listing*

- A listing provides the basis for a company to develop its shareholder base and for the enhancement of communications with that shareholder base.
- Through a listing, a company makes its name, its products, and its services more familiar not only to home investors but also to international investors. The information services of an Exchange normally must disseminate information concerning the company for the benefit of investors through its information services.
- Newspapers also generate a large amount of free publicity. In addition, research reports written by stockbrokers usually further this effect.
- A listing provides better opportunities for companies wishing to take advantage of capital raising facilities. Though there is no requirement for a company to raise finance on the occasion of its initial listing, there is comfort to know that when extra capital is required, this company will have access to the market for its capital raising needs.
- Another important advantage which a listing gives to the shareholder of a company is the ability to dispose his shares at a fair and reasonable price. Major shareholders can even realise part of their investment without necessarily losing control of it and without having to lock their investment in one company.
- However a listing also means (a) public accountability (b) the supply of information on a regular basis to shareholders, and (c) the need to pay dividends in order to support share price and to establish a good stock market rating and (d) facilitating a take-over bid by a competitor.

We at the Capital Market Development Section wish to encourage all those who wish to know more about how to list your companies on the Exchange to meet and discuss with us your proposals. We are there advise on the best way to proceed, the documents that you will require and so on.

I have elaborated fairly extensively on the need for a steady supply of securities. But the other constraint, which we have to overcome, is the demand for securities.

A capital market is healthy and efficient when it is liquid. Supply for securities must match demand for securities.

Securities are demanded by

- Individual investors
- Mutual funds, Unit Trusts, Investment Companies
- Insurance companies
- Pension and provident funds.

**Action No: 4**

The challenge would be to convince individual investors, life insurance companies, and the provident funds to invest on the Exchange through a well-planned Investor Education and Awareness Campaign.

- We also wish to encourage the establishment of unit trusts and mutual funds once the Exchange is operational. We are available for any advice needed in this direction.
- We also will explore the possibility of approving foreign funds, which will be authorized to invest on the Maldives Stock Exchange.

*Conclusion*

My concluding remarks are "where there is a will, there is a way". If there is a consensus on the objectives we shall reach there.

Thank you!



## *Accountability of share holders*

### *Role of International Credit Rating Agencies by Ravi Abeysuria*

#### **Introduction**

The underlying theme of this seminar is the development of a capital market for the Republic of Maldives. The issue of capital market development is, as I am sure you are aware, is an important one for Maldives at this stage of its economic development and indeed one that is being accorded considerable priority by other developing economies as well.

Individual entrepreneurs rarely have enough of their own capital to undertake investments themselves. Individual savers, without pooling their money, would not be able to take advantage of high return opportunities. The capital market - government securities, bank lending, equity markets and bond markets solves their problems by agglomerating capital from many savers, allocating capital to the most important uses, and monitoring to ensure that it is being used well. Well functioning capital markets do a very good job of selecting the most productive recipients for the resources and ensure that they are using them in high return activities.

For credit rating agencies to contribute to the development of capital markets governments have to establish the building blocks and an enabling environment for the capital market to function. Ratings and rating agencies are simply one component of a much larger facilitating infrastructure. Rating agencies can make a useful and important contribution to the development of healthy capital markets, but they cannot do it alone. The most important challenge to governments in the region is to create the infrastructure and an environment where ratings can make a meaningful contribution.

#### **Creating the building blocks and an enabling environment**

I would like to begin by sharing with you what I see as the most critical issues for the development of a capital market. Markets grow from the participation of issuers, investors, and intermediaries – not just from establishing the market infrastructure. Participation results when a fairly comprehensive range of economic, technical, as well as political and “behavioral” factors come together. Unfortunately, many of these factors are not well developed or are inappropriate in emerging markets and take considerable time to get into place.

Market development will be accelerated if regulators who are interested in the market’s development work closely with market participants to identify problems and solutions, and with other regulators to persuade them to address problems under their control. Regulators should keep regulations simple to make them easier for the regulated to comply with and reduce approval delays caused by the regulator’s lack of experience. Removing unnecessary information disclosure requirements and consolidating approval process under one regulator can speed up the issuance process.

Although there is no one way to build a market, Maldives could draw on the experiences of other emerging market countries for guidance on how to solve

problems and what works best in different types of conditions.

