



# Report and Recommendation of the President to the Board of Directors

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Project Number: 36117  
November 2007

Proposed Loan  
Democratic Socialist Republic of Sri Lanka: Small and  
Medium Enterprise Regional Development Project

Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 14 November 2007)

Currency Unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.0090
\$1.00	=	SLRs110.5200

## ABBREVIATIONS

ADB	–	Asian Development Bank
AWDR	–	average weighted deposit rate
BDS	–	business development services
BOC	–	Bank of Ceylon
CAR	–	capital adequacy ratio
CB	–	Commercial Bank of Ceylon Limited
CBSL	–	Central Bank of Sri Lanka
CRIB	–	Credit Rating Information Bureau
DFCC	–	DFCC Bank
EA	–	executing agency
EIA	–	environmental impact assessment
EMS	–	environmental management system
FIU	–	Financial Intelligence Unit
FTRA	–	Financial Transaction Reporting Act
GDP	–	gross domestic product
IA	–	implementing agency
ICA	–	Institute of Chartered Accountants
IFC	–	International Finance Corporation
MEDIP	–	Ministry of Enterprise Development and Investment Promotion
MOFP	–	Ministry of Finance and Planning
MOU	–	memorandum of understanding
NDB	–	National Development Bank of Sri Lanka PLC
NPL	–	nonperforming loan
NSB	–	National Savings Bank
PCB	–	private commercial or specialized bank
PIU	–	project implementation unit
PPAR	–	project performance audit report
PPMS	–	project performance management system
PSC	–	project steering committee
SMERDP	–	Small and Medium Enterprise Regional Development Project
SB	–	Sampath Bank Limited
SEDF	–	South Asia Enterprise Development Facility
SME	–	small and medium enterprise
TA	–	technical assistance

## NOTES

- (i) The fiscal year (FY) of the Government of Sri Lanka ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ends on 31 December 2000.
- (ii) In this report, "\$" refers to US dollars.

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## **LOAN AND PROJECT SUMMARY**

<b>Borrower</b>	Democratic Socialist Republic of Sri Lanka
<b>Classification</b>	Targeting classification: General intervention Sectors: Industry and trade Subsectors: Small and medium enterprises Themes: Sustainable economic growth, private sector development Subthemes: Promoting economic efficiency and enabling markets, private sector investment
<b>Environment Assessment</b>	Category FI. An Environmental Management System Framework was prepared (Appendix 5).
<b>Project Description</b>	The Small and Medium Enterprise Regional Development Project (SMERDP) is aimed at accelerating the development of small and medium enterprises (SMEs) located outside the urbanized western province (Colombo, Gampaha, and Kalutara districts) by improving their access to credit and business development services (BDS), as well as by catalyzing development of SME value chain clusters for providing linkages to information, technology, and markets. The SMERDP also seeks to reinforce corporate governance and strengthen risk management in private commercial or specialized banks (PCBs).
<b>Rationale</b>	<p>The major development challenge in Sri Lanka today is a growing regional divide in terms of employment and economic growth. The gross regional domestic product of the western province is nearly two to four times those of the other three provinces. As a result, unemployment, underemployment, and the incidence of poverty in these three provinces are much higher than those of the western province. Accordingly, the policy priority of the Government of Sri Lanka (the Government) is to foster economic development outside the western province to address regional inequalities.</p> <p>The Government's development agenda for the underdeveloped provinces recognizes the private sector as the engine for growth and employment. Regional SMEs—meaning SMEs outside the western province—comprise 75% of the country's 30,000 registered SMEs. Regional SMEs account for most of the private sector in the underdeveloped provinces.</p> <p>An investment climate assessment conducted jointly by Asian Development Bank (ADB) and the World Bank in December 2004 indicates that while Sri Lanka compares well in South Asia for its skilled labor and ease of doing business, access to credit (particularly medium- to long-term credit) remains for SMEs a key constraint. Lack of credit access is more marked in the provinces outside the western province, where credit availability meets only 40% of the existing demand. Regional SMEs' competitiveness</p>

also suffers disproportionately from limited access to technology and markets, as well as from poor infrastructure services. As a result, they are unable to realize their full potential to grow and generate employment.

By providing access to medium- to long-term funds and encouraging the PCBs to proactively seek financing opportunities among regional SMEs, the SMERDP seeks to redress existing regional imbalances and enhance the growth and development of regional SMEs. Simultaneously, access to BDS can foster linkages to appropriate technology and target markets. Access to scale economies, equity, and skills can be facilitated through the development of SME value chain clusters.

### Impact and Outcome

The impact of the proposed SMERDP is reduction in regional inequalities through the accelerated development of regional SMEs thereby enhancing private sector share in economic development. The SMERDP's specific and immediate expected outcome is accelerated development of the SME sector outside the western province through increased output and employment generation.

### Components

The SMERDP comprises a credit facility for enhancing access to medium- to long-term financing through PCBs to eligible regional SMEs and SME value chain clusters. The credit facility is supplemented by three complementary components that seek to reinforce PCB corporate governance, strengthen PCB risk management, and foster regional SME bankability.

### Investment Plan

The Project's estimated investment cost is \$88.89 million, with ADB contributing 56.25%.

### Financing Plan

<b>Source</b>	<b>Total (\$ million)</b>	<b>%</b>
ADB	50.00	56.25
PCBs	16.67	18.75
SMEs	22.22	25.00
<b>Total</b>	<b>88.89</b>	<b>100.00</b>

ADB = Asian Development Bank, PCB = private commercial or specialized bank, SME = small and medium enterprise.

Source: ADB estimates.

Financing will include a loan of SDR 32,226,000 (\$50 million equivalent) from ADB's Special Funds resources, with a 32-year term, including a grace period of 8 years, and an interest charge of 1% during the grace period and 1.5% thereafter. It will include such other terms and conditions as may be set forth in the draft loan and project agreements.

<b>Allocation and Relending Terms</b>	<p>The Ministry of Finance and Planning (MOFP) will make the ADB loan available through the Central Bank of Sri Lanka (CBSL) to the PCBs at the average weighted deposit rate under a subsidiary loan agreement. The Government has requested that the loan term (from the Government to PCBs) should not exceed 20 years.</p> <p>The ADB loan will be relented by the Government to PCBs in local currency. The Government will bear the foreign exchange risk. PCBs will onlend the funds to eligible regional SMEs and SME value chain clusters. The PCBs will onlend the money at interest rates reflecting their costs of funds plus a spread that covers transaction costs and risk-adjusted returns. The ADB loan will be allocated to PCBs in the following indicative amounts (in dollar equivalents): (i) Commercial Bank of Ceylon Limited, \$15.0 million; (ii) DFCC Bank, \$15.0 million; (iii) National Development Bank of Sri Lanka PLC, \$10 million; and (iv) Sampath Bank Limited, \$10 million. The PCB loans are to be disbursed over 3 years, subject to a midterm review after 18 months to evaluate disbursement progress. Another review will be undertaken at the end of 3 years, at which point other eligible PCBs could be considered if any of the four PCBs fails to perform satisfactorily.</p>
<b>Period of Utilization</b>	30 June 2011
<b>Estimated Project Completion Date</b>	31 December 2010
<b>Executing Agency</b>	Ministry of Finance and Planning (MOFP)
<b>Implementation Arrangements</b>	Each eligible PCB will be an implementing agency and will establish a project implementation unit in its relevant operational department. The MOFP will establish a project steering committee (PSC) that will oversee implementation of the Project. The PSC will comprise six members, including representatives of the MOFP, CBSL, and the four PCBs.
<b>Procurement</b>	Procurement under ADB-financed subloans will be in accordance with ADB's <i>Procurement Guidelines</i> (2007, as amended from time to time), as these relate to financial intermediary loans. Subborrowers will be required to undertake procurement in accordance with established private sector or commercial practices that are acceptable to ADB.
<b>Project Benefits and Beneficiaries</b>	There are significant benefits in pursuing private sector-led regional SME development. The SMERDP's main benefits are (i) SME-driven increased regional employment and output; (ii) enhanced business opportunities for regional SMEs, SME value chain clusters, SME BDS providers, and PCBs through improved access to credit; (iii) enhanced capabilities of PCBs and their SME credit staff in SME financing operations as well as in risk mitigation, project appraisal, supervision, credit and portfolio

administration for small loans; (iv) expanded SME portfolios of PCBs; and (v) through greater interaction as part of the SMERDP, improved operational governance of PCBs due to closer central bank monitoring and supervision, as well as transaction-based accountability for corporate governance and anti-money laundering. Through support for SME value chain clusters, the SMERDP will also benefit from the mapping of SME value chain clusters undertaken by development partners. The SMERDP is expected to generate employment for approximately 50,000 people from mid-2008 to mid-2011 as well as annual output amounting to about 2.0% of the 2005 SME sector output.

## **Risks and Assumptions**

Achieving the expected benefits and impacts depends on several assumptions that are subject to varying degrees of risks. Mitigation measures are being put in place wherever feasible. Escalation of conflict could pose risks for regional SMEs should areas outside the current conflict zone become involved. While the PCBs stand ready to lend to SMEs in the conflict-affected areas, such lending would be undertaken only as the security situation permits and the PCBs perceive the risks to be acceptable.

Delinquency risks that PCBs face in expanding regional SME portfolios are mitigated through (i) improved access to credit information, (ii) better use of collaterals, (iii) strengthened governance structures and risk management practices, (iv) risk-based pricing, and (v) CBSL monitoring.

Risk associated with the creditworthiness of SMEs in some locations could affect utilization of the SMERDP facility. This risk is mitigated through access to BDS and introducing lead firms in SME value chain clusters that will inject equity, know-how, and marketing into SMEs. In addition, ADB assessment indicates that PCBs have significant lending opportunities to viable regional SMEs.

Although the demand for SME credit is robust, there could be implementation delays in case the eligible PCBs would refocus their priorities and/or fail to sustain expected performance standards. These risks have been addressed by assessing PCB eligibility and commitment upfront. In addition, the Project enables substitution of PCBs in case of performance shortcomings.

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Regional Development Project (SMERDP). The Design and Monitoring Framework is in Appendix 1.

## II. RATIONALE: SECTOR PERFORMANCE, PROBLEMS, AND OPPORTUNITIES

### A. Performance Indicators and Analysis

2. **Macroeconomic Context.** The economy of Sri Lanka witnessed an impressive 7.2% gross domestic product (GDP) growth in 2006. GDP growth has been consistently above 5.5% since 2003. The per capita income, at \$1,355 in 2006, is the highest in South Asia. While in the 1990s growth was driven by the manufacturing sector, since 2001 services have taken over the lead in economic growth. These include in particular telecommunication, transportation, and financial services. However, rural and agriculture sectors have remained stagnant. Moreover, high inflation and a large fiscal deficit remain concerns. In addition, a financing gap persists with the country's domestic savings falling far short of its investment needs.

3. **Development Challenge.** Notwithstanding the economic growth, regional inequalities represent a major development challenge in Sri Lanka. The per capita gross regional domestic product of \$1,467 in the western province, the most developed of the four provinces, is some two to four times those of other provinces. The share of the western province in the total economy has increased while the contribution of the other three provinces has declined. Unemployment fell to 6.4% in 2006 from 8.3% in 2004,<sup>1</sup> but youth unemployment is a particularly critical problem. Nearly 80% of the unemployed (and mostly outside the western province) are in the age group of 15–29 years. The overall poverty incidence is 22.7%.

4. The ongoing conflict accentuates regional disparities and exacerbates poverty. The share of households living below the poverty line in the western province (9.2%) is less than half of those in all other provinces (18.1% to 31.8%).<sup>2</sup> The indirect and direct economic costs of the ongoing conflict in the north and east are estimated to reduce the growth by 2 percentage points per annum. The strain on government resources adds to the crowding out of the private sector and also constrains public expenditure for development. Adverse effects on business confidence due to the conflict impede both domestic and foreign private sector investment.

