



Project Administration Memorandum

Project Number: 36357
Program Loan Number: 2138
December 2005

Sri Lanka: Financial Markets Program for Private Sector Development

The project administration memorandum is an active document, progressively updated and revised as necessary, particularly following any changes in project or program costs, scope, or implementation arrangements. This document, however, may not reflect the latest project or program changes.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 24 October 2005)

Currency Unit – Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00 = \$0.010

\$1.00 = SLRs101.52

(At the time of Inception Mission, the exchange rate was \$1.00 = SLRs99.611)

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CAR	–	Capital Adequacy Requirement
IA	–	Implementing Agency
IBSL	–	Insurance Board of Sri Lanka
LA	–	Loan Agreement
MOFP	–	Ministry of Finance and Planning
OCR	–	ordinary capital resources
PBank	–	People's Bank
PPMS	–	Program Performance Management System
PSDP	–	Private Sector Development Program
SEMA	–	Strategic Enterprise Management Agency
SME	–	small- and medium-sized enterprise
SOE	–	state-owned enterprise
TA	–	technical assistance
W/A	–	Withdrawal application form

NOTES

- (i) The fiscal year (FY) of the Government, its agencies and People's Bank ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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LOAN PROCESSING HISTORY

Milestones	Dates
Fact Finding Mission	16 Aug – 06 Sep 2004
1 st Management Review Meeting	21 Oct 2004
Appraisal Mission	23 Oct – 02 Nov 2004
2 nd Management Review Meeting	12 Nov 2004
Loan Negotiations	15-16 Nov 2004
Board Consideration and Approval	15 Dec 2004
Loan Agreement Signing	20 Dec 2004
Loan Effectiveness	21 Mar 2005

I. PROGRAM DESCRIPTION

A. Program Description

1. The Financial Markets Program for Private Sector Development (the Program) approved in December 2004, is the second subprogram of the cluster loan Private Sector Development Program [PSDP] approved by the Asian Development Bank (ADB) in December 2000. The program supports the creation of an enabling environment for private sector development. The Program and actions are intended to complement the results achieved by the PSDP subprogram I, particularly in the areas of (i) developing financial markets and the private sector's access to finance, and (ii) supporting the Government of Sri Lanka's public enterprise reform program in the banking industry through the newly created Strategic Enterprise Management Agency (SEMA).

B. Objectives and Scope

2. The Program seeks to facilitate participation of the private sector including small- and medium-sized enterprises (SMEs) in the Sri Lankan economy by supporting Government reforms to eliminate impediments to and develop opportunities for their involvement. Although the country is experiencing economic growth, most of it is being generated from larger enterprises and/or SMEs in industrial areas. The Program aims to create a private sector that would take a lead role in generating employment, boosting economic growth, and raising income levels for a larger segment of the population, including those in rural areas. People's Bank (PBank), the second largest bank in the country, with an extensive nationwide branch network particularly in rural areas, will play a pivotal role in servicing the commercial, SMEs, and retail sectors.

3. The principal objective of the Program is to facilitate private sector development by strengthening the financial markets, including the restructuring and phased recapitalization of PBank. The Program will have the following elements: (i) developing financial markets; and (ii) strengthening the banking system. This includes further restructuring of PBank, based on an agreed time schedule to meet certain performance targets to improve efficiency and profitability. PBank will be recapitalized in phases in accordance with the recapitalization plan.

C. Project Components and Outputs

4. The Program entails five policy outcomes in two focus areas:

1. Focus Areas and Policy Outcomes

Focus Area 1: Development of Financial Markets

Policy outcome 1.a: Increased Financial Products and Services Available to the Capital Market

Policy outcome 1.b: Enhanced Corporate Governance in the Financial Market

Policy outcome 1.c: Improved Regulations of the Insurance Industry

Focus Area 2: Operational Improvement of State-Owned Commercial Banks

Policy outcome 2.a: Improved Corporate Governance of State-owned Commercial Banks

Policy outcome 2.b: Restructuring and Recapitalization of People's Bank

Focus Area 1: Development of Financial Markets

5. The fundamental objectives of developing the financial markets are (i) increased financial products and services available to the capital market, (ii) enhanced corporate governance in the financial markets, and (iii) improved regulations of the insurance industry.

Policy Outcome 1.a: Increased Financial Products and Services Available to the Capital Market

6. **Financing Through Secured Transactions.** The Program will support the legal and policy reforms to modernize Sri Lanka's secured transactions system, including the establishment of a computerized national system of registration for securing movable property including machinery and/or equipment, which will make it easier for businesses to obtain financing by providing movable assets as collateral for loans. It will also support establishment or appointment of an agency responsible for movable property registration. Introduction of a Secured Transaction Bill and amendments to the Finance Companies Act into Parliament will be supported by the Program.