Some involved in building capital markets think creating markets is a technical, top-down, infrastructure-building exercise. They may set up a regulatory agency, incorporate exchanges, enact securities laws, introduce issuing, trading, clearing and settlement, market surveillance and enforcement systems and educate the regulators and market participants. Expecting, once the systems are plugged in and doors opened for business a market to spring into life. Unfortunately, “build it and they will come” approach often does not work. Doors are opened, systems are turned on, and markets do not function. There are no issuers, and no investors or intermediaries to transact. When a market has no market participation it is as good as no market.

Issuers, investors, and intermediaries will participate in a market **if they see an economic benefit** (low cost source of funds, higher returns, profits), are willing (have the right attitudes) and able (have the skills, regulations), and are structured right as an industry to participate. There could be a lot of reasons why they might not participate. The three elements of need/benefit, willingness, and ability drive one another. When benefits are clear and significant, issuers will be more willing to do “costly” activities like disclosing information. If the intermediaries are better skilled, investors will be less fearful and more willing to enter the market. Market participation cannot be forced, but an enabling environment can encourage it, and an “unabling” environment can discourage it. The environment consists of a range of interactive factors around the market, across other parts of the financial system, and inside the Market.

### **Key Success Factors Around, Across and Inside the Market**

To build a successful capital market you need four key factors, two from “inside” the market and two from “around” it. The “inside” factors are suitable and appropriate issuers, investors, and to a lesser extent intermediaries, and a committed government. The “around” factors are macro stability and taxation. For most countries, the lack of appropriate issuers and investors is the main stumbling block to develop their markets.

#### *Inside the Market*

##### *1. Market Participants*

Essentially, a market needs issuers and investors. A lot of countries have pushed forward to build markets despite the lack of these players. An active market needs a diversified issuer base. For Maldives, potential issuers can include hotel and infrastructure building companies. Issuers should be profitable enough to attract investors, need to see some economic benefit such as low cost source of funds and must be willing to provide greater financial disclosure, transparency and information.

Developing the investor base is one of the biggest impediments to market growth. Retail investors alone usually cannot support the market’s growth. Investors should be diversified and composed of local and foreign institutional investors such as pension funds, provident funds, insurance companies and financial institutions. They too need to see economic benefits such as higher returns to compensate for longer-term investments, and instrument structures or maturities that better match their liabilities

than other products. They need to be willing to be in the market (take risks) and be able (through skills and awareness creation) to invest. How diversified, sizeable, and capable the issuers and investors are will determine how fast and large the market can grow.

Intermediaries are also required to bring issuers and investors together. Both institutional and retail investors need to be serviced by establishing appropriate distribution channels. They need to be profitable, capable of dealing in securities and carry out their business professionally and ethically. They need to make enough money in good times to support the ups and downs of the market. There should be enough firms to create competition but not so many that no one makes money. The industry should not be dominated by banks but should include several independent securities firms since banks can constrain the operations and perspectives of their securities affiliates.

## *2. Government commitment*

There must be unwavering commitment to build the capital market by all concerned. Maldives Capital Market Development Authority need to take the lead in getting the process under way by bringing together key market players to build systems. Their level of commitment will determine how fast the market grows. Without “inside” government commitment, the market is not likely to grow. They will need to focus on legal and regulatory reform, product and institutional development and establish the market infrastructure and operations.

The government securities market to provide a benchmark yield curve is a prerequisite to develop the corporate bond market. Without such a benchmark, the pricing of corporate bonds will be difficult and complicated. Government securities markets also provide dealers with experience trading fixed-income securities (as these markets are likely to have more trading) and a chance to earn profits and build credibility as an intermediary. Governments should also not crowd out the private sector from local and foreign investment.

### *Around the Market*

#### *1. Macroeconomic Stability and Credibility*

Capital markets require stable macro and political environments to give investors the confidence to invest. Economic growth must be strong enough to generate appropriate issuers and investors; inflation and interest rates cannot be too high or volatile. Without sufficient GNP growth, savings and investment rates and per capita GNP the economy might not provide the issuers and investors needed. Many markets in the region suffer from political instability and lack credible policymaking.

#### *2. Taxation*

Taxation is a well-known potential market destroyer, directing financial flows by changing relative costs of different products. Many emerging market countries employ stamp duties, transaction taxes, and income taxes on the cost of issuing, investment returns and inter mediation profits. These impediments should be avoided

or they will prevent the market from ever starting. Maldives neutral tax environment is a clear advantage for capital market development.