5. **Development Paradigm.** Expanded roles for foreign direct investment and public-private partnerships are critical elements of the Government of Sri Lanka's (the Government) development agenda. The narrowing fiscal space is prompting growing reliance on the private sector for investments and service delivery. The Government is cognizant that a well-functioning small and medium enterprise (SME) sector could take the lead in generating jobs and economic growth while raising income levels for a large segment of the population. Since regional<sup>3</sup> SMEs (i.e., SMEs outside the western province) comprise 75% of the total number of registered SMEs in the country, the Government recognizes the importance of SMEs in equitable regional growth. However, regional SMEs have not realized their full potential for contributing to economic growth and employment generation. Accordingly, regional SME development is one of the key elements of the

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<sup>1</sup> The latest census excludes the north and east, and therefore the figures are not strictly comparable.

<sup>2</sup> Sri Lanka Department of Census and Statistics. 2002. *Household Income and Expenditure Survey*. Colombo. The poverty line is calculated as SLRs1,423 per month, based on the cost of basic needs methodology. Data is not available for the northern and eastern provinces.

<sup>3</sup> The term "regional" in the context of this document denote all provinces except the western one.

Government's strategy for reducing regional inequalities in its 10-year (2006–2016) National Development Strategy, the *Mahinda Chintana: Vision for New Sri Lanka*.

6. **SMEs.** There are nearly 30,000 registered SMEs<sup>4</sup> in Sri Lanka, three fourths of which are regional SMEs. Estimates of the SMEs in the informal sector or unregistered is much higher. At the sector level, SMEs account for 65% of total tea production, 50% of apparel and garment manufacturing, more than 70% of the road transportation sector, 80% of domestic trade activities, 45% of tourism and recreation services, and 50% of the local construction industry. It is estimated that one third of the total number of SMEs produce for export markets. Following is a broad segregation of SME types:

- (i) Small informal enterprises typically employ 5 to 9 persons and are largely family based. Having grown from microenterprises,<sup>5</sup> these enterprises use significant portions of their business revenues to invest in expansion. Typically, these enterprises lack access to formal credit and support services. Access to formal credit and business development services (BDS) could help realize the growth potential.
- (ii) Small formal sector enterprises typically employ 6 to 49 persons and have well-established relationships with larger manufacturing and trading concerns. While significant growth potential exists, they face leadership and management challenges. Sources of finance are usually retained earnings and supplier credits.
- (iii) Medium-sized enterprises typically employ between 50 and 150 persons and serve as a link between the formal and informal economies through well-established supplier and buyer relationships with small formal and informal SMEs, as well as with large domestic and international corporate entities. Although professionally managed, there is a need to maintain competitiveness. Access to finance remains constrained even for this category of SMEs.

7. The vision and strategies for SME development in Sri Lanka explicitly address the concerns of entrepreneurs in the SME sector within the national economic and social framework as set out in the 10-year National Development Strategy (2006–2016). The Ministry of Enterprise Development and Investment Promotion (MEDIP) facilitates measures to promote development, growth, and international competitiveness in the SME sector as an integral part of the national economy. All policy and programming initiatives for the SME sector are designed to be consistent with and complementary to the existing policy initiatives of other key ministries. The Government also established the National Enterprise Development Authority (NEDA), with private sector participation, to coordinate SME development interventions implemented by various agencies and government levels.

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<sup>4</sup> For this document, SMEs are defined as those employing between 10 and 150 staff. Definitions of SMEs vary considerably and have also evolved. In terms of the total value of assets, the definition proposed by the Task Force for SMEs (December 2002) classified (i) small enterprises as those with fixed asset value, excluding land and buildings, of SLRs1 million to SLRs20 million; and (ii) medium-scale enterprises as enterprises with fixed asset value, excluding land and buildings, of SLRs20 million to SLRs50 million. However, the definition adopted by banks suggests the need for a more liberal enterprise fixed asset value, excluding land and buildings, of SLRs100 million (about \$1 million) to appropriately capture the full extent of the SMEs in Sri Lanka.

<sup>5</sup> Typically employ up to four persons, mostly from the same family. Activities include handicraft, shops, trade, and services, and often at the premises of the owners.

## B. Analysis of Key Problems and Opportunities

### 1. Analysis of Key Problems

8. An investment climate assessment<sup>6</sup> indicates that Sri Lanka fares well on indicators such as skilled labor force and ease of starting business compared to other developing countries. However, political stability, quality of infrastructure, and predictability of labor regulations affect investment inflows.<sup>7</sup> From a development perspective, the assessment emphasizes that rural SMEs make a large contribution to GDP (12%) and represented 78% of agricultural GDP in 2003. Nearly 72.2% of the population lives in rural areas.<sup>8</sup> The potential for SME-driven regional growth is particularly marked in the sectors of fisheries, dairies, spices, leather and footwear, coir, fruits and vegetables, as well as packaging. However, regional SMEs also have restricted access to finance and, compared to SMEs in the western province, generate lower employment as well as lower quantity and quality of output (please refer to Appendix 2 for a more detailed analysis of the SME sector).

#### a. Access to Bank Credit

9. Banks are the main providers of SME credit, and especially four private commercial or specialized banks (PCBs): Commercial Bank of Ceylon Limited (CB), DFCC Bank (DFCC), National Development Bank of Sri Lanka PLC (NDB), and Sampath Bank Limited (SB). Also important are two state-owned banks: the Bank of Ceylon (BOC) and People's Bank.<sup>9</sup> Compared to state-owned banks, the regional SME portfolios of PCBs represent higher proportions of their total portfolios.<sup>10</sup> Despite PCBs' relatively smaller regional branch networks,<sup>11</sup> their better operational efficiencies<sup>12</sup> enable PCBs to cover larger areas per branch compared to the state-owned banks. SME lending by public sector banks is in instances under government-sponsored programs.

10. Notwithstanding the coverage by the banks, an overall limited access to formal credit remains the strongest constraint on SMEs. In Sri Lanka, the industrial and agricultural sectors receive only 10% and 4% of total bank financing, respectively. Only 35% of registered regional SMEs are estimated to have access to formal finance. The overall supply-demand gap for SME credit is estimated at 50% nationally, and 60% outside the western province. The access to bank credit improves with increasing firm size. Start-up SMEs find it even harder to borrow from banks,<sup>13</sup> and even SMEs that have access are able to borrow much less than their investment needs.

11. Around 65% of total SME lending volume by all banks in Sri Lanka is short-term credit, while the remaining 35% is medium- to long-term credit. Due to the relatively small equity market and nascent long-term debt market, financial institutions like banks are unable to mobilize

<sup>6</sup> ADB and World Bank. 2004. *Sri Lanka: Improving the Rural and Urban Investment Climate*. Sri Lanka.

<sup>7</sup> Compared with Malaysia and Thailand, where annual investment inflows are about 3% of GDP, inflows in Sri Lanka averaged 1.3% of GDP during 1990–2002.

<sup>8</sup> Sri Lanka Department of Census and Statistics. 2002. *Household Income and Expenditure Survey*. Colombo.

<sup>9</sup> Sri Lanka has a wide range of financial institutions, which number approximately 96, but the discussions in this document are confined to banks that meet the eligibility criteria set by ADB for participation in the SMERDP. A separate loan is being processed for Bank of Ceylon (BOC).

<sup>10</sup> On average, SME lending as a percentage of total lending and the number of regional SME loans as a proportion of total SME loans is greater for the four PCBs.

<sup>11</sup> The number of regional branches of the four PCBs, at 107, although less than the 212 branches of BOC, are also well dispersed throughout the country.

<sup>12</sup> In terms of average processing time (i.e., the number of days from submitting a loan application to funds disbursal).

<sup>13</sup> Only 14% of working capital for small firms in Sri Lanka is financed by bank loans compared to 30% for medium firms. Utilization of bank credit by manufacturers employing fewer than 100 employees is just 7%. Only 11% of new SME investment in Sri Lanka is financed through bank loans.

adequate long-term funding domestically. With an international credit rating below investment grade, Sri Lanka also has limited access to the international financial markets.

12. SME lending is heavily concentrated in the western province, which limits the potential of regional development. Despite having regional branch networks, and due to perceived higher risk of lending in other parts of the country, banks have historically concentrated SME lending to the more urbanized western province. Regional SMEs' relatively smaller size and their geographic locations increase unit transaction costs. Moreover, reliable credit information is often lacking. As a result, the banks require substantially larger spreads than are offered to established, larger enterprises. Venture capital companies are also reluctant to invest in SMEs, due to an absence of credible sponsors and information. The poor past performance of venture capital companies that did invest in a few SMEs discourages further investments.

#### b. Enabling Environment

13. While the Government has successively taken measures for enhancing the operating environment for SMEs, some gaps and weaknesses still need to be addressed. These include:

- (i) **Inadequate and unreliable credit information.** The available information and track record of a potential SME borrower is limited, as credit rating agencies and credit information bureaus do not cover their operations. Meanwhile, in most cases the systems of internal financial accounting in SMEs are weak. The resulting information asymmetry prevents banks from reasonably assessing SMEs' creditworthiness. As a result, the banks rely heavily on collateral, and especially in the form of land, when considering SME loan proposals.
- (ii) **Lack of a framework and system for securing movables.** SME entrepreneurs typically have little land to offer by way of collateral, but they have movable property ranging from equipment to inventory to receivables. However, the absence of a legal and regulatory framework to allow financial institutions to secure their lending against such security is a constraint. Linked to this is the lack of a central registry to ensure the integrity of such collaterals. While registries for movable property do exist in Sri Lanka, they are many and dispersed throughout the country. Each district has its own registry, making it difficult for banks to keep track of pledged collateral nationwide.

#### c. Nonfinancial Constraints

14. SMEs' growth prospects are also impeded by a lack of access to nonfinancial inputs, low levels of technology absorption, and weak management.

- (i) **Nonfinancial inputs.** Since the mid-1980s, Sri Lanka has undertaken liberalization policies. Barriers to entry have been reduced and import restrictions have been brought down. In a number of sectors, however, a lack of uniform grading and sorting, poor packaging, and weak supply chains result in extensive post-harvest waste from spoilage. Smaller firms that cannot manage their supply chains do not find it easy to obtain access to adequate quantity and quality of raw materials and intermediate inputs.
- (ii) **Managerial, technical, and marketing constraints.** As in many other developing countries, SMEs in Sri Lanka often begin as family-owned and family-operated

businesses.<sup>14</sup> In addition, SMEs are disadvantaged in terms of research and development as well as vocational training required for improved harvesting methods and consequent product quality. SMEs, and especially start-ups, face difficulties in upgrading technology and locating buyers for their products.

#### d. Physical Infrastructure Constraint

15. The quality of and access to infrastructure plays an important role in the establishment, operation, and expansion of an enterprise. Sri Lankan firms have identified poor infrastructure, like roads and unreliable power, as the primary hindrances for doing business (footnote 6). In addition to the bottlenecks in medium- to large-scale infrastructure, SMEs are often constrained by a lack of supporting small-scale infrastructure such as, for example, fishing harbors, common market facilities, and small non-vehicular bridges. Inadequate physical infrastructure is even more acute outside the western province. This exacerbates regional disparity as inadequate infrastructure facilities add to SMEs' costs of doing business, reduce their productivity, and limit their expansion.

## 2. Analysis of Opportunities

16. Regional economic disparity is of enormous economic and political significance in Sri Lanka. With the availability of medium- to long-term funds, there arises considerable interest among the banks in exploring SME financing opportunities beyond the western province. This makes a business case for banks to both diversify and to expand their portfolios outside the western province's crowded banking sector. As critical as access to credit is, however, its development impact depends on reform measures, both financial and nonfinancial.