7. **Publicly Traded Securitized Bonds.** The Program will focus on introducing publicly traded securitized bonds in the capital market. A Securitization Bill will be introduced to Parliament, whereby special purpose vehicles (SPVs) may be established as separate legal entities to pool real or intangible assets against which public securities may be issued. The Securities and Exchange Commission (SEC) will administer and provide regulatory supervision of SPVs. Securitized bonds should improve the financial sources available for the home mortgage market and other markets and industries. Publicly traded securitized bonds should reduce interest rates for borrowers, lower the credit risk for lenders and investors, increase liquidity in the bond market, and lengthen the yield curve for bonds. The long-term effects will be to reduce interest rates and strengthen the financial system.

8. **Improved Asset Risk Management.** The Program will also encourage the development of new products and services to improve the performance and reduce the risks associated with asset management through encouraging (i) the Central Bank of Sri Lanka (CBSL) to introduce directives for interest rate swaps; and (ii) the Government to permit public trading of derivatives and futures. The Program will also support the development of an equity clearing system cycle to improve the clearing of equity securities from trade date plus 6 days (T+6) to trade date plus 3 days (T+3). The SEC will initially require the Colombo Stock Exchange (CSE) to submit a plan for implementing the new clearing system, and the SEC will ensure the operationalization of the system within 3 years from Program approval.

9. **Sovereign Bonds.** The Program supports the creation of the Public Debt Department within CBSL and the eventual creation of a Public Debt Office, which, through its establishment as a separate authority and election of its board members, will become independent from political or economic influence from the CBSL and Ministry of Finance and Planning (MOFP). The Public Debt Office will be responsible for the management, issuance, and modalities of all public debt and guarantees. An independent Public Debt Office issuing sovereign bonds through the price discovery method will improve the method of debt issuance and lead to development of a market yield curve. Such reforms would (i) encourage corporate issuers to raise capital through the public bond market; (ii) improve debt market liquidity; and (iii) improve investor confidence, thereby attracting foreign investors.

10. **Harmonizing Taxes.** The Program will encourage the tax laws to be harmonized so that the double taxation on money market mutual funds (withholding tax and tax on dividends) will be eliminated. Harmonizing the taxation rules on money market mutual funds through amendments to the Revenue Act and the Companies Act (if needed) would improve the market liquidity of debt instruments.

Policy Outcome 1.b: Enhanced Corporate Governance in the Financial Markets

11. **Enhanced authority to SEC and CBSL as regulators.** The Program supports the drafting of the Sri Lankan Corporate Governance Code. The SEC will become a more effective regulator by improving the reporting, regulations, and functional framework of the capital market by issuing a directive making it mandatory for listed companies to follow the Sri Lankan Corporate Governance Code. Additionally, CBSL shall be given the power to take action against fraudulent financial schemes (e.g. pyramid schemes) in the market it regulates. To reduce political interference in capital market regulation, the SEC commissioners will be appointed to reflect diverse public and private interests and facilitate an independent SEC. Moreover, an Anti-Money Laundering Bill will be drafted and submitted to Parliament for approval.

Policy Outcome 1.c: Improved Regulations of the Insurance Industry

12. **Insurance Board of Sri Lanka (IBSL) and the Insurance Act.** The IBSL will be made operational by appointing a board of directors, a majority of whose members are from the private sector. Additional staff is needed to be hired to effectively implement, monitor, and supervise insurance companies. Also, to support increasing the availability of long-term capital and the number of institutional investors in the bond market, amendments will be made to the Regulation of Insurance Industry Act that will permit insurance companies to invest in securitized bonds.

Focus Area 2: Operational Improvement of State-Owned Commercial Banks

Policy Outcome 2.a: Improved Corporate Governance of State-Owned Commercial Banks

13. A bill will be introduced into Parliament, the SEMA Bill, to permit, among others things, Bank of Ceylon (BOC) and PBank to make all business decisions without political interference or consideration, especially pertaining to the recruitment, transfer, and promotion of employees. The amended BOC Act and PBank Acts will provide commercial and political independence to the boards and management and prevent the Government from intervening in the day-to-day affairs of these two banks, including their credit decisions and the interest rates they set on loans to a State-owned enterprise (SOE).