All these factors influence the market's attractiveness to an issuer, investor, and intermediary and hence need to be considered from the market participant's point of view – that is from the bottom up. Recognizing the fact that market participants are affected by such a broad range of factors makes it clear why developing capital markets are so difficult and time-consuming. Moreover, many of the factors go beyond technicalities and involve attitudes, cultures and politics. Some matters take years to get it right, such as corporate governance, which influences an investor's willingness to invest in a company.

### **The Importance of Financial Disclosure and Transparency**

Information is the lifeblood of capital markets. Economists have demonstrated that one of the most important functions of a financial system is gather information on prospective issuers of securities (equity & debt) and communicating this information to investors so that capital can be allocated efficiently. In theory, all market participants have access to the same information. In reality, the information flow is often *asymmetric*, that is, issuers of security have private information about their true financial position and future prospects that they choose not to make public and share with investors. This creates serious *adverse selection and moral hazard* problems.

#### *Adverse selection*

Refers to the difficulty, in the absence of good information, of distinguishing low risk issuers of security from high-risk issuers of security. If the investor is unable to distinguish among good and poor quality issuers of security, there is a greater risk that the investor will lose money. Good investment projects requiring more capital than they have will be mingled with those who see an opportunity to cash in on the market's ignorance. This will result either in a reluctance to invest, in which case there is a shortage of capital for good quality issuers of security, or a desire for much higher premium to compensate for the added, un-measurable risk, which means that quality issuers of security will be forced to pay a higher price for capital than they would if markets were more efficient.

#### *Moral hazard*

Refers to the risk that the issuers of security, once the investment has been made, may use the proceeds for a completely different purpose than the one the investor intended. Management and controlling shareholders are able to “tunnel” the funds out of the companies they control. Moral hazard risk exists where the investor or lender cannot monitor the management's use of funds, often because of a lack of transparency or weak disclosure and accounting standards.

The best protection against adverse selection and moral hazard is information, transparency, and openness. Opaqueness can encourage excessive risk-taking and bad management. Publicly held companies' need to be completely transparent in their reporting to the investors and to provide better and timely information. The true level

of investment, the true level of obligations, and the true nature of often complicated relationships among the related corporations and between corporations and financial institutions need to be brought into the open, with appropriate sanctions, in the form of higher rates or reduced credit lines, for those companies that show poor judgement or mismanagement. Financial transparency breeds systemic confidence, and systemic confidence enhances efficient capital flows.

Governments can help mitigate adverse selection and moral hazard problems in securities markets by promulgating standard accounting procedures, creating and enforcing a legal structure that allows for well-designed contracts, establishing a securities and exchange commission, formulating laws to protect minority shareholders against majority shareholders, and all security holders against fraud, and providing a balanced approach to bankruptcy.

### Developing Bond Markets

Bonds have one significant advantage – and a disadvantage. The lender cannot recall the funds, even if they are displeased with what the borrower is doing, in other words a borrower is not on a “short” lash as with bank loans. This has the advantage of enabling the borrower to pursue long term strategies.