#### a. Enhancing the Enabling Environment

17. **Credit Information.** The Government is facilitating the conversion of the manual format at Credit Rating Information Bureau (CRIB) to a web-based electronic-enabled system by the end of 2007 to ensure availability of credit history for all SMEs at the CRIB. These efforts will enable coverage of all SME borrowers and will help the banks to shift from purely collateral-based lending to cash flow-based lending that emphasizes greater reliance on character, better understanding of the business, and credit rating information at the outset of the credit relationship with SMEs.<sup>15</sup> Credit information will also facilitate adoption of credit scoring methods by lenders to reduce appraisal time and cost.

18. **Securing Movable.** The Government is also pursuing enactment of a secured transactions bill and the establishment of a national system of registry as part of ADB's ongoing Financial Markets for Private Sector Development Program<sup>16</sup> to enable SMEs to use their movable property as collaterals. Enactment is expected in March 2008, and CRIB will be assigned the function of registry for securing movable property.

<sup>14</sup> SMEs with professional managers are more successful in consolidating and expanding their businesses. ADB and World Bank. 2004. *Sri Lanka: Improving the Rural and Urban Investment Climate*. Sri Lanka.

<sup>15</sup> Support for cash flow-based lending, however, does not mean the elimination of collateral. The basis for credit in cash flow-based lending is not the collateral offered by the borrower but rather the borrower's ability to repay the loan (i.e., SMEs can obtain credit on the strength of their creditworthiness). Less restrictive covenants can be utilized, such as *pari passu* treatment for all creditors or the guarantee of the owners instead of requiring hard collateral. Having such a system in place could serve as an incentive for SMEs in the informal sector to move to the formal sector.

<sup>16</sup> ADB. 2004. *Financial Markets Program for Private Sector Development*. Manila (R265-04).

## b. Improving Access to Nonfinancial Inputs

19. **SME Value Chain Clusters.** SME value chain clusters are essentially economic groupings that comprise a group cluster of SMEs in a particular sector around a lead firm.<sup>17</sup> SME value chain clusters entail vertical integration that allows for transactional and technological efficiencies as well as enhanced economies of scale. For the SME, benefits include (i) enhanced economies of scale through bulk purchasing and coordinated product promotion, (ii) improved market access, (iii) adoption of the industry's best practices and technological efficiencies, (iv) marketing and managerial knowledge, and (v) greater certainty of buyers for the SME's products and services. Furthermore, lead firms can trigger dialogue with equity firms or venture capital companies, for purposes of needs-based equity partnerships in new SME businesses. SME value chain clusters also facilitate access to bank finance on account of better business prospects. For the lead firms, the cluster strengthens forward and backward linkages as well as provides economies of scale. Mapping for SME value chain clusters in illustrative sectors have been undertaken by development partners<sup>18</sup> for the coir, spices, rubber, ceramics, tea, gems and jewelry, information technology, organic products, and tourism segments. Access to credit for such SME value chain clusters will enhance the prospects for the underdeveloped provinces as well as for the clusters themselves.

20. **SME Value Chain Cluster Concept in Sri Lanka.** In the fisheries sector, for example, the formation of SME value chain cluster between groups of fisher folk and a lead firm (processing plant) facilitates access to formal finance for the fisher folk since the banks are more assured of the success of enterprise with the presence of a lead firm as part of the cluster. For the fisher folks, this arrangement enhances productivity through upgrading of boats (from one day to multi day boats) and provision of cold storage on the boats. Ultimately, the fisher folk benefit from higher return on investments in terms of daily landed catch and less wastage. For the lead firm, the incentive is the backward linkage enabling assured supply of raw material (i.e., supply of more fish).

## c. Providing Business Development Services

21. MEDIP has established five centers throughout the country to assist SMEs in obtaining BDS, including outsourcing activities (e.g., payroll and accounting), information technology services, technical services (e.g., design and engineering), and financial brokering. A registry of BDS providers is available on the Government's web site.<sup>19</sup> Survey findings<sup>20</sup> indicate that only one third of SMEs use BDS at least once in every 3 months, and the rest seldom or never use BDS. The BDS most commonly used are legal and tax advice, business registration and licensing assistance, accounting services, and computer-related services. There is significant demand for BDS, and primarily for business management training, for preparing loan proposals and business and marketing plans, and for quality control. The SMEs feel the need for financing to acquire quality BDS services from reputable and competent commercial providers. This, in turn, would provide an incentive for professional BDS providers to upgrade and enhance their skills. Greater use of BDS by SMEs would help to diversify and broaden the availability of such services.

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<sup>17</sup> Lead firms are defined as corporations with (i) an established track record in the sector, or an established track record of effective diversification in other sectors; and (ii) offtake agreements to buy products or invest a majority equity stake in the new SME business as part of a value chain cluster.

<sup>18</sup> Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation) and United States Agency for International Development.

<sup>19</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Small- and Medium-Sized Enterprise Sector Development Program, Business Services Support Facility*. Manila.

<sup>20</sup> Small and Medium Enterprise Policy Unit, Ministry of Enterprise Development and Investment Promotion. 2003. *National Strategy for Small and Medium Enterprise Sector Development in Sri Lanka*. Sri Lanka.

#### d. Enhancing Physical Infrastructure

22. Regional infrastructure development is critical for meeting SMEs' needs for power, transport, water, and sanitation. The Government recognizes the importance of improving and expanding regional public infrastructure for sustaining economic and social development. In this context, the 2007 Budget allocates 5% of GDP per annum for infrastructure development over the next 4 years. Furthermore, the 2007 Budget announced a 2.5% regional infrastructure development levy on the value of motor vehicles (inclusive of all taxes and duties) levied at the point of customs. The Government is also keen to enhance the private sector's role in providing infrastructure services through public-private partnerships.

#### e. Financial Sector Reforms

23. Sri Lanka's financial sector (Appendix 3) has grown rapidly in recent years, both in terms of the number of institutions and the range of services offered. Foreign ownership of banks, insurance companies, and stockbrokerage firms have been permitted. Interest rates have been deregulated, prudential norms have been made more stringent, and credit ratings have been made mandatory. Banks have expanded their branch networks, and intense competition has led to rapid growth in value-added services. Within the financial sector, the PCBs are market leaders in products and services. Mergers, acquisitions, and strategic alliances are becoming common among banks and other financial institutions.

24. Through its ownership of BOC and People's Bank, the Government's presence remains substantial. Although the financial soundness of the banking system has improved, the nonperforming loan ratio, at 12.6% in 2006, is still relatively high for state-owned banks. The interest spread in Sri Lanka is the highest in South Asia,<sup>21</sup> reflecting the need for improving banks' operational efficiency and risk management. Further, corporate governance, while significantly improved, needs to be continuously strengthened. Progress in these areas is critical for facilitating the adoption of Basel II. The current policy direction of Government is to commercialize the operations of the state-owned banks rather than privatize.

25. Sri Lanka's capital market is also small, with a market capitalization of about 25% of GDP. However, the capital market has proved resilient even in the face of political uncertainties. While there is an active market for government securities, the private debt securities market is small. Government control of the long-term savings through two pension funds and savings banks enables it to preempt most savings for financing government borrowing, which constrains private debt markets.

### 3. The Government Strategy for Regional SME Development

26. The Government's development agenda outlined in the *Mahinda Chintana* combines market-based economic policies (including to attract foreign direct investments) with support for domestic enterprises. The Government aims to pursue a gradual approach to reforms with the aim of building broad based ownership of such reforms. To achieve high growth rates, emphasis is on investments in infrastructure and a knowledge economy with a focus on regional development. A greater role for the private sector underlies the development agenda.

27. To bring dynamism in the SME sector in terms of new entrants and growth of established enterprises, the 10-year National Development Strategy (2006-2016) emphasizes increasing investment in the SME sector and removing barriers to its growth through legislative and regulatory

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<sup>21</sup> ADB. 2005. *Sri Lanka: Financial Sector Assessment*. Manila.

reforms. Further, the task force on national strategy for SME development outlined a framework that includes (i) an enabling environment for preparing SMEs to meet the challenges of an internationally competitive economy;<sup>22</sup> (ii) facilitating cooperation and synergies among entrepreneurs wherever possible through developing SME value chain clusters; (iii) fostering stable and quality employment in SMEs by improving skills and technology; (iv) minimizing the imbalance between large-scale enterprises and SMEs, including to encourage integration through value and supply chains; and (v) improving income- and wealth-generating opportunities for low-income groups through enterprises.

28. In order to address regional inequalities, the Government has advanced its commitment for facilitating regional public infrastructure development (para. 22). Resources have also been earmarked in the budget for promoting value addition in SME outputs through research and development. In addition, import duty has been removed on machinery and equipment for sectors such as tea, rubber, and coconut coir. To enhance credit flow for SMEs and SME-related infrastructure, the Government has also established Lanka Puthra Development Bank.

#### 4. Asian Development Bank Support for SME Development

29. ADB has provided sustained support for the SME sector through efforts to broaden financial markets, fiscal improvement programs, and SME-focused interventions.<sup>23</sup> Such long-term structural issues as developing the capital market and availability to the private sector of alternative sources of medium- to long-term funds are being addressed through ADB support. Continuing ADB support in this area has included developing contractual savings institutions, alternative sources of medium- to long-term funds, the insurance industry and pension and provident funds, and liberalization of these institutions' investments to include private securities in the capital market.

30. Developing securitized debt and equities markets under ADB's Financial Sector Development Program (1990), strengthening the Securities and Exchange Commission, and introducing a securitization bill as well as amendment to the Securities and Exchange Commission Act under the ongoing Financial Markets for Private Sector Development Program are all expected to deepen and improve the efficiency of the financial markets while enhancing corporate governance. Simultaneously, the ongoing Fiscal Management Reform Program is helping create an enabling environment to foster tax revenues mobilization, improved effectiveness of public expenditures, fiscal decentralization, and coordination to ultimately place public finances onto a sustainable path. These structural measures are long-term initiatives, the impact of which will only gradually take hold after continuous implementation. ADB is also providing extensive support for infrastructure development<sup>24</sup> involving ports, highways, and roads that cumulatively will enhance the competitiveness of SMEs and provide the basis for a higher growth rate.

<sup>22</sup> This would include cleaner production technologies and rationalizing regulation and taxes.

<sup>23</sup> ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Financial Markets Program for Private Sector Development*. Manila; ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Fiscal Management Reform Program*. Manila; ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Private Sector Development Program*. Manila; ADB. 1994. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Fourth Development Finance Loan*. Manila; ADB. 1990. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Financial Sector Program*. Manila; ADB. 1987. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the SME Industries Project*. Manila; and ADB. 1985. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Development Financing Project*. Manila.

<sup>24</sup> During the period 2001–2007, ADB has financed six infrastructure projects at a total cost of \$600 million.

31. Besides the SME policy unit at MEDIP, the ADB-financed SME Sector Development Program I<sup>25</sup> also introduced policies to reduce the costs of operating and financing SMEs. These policy changes include reducing the corporate income tax for SMEs, abolishing turnover tax on banking and financing activities, harmonizing tax incentives, and abolishing stamp duty on letters of credit. Commercial legal reforms, such as the Bankruptcy Act, are underway to provide for court supervised restructuring of SMEs in the event of financial default. In addition, an integrated approach for enhancing SMEs' access to finance and BDS was initiated. The associated credit line was fully utilized, but SMEs in the western province (footnote 25) benefited largely.