Policy Outcome 2.b: Restructuring and Recapitalization of People's Bank

14. During the past 3 years, PBank's management has significantly improved financial profitability. With the bank in a much stronger financial position, the Government has decided to recapitalize PBank (subject to certain prerequisites described below) for a maximum of SLRs8.5 billion (approximately \$82 million) in order to (i) improve PBank's financial viability and meet the CBSL's minimum regulatory Capital Adequacy Ratio (CAR) requirements to operate as a bank; (ii) strengthen the country's financial system by having PBank become a strong, competitive, and profitable bank that will contribute to the national budget and become a source of capital formation; and (iii) permit PBank to continue its existing business, particularly private sector and

SME credit including in the rural areas and thereby supporting the Government's development and economic growth strategy.

15. Prerequisites for the Government to recapitalize PBank include a memorandum of understanding (MOU) to be entered into between (i) the Government and SEMA, and (ii) the board of directors and management of PBank. In the MOU, management and the board of directors would agree to the restructuring plan according to the agreed time schedule and meeting the outlined performance targets. After appropriate consultation with PBank trade unions and the existing staff management briefing and feedback system, by 30 September 2005, PBank must enter into a collective agreement (Collective Agreement) with the trade union representing more than 85% of the permanent employees of PBank. In the Collective Agreement, the parties agree to implement the restructuring plan and meet the performance targets. All appropriate labor rules and regulations will be adhered to. If the MOU and Collective Agreement are entered into and if the performance targets are met, the Government agrees to recapitalize PBank to meet its minimum core capital ratio requirements in accordance with the phased-in recapitalization plan for a maximum amount of SLRs8.5 billion.

16. An oversight committee appointed by the Government will closely assess the progress in resolving some of PBank's major weaknesses, particularly human resource management, and will have the authority to make corrections to the restructuring plan as needed. As part of the assessment, an independent review of PBank's operations will be performed at least every 6 months. Before the Government injects additional capital into PBank, an independent review of operations, satisfactory to ADB, will be conducted. The review will include the loan books, collateral security, pension funds, the value of investments in subsidiaries and associate companies, and information technology to ascertain sustainability as a result of the phased-in recapitalization.

17. Due to PBank's size, customer profile, and strength of its labor unions, successful implementation of restructuring PBank' would entail close monitoring and oversight, and would need an estimated time frame of three to five years. A discussion of the plans is presented below.

18. **Injection of Capital Based on Performance.** The Government agrees to provide a maximum equity investment in PBank of SLRs8.5 billion (approximately \$82 million). As presented in Table 1, PBank as of 31 December 2004 is forecasted to need approximately SLRs8.5 billion to meet the minimum 10% core capital requirement. The Government agrees to a phased equity investment in PBank to meet the minimum risk-weighted capital requirement of 10%. Based upon the forecast presented in Table 1 below, PBank will meet its CAR by 2007. The Government's Letter of Comfort will be in place until the actual CAR is met and PBank no longer has a capital deficit.

Table 1: Forecasted People's Bank Risk Weighted Assets and Capital Funds Movement, 2004-2008 (SLRs million)

Item	2004 ¹	2005 ¹	2006 ¹	2007 ¹
Risk Weighted Assets (RWAs)	91,000	93,000	95,000	98,000
Capital Required @ 10% of RWA	9,100	9,300	9,500	9,800
Total Capital in Hand of which:	593	4,033	8,617	12,659
Tier 1	155	3,595	6,179	10,221
Tier 2	438	438	2,438	2,438
Capital Deficit/(Excess)	8,507	5,267	883	(2,859)
Capital Funding				
Retained Profit ²	1,838	1,440	1,583	2,041
General Reserves	(2,935)	(1,097)	344	1,928
Revaluation Reserves ³	438	438	2,438	2,438
Equity Capital injections ⁴	-	2,000	3,000	5,000
Other—Paid-Up Ordinary Share and Capital Pending Allotment	1,202	1,202	1,202	1,202
Other	488	488	2,488	2,488
Total Capital in Hand	593	4,033	8,617	12,659

Note: The actual amount and time period of the invested phased-in recapitalization can vary from the forecasted amounts indicated in the table.

¹ All numbers are estimates.

² Assumes dividend is paid.

³ According to CSBL principals, a bank can revalue its fixed assets every 7 years, but only if it meets tier 1 capital requirements.

⁴ Phased-in recapitalization will only be made to meet PBank's minimum core capital requirements. The forecasted phased-in recapitalization is based upon the forecasted risk weighted assets requirement of 10% as follows: SLRs2,000 million in 2005; SLRs1,000 million in 2006; and SLRs2,000 million in 2007.