GDPs, Equities, Bank Claims on Private Sector, Government Bonds & Corporate Bonds in Selected Developing and Developed Countries										
Country	GDP		Total Equities		Bank Claims on P/S		Government Bonds		Corporate Bonds	
	US\$ bn	Log 10	US\$ bn	%	US\$ bn	%	US\$ bn	%	US\$ bn	%
Sri Lanka	15	1.2	1.6	10.4	4.2	27.3	1.5	9.7	0.0	0.3
Slovak Republic	20	1.3	1.0	4.9	8.9	44.6	2.8	13.9	0.5	2.6
Hungary	48	1.7	14.0	29.2	8.3	17.2	11.8	24.6	0.2	0.5
Czech Republic	56	1.7	12.1	21.6	35.2	62.9	2.3	4.1	3.7	6.6
Philippines	65	1.8	35.3	54.3	32.7	50.3	7.9	12.2	1.3	1.9
Malaysia	72	1.9	98.6	136.9	74.9	104.0	19.7	27.4	15.1	21.0
Indonesia	92	2.0	22.1	24.0	63.4	68.9	-	-	1.0	1.1
Thailand	113	2.1	34.9	30.9	144.4	127.8	9.7	8.6	3.5	3.1
Poland	158	2.2	20.5	12.9	30.8	19.5	12.6	8.0	-	-
Korea	321	2.5	114.6	35.7	264.7	82.5	178.5	55.6	99.3	30.9
India	372	2.6	105.2	28.3	98.8	26.6	63.1	17.0	16.5	4.4
The Netherlands	378	2.6	603.2	159.6	468.7	124.0	199.4	52.8	44.2	11.7
Italy	1,186	3.1	569.7	48.0	740.6	62.4	1,215.6	102.5	364.3	30.7
UK	1,399	3.1	2,374.3	169.7	1,690.5	120.8	464.3	33.2	388.5	27.8
France	1,455	3.2	991.5	68.1	1,121.8	77.1	731.3	50.3	478.6	32.9
Germany	2,123	3.3	1,094.0	51.5	2,673.0	125.9	865.9	40.8	1,140.0	53.7
Japan	3,787	3.6	2,495.8	65.9	5,046.3	133.3	3,700.5	97.7	1,513.1	40.0
USA	8,511	3.9	13,451.4	158.0	5,412.9	63.6	8,002.4	94.0	5,970.8	70.2

Source ADB Note on Corporate Bond Market Development

**Table 1**

Most corporate bond markets in developing countries are fledgling and small, even relative to their own GDPs. Table 1 show the size of the stock market, bank claims on the private sector, government bond market and the corporate bond market as a percentage of the GDP for a few selected developing and developed countries.

Table 1

Using the data from Table 1 if one calculates the correlation coefficients between the common logarithms of GDP on one side and stock market, bank claims on the private sector, government bond market and corporate bond market as a percentage of GDP on the other, one could see an interesting relationship as shown in Table 2.

<b>Correlation Coefficients between Log GDP and different Market sizes as % of GDP</b>		
	Developing Countries	Developed Countries
Equity	0.1326	-0.0770
Bank Claims on P/S	0.1943	-0.2677
Government Bonds	0.3858	0.4622
Corporate Bonds	0.4253	0.9161

*Table 2*

It is clear that the logarithmic size of the GDP has little or negative relationship with the relative sizes of stock market or bank loans provided to the private sector for developing and developed countries respectively. In contrast, the size of the corporate bond market relative to the GDP is directly correlated to the country's logarithmic size of GDP and it is very significant (0.91) for developed countries. One could infer from this data that economic development will come about with the increasing role of the corporate bond market.

For one, the banking system on its own cannot support the future financing needs of your economy. Capital markets will have to play an increasingly important role in a service-oriented economy such as Maldives. You need to build your telecommunication and airport facilities, and develop your port.

The money that will be needed to fund this infrastructure development will be staggering. Second, it is not only infrastructure projects that need long term funds your hotel projects also need financing to sustain their growth as they expand their activities.

No doubt a part of the funds required would be financed from foreign investments, equity issues and bank financing, but the long-term nature of many projects calls for longer maturities and predictable fixed rates of interest that bond markets provide.

As the potential issuers recognise the need to have appropriate forms of financing matching the tenor of their projects, they will seek to issue bonds or debentures. Most corporates prefer debt to equity financing because debt allows owners to retain greater control over corporate decisions and also because bank finance or rights issues cannot adequately meet their massive investment requirements.

As shown in Figure 1 the corporate bond market, rather than bank lending is now considered crucial to developing countries such as Maldives.

The recent Asian financial crisis unveiled the limitation of the banking systems in financing industrial investments, even if the banking system is well regulated, supervised, capitalised and managed, the banking system's primary role is to create and maintain liquidity to finance production in the short-term horizon. Consequently, the corporate bond market is expected to provide debt capital to the areas that have been ill served by either government financing or bank lending, on top of equity capital.