32. **Lessons Learned.** An Operations Evaluation Department analysis of credit lines<sup>26</sup> highlights that (i) it must be recognized that an underdeveloped domestic market for long-term funds for SMEs exists, (ii) appropriate selection of effective private sector banks and selective use of performance-oriented state-owned banks are key to efficient delivery of SME subloans, and (iii) using market-based lending rates to SMEs is more effective than subsidized credit.

## 5. Donor Coordination

33. Private sector driven regional SME development to generate employment is widely considered as a priority intervention. Accordingly, technical assistance (TA) studies and capacity building for fostering bankable SME projects, especially through a SME value chain cluster approach, have been encouraged by development partners in Sri Lanka.<sup>27, 28</sup> ADB's TA study for preparing the SMERDP was coordinated with development partners, who concurred with the significance of value chain clusters.<sup>29</sup> The German Agency for Technical Cooperation and United States Agency for International Development will recommend value chain clusters mapped and developed under their projects for SMERDP financing (para. 55).

34. The SMERDP is designed to benefit from South Asia Enterprise Development Facility (SEDF)<sup>30</sup> interventions, funded by the International Finance Corporation (IFC), for enhancing the PCBs' capacity for SME financing with regard to financing product development, risk management practices, and knowledge dissemination (paras. 46-47). The SMERDP design also incorporates experience from the ongoing SME credit line from the Japan Bank for International Cooperation. Please refer to Appendix 4 for the external coordination matrix.

35. **Proposed SMERDP.** A dynamic SME sector is needed to accelerate regional growth for employment and private sector development. The contribution of regional SMEs to economic growth depends on financial and nonfinancial inputs for stimulating start-up SMEs, growth of established SMEs, and development of SME value chain clusters. The Government initiatives (paras. 26-28) and ADB's interventions for SME development as well as the ongoing financial and fiscal reforms and infrastructure investments (paras. 29-31), provide the opportunity for accelerating regional SME development.

<sup>25</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans, Partial Credit Guarantee, and Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Sector Development Program*. Manila.

<sup>26</sup> ADB. 2005. *Annual Evaluation Review*. Manila.

<sup>27</sup> The project Capacity Building for Competitiveness and Qualified Employment, supported by German development assistance through the German Agency for Technical Cooperation, has promoted the value chain promotion component in spices, rubber, organic products, and alternative tourism.

<sup>28</sup> The Competitiveness Program of the United States Agency for International Development has identified eight private sector clusters: coir, spices, rubber, ceramics, tea, tourism, gems and jewelry, and information technology.

<sup>29</sup> ADB. 2005. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Sector Development Program II*. Manila (TA 4633-SRI).

<sup>30</sup> ADB is one of the seven sponsors of the South Asia Enterprise Development Facility (SEDF).

36. Inadequate mobilization of medium- to long-term resources by the domestic market and the SME financing pattern that is skewed in favor of the western province have resulted in a demand-supply gap for medium- to long-term credit for regional SMEs. Regional SMEs have bankable demand for credit, and therefore access to adequate medium- to long-term credit is important for enabling them to benefit from economic opportunities by adopting new technologies and business processes. This, in turn, is important for increasing and diversifying the sources of income outside the western province. Accordingly, and consistent with ADB's country strategy and program update 2005/2006 for Sri Lanka,<sup>31</sup> the proposed SMERDP provides a credit facility to participating financial institutions (four PCBs) for lending on to SMEs located outside the western province. This will fill a critical market gap and catalyze establishment and development of SME value chain clusters and provision of commercial BDS for SMEs. The SMERDP builds on lessons learned in SME development (para. 32) and is firmly anchored to the market with risk-based pricing consistent with Basel II requirements, as directed by CBSL.

### III. THE PROPOSED PROJECT

#### A. Impact and Outcome

37. The impact of the proposed SMERDP is reduction in regional inequalities through the accelerated development of regional SMEs thereby enhancing private sector share in economic development. The SMERDP's specific and immediate expected outcome is accelerated development of the SME sector outside the western province through increased output and employment generation. The design and monitoring framework is attached as Appendix 1.

#### B. Small and Medium Enterprise Regional Development Project

##### 1. Outputs

38. The Sri Lankan credit market suffers from a dearth of medium- to long-term funds. Constrained by the limited availability of matching term funds, the banks and financial institutions are reluctant to lend to regional SMEs. The objective of the SMERDP is to fill this critical market gap by providing medium- to long-term credit for SMEs, mainstreaming best practices in SME financing, creating SME value chain clusters as a medium for accelerated SME development, and improving SMEs' access to nonfinancial inputs by providing BDS.

##### 2. Components

39. The SMERDP comprises a credit facility, the core component, for enhancing access to medium- to long-term financing through PCBs to eligible regional SMEs and SME value chain clusters. The credit facility is supplemented by three complementary components that seek to reinforce PCB corporate governance, strengthen PCB risk management, and foster regional SME bankability.

##### a. Core Component: Credit Facility

40. **Eligible PCBs.** PCBs eligible to utilize the SMERDP credit facility are CB, DFCC, NDB, and SB. The eligible PCBs (i) demonstrated commitment and a proven track record of serving the SME market, (ii) met operational and financial eligibility criteria (including a credit rating of at least AA-

<sup>31</sup> ADB. 2004. *Country Strategy and Program Update (CSPU) 2005–2006 for Sri Lanka*. Manila. The CSPU identifies access to credit and access to infrastructure as the priority constraints hampering SME development, with such constraints being especially acute outside the western province.

i.e., investment grade of a very high credit quality as per the Sri Lanka long term national rating scale of Fitch Ratings Lanka),<sup>32</sup> (iii) complied with corporate governance standards, (iv) demonstrated the capacity to reach out to regional SMEs, and (v) are equipped with adequate risk management processes and procedures. ADB reserves the right to disallow disbursements to any eligible PCB for not conforming to any of the eligibility criteria, as outlined in Section A of Appendix 6, until such time as the PCB is able to satisfy the established criteria. A due diligence analysis of the eligible PCBs is also included in Appendix 6.

41. The regional branch network of BOC, including its presence in conflict-affected areas, is greater than those of all the eligible PCBs put together. BOC meets the eligibility criteria and has a rating better than some of the eligible PCBs. Considering the ongoing institutional and operational reforms at BOC, and in consultation with the Government, it was decided to separately explore a nonsovereign facility that will not only anchor BOC to international markets but also ensure that its business decisions and processes align with international best practices. In addition, ADB is expanding the funding resources and financial services available to the SME sector in Sri Lanka through an earlier loan in 2007 to Lanka Orix company Limited, as well as through proposed loans to People's Leasing Company Limited and Commercial Leasing Company Limited.

42. **Eligibility Criteria for Subborrowers.** The following are eligible to access SMERDP credit facility:

- (i) Start-up SMEs as well as SMEs undertaking expansion or modernization, provided their annual turnover does not exceed SLRs300 million or their fixed assets do not exceed SLRs100 million (excluding land and building).
- (ii) SME value chain clusters representing economic groupings of lead firms and eligible SMEs, or commercially viable partnerships between a lead firm or lead firms and group of SMEs, for the purpose of achieving economies of scale through bulk purchasing and coordinated product promotion by the lead firm or enhanced import/export competitiveness, market access, technology, and skills transfer from the lead firm.

43. **Eligibility Criteria for Subprojects.** The subproject selection criteria have been designed for outreach to regional SMEs as well SME value chain clusters. The subproject shall:

- (i) be located outside the western province;
- (ii) be economically and financially viable; for SMEs and SME value chain clusters;
- (iii) either be for start-up, expansion, or modernization activities in any of the eligible subsectors<sup>33</sup> as agreed between Government and the ADB, or for financing BDS requirements<sup>34</sup> of SMEs or SME value chain clusters;
- (iv) comply with Government's and ADB's environmental and social safeguard policies; and
- (v) not entail any activities that would generate involuntary resettlement whether permanent or temporary, including for squatters.

<sup>32</sup> Fitch Ratings Lanka (FRL) (formerly known as Duff & Phelps Credit Rating Lanka) pioneered credit ratings in Sri Lanka on 5 October 1999.

<sup>33</sup> Except those on the exclusion list of ADB (see Supplementary Appendix F), will include but not be limited to the following sectors (leather products, fisheries, dairy, coconut coir, spices, fruits and vegetables, as well as packaging) that have been selected on the basis of (i) domestic demand and export potential, (ii) factor endowments, (iii) potential for development of pilot SME value chain clusters, and (iv) credit finance absorption capacity. Any PCB can, with adequate justification, request the inclusion of other sectors subject to Government and ADB approval.

<sup>34</sup> Include but are not limited to, providing key sector specific design, testing, standards certification (especially for exports), product development, and technology, as well as assistance in the operating functional areas of marketing, production, financial management and commercial skills transfer services.

### b. Complementary Component 1: Supporting PCB Governance

44. **Role of CBSL.** In addition to channeling the SMERDP credit facility, the CBSL has agreed to take an active role in strengthening the governance of eligible PCBs in consideration of its (i) ready access to information pertaining to the continued eligibility of the PCBs, including their financial soundness and capabilities for providing credit to the SME sector; (ii) regulatory and supervisory role over the PCBs; (iii) role in setting corporate governance standards for banks;<sup>35</sup> and (iv) key role through its recently established Financial Intelligence Unit to combat money laundering and financing of terrorism.<sup>36</sup>

45. CBSL's role was discussed with the International Monetary Fund and World Bank. Both endorsed the strengthened governance on disbursements and utilization under the Project that would be made possible as a result of CBSL monitoring. Supervision of Corporate Governance Code compliance involves regular on-site inspections of the PCBs by CBSL's Bank Supervision Department. The SMERDP will support further strengthening of PCB governance through active dialogue with the PCBs based on project steering committee (PSC, para. 63) assessment of the on-site inspection reports with respect to (i) corporate governance structures that promote effective identification, monitoring, and management of all material business risks; (ii) systems for ensuring compliance with all statutory and regulatory requirements; (iii) implementation of financial disclosure requirements for market participants and observers; and (iv) setting of corporate governance objectives, strategies, and techniques. A PCB's unsatisfactory progress can lead to cancellation of its access to the SMERDP credit facility.

### c. Complementary Component 2: Strengthening PCB Risk Management

46. **Role of SEDF.** PCBs need to strengthen their risk management procedures for their SME lending portfolios. Such efforts will, for example, require (i) greater reliance on cash flow and past performance as bases for lending to regional SMEs instead of solely using collateral-based lending, (ii) increased application of SME credit scoring by PCBs and collaboration with domestic rating agencies, and (iii) risk-based loan pricing. The IFC's SEDF in Colombo has a key role in supporting the PCBs in this regard.<sup>37</sup> The SEDF's ongoing TA programs are enabling capacity building for PCBs on risk management, process reengineering, streamlining procedures, and developing new products.<sup>38</sup> Utilizing the SEDF's capacity building complements SME financing under the SMERDP.

47. The PSC will call for PCB progress reports by SEDF in order to assess the core areas of PCB risk management in terms of (i) management structure and organization, (ii) SME credit

<sup>35</sup> Central Bank of Sri Lanka. 2002. *Code of Corporate Governance for Banks and Financial Institutions*. Colombo.

<sup>36</sup> In response to recommendations of the intergovernmental Financial Action Task Force to combat money laundering and terrorist financing, Sri Lanka has enacted three acts, namely the (i) Convention on the Suppression of Terrorist Financing Act No. 25 of 2005, (ii) Prevention of Money Laundering Act No. 5 of 2006, and (iii) Financial Transaction Reporting Act (FTRA) No. 6 of 2006. The FTRA has institutionalized the CBSL's Financial Intelligence Unit (FIU) and made it mandatory for all financial institutions and professionals to adhere to guidelines and stipulations on reporting suspected transactions seeming to suggest money laundering activities. Financial institutions are required to report to the FIU cash transactions and electronic fund transfers above SLRs500,000 and any suspicious transactions.