Source: People's Bank.

19. As outlined in Table 2 below, certain financial performance targets must be met on a yearly basis in order for the Government to invest the phased-in recapitalization to meet the minimum core capital requirements. The performance milestones included in the restructuring plan are outlined below:

**Table 2: People's Bank Restructuring Plan
Key Performance Objectives for Capital Injection**

Deliverables	31 Dec 2004	31 Dec 2005	31 Dec 2006	31 Dec 2007	31 Dec 2008
Net Profit After Tax (SLRs Million)	1,838	2,057	2,262	2,920	3,481
30% Dividend ¹	-	617	679	879	1,044
Retained Profit	1,838	1,440	1,583	2,041	2,437
Cost/Income Ratio	73.5%	72.8%	71.9%	69.0%	66.0%
Return on Assets	0.79%	0.84%	0.89%	1.06%	1.17%
Number of Employees	10,060	9,700	9,400	9,100	8,800
Profit per Employee (SLRs Million)	0.18	0.21	0.24	0.32	0.40
NPL to Total Lending Portfolio	17.0%	15.2%	13.0%	11.2%	9.7%
Capital Adequacy (tier 1 & 2)%	0.7%	4.3%	9.1%	12.9%	16.4%

¹ Mandatory dividend payment for all Strategic Enterprises.

NPL = nonperforming loan, SLRs = Sri Lankan rupees.

Source: People's Bank.

D. Important Features

20. **Restructuring and Recapitalization of People's Bank.** The Program supports the Government's efforts to strengthen the banking system by further restructuring PBank, based on an agreed time schedule to meet certain performance and profitability targets. PBank will be recapitalized in phases according to the recapitalization plan to meet the minimum core capital ratios to maintain its banking license.

21. **Development of Financial Markets.** The Program supports the development of the financial markets, one of the key constraints to economic growth, including SME development. The Program improves the efficiency of the financial markets, increases availability of alternative financial sources of funding to the private sector, and improves corporate governance.

II. COST ESTIMATES AND FINANCING PLAN

A. Program Cost Estimates

22. The program loan will finance the cost of adjustment arising from the proposed reforms, whose total is estimated to be \$90 million. The expected costs of the proposed reforms are:

- (i) recapitalizing PBank (\$82 million)
- (ii) drafting, gazetting, and introducing Acts to Parliament under the policy reform program and the administrative costs for SEMA to manage PBank (\$3 million); and
- (iii) establishing and operationalizing the Public Debt Office (\$5 million).

23. The Program comprises (i) a policy loan, and (ii) a TA loan, totaling \$65 million.

24. **The Policy Loan.** A loan of \$60,000,000 is provided to Sri Lanka from ADB's ordinary capital resources to help finance the Program. The loan has a 15-year term, including a grace period of 3 years, an interest rate to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, and a commitment charge for the undisbursed balance of 0.75% per annum. (A front-end fee of 1% will be waived for loans approved before 30 June 2005). The loan supports a program of reforms and will be released in three equal tranches of \$20 million each and such other terms and conditions set forth in the loan agreements. The Government has provided ADB with (i) reasons for its decision to borrow under ADB's LIBOR-based lending facility on the basis of these terms and conditions, and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any communication or advice from ADB.

25. The loan is expected to be utilized within 36 months from the date of loan effectiveness. It will be released in three equal tranches of \$20 million each. The first tranche was made available upon loan effectiveness. The second and third tranches will be released upon compliance with specified conditions in the policy matrix.

B. Allocation of Loan Proceeds

26. The proceeds of the policy loan will be utilized to finance the full foreign exchange costs (excluding local duties and taxes) of imports produced in and procured from ADB's member countries, other than those specified in the list of ineligible items (Appendix 1) and imports

financed by other bilateral and multilateral sources. All procurement will be through normal commercial practices in the case of procurement by the private sector, or prescribed procedures acceptable to ADB in the case of procurement by the public sector, having due regard to the principles of economy and efficiency. The Government will certify that (i) the value of the country's eligible imports is equal to or exceeds the amounts of ADB's projected disbursements under the policy loan in a given period; and (ii) the policy loan proceeds will be accurately utilized in a manner satisfactory to ADB. The policy loan proceeds will be disbursed on the basis of the certification provided by the Government, which confirms that the above requirements for the policy loan have been met. ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the Government's certification. All procurement under the loan will be undertaken through normal commercial practices for the private sector or the Government's prescribed procurement procedures acceptable to ADB, with due consideration to economy and efficiency.