## Increasing Roles of Corporate Debt Market in Economic Development

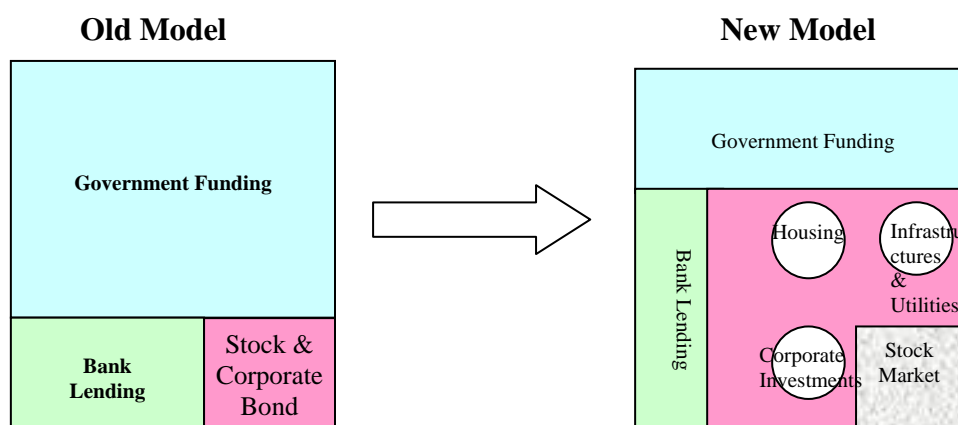


Figure 1: Increasing Roles of Corporates Debt Market in Economic Development

### The role of credit ratings

Lets move now to the role of international credit rating agencies. In the traditional banking system, bank performs the task of inter mediating funds between savers and borrowers. The bank maintains a branch network to mobilise savings in the form of deposits and lend these funds to borrowers. Banks charge a spread between deposit and lending rates to absorb the losses when borrowers default. Bank savings and deposits to a large extent are protected against loss through the capital and loss reserves of the bank and have the comfort of a Central Bank's off-site and on site surveillance system supervising the activities of the banks.

In the case of bonds or debentures, an intermediary connects the saver directly to the borrower, but does not absorb any loss if the borrower defaults. The process of corporates bypassing the banking system and borrowing directly from the investors through the capital market has become a global phenomenon. This process, called "disinter mediation" has brought about more efficient allocation of capital, and has resulted in a profound shift in the relationship between investors and borrowers on a much wider scale than ever before. The crucial aspect of the bond market as opposed to the banking system is that the risk of loss and therefore the responsibility for evaluating default risk falls on the investor.

Credit ratings play a vital role in the disinter mediation process. They provide through a simple symbol system, objective and independent opinions of relative default risk that investors can use as a supplement to but not as a substitute for their own internal credit research when making investment decisions. Ratings are not guarantees against loss and not predictors of default they are simply opinions about relative measures of risk.

Ratings reduce uncertainty, less uncertainty means greater investor confidence, which encourages capital market growth and greater market efficiency and liquidity. Ratings help reduce information costs and increase the ability of investors to determine the quality of borrowers in the market. Essentially, the rating system fosters market efficiency by providing a common language for credit risk evaluation and by

contributing to the market's common body of analytical information on various fixed income borrowers. This increases the degree of 'transparency' in the capital market, which itself serves several purposes. Greater transparency helps investors reduce the uncertainty about the credit risks of unfamiliar securities and issuers, which may channel more savings into new segments of the capital market.

Ratings are simply a way of communicating to investors and to the market the rating agency's opinion on the relative risk of a given borrower's ability and willingness to make full and timely payments of principal and interest over the life of the rated instrument, nothing more. To the extent that ratings serve as a form of investor protection, it is due solely to investors' understanding of what a given rating opinion is supposed to mean, and the relative accuracy of that opinion in relation to its definition. It is important to repeatedly stress that ratings are simply objective and independent opinions. To the extent that international credit rating agency's opinions are respected in the market place, it is because that they have demonstrated over time an ability to assess relative risk.

### **Benefits and Use of Credit Ratings**

Credit Ratings widen investment horizons by helping borrowers to obtain wider access to investor capital, reduced funding costs and add financial flexibility. In the developed countries, the role and use of ratings have become institutionalised. This same trend has been occurring in the Euro markets and in Japan, and is now beginning in Asia. A credit rating from an international rating agency can provide access to international pools of debt capital to high quality borrowers in the Maldives at much lower costs than their current borrowing rates.