<sup>37</sup> Required improvements in risk management by PCB include (i) CB: streamlining and automation of the risk management function in view of the growing portfolio diversification; (ii) DFCC: creation of a centralized risk management function, initially focusing on credit and progressively on operational and market risk management; (iii) NDB: rationalization of the risk management function and increased automation of the credit process; and (iv) SB: further streamlining of the risk management function, focusing on credit and operational risk management processes.

<sup>38</sup> IFC'S SEDF has concluded memoranda of understanding with CB, DFCC, NDB, and SB. SEDF has been undertaking comprehensive capacity building activities for all the PCBs, as well as for SME borrowers.

policies, (iii) SME credit approval processes, (iv) SME portfolio monitoring mechanisms, (v) SME bad debts management, and (vi) SME risk modeling. To track improvements in the PCBs' risk management, a midterm evaluation (18 months after effectiveness of the Project) and a final evaluation at the end of the Project will be conducted. Unsatisfactory progress by a PCB can lead to cancellation of its access to the SMERDP credit facility.

#### d. Complementary Component 3: Fostering Regional SME Bankability

48. **Access to Investments.** The SMERDP fosters regional SME bankability by lending to SME value chain clusters which, in turn, promote equity investments through (i) lead firms in the formation of SME value chain clusters; and (ii) local venture capital companies (such as Lanka Venture Capital), facilitating such companies also to link up with lead firms. Local venture capital companies have a greater incentive to participate since the presence of a lead firm in the cluster will ensure adequate equity capital and support for the venture. Letters of intent received from Sri Lankan private equity firms for specific subprojects confirm their interest as possible equity investors in potential SMERDP subprojects.

49. An indicative pipeline of possible bankable equity investments in SME value chain clusters in the illustrative sectors (footnote 33) has been outlined in Supplementary Appendix C.

### 3. Project Investment Plan and Financing Plan

50. **Cost Estimates.** The total project investment cost (Table 1) is estimated at \$88.89 million equivalent. The SMERDP funding will not exceed 56.25% of subproject costs.

**Table 1: Project Investment Plan**  
(\$ million)

Item	Amounts
<b>A. Base Cost</b>	
1. ADB Project Loan	50.00
2. PCB Contribution	16.67
3. SME Contribution	22.22
<b>Subtotal</b>	<b>88.89</b>
<b>B. Contingencies</b>	<b>0.00</b>
<b>C. Financing Charges During Implementation<sup>a</sup></b>	<b>—</b>
<b>Total (A+B+C)</b>	<b>88.89</b>

ADB = Asian Development Bank, PCB = private commercial or specialized bank, SME = small and medium enterprise.

<sup>a</sup> PCB interest charges (based on average weighted deposit rate) will be greater than 1% interest charge on the ADF loan.

Source: Asian Development Bank estimates.

51. The financing plan is shown in the table below. Subloans from PCBs to SMEs will not exceed 75% of subproject costs.

**Table 2: Project Financing Plan**

(\$ million)

<b>Source</b>	<b>Total</b>	<b>%</b>
ADB	50.00	56.25
PCB	16.67	18.75
SMEs	22.22	25.00
<b>Total</b>	<b>88.89</b>	<b>100.00</b>

ADB = Asian Development Bank, PCB = private commercial or specialized bank, SME = small and medium enterprise.

Source: Asian Development Bank estimates.

52. **Financing Plan.** The Government has requested a loan of SDR 32,226,000 (\$50.0 million equivalent) from ADB's Special Funds resources. The loan will have a 32-year term, including a grace period of 8 years, and an interest charge of 1% during the grace period and 1.5% thereafter. It will include such other terms and conditions as may be set forth in the draft loan and project agreements. The financing charges are not to be capitalized. The Government will bear the foreign exchange risk.

53. **Relending (Government through CBSL to PCBs).** The Government will be the borrower. The ADB loan will be provided in foreign exchange and relent by the Government to PCBs in local currency. The Government will make the ADB loan available through CBSL to the PCBs at the average weighted deposit rate (AWDR)<sup>39</sup> under a subsidiary loan agreement. The Government has requested that the loan term (Government to PCBs) not exceed 20 years.

54. The SMERDP proceeds will be allocated to the PCBs in the following indicative amounts (dollar equivalents): (i) CB, \$15.0 million; (ii) DFCC, \$15.0 million; (iii) NDB, \$10 million; and (iv) SB, \$10 million. The PCB loans are to be disbursed over a 3-year period, subject to a midterm review after 18 months<sup>40</sup> to review disbursement progress and refine the arrangements as needed. At the end of 3 years, another progress review will be undertaken. Reallocation of funds can occur if any eligible PCB is not in compliance with (i) all applicable prudential regulations and guidelines of the CBSL, and (ii) maintenance of at least investment grade as rated by a credit rating agency acceptable to ADB. Reallocation of funds, if it leads to an increase in the approved amount of loan to any PCB or the addition of any new eligible PCB, will be subject to prior agreement between the Government and ADB, and consequent changes to the subsidiary loan agreements with the PCBs.

55. **Onlending (PCBs to Regional SMEs and/or SME Value Chain Clusters).** The maximum subloan size will be SLRs20 million, of which PCBs will be able to lend up to 75% from the ADB loan proceeds. The minimum tenor of a subloan will be 4 years. Onlending from PCBs to eligible subprojects will be at interest rates that reflect their cost of funds<sup>41</sup> plus a spread to cover transaction costs and risks. Subloans will be on commercial and competitive terms based on the PCB's selection process. Subloans will only include activities not listed in ADB's Subproject Exclusion List (Supplementary Appendix F) and will be subject to post-lending monitoring and review by ADB. Appendix 7 provides a funds flow illustration for the Project.

<sup>39</sup> Average weighted deposit rate is defined as the weighted average of the interest rates on all outstanding interest bearing deposits of commercial banks calculated and published by the Central Bank of Sri Lanka on its website, [www.cbsl.gov.lk](http://www.cbsl.gov.lk).

<sup>40</sup> There will also be annual reviews to assess disbursement progress.

<sup>41</sup> This currently represents the average weighted deposit rate.

#### 4. Procurement

56. Procurement under ADB-financed subloans will be in accordance with ADB's *Procurement Guidelines* (2007, as amended from time to time) as they relate to financial intermediary loans. Subborrowers will be required to undertake procurement in accordance with established private sector or commercial practices that are acceptable to ADB.

#### 5. Disbursement Arrangements

57. The PSC will be responsible for preparing disbursement projections, collecting supporting documents, preparing withdrawal applications, and sending the latter to ADB in accordance with ADB's *Loan Disbursement Handbook* (2007, as amended from time to time). To facilitate the timely release of loan proceeds and to expedite project implementation, the Government will, immediately after the loan becomes effective, open and maintain a project imprest account with CBSL for the Project that is to be managed by the PSC. The initial advance to the imprest account will be 6 months' worth of estimated expenditures or 10% of the loan amount, whichever is lower. To facilitate implementation, a second-generation imprest account will be set up in each PCB to draw its equitable share from the first-generation imprest account. ADB's statement of expenditure procedure will be used to liquidate advances from the imprest accounts. The maximum individual payment permitted under the statement of expenditure procedure is \$200,000 equivalent. Appendix 10 provides the financial management assessment report.

#### C. Special Features

58. The Government's equitable regional development priority allows ADB the opportunity to support a high-priority inclusive development intervention. The request for ADB support recognizes its involvement with the financial sector, SMEs, microfinance, and private sector development.

59. **Regional Development.** The SMERDP provides critical support for minimizing the regional divide by systematically providing business and employment opportunities for populations outside the western province to participate in, and benefit from, economic growth. Broader sharing of the benefits of growth will reinforce the sustainability of the development process. This is also consistent with the Government's and ADB's strategies for supporting growth outside the western province.

60. **Enhancing Private Sector Role.** Private sector-led SME development for economic growth and employment through the SMERDP includes piloting successful practices in the development of SME value chain clusters in Sri Lanka through commercially viable supporting partnerships between credible private lead companies and a cluster of SMEs. Among other things, this will mainstream skills and technology required for enhancing productivity and competitiveness. It also fosters bankable SMEs and encourages the lead firms to contribute equity to SMEs. Identified sectors aligned with underdeveloped resource endowments, such as those related to value addition to agriculture produce, are expected to have significant impact. The efforts of development partners (paras. 33–34) in mapping SME value chain clusters will be leveraged through the SMERDP credit facility.

61. **Governance.** The SMERDP seeks to accelerate and deepen good governance in the PCBs in accordance with CBSL corporate governance standards and Sri Lanka's international obligations by (i) using CBSL for linking corporate governance with disbursements to PCBs, (ii) incorporating anti-money laundering risk management requirements, (iii) reporting on corporate governance structures and activities in PCB annual reports, and (iv) applying SME lending

monitoring systems. The SMERDP also seeks to accelerate and enhance financial management controls through (i) the CBSL imprest account; (ii) funds flow controls, including vetting and approval procedures; and (iii) audit and accounting requirements.

## **D. Implementation Arrangements**

### **1. SMERDP Management**

62. **Executing Agency/Implementing Agency.** The Ministry of Finance and Planning (MOFP) is the Executing Agency (EA), and each eligible PCB will be an implementing agency (IA). Each eligible PCB will establish a project implementation unit (PIU) in its relevant operational department. Appendix 8 provides an SMERDP organization chart showing implementation arrangements.

63. **Project Steering Committee (PSC).** Within one month of loan effectiveness, MOFP will establish a PSC to oversee SMERDP implementation. The PSC will comprise six members that will include representatives of the MOFP, CBSL, and four PCBs. The PSC will be chaired by the Secretary of MOFP or, in his absence, Deputy Secretary, Treasury. The PSC chairperson will liaise with ADB. The PSC may, from time to time, co-opt representatives from other relevant agencies. The committee will meet as needed, but at least once every 2 months. ADB may attend the PSC meetings as determined necessary. The PSC will regularly monitor (i) PCBs' continued eligibility based on eligibility criteria, corporate governance, and anti-money laundering requirements; and (ii) eligible disbursements against estimated PCB targets to regional SMEs and SME value chain clusters at market interest rates consistent with ADB's financial intermediary loan policy.<sup>42</sup> The PSC will also be responsible for fostering dialogue with the PCBs on implementation progress for complementary components 2 and 3.

64. CBSL will provide a secretariat to the PSC for coordinating the inputs of all PIUs, including benefit and impact monitoring reports for consideration by the PSC. The PCB PIUs will be responsible for coordinating with relevant PCB departments, ensuring that information and reporting requirements related to PCBs and subloans are met, and making sure all necessary accounts, related financial statements, and disbursement records are duly submitted through CBSL to the PSC. Appendix 10, Section F provides details of staffing arrangements for the PIUs and PSC secretariat.

### **2. Implementation Period**

65. The SMERDP will be implemented over 3 years. The schedule is in Appendix 8.

### **3. Anticorruption**

66. ADB's *Anticorruption Policy* (1998, as amended to date) was explained to and discussed with the Government, EA, and IAs. Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the SMERDP. To support these efforts, relevant provisions of ADB's *Anticorruption Policy* are included in the loan regulations for the Project. In particular, all contracts financed by ADB in connection with SMERDP shall include provisions specifying the right of ADB to audit and examine the records and accounts of the EA, and other service providers as they relate to the Project. During review missions, the

<sup>42</sup> ADB. 2003. *Operations Manual. Section D6/BP: Bank Policies*. Manila (15 December).

financial management, governance, and anticorruption risk assessments will be updated to ensure that their provisions remain valid and are helping to realize the Project's objectives.