III. IMPLEMENTATION ARRANGEMENTS

A. Executing and Implementing Agencies

27. The Ministry of Finance and Planning (MOFP) is the Executing Agency for the Program and the CBSL, IBSL, PBank, the Department of Census and Statistics, and SEMA will be the Implementing Agencies (IAs). A coordination committee will be formed chaired by the Secretary, MOFP, to coordinate policy decisions that may need to be taken to pursue reforms under the Program. The committee, which will meet regularly and as needed, is made up of key officials from concerned ministries and agencies. The coordination committee may also call upon affected sectors for consultations on important issues that will have a bearing on the Program, such as the labor unions, employers' federations, nongovernment organizations, academics, PBank, and the CSE.

B. Project Management Organization

Table 1: Key Functions of the Executing Agency

Executing Agency	MOFP
Key Functions	<ul style="list-style-type: none"> • Open an account at CBSL to receive the loan proceeds. • Carry out procurement and consultant service recruitment. • Organize audits of the the Program account by chartered accountants annually. • Ensure that selection criteria is adopted in connection with identifying staff members of People's Bank and IBSL for training provided under the TA Project and the recipients of such training continue their services for no less than two years upon completion of the training. • Establish and chair coordination committee. • Harmonizing taxation rules on money market mutual funds through amendments with Revenue Act and the Companies Act (if needed). • Amend the SEC Act incorporating an obligation of MOFP to appoint SEC commissioner from diverse public and private iinterests and facilitate an independent SEC. • Appoint a majority of the members of IBSL's Board of Directors from the private sector.

- Recapitalize PBank to meet its minimum core capital ratio requirements in accordance with the agreed upon time schedule and the phased-in recapitalization plan. The Government's Letter of Comfort will be in place until the actual CAR is met and PBank no longer has a capital deficit.
- Liaise with IAs and ADB to address any implementation issues.
- Prepare the quarterly progress reports based on the information submitted by IAs.

Table 2: Key Functions of IAs

Implementing Agency	CBSL
Key Functions	<ul style="list-style-type: none"> • Introduction of Securitization Bill to Parliament. • Introduce derivative for interest rate swaps. • Permit public trading of derivatives and futures. • Create of the Public Debt Department and the eventual Public Debt Office which will be responsible for the management, issuance and modalities of all public debt and guarantees. The Public Debt Office will become independent from political and economic influence of CBSL and MOFP. • Take action againsts fraudulent financial schemes (e.g. pyramid schemes) in the market it regulates. • Draft Anti-Money Laundering Bill and submit to Parliament.
Implementing Agency	SEC
Key Functions	<ul style="list-style-type: none"> • Administer and provide regulatory supervision for SPVs. • Require CSE to submit a plan for implementing a new equity clearing system cycle to improve the clearing of equity securities from T+6 to T+3. • Require operationalization of the equity clearing system by CSE within 3 years from Program approval. • Issue a directive making it mandatory for listed companies to follow the Sri Lanka Corporate Governance Code.
Implementing Agency	IBSL
Key Functions	<ul style="list-style-type: none"> • Hire staff to effectively implement, monitor and supervise insurance companies. • Amend the Regulation of Insurance Industry Act to permit insurance companies to invest in securitized bonds.

Implementing Agency	People's Bank
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Key Functions

- Implement Restructuring Plan in accordance with the agreed upon time schedule.
- Enter into a Collective Agreement with the trade unions whereby the parties agree to implement the restructuring plan and meet the performance targets.

Implementing Agency	The Department of Census and Statistics
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Key Functions

- Establish a computerized national system of registration for securing movable property including machinery and/or equipment.
- Appointment of an agency responsible for movable property registration.
- Introduction of Secured Transaction Bill to Parliament.
- Amendments to the Finance Companies Act to Parliament.

Implementing Agency	SEMA
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Key Functions

- Draft SEMA Bill introduced to Parliament.
- Draft Amendments of BOC Act and PBank Acts to prevent the Government from intervening in the day-to-day affairs of the two banks including the credit decisions and the interest rates they set on SOEs.
- Appoint oversight committee and closely assess the progress in resolving some of PBank's weaknesses, and make corrections to the restructuring plan as needed.
- Organize an independent review of PBank's operations at least every 6 months.
- Before the Government injects additional capital into PBank, an independent review of operations, satisfactory to ADB, will be conducted.

IV. IMPLEMENTATION SCHEDULE

28. Implementation is expected to last 3 years and is scheduled for completion in December 2007. The program implementation schedule is included in Appendix 1.