Borrowers can use ratings as a 'credit passport' to communicate their credit quality to international and local investors. For highly creditworthy borrowers, obtaining a credit rating would enable them to raise low cost funds by way of bonds, debentures, commercial paper, or pro notes, by attracting the risk averse investors, who may settle for lower yields for highly rated corporate debt issues. They could come to the market with larger and more frequent debt issues and with less regard to market conditions. This could result in substantial savings in cost of capital. Corporate bonds and debentures would be much easier to market using a rating in place of a 'story' about the credit quality of the borrower.

Even for issuers who are unwilling or are too small to tap the capital market for funds, ratings could be used to differentiate them among their joint venture partners, shareholders, and suppliers, to obtain a better market standing, credit facilities, etc. The mere process of undertaking a credit rating will give corporates, a comprehensive third party review of the company's product, market offering, adequacy of systems and controls and risks the company is exposed to, etc. Considerable value addition, by way of ideas, strategies and systems improvement advice may be offered to the management to take appropriate steps to overcome their weaknesses.

In the absence of ratings, most investors will have to make their investment decision on the basis of historical information, or alternatively some may just go by the name. In fact without a rating most investors in fixed income instruments have no means of

evaluating the default risk or risk of full or partial loss of their investment. In addition, they have no means of comparing the default risks of many potential investment return opportunities available to them.

### **Concluding Remarks**

The issues I have described are clearly not the only ones, which Maldives may need to deal with in your efforts to build a capital market in general and the corporate bond market in particular. In conclusion, I wish to emphasise that the very purpose of Fitch ratings is to improve efficiency of capital markets for the benefit of investors and all other market participants. We believe that viable, independent rating systems contribute to the development of healthy capital markets, but rating agencies work best when certain key ingredients are present in the market.

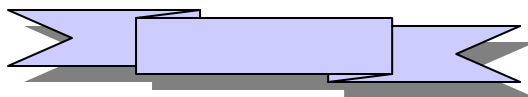
Without an enabling environment and broad-based transparency it is hard to build an effective capital market. It would be unwise to expose investors to the risk of loss without giving them the necessary tools such as appropriate disclosure of financial information, adequate and reliable accounting standards and credit ratings to take on the responsibility. I wish your efforts to build an efficient, transparent, competitive and stable capital market, all success.

### *References*

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Harwood, Alison. 2000. "Building Local Bond Markets, An Asian Perspective", *International Finance Corporation*.

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### *Key Questions and Answers by Panel members*

During the questions and answers sessions there were many interesting issues raised the salient ones being:

- (a) The access of the population living in the islands to the Stock Exchange
- (b) The existing problems encountered by shareholders of public companies to transfer shares
- (c) Whether there would be a computerized depository for the safekeeping of the shares
- (d) If other industries would have an incentive to go public as is the case for industries in the tourism sector
- (e) What were the Privatisation programme of Government
- (f) Whether there was a need for dealers to pass examinations
- (g) What were the procedures for licensing dealers

#### **(a) Access to the Stock Exchange**

Professor Mc Kenzie stated that access of the population living in the village would be from institutions and larger players. When a market is developed , intermediaries ,such as investment advisers are licensed to provide advice to small investors. The other institutions that can grow as a result of a developed market are mutual funds which are privileged vehicles for the small investor living in the village who may not have sufficient capital to put in a number of companies. Yet through a mutual fund, this is made possible and in this way the risks are spread. Besides the mutual fund there are pension funds which could develop in which small investors could participate.

Furthermore once the dealers are licensed they will have to undertake market surveys and if the result of the surveys show that 2/3 of the investing public is in the islands, then the dealers would have to identify them and develop an investor base. Once different products are developed ::shares, mutual funds, bonds, treasury bills they could be presented as a package to potential investors.

Mrs Dindoyal emphasized that given that the Maldives has a geographically dispersed population, when dealing houses are licensed, consideration would also be given to the possibility of these dealing houses to have the possibility of these dealing houses to have agents in the village to access those people and develop a customer base in the Maldives generally for the Stock Exchange.