67. The Project supports good governance in PCBs by ensuring CBSL monitoring of PCB governance, including transparency and disclosure requirements. In addition, market-based pricing, autonomy to PCBs in selecting subprojects, and regular monitoring by PSC reduce the vulnerability to corruption. A summary governance and anticorruption risk assessment is in Appendix 11, and a detailed assessment is in Supplementary Appendix D.

#### **4. Accounting, Auditing, and Reporting**

68. The PCBs will have their accounts and financial statements (balance sheet, income statement, and statement of sources and applications of funds) audited annually in accordance with sound internationally accepted auditing standards by independent external auditors acceptable to ADB. The PCBs will submit their audited accounts and financial statements, through CBSL, to the EA and ADB not later than 6 months after the end of the fiscal year. In addition, PCBs will submit semiannual unaudited accounts to CBSL.

69. Through CBSL, the EA will (i) maintain consistent records and accounts adequate to identify goods and services financed from the Project's proceeds, (ii) ensure separate accounts for each loan to the IAs, (iii) ensure accounts and related financial statements are audited annually in accordance with appropriate auditing standards consistently applied by auditors acceptable to ADB, and (iv) submit to ADB certified audited accounts and financial statements within 9 months after the end of the fiscal year.

70. The Project's monitoring reports prepared by the PSC secretariat based on inputs from PCBs will be provided quarterly to the PSC, EA, and ADB. The reports will contain (i) description of progress made during the period; (ii) changes to the implementation schedule, if any; (iii) problems and difficulties encountered and the remedial actions taken; (iv) the social, environmental, and economic impacts; (v) the work to be carried out in the next period; and (vi) a summary financial account for the SMERDP with expenditures to date. Within 3 months of the Project's completion, the EA, through the PCBs, will furnish to ADB a project completion report containing a detailed evaluation of project design, costs, PCB performance, social and economic impacts, and other details as may be requested by ADB.

#### **5. Project Performance and Benefit Monitoring and Evaluation**

71. The CBSL and PCBs, will need to maintain a systematic project performance management system (PPMS), satisfactory to ADB, that will be included in the PCBs' management information system. The key performance indicators and assumptions in the design and monitoring framework will be the basis for the PPMS. Within 4 months of loan effectiveness, the CBSL and PCBs will have established the baseline for each of these indicators and such information will be made available to review missions and to the Government for future impact assessment surveys. The scope of the survey, quantity and quality of data, and frequency of collection will be guided by the need for feedback on implementation.

#### **6. Project Review**

72. To ensure responsive and timely implementation, there will be review missions in accordance with the SMERDP implementation schedule set forth in Appendix 8. There will be regular interaction among the EA, CBSL, PIUs, and ADB. Annual performance review will be conducted by the Government, CBSL, ADB, and the PCBs based on an annual progress report to

be prepared by each PCB. In addition, a comprehensive midterm review will be undertaken by the Government, CBSL, PCBs, and ADB approximately 18 months after the Project's effectiveness that will (i) evaluate the scope, design, and implementation arrangements; (ii) assess implementation performance against project indicators; (iii) review and establish compliance with loan covenants; (iv) identify problems and constraints and, if necessary, recommend changes in the design or implementation arrangements.

#### IV. PROJECT BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

##### A. Benefits and Impacts

73. The PCBs, SMEs and SME value chain clusters are private sector entities. The benefits of pursuing a private sector-led regional SME development could be significant. More broadly, an emphasis on market-based interest rates for SME credit introduces a sustainable development paradigm in contrast to dependence on government-sponsored, subsidized programs. In this context, successful SMERDP implementation will develop support for sustaining private sector-driven policies for economic growth.

74. **Regional Development.** Recognizing that high incidence of poverty and lack of gainful employment opportunities fuel discontent and unrest, the Project's regional development impact contributes to stability in Sri Lanka's less developed provinces. Designed to promote regional SMEs, the Project will benefit SMEs and SME value chain clusters by improving access to credit. Subloans are estimated to generate employment for approximately 50,000 people from mid-2008 to mid-2011, as well as annual output equal to 2.0% of the 2005 SME sector output. Employment will help reduce the relatively high incidence of poverty outside the western province. The SMERDP also supports the poverty reduction goal through greater access to skills and technology for SME development, which, in turn, will facilitate better utilization and value addition of such productive resources as labor, farm inputs, and infrastructure. The Project's poverty impact is discussed in the summary poverty reduction and social strategy in Appendix 9.

75. **Institutional.** The SMERDP will enhance the regional outreach of PCBs and the capability of PCBs' SME credit staff in terms of (i) project appraisal, supervision, credit and portfolio administration; (ii) opportunities to apply relevant risk management and credit scoring techniques; and (iii) improved operational governance of PCBs through transaction-based accountability for corporate governance and anti-money laundering. Mainstreaming best practices in SME financing will also improve portfolio quality over time, which will prompt other banks to increase their regional SME portfolios. Moreover, gradual broadening and deepening of SME portfolios not only provides a base of recurring earning assets but also enables the PCBs to tap into the savings potential outside the western province.

##### B. Risks

76. Achieving expected impacts will depend on several assumptions that are subject to varying degrees of risks. Mitigation measures are being put in place wherever feasible. Major risks are seen to be the following:

- (i) **Security.** Escalation of conflict could pose risks for regional SMEs should areas outside the current conflict zone become involved. While the PCBs stand ready to lend to SMEs in the conflict-affected areas, such lending would be undertaken as the security situation permits and the PCBs perceive the risks as acceptable.
- (ii) **SME viability.** The creditworthiness of SMEs in some locations could affect utilization of the SMERDP facility. ADB's assessment indicates that PCBs have significant opportunities for lending to viable regional SMEs. This risk is further

- mitigated through access to BDS and the introduction of lead firms in SME value chain clusters that will inject equity, know-how, and marketing into SMEs.
- (iii) **Delinquency.** Delinquency risks that PCBs face in expanding their regional SME portfolios are mitigated through (a) improved access to credit information, (b) better use of collaterals, (c) strengthened governance structures and risk management practices, (d) risk-based pricing, and (e) CBSL monitoring.
  - (iv) **Implementation.** While the demand for SME credit is robust, there could still be implementation delays in case the eligible PCBs would refocus their priorities and/or fail to sustain expected performance standards. These risks have been dealt with by assessing PCB eligibility and commitment up front. In addition, the Project enables substitution of PCBs in case of performance shortcomings.
  - (v) **Complementary support.** The risk of complementary support not progressing as envisaged is not considered significant. The Government fully realizes that macroeconomic stability requires structural and sector-level reforms. In particular, the Government has reemphasized financial and fiscal reforms.
  - (vi) **Private sector perception.** Private investors' perceptions are critical for the flow of investment in regional SMEs. Measures under the Project to sustain investor confidence include PCBs' commitments upfront to provide credit to viable regional SMEs and SME value chain clusters. For its part, the Government has given priority to reducing regional inequalities by facilitating regional public infrastructure development and promoting value addition in products manufactured or processed by SMEs. The enabling environment for SMEs is also being enhanced.

77. **Environmental and Social Safeguard Policies.** The SMERDP is classified as Category FI in accordance with ADB's *Environment Policy* (2002). An environmental management system framework endorsed by the Government on behalf of the PCBs is attached as Appendix 5. SMERDP will not trigger ADB's *Policy on Involuntary Resettlement* (1995). SMERDP will also not have any impacts on indigenous peoples/ethnic minorities and will not trigger ADB's *Policy on Indigenous Peoples* (1998). An annual environmental compliance monitoring report will be submitted by the PCBs to ADB through the PSC.

## V. ASSURANCES AND CONDITIONS

### A. Specific Assurances

78. In addition to the standard assurances, the Government has given the following specific assurances which are incorporated in the legal documents:

- (i) In the event of default by a PCB and its failure to remedy within 6 months, MOFP, through CBSL, will ensure a new PCB is selected in accordance with the same selection criteria as for the four initial PCBs as agreed between the Government and ADB. The selection of a new PCB will be subject to prior joint approval by MOFP and ADB;
- (ii) MOFP will ensure not to onlend any funds to a PCB, unless such PCB has recruited the necessary safeguard implementation staff and that such positions will remain filled throughout the duration of the Project;
- (iii) Within one month of loan effectiveness, each PCB will have established or updated its Environmental Management System (EMS) in accordance with the EMS framework agreed upon between the Government and ADB. Each PCB will implement the Project in full compliance with such EMS, as may be amended from time to time, in line with the EMS framework;

- (iv) The Government shall ensure that a satisfactory financial management system is maintained throughout the duration of SMERDP;
- (v) Annual Project reports will include at least the following information (a) emerging sector policy issues; (b) performance of all PCBs; (c) subproject performance; (d) subborrowers repayment performance; (e) subprojects' contributions towards achieving project objectives; (f) lessons learned; and (g) benefit monitoring in terms of output and employment;
- (vi) Each PCB will ensure to advise the PSC (and the PSC shall immediately advise ADB) in advance of any major decision on events such as mergers and acquisitions, changes in key management officers, and any charter changes that may have a significant adverse impact on its organization, management, policies, procedures and operations. In such event, MOFP and ADB jointly reserves the right for reallocation of credit across PCBs and for lending to new eligible PCBs;
- (vii) Throughout Project implementation, the PCBs must be in compliance with (i) all applicable prudential regulations and guidelines of the CBSL, and (ii) maintenance of at least investment grade as rated by a credit rating agency acceptable to ADB. Compliance with CBSL prudential regulations and guidelines will be certified by an acceptable auditor to ADB while the applicable credit rating will be based on the submission of the actual credit rating report to CBSL.
- (viii) The Government shall through the PSC monitor the PCBs' progress reports under the International Finance Corporation funded South Asia Enterprise Development Facility.

## **B. Conditions for Loan Effectiveness**

79. Prior to the effectiveness of the Loan Agreement, the Subsidiary Loan Agreements, in form and substance satisfactory to ADB, shall have been duly executed and delivered on behalf of the Borrower and the PCBs and shall have become fully effective and binding upon the Borrower and the PCBs in accordance with its terms, as well as the Project Agreement between ADB and the PCBs with respect to subloans under the Project.

## **VI. RECOMMENDATION**

80. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 32,226,000 to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Regional Development Project from ADB's Special Funds resources with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; a term of 32 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Project Agreements presented to the Board.