V. DISBURSEMENT PROCEDURES

29. Disbursement procedures - Simplified disbursement procedures and related requirements will be adopted. Prior to submitting the first application to ADB for withdrawal from the loan account, the Democratic Socialist Republic of Sri Lanka (Borrower) shall open an account at CBSL into which all withdrawals from the Loan Account shall be deposited.

30. To withdraw the proceeds of the loan the Borrower should submit a withdrawal application (see Appendix 2) to ADB who will certify that the value of eligible imports (see Appendix 3) exceeds the amount of ADB's projected disbursements under the program loan in a given period. ADB will have the right to audit the use of loan proceeds and to verify the accuracy of the Borrower's certification.

31. **Tranching** - The proceeds of the policy loan will be available for withdrawal in three tranches upon satisfactory compliance with agreed policy actions as outlined in the Policy Matrix in Appendix 4. First tranche will be released upon loan effectiveness; the subsequent two tranches will be released during the Program period of 3 years, tentatively envisaged 18 and 36 months after loan effectiveness, respectively. ADB and the Government would review the progress of implementation of specified policy actions set out in the policy matrix through periodic review missions. A comprehensive mid-term review will be undertaken before the scheduled release of the second tranche.

32. Counterpart funds will be used to meet program expenditures and associated costs of reform.

VI. PROGRAM MONITORING AND EVALUATION

33. MOFP will establish a program performance management system (PPMS) as agreed on with ADB, and cause it to be operated throughout Program implementation. Under the PPMS, MOFP will periodically review the Program for evaluation of the scope, implementation arrangements, benefit monitoring, progress, and achievements. Quarterly PPMS reports in line with ADB's PPMS Guidelines will be submitted to the coordination committee of the Program, made available to ADB and published. Not later than 3 months after Program completion, MOFP will provide ADB with a report, including an assessment of overall Program performance.

VII. REPORTING REQUIREMENTS

34. An audit of the use of the loan proceeds of the policy loan will be undertaken if requested by ADB. ADB retains the right to audit any account and verify the validity of the certification issued by the Government for each withdrawal application. Prior to withdrawal, the Government will open a deposit account at CBSL to receive loan proceeds.

VIII. PROGRAM REVIEW

35. MOFP and ADB will undertake a comprehensive midterm review of the Program in the second quarter of 2006. The midterm review will (i) review the Program scope, design, and implementation arrangements; (ii) assess implementation performance against Program performance indicators and objectives; (iii) review and establish compliance with legal covenants; and (iv) identify problems and constraints. If the midterm review determines that changes are required in program implementation, MOFP and ADB will agree on measures, including changes in implementation arrangements, to ensure that program obligations are met. MOFP and ADB will carry out a final review at the conclusion of the Program.

IX. MAJOR LOAN COVENANTS

36. In addition to the standard conditions (details enumerated in the Loan Agreement), the following major covenants are included in the Loan Agreement. These covenants are directly related to the Program and are considered essential to ensure its successful implementation.

Conditions for Release of the Second Tranche (Ref. Program Loan Agreement, Attachment 2 to Schedule 3, Compliance Deadline: Before the Second Tranche, June 2006)

Secured Transaction Financing

1. The Borrower's Cabinet shall have approved a Secured Transactions Bill incorporating the following key policy measures:
 - a) Establishment of a national a system of registration for securing moveable property, including machinery and equipment (Moveable Property Registry)
 - b) Establishment or appointment of an agency, which may be the Register of Moveables at the Department of Census and Statistics, responsible for the Moveable Property Registry; and
 - c) Any necessary consequential amendments to the Registration of Documents Ordinance No. 23 of 1927, and the Companies Act.
2. The Borrower's Cabinet shall have approved a bill to amend the Finance Companies Act No. 78 of 1988 to permit a leasing company to transfer assets to a special purpose vehicle (Amendments to the Finance Companies Act), and shall have published those proposed amendments in the Government Gazette.

Public Trading of Securitized Bonds

3. The Borrower's Cabinet shall have approved a Securitization Bill incorporating the following key policy measures:
 - a) Special purpose vehicles may be established as separate legal entities to own and pool real or intangible assets (Securitized Assets) against which securities may be issued;
 - b) The SEC will (i) administer and provide regulatory supervision of such special purpose vehicles, and (ii) be afforded the authority to issue subsidiary regulations relating to such special purpose vehicles including (a) the procedures and requirements for establishment and registration of special purpose vehicles, and (b) reporting, disclosure and any other requirements for such special purpose vehicles to facilitate the ability of such special purpose vehicles to own and transfer such securities;
 - c) Special purpose vehicles must be registered with the SEC; and
 - d) Parate Rights will be revised or amended as appropriate to permit the transfer of ownership rights to assets held by registered special purpose vehicles.