**(b) Existing difficulties experienced in the transfer of shares**

One participant of the seminar highlighted the fact that it was very difficult to transfer shares for the time being in the Maldives. One has to go to the Court or the island chief, have two witnesses before the transfer could be effected. He wondered how the forthcoming Stock Exchange would cope with transferability when there are over 200 islands involved. He requested whether the problem has been looked into. Mrs. Dindoyal explained that one of the purposes of setting a Stock Exchange was to ensure that the constraints in relation to transfer were reduced. The intermediaries, namely the brokers and the agents will be involved in the buying and selling of shares for their customers and transfer

functions would be delegated to them. Mr. Maqbul was of the opinion that all such matters have to be raised and to the extent that these are a function of any particular regulation or law they need to be looked into as the free transferability of shares of public companies ' shares is essential for the smooth running of an Exchange. He mentioned the CDS system, which cut across all requirements as it is almost paperless. Mr. Naeem emphasized that with the Stock Exchange the problems of transfer, which exist today, will all be eliminated and there may not be any need to go to Court and this will be the task of well-established brokers. In fact what will be required will be for the brokers to transfer at the right price.

Mr. Mckenzie emphasized that the listing requirements which listed companies have to comply with will specifically provide that all transfer restrictions are removed so that shares are freely transferable on the Exchange. One participant pointed out that the real problem was not the law but the identification of the transferor and the transferee and the problem is made worse in the islands. Mr. Mckenzie was of the view that these could be resolved with the establishment of brokerage firms which must work on the "Know your clients" basis.

**C. Whether there would be a computerized depository for the safe keeping of shares**

A participant wished to know whether with the forthcoming Stock Exchange it would not be better to think in the lines of a straight depository of shares which is computerized and will thus eliminate all problems of lost certificates, identification of persons and so on....

Mrs. Dindoyal stated that in actual fact whilst building the infrastructure

for the Exchange much attention was being given to this aspect as there is much more security and safety for investors with a computerized CDS than with a manual system. A computerized depository may be more essential than even automated trading in the initial stages.

**(c) If other industries would have the same incentives to go public as industries in the tourism sector**

A participant enquired whether there were any plans for Government to extend some kind of incentives to other companies to go public as is the case for the tourism sector which has been granted an extension of lease if 50% of their shares are placed in the public.

Mr. Naeem pointed out that since the Maldives did not impose any kind of corporate taxation, it would be difficult to find out what incentives could be granted to public companies. However other incentives such as a reduction of import duties could be envisaged but he does not know of any policy decision in that direction.

**(d) Whether there were Privatisation programme, which are a kind of incentive towards a free market**

The discussions on Government incentives gave rise to another question put by a participant with regard to Privatisation which he believed was in itself an incentive which will be welcome as it will authorize enterprises in the Maldives to become free bodies operating within a free market

.Mr. Naeem said that though there is more or less a policy to list Government enterprises he would not be in a position to expand further on this as it is a subject which is still under consideration.



# Appendices



## *Agenda*

Time	Topics	Speakers
9:00 – 9:05	Recital of Noble Quran	Mauhadh Garee
9:05 – 9:15	Welcoming of the Guests	Ms. Fathimath Shafeega
9:15 – 9:30	Opening the seminar	Hon. Abdulla Yameen
9:30 – 9:45	Address	Hon. Mohamed Jaleel
9:45 – 10:15	Stock Market in Action – A Video Presentation	Mr. Ibrahim Naeem
10:15 – 10:45	Seller Perspective – Why companies should consider “Going Public” Buyer Perspective – Why investors should save and lend to “Listed” Public companies	Mr. Peter McKenzie QC
10:45 – 11:15	Tea Break	
11:15 – 11:45	Regulatory Framework-Stock Exchange / Regulator	Mr. Makbul Rahim
11:45 – 12:15	Developing a Capital Market / Administrative Framework / Role of Dealers	Mrs. Sharda Dindoyal
12:15 – 12:45	Accountability to Shareholders – Role of International Credit Rating Agencies	Mr. Ravi Abeysuria
12:45 – 14:00	Panel Discussion	Mr. Ibrahim Naeem