Haruhiko Kuroda  
President

15 November 2007

## DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanism	Assumptions and Risks
<p><b>Impact</b></p> <p>Reduction in regional inequalities through the accelerated development of regional SMEs thereby enhancing private sector share in economic development.</p>	<ul style="list-style-type: none"> <li>• Increase in private sector contribution to gross domestic product</li> <li>• Increase in SMEs' share of private sector activity from mid-2008 to mid-2011, with annual average incremental output amounting to 0.67% of 2005 private sector output</li> </ul>	<ul style="list-style-type: none"> <li>• Government economic and social statistics</li> <li>• Central Bank of Sri Lanka (CBSL) annual reports</li> </ul>	<p><b>Assumption</b></p> <ul style="list-style-type: none"> <li>• Macroeconomic stability</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Political and security situation deteriorates to the point that SME operations outside the western province are adversely affected</li> <li>• Natural disasters</li> </ul>
<p><b>Outcome</b></p> <p>Accelerated development of the SME sector outside western province leads to increased output and employment generation</p>	<ul style="list-style-type: none"> <li>• Incremental output in regional SMEs outside Colombo, Gampaha, and Kalutara amounting to about \$170 million from mid-2008 to mid-2011, with annual average incremental output amounting to 2.0% of 2005 SME sector output</li> <li>• Increased employment opportunities in regional SMEs outside Colombo, Gampaha, and Kalutara for 50,000 persons from mid-2008 to mid-2011</li> </ul>	<ul style="list-style-type: none"> <li>• Government SME statistics</li> <li>• CBSL reports</li> <li>• PCB reports on SME loan portfolios, including regional breakdowns</li> <li>• PCB loan appraisal reports (captures employment generated by subprojects)</li> </ul>	<p><b>Assumption</b></p> <ul style="list-style-type: none"> <li>• Generally improving economic and policy environment in the country</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Security situation deteriorates further</li> <li>• Unavailability of data</li> </ul>
<p><b>Outputs</b></p> <p>1. Provision of medium- to long-term credit by PCBs to regional SMEs and SME clusters</p>	<ul style="list-style-type: none"> <li>• SME credit to total credit ratio of PCBs outside Colombo, Gampaha, and Kalutara districts increased by about 4% from mid-2008 to mid-2011</li> </ul>	<ul style="list-style-type: none"> <li>• PCB compliance reports to CBSL</li> <li>• PCB annual reports</li> <li>• CBSL annual reports</li> </ul>	<p><b>Assumption</b></p> <ul style="list-style-type: none"> <li>• Sound financial and operational performance of eligible PCBs</li> </ul> <p><b>Risk</b></p> <ul style="list-style-type: none"> <li>• PCB regional lending leads to higher nonperforming loans due to operational risks</li> </ul>

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanism	Assumptions and Risks
1.1 Access to Credit	<ul style="list-style-type: none"> <li>• Project steering committee established within one month of loan effectiveness of the Small and Medium Enterprise Regional Development Project (SMERDP) for monitoring credit disbursements of PCBs</li> <li>• SMERDP credit facility fully utilized by PCBs by end-2010</li> </ul>	<ul style="list-style-type: none"> <li>• Report on project loan performance versus disbursement targets of PCBs</li> <li>• Quarterly monitoring reports of project steering committee</li> <li>• Annual and midterm review reports of project steering committee</li> <li>• Externally audited PCB accounts and financial statements within 6 months of end of each fiscal year</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Availability of qualified SME finance staff and SME risk management systems in PCBs</li> <li>• Access to business development services (BDS) for SMEs on cost-recovery basis</li> <li>• PCBs find it cost-effective to lend to regional SMEs and SME value chain clusters and expand their SME lending portfolios</li> <li>• PCB commitment to establish or strengthen systems for environmental safeguard compliance monitoring</li> </ul>
2. Strengthening PCB capacity for regional SME lending, risk management, and corporate governance	<ul style="list-style-type: none"> <li>• SME finance staff of PCBs to undergo training</li> <li>• PCB compliance with anti-money laundering framework and corporate governance standards in Sri Lanka</li> </ul>	<ul style="list-style-type: none"> <li>• Quarterly monitoring reports of project steering committee</li> <li>• Annual and midterm review reports of project steering committee</li> <li>• On-site inspection reports of CBSL's Bank Supervision Department</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Availability of regional PCB branches or other regional lending means</li> <li>• PCB commitments to strengthen their SME finance units for undertaking credit risk management and risk-based loan pricing</li> <li>• PCB commitment to establish and/or strengthen corporate governance structures and anti-money laundering framework checks and balances</li> </ul>
3. Fostering regional SME bankability	<ul style="list-style-type: none"> <li>• Catalyze establishment and development of SME value chain clusters, with 3–5 SME value chain clusters to be developed in each illustrative sector</li> <li>• PCB lending to bankable regional SMEs, and SME</li> </ul>	<ul style="list-style-type: none"> <li>• Quarterly monitoring reports of project steering committee</li> <li>• Annual and midterm review reports of project steering committee</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Productive loan utilization by SME value chain clusters</li> <li>• Lead corporate firms driving establishment of SME value chain clusters</li> </ul>

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanism	Assumptions and Risks
	value chain clusters established by lead firms <ul style="list-style-type: none"> <li>• Increasing cash flow-based lending to regional SMEs by PCBs</li> <li>• Increasing application of SME credit scoring by PCBs</li> </ul>		
<b>Activities with Milestones</b> <b>1. Access to Credit</b> 1.1 Disbursement to PCBs (continuous, beginning no later than QII 2008) 1.2 Onlending from PCBs to regional SMEs and/or SME value chain clusters (continuous, beginning no later than QII 2008)  <b>2. Supporting PCB Governance</b> 2.1 Track PCBs' compliance with CBSL's Code of Corporate Governance for Banks and Financial Institutions (continuous, beginning no later than QII 2008)  <b>3. Strengthening PCB Risk Management</b> 3.1 Midterm evaluation of PCBs' progress in strengthening risk management functions (QII 2009) 3.2 Final evaluation of PCBs' risk management functions (QIV 2010)  <b>4. Fostering Regional SME Bankability</b> 4.1 Catalyze establishment and development of SME value chain clusters, with 3–5 SME value chain clusters to be developed in each illustrative sector (continuous, beginning no later than QII 2008) 4.2 PCB lending to bankable regional SMEs and SME value chain clusters established by lead firms (continuous, beginning no later than QII 2008)  <b>5. Project Supervision and Administration</b> 5.1 Establish project steering committee, with provisions to co-opt members later (QI 2008) 5.2 Establish project implementation units (QI 2008) 5.3 Conduct reviews <ul style="list-style-type: none"> <li>• Project steering committee meetings (once in 2 months)</li> <li>• ADB review missions (once in 6 months)</li> </ul> 5.4 Prepare and submit: <ul style="list-style-type: none"> <li>• Project steering committee monitoring reports (quarterly)</li> <li>• Project steering committee review reports (annual and mid-term)</li> <li>• Project steering committee completion report (QI 2011)</li> </ul>		<b>Inputs</b> <ul style="list-style-type: none"> <li>• \$50 million Special Funds resources</li> <li>• \$16.67 million PCBs' own credit contributions</li> <li>• \$22.22 million SMEs and SME value chain clusters contributions</li> </ul>	

BDS = business development services, CBSL = Central Bank of Sri Lanka, PCB = private commercial or specialized bank, SMERDP = Small and Medium Enterprise Regional Development Project, SME = small and medium enterprise.

## SME SECTOR ANALYSIS

1. **Overview.** Small and medium enterprises (SMEs) account for about 80–90% of the total number of enterprises in Sri Lanka and 75% of employment in the private sector. Nevertheless, SMEs are not realizing their full potential for contributing to Sri Lanka’s economic growth and employment. Strong SME growth could therefore underpin Sri Lanka’s drive to achieve prosperity, alleviate conflict, increase employment, and lessen the fiscal burden.

### A. Major Constraints Facing SMEs

2. Although successive governments in Sri Lanka since 1948 have introduced various support programs to facilitate SMEs’ growth and expansion, many SMEs still face significant constraints in doing business. As revealed in an investment climate survey, firms emphasize financing and infrastructure constraints as two major impediments in their development.<sup>1</sup> Rural firms also face major constraints in gaining access to markets.

3. **Financing.** Only 14% of working capital for small firms in Sri Lanka is financed by bank loans, and that figure is about 30% for medium-sized firms. Bank finance is even more limited for new investment. Only about 11% of new investment at small firms in Sri Lanka is financed through bank loans. Private commercial or specialized banks play a particularly limited role for rural firms, with less than 12% of them applying to these institutions for credit.

4. **Infrastructure.** The prolonged civil conflict in Sri Lanka since 1983 has discouraged investment and diverted resources from productive uses. Low investment in infrastructure has undermined firms’ productivity and economic growth. The lack of roads and unstable electricity supply are key obstacles to existing businesses and start-up enterprises. To cope with outages, nearly 75% of urban manufacturing firms own generators. For these firms, a generator costs the equivalent of 12% of their fixed assets, on average, and absorbs resources that could otherwise be invested productively in their core business. In addition to the bottlenecks in large-scale infrastructure, SMEs are often constrained by a lack of such supporting infrastructure as common markets, small connection roads, landing piers, and waste disposal facilities.

5. **Markets.** More than 27% of nonfarm rural business owners cite low market demand as a key constraint (footnote 1). This constraint stems from a range of factors. Rural entrepreneurs have few contacts or links with larger firms or buyers that could increase their exposure to bigger and more diverse markets. The goods they produce are often of low quality and have limited appeal in larger markets. Poor transport and telecommunications restrict their access to information. The vast majority of firms sell their goods locally and only about 10% of rural nonfarm enterprises sell their output to a large domestic or international firm.

6. The lack of finance, infrastructure, and markets reinforce one another and exacerbate the difficulties SMEs face in doing business.

### B. Increasing Regional Disparity

7. The constraints are felt more strongly by SMEs outside the western province, and this contributes to mounting regional disparity. The economic weight and growth in Sri Lanka is

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<sup>1</sup> World Bank and ADB. 2004. *Sri Lanka Improving the Rural and Urban Investment Climate Survey*. Colombo.

heavily biased in favor of the western province,<sup>2</sup> where the capital and main port are located. The western province's share of national gross domestic product (GDP) increased from 45% in 1998 to 50% in 2003. The per capita gross regional domestic product of the western province was about \$1,467, while that of the northwestern province was next, at \$697. Gross regional domestic product in 2003 was lowest, at just \$397, for the northern province. The incidence of poverty is also much higher outside the western province. The share of households living below the poverty line<sup>3</sup> was 9.2% in the western province in 2002 but more than double this (19.2%) in all other provinces.

8. The western province, with its higher concentration of economic activity, receives net positive financial transfers from the rest of the country. Based on information gathered from foreign banks and the five largest domestic commercial banks that hold 90% of commercial bank assets, the ratio of net credit to deposits for the western province is 110% compared to the national average of 83%. This net transfer of savings from poorer to more developed regions exacerbates regional disparities.

9. As better economic conditions and opportunities attract more businesses to the western province, the concentration of wealth and development is bound to intensify. Large regional disparities create potential for dissatisfaction, disunity, and conflict. Therefore, reducing regional disparity is of enormous economic and political significance for Sri Lanka.

### **C. Fostering Linkages: SME Value Chain Clusters to Address Constraints**

#### **1. Potential Benefits of Improving Supply Chain and SME Value Chain Clustering**

10. The Government recognizes that constraints faced by regional firms are associated with regional disparity in Sri Lanka. Past measures, however, have focused on the state's trying to substitute for the role of markets. In finance, for example, the Government directed lending through state-owned financial institutions, and it subsidized or controlled interest rates.

11. The SME value chain cluster concept has proven useful in addressing SME financing and other constraints, especially in agriculture-related sectors. The concept encourages firms of different sizes and at different levels in a value chain to develop mutually beneficial commercial relationships. Typically, an SME value chain cluster involves large lead firms engaging SMEs as suppliers and subcontractors of products and services. Large firms benefit by gaining reliable inputs and supply chain integration while SMEs are able to overcome bottlenecks in marketing, logistics, technology, product development, quality assurance, and standards. Involving large firms also helps to address the information opaqueness of SMEs that limits their access to bank financing. More importantly, clustering can help SMEs to improve the competitiveness of their products and services so as to boost their financial performance. An SME that consistently proves it can pass the test of markets will overcome initial financing difficulties. The benefits of clustering stem from economies of scale, increased information, and technology spillovers among firms.

12. While SME value chain clusters warrant support from governments and development agencies for their initialization, direct credit allocation from, or directed lending by, governments

<sup>2</sup> The western province comprises the Colombo, Gampaha, and Kalutara districts.

<sup>3</sup> The poverty line is calculated as SLRs1,423 per month, based on the cost of basic needs methodology. Data is not available for the northern and eastern provinces.

is not appropriate. Lending should be carried out by financial intermediaries having sound project evaluation, risk management, and market discipline. Thus, the development of clustering should be driven by private sector firms in pursuit of mutually beneficial outcomes. Resources for cluster development, including finance, should come from private sector participants.