Corporate Governance in the Financial Market

4. SEC shall have issued a directive or regulation requiring companies registered under the Companies Act, and publicly listed on the CSE to comply with the Sri Lankan Corporate Governance Code.
5. The Borrower shall have introduced into Parliament a bill to amend the SEC Act incorporating an obligation of the MOFP to appoint SEC commissioners that collectively facilitate an SEC that is independent from the Borrower by virtue of reflecting a balanced and diverse representation of public and private interests.
6. The Borrower shall have introduced into Parliament a bill to amend the Banking Act to provide the CBSL the power and authority to take action against Fraudulent Financial Schemes and to issue regulations or directives in relation to Fraudulent Financial Schemes.

Money Laundering

7. The Borrower's Cabinet shall have approved an Anti-Money Laundering Bill.

Insurance Industry Regulation

8. The Borrower's Cabinet shall have approved a bill to amend the Insurance Act permitting insurance companies registered under the Insurance Act to invest in securities including unit trusts, commercial paper, debt securities and bonds issued against Securitized Assets (Amendments to the Insurance Act).

Corporate Governance of State-owned Commercial Banks

9. The Borrower shall have introduced into Parliament a bill to amend the PBank Act incorporating, at least, measures to ensure the commercial and political independence of the PBank (i) board of directors; and (ii) management.

10. The Borrower shall have introduced into Parliament a bill to amend the BOC Act incorporating, at least, measures to ensure the commercial and political independence of the BOC (i) board of directors; and (ii) management.

SEMA

11. The Borrower shall have introduced into Parliament the SEMA Act incorporating, at least:
- a) the essential principles contained in the Presidential Decree, dated 4 June 2004, establishing SEMA;
 - b) measures to ensure the commercial and political independence of the PBank (i) board of directors; and (ii) management;
 - c) measures to ensure the commercial and political independence of the BOC's (i) board of directors; and (ii) management; and
 - d) any necessary consequential amendments to the PBank Act, and the BOC Act.

PBank's Unions

12. PBank shall have entered into the Collective Agreement with the trade union representing more than 85% of the permanent employees of PBank. The parties agree to implement the restructuring plan and meet the performance targets.

Restructuring and Recapitalization of PBank

13. PBank shall have continued to implement (a) the Restructuring Plan; and (b) the Performance Indicators, in each case, (i) in accordance with the agreed time-schedule stated in the Restructuring Plan, or such other time-schedule as shall have been agreed by PBank, SEMA and ADB in a separate writing, and (ii) to the satisfaction of each of SEMA and ADB.

Conditions for Release of the Third Tranche, Ref. Program Loan Agreement, Attachment 2 to Schedule 3, Compliance Deadline: Before the Third Tranche, December 2007).

Secured Transaction Financing

1. The Borrower shall have introduced into Parliament the Secured Transactions Bill; and The Borrower shall have introduced into Parliament the Amendments to the Finance Companies Act.

Public Debt Office

2. The Borrower's Cabinet shall have approved a bill to establish a Public Debt Office as an agency independent from the CBSL and the MOFP and responsible for management, administration and issuance of all of the Borrower's sovereign debt.

Equity Settlement Cycle

3. The CSE's system for reducing the period between the time a buyer of shares listed on the CSE places an order with a registered dealer to buy such shares and the transfer of payment for and delivery of such shares to the seller; from the date of T + 6 days to the date of T + 3 days as is fully operational as evidenced by a written certification from the SEC.

Money Laundering

4. The Borrower shall have introduced into Parliament the Anti-Money Laundering Bill.

Insurance Industry Regulation

5. The Borrower shall have introduced into Parliament the Amendments to the Insurance Act.

Restructuring and Recapitalization of PBank

6. PBank shall have continued to implement (a) the Restructuring Plan; and (b) the performance indicators, in each case, (i) in accordance with the agreed time-schedule stated in the Structuring Plan, or such other time-schedule as shall have been agreed by PBank, SEMA and ADB in a separate writing, and (ii) to the satisfaction of each of SEMA and ADB; and
7. The Borrower shall have provided PBank with funds in the amounts and at the times required in accordance with the Phased Recapitalization Plan.