## Participants

Hon. Abdul Rasheed Hussein	Minister of Fisheries and Agriculture	
Hon. Abdulla Kamaaluddin	Minister of Human Resources, Employment and Labour	
Hon. Mohamed Jaleel	Minister of State for Finance and Treasury & Vice Governor of MMA	
Hon. Abdullah Yameen	Minister of Trade and Industries	
Khadeeja Hassan	General Manager	Maldives Monetary Authority
Abdul Ghafoor	Deputy General Manager	Maldives Monetary Authority
Fathimath Shafeega	Deputy Manager	Maldives Monetary Authority/CMDS
Sharda Dindoyal	Adviser	Maldives Monetary Authority/CMDS
Khadeeja Mufliha	Officer	Maldives Monetary Authority/CMDS
Ahmed Inaz	Officer	Maldives Monetary Authority/CMDS
Amelia Hussein	Officer	Maldives Monetary Authority/CMDS
Makhzoom Saleem	Officer	Maldives Monetary Authority/CMDS
Shafeenaz Abdul-Sattar	Asst. Manager	Maldives Monetary Authority
Aminath Zahir	Asst. Manager	Maldives Monetary Authority
Ibrahim Naeem	Asst. General Manager	Maldives Monetary Authority
Mariyam Hussain Didi	Asst. Manager	Maldives Monetary Authority
Mariyam Khalidha	Asst. Manager	Maldives Monetary Authority
Fathimath Jauza	Senior Officer	Maldives Monetary Authority
Ibrahim Naeem Ismail	Asst. Manager	Maldives Monetary Authority
Rilwaan Shareef	Executive Director	Ministry of Finance & Treasury
Abdulla Jihad	Director	Ministry of Finance & Treasury
Ibrahim Mohamed	Director	Ministry of Finance & Treasury
Juway Saeed	Asst. Director	Ministry of Finance & Treasury
Ibrahim Rasheed	Director General	Ministry of Finance & Treasury
Fathimath Ali	Asst. Und. Secretary	Ministry of Finance & Treasury
Ahmed Nashid	Managing Director	A.D.K. Medical Hospital
Mohamed Hameed	D.Managing Director	A.D.K. Medocal Hospital
Ismail Riza	Deputy General Manager	Allied Insurance Company
Ahmed Ameer	Executive Officer	Allied Insurance Company
Abdul Wahid Thoufeeg	Manager	Allied Insurance Company
Fathimath Ali	Asst Undersecretary	Ministry of Finance & Treasury
Abdulla Muiz	State Attorney	Atterny Generals' Office
Mohamed Nasheed	Lawyer	Axis Chambers
Mohamed Ahmed	Asst. General Manager	Bank of Maldives
Keith Brown	General Manager	Bank of Maldives
Hussain Afeef	Chairman	Champa Trade & Travels
Mohamed Saleem	General Manager	Champa Trade & Travels
Abdulla Saeed	Managing Director	Cyprea Hotels and Travels PVT Limited
Mohamed Waheed	Managing Director	Deen's Agency
Krishna Rengaraj	Director	Ernst & Young
Moosa Ali	Project Coordinator	Ministry of Atolls Administration
Ahmed Didi	Managing Director	Focus computers
Mohamed Asaff Shaikh	Chief Manager	Habib Bank Limited
Musthafa Fareed	Managing Director	Insular Trust Pvt.Ltd.
T.G. Amardasa	Manager	Insurance Corporation of Sri Lanka
WWJC Perera	Partner	KPMG Ford Rhodes Co.
Ismail Shafeeg	Managing Director	Maldives Ports Authority
Mahudhy Imad	Asst. Managing Director	Maldives Ports Authority
Sim Ibrahim Mohamed	Secretary General	Maldives Association of Tourism Industry
Ibrahim Shakeeb	Managing Director	Maldives Industry of Fisheries Company
Athif Shkoor	D. General Manager	Maldives Industry of Fisheries Company
Asad Ali	Managing Director	Novelty Printers & Publishers
Ahmed Shiyaam	Managing Director	Sun Travels and Tours
T.S.Kumar	Chief Accountant	Sun Travels and Tours
Sundren Menon	Resident Manager	Coopers & Lybrand
G.N. Dash	Chief Executive Officer	State Bank of India
Abdulla Nashih	Reporter	Aafathis Newspaper
Ahmed Saeed	Staff Reporter	Haveeru Newspaper
Hussain Aasir		RKL Pvt. Ltd
Abdulla Shakoor	Managing Director	State Electric Company
Rifath Jaleel	Finance Controller	State Electric Company
Mohamed Manik	Managing Director	State Trading Organisation
Mr. Ali Abdulla		World Link
Hassan Zahir	Chief Executive Officer	Lintel Investment Maldives Services
Ali Hashim	Director Finance & Investment	Lintel Investment Maldives Services
Ahmed Mujthaba	President	Maldives Chamber of Commerce
Mohamed Nazeer	Proprietor	Capital Market Technical Committee





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