Program Implementation and Other Matters

PBank Six-Monthly Reviews

1. The Borrower shall cause SEMA to, and SEMA shall, coordinate the conduct of an independent third-party review of the implementation of the Restructuring Plan of PBank at least every six months basis, and shall provide ADB with a report of each such review within 45 days of the end of every six months.
2. No later than 30 January 2005, PBank shall commence a formal process of consultation and dialogue with the Joint Council on the Restructuring Plan, to consult and discuss the implementation of the Restructuring Plan and to obtain their input and consider their views in the context of the Plan; and shall inform employees and obtain feedback through the team briefing process on the restructuring plan. The formal process of consultation shall continue and expand upon the Joint Council consultation process and the Team Briefing Process PBank has already commenced in the context of the ongoing reform process.
3. No later than 30 September 2005, the Borrower and SEMA will ensure that PBank enters into an agreement with the Ceylon Bank Employees Union and any trade union of the Joint Council People's Bank deems relevant following the consultation process on the Restructuring Plan that requires the parties to implement the Restructuring Plan (Collective Agreement).

Corporate Governance

4. Within 6 months of the Effective Date, the Borrower shall cause the SEC to commence preparation of a Sri Lankan Corporate Governance Code for companies registered under the Companies Act and publicly listed on the CSE (Sri Lankan Corporate Governance Code) taking into account the Code of Corporate Governance for Banks and other Financial Institutions (2002) issued by the Central Bank of Sri Lanka in 2002 and international best practice.

Program Management

5. Within three months of the Effective Date, the MOFP shall establish and maintain a Program Performance Management System (PPMS) for the monitoring and evaluation of the Program during and after implementation, acceptable to ADB. The PPMS shall include a database on the status of policy measures. Quarterly reports on the PPMS shall be submitted to the coordination committee and ADB within 30 days of the end of each quarter.

Review and Evaluation of the Program

6. The MOFP shall provide ADB with quarterly progress reports on the policy and institutional reforms. ADB shall monitor implementation of the Program through period review and progress reports. ADB shall conduct annual reviews throughout the implementation of the Program. Not later than 3 months after Program completion, MOFP shall provide ADB with a report, including an assessment of the overall performance of the Program.
7. The Borrower and ADB shall conduct a comprehensive midterm review at the end of the second year of the Program.
8. Without limiting the generality of Section 4.05 of the Loan Agreement or paras 2 to 4 of Schedule 5, SEMA shall assist ADB by providing relevant data and information in such detail as ADB may require to facilitate review by ADB of the progress in the implementation of the Program.

X. KEY PERSONS INVOLVED IN THE PROGRAM

37. All official communication related to the Program should be addressed to the following key personnel:

Names	Company	Position	Address	Telephone / Fax No./ Email address
To be named	ADB	Director	6 ADB Avenue, Mandaluyong, Phil.	T-632-6324444 F-632-6362337
Barbara Ericsson	ADB	Principal Financial Sector Specialist	6 ADB Avenue, Mandaluyong, Phil.	T-632-6325708 F-632-6362337 Email: berricson@adb.org
Sujatha Cooray	MOFP/ ERD	Director General	Ministry of Finance & Planning, 3 rd Flr, Galle Face Secretariat, Colombo 1, Sri Lanka	T-94-11-2541279 F-94-11-2447633 Email: sujatha@erd.gov.lk
Chandra Ekanayake	MOFP/ ERD	Additional Director General	Ministry of Finance & Planning, 3 rd Flr, Galle Face Secretariat, Colombo 1, Sri Lanka	T-94-11-2484653 F-94-11-2333482 Email: chandrae@erd.gov.lk
Ajitha Batagoda	MOFP/ ERD	Asst. Director	Ministry of Finance & Planning, 3 rd Flr, Galle Face Secretariat, Colombo 1, Sri Lanka	T-94-11-2484715 F-94-11-2447633 Email: ajitha@erd.gov.lk
H.M. Gunasekera	MOFP/ Department of Development Finance	Additional Director General/ Project Director	Ministry of Finance & Planning, 1 st Flr, Galle Face Secretariat, Colombo 1, Sri Lanka	T-94-11-2484593 F-94-11-2394908

XI. ANTICORRUPTION

38. The Program is subject to ADB's Anticorruption Policy. Anyone coming across evidence of corruption associated with the program is required to contact ADB's Office of the General Auditor, which will investigate allegations. Further information on ADB's anticorruption policy is available through ADB's website: <http://www.adb.org> (and selecting 'anticorruption' as topic), or directly through: <http://www.adb.org/Documents/Policies/Anticorruption/default.asp>