## 2. Need and Potential for Cluster Development in Illustrative Sectors

13. A number of sectors were studied carefully at the project preparatory stage to examine their potential for clustering. These include leather products, fisheries, dairy, spices, coconut coir, fruits and vegetables, and packaging.<sup>4</sup> Performance in these sectors has been relatively unsatisfactory due to low quality of output and fragmented supply chains that result in considerable waste in production and distribution. These sectors have (i) potential for improved quality and output by geographically dispersed SMEs; (ii) rich factor endowment in Sri Lanka and potential for exports; and (iii) corresponding opportunities for credit backed equity investment from larger corporations with good track records in growth and exports, along with experience in developing value chains through SME clusters.

14. **Fisheries Sector.** Wastage is estimated at 30–40% due to inadequate cold storage and preservation. Fishing clusters can be formed by enhancing the linkage between fishing societies, processing companies, and markets. This will improve collection logistics, reduce fuel usage, improve fish quality, and facilitate faster collection and quicker disposal. There are large corporations that have indicated interest in strengthening the supply chain by engaging fishermen as suppliers.

15. **Dairy Sector.** Farms are small and productivity per animal is low because of poor quality breeding and feeds. The relatively long time between milk collection and milk processing leads to milk having a heightened bacteria count and excessive spoilage. The costs of bringing milk from the farm to the factory are very high, as is taking the products from the factory to the market. An enhanced supply chain can bring down collection and distribution costs, which could, in turn, bring down costs and retail prices. That would boost sales volumes and margins for processors and farmers. An SME value chain cluster can be made up of dairy processing companies and dairy farmers, with enhanced linkages between the farmers and processors. It also could involve improving dairy farmers' access to extension services. Such support facilities as, for example, cooling equipment can also be established to reduce waste.

16. **Fruit and Vegetable Sector.** Sri Lanka possesses good growing potential due to the country's climate and fertile soil. The sector is composed of a large number of small growers who are price-takers, however, and margins are largely determined by middlemen and collectors. Contract farming accounts for only a small fraction of production. Post-harvest losses are estimated at 30–40%. Exports of perishable fruits and vegetables are still limited, as the sector lacks the ability to provide a stable supply with consistent quality to overseas buyers. The development of some clustering by leading exporters engaging in contract farming has yielded positive results. Under these contracts, the farmer (or farmer group) is obliged to grow a certain volume and quality for a specified off-taker (trade house or supermarket chain). Small farmers have benefited from increased pre- and post-harvest information and services; improved production quality; and better access to packing, storage, and distribution channels. Meanwhile, leading exporters have benefited from increased supply and quality. Contract farming has also improved farmers' access to finance, as it helps in providing financial institutions with information about the creditworthiness of farmers.

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<sup>4</sup> It is important to bear in mind that these are illustrative sectors and do not constitute an inclusive list.

17. **Coconut Coir Sector.** Although Sri Lanka is the leading exporter of coir fiber and pith, more than half of these products are exported as low-value commodities. In contrast, 95% of India's coir-based products are value-added outputs. A key obstacle facing Sri Lanka's coir industry is the low level of its technology and absence of an effective quality control system. Poor and variable husk quality (relating to high dust content, short fibers, husk residues, and moisture in the fiber) limits export potential. The industry's future success lies in improved product quality and consistency. Consequently, export opportunities will be critically dependent upon value chain development to facilitate supply chain efficiencies. A cluster of spinning and weaving SMEs could be developed around larger producers and exporters, which could in turn act as a resource and information center for the cluster. Development of the industry will particularly benefit poorer areas, where there is an urgent need to create employment and generate income.

18. **Spices Sector.** Cinnamon and pepper are the two leading exports in the sector. As elsewhere in agriculture, however, the spices sector is negatively affected by uneven quality and much post-harvest loss. For example, spice collectors use the same bag to hold all grades of the particular spice purchased, which leads to mixed product quality and additional costs from sorting. There are also many layers of collectors and dealers in the supply chain, which adds to the cost of distribution. The priorities for the spice sector are to establish effective collecting and processing cooperatives and supply chain institutions for the small producers that are similar to those already established in the tea industry.

19. **Leather Sector.** The sector can be developed by using a cluster approach where much of the manufacturing tasks can be subcontracted out and the final assembly and marketing can be done by large-scale manufacturers. In this arrangement, the large companies are able to accept and fill bigger orders and the SMEs are assured of work and upgrading their skills and equipment. Cluster development can take advantage of this market opportunity by improving time and quality management, as well as by facilitating the diffusion of skills and technology to small subcontractors.

#### **D. Economic and Poverty Reduction Benefits from Clustering Development**

20. Overall, there is a strong potential for developing clusters to strengthen many sectors' supply chains. This can benefit large as well as smaller firms. In particular, it helps SMEs to gain information, technology, market access, and creditworthiness. It also helps SMEs to overcome some size limitations. For example, Sri Lankan entrepreneurs operating in export markets often face difficulties in meeting the minimum order sizes placed by importers in other countries. Fruit and vegetable exporters, for example, are often unable to fill even one container with produce of consistent quality while a single order may be for several containers. Utilizing the market capacity of large firms clearly benefits smaller players.

21. The investment in developing SME clusters through the \$50 million ADB loan can have direct impact on the regional economies. The \$50 million loan will be accompanied by about \$16.67 million in the private commercial or specialized banks' (PCBs') own increased investment into regional SMEs and SME value chain clusters. Injecting \$66.67 million into the regional economies will first increase credit and investment in the underdeveloped provinces. The initial investment will initiate a series of expanding effects, conventionally known as the "multiplier process." This is because, given initial investment, additional income is created that is again partly spent on consumption goods and so on. As a result, national income increases by more than the initial investment expenditure. The magnitude of the investment multiple varies,

but it is estimated to be around 2.5 times.<sup>5</sup> Assuming that the investment is rolled over every four years, this could induce an increase in output outside the western province of about \$170 million from 2008 to 2011.

22. Benefits will arise from greater direct investment. More importantly, increased linkages between firms will facilitate efficiency improvements. Given that investment is located outside the western province, it represents a step towards encouraging private investment where it is needed most. Contributing to the prevalence of poverty outside the western province is the fact that agricultural productivity grew little over the past decade, even as agricultural prices stagnated. As a result, rural and agricultural households suffered a decline in real incomes. The development of industries through SME clustering outside the western province can help to lift household income.

### E. Overall SME Credit Demand Analysis

23. Demand and supply of SME credit is determined by a complex set of factors. However, SME financing issues can be largely overcome (and, as a result, the supply-demand gap for SME credit can be minimized) if two fundamental factors are addressed: (i) improving the capacity and incentives to provide SME finance from the bank level, and (ii) fostering bankable projects at the firm level. The Small and Medium Enterprise Regional Development Project can act as a catalyst in addressing SME financing issues from both the bank and firm level by: (i) strengthening PCBs' risk management as well as providing PCBs with access to medium- to long term funds thereby encouraging PCBs to proactively seek financing opportunities among regional SMEs, and (ii) financing SME value chain clusters to overcome market imperfections such as coordination failures through forging stronger linkages between large firms and SMEs, thereby nurturing the supply of bankable projects at the firm level.

### F. Growth Impediments and Interventions in the SME Sector

24. Preparatory work and complementary reforms have already been undertaken to help accelerate SME sector development, as shown in the table below.

**Table A2: SME Sector Growth Impediments and Interventions**

<b>Impediment to SME Sector Growth</b>	<b>Intervention</b>
Absence of secured transaction bill	Enactment of secured transaction bill by March 2008 through ADB's Financial Markets Program for Private Sector Development.
Absence of national system of registration for securing moveable property	National system of registration for securing moveable property at CRIB through ADB's Financial Markets Program for Private Sector Development.
Absence of credit rating information system for small and medium enterprise (SME) borrowers	Government's CRIB modernization project will implement a web enabled system by 1 January 2008 encompassing credit rating

<sup>5</sup> See, for example, Dietzenbacher, Eric. 2002. Interregional Multipliers: Looking Backward. In *Looking Forward 1, Regional Studies*. Vol. 36.2, pp. 125–136.

Impediment to SME Sector Growth	Intervention
	information for SME borrowers across the island.
Inadequate physical infrastructure	Through public-private partnerships and enhanced public expenditure, the Government will increase its focus on infrastructure.
Absence of medium- to long-term credit for SME borrowers	Provision of sustainable medium- to long-term credit for SME borrowers through ADB's proposed SMERDP and continuing support through various ADB technical assistance projects for developing the domestic capital market.
Concentration of SME lending in western province	Provision of SME lending outside western province through ADB's proposed SMERDP.
Nonfinancial inputs, as well as marketing, technical, and managerial constraints within SMEs	Access to SME value chain clusters (economic groupings of private-lead firms and SMEs) and to business development services through ADB's proposed SMERDP facility.

ADB = Asian Development Bank, CRIB = Credit Rating Information Bureau, SMERDP = Small and Medium Enterprise Regional Development Project, SME = small and medium enterprise.  
Source: ADB.

## THE SRI LANKAN FINANCIAL SECTOR

### A. The Financial Sector

1. The past two decades witnessed significant financial reforms in Sri Lanka. Reforms consisted of interest rate deregulation, restructuring of state-owned banks, allowing entry of private sector financial institutions, easing restrictions on foreign financial institutions, reduction of directed lending, and a shift in focus of banking sector supervision from micro-intervention to prudential regulations. As a result of reforms, the Sri Lankan financial sector has become a diversified sector that includes most of the institutional elements of a modern financial system.

2. In Sri Lanka, the commercial banks dominate in terms of assets, but a wide range of other institutions also offer financial services. In addition to the financial intermediaries, a domestic capital market has developed over the years. There are 22 commercial banks, 42 depository institutions (a national savings bank, 24 finance companies, and 17 regional rural development banks), 3 state-sponsored long-term financial institutions, 13 insurance companies, and 2 public pension funds. The equity market has remained fairly small (with a market capitalization of about 25% of GDP), despite a relatively long period of existence. Some 241 companies are listed on the Colombo Stock Exchange, representing 20 business sectors. Government debt securities dominate Sri Lanka's debt market, representing 98% of the total value of issued debentures. Until recently, there has been no market-based yield curve because primary government issues were sold at below-market rates to state-owned institutions. To prevent losses, almost all investors hold bonds to maturity. The maximum maturity of most sovereign bonds is 5–7 years. Since 1997, certain corporate bonds have also been listed on the Stock Exchange, but such instruments are relatively illiquid. There is also a wide range of nonbank financial institutions that complement the role of the commercial banks. The major nonbank financial institutions include insurance companies, contractual savings institutions, factoring companies, leasing companies, venture capital and private equity firms, and microfinance providers.

3. Overall, the banking sector dominates the financial sector, with total assets of commercial banks accounting for about 70% of all financial sector assets. This discussion is thus focused on the banking sector. The institutional structure of the banking market reflects the long history of establishing special-purpose institutions or providing specific legal powers to meet identified economic needs. The three state-owned institutions, namely, People's Bank, Bank of Ceylon (BOC), and National Savings Bank (NSB), have the largest branch networks and numbers of deposit accounts. There are 11 licensed commercial banks having broad business activities, and these generally have subsidiaries and affiliates engaged in all areas of the financial services. There has been some consolidation in the sector, with four foreign banks exiting the market over the past few years while several of the smaller domestic banks were restructured.

4. The two state-owned commercial banks, the BOC and People's Bank, are incorporated under their own statutes rather than the banking law. This reflects their mandates to meet the policy objectives of providing financial services throughout the country and to target government priority sectors rather than the pursuit of purely commercial objectives. While the two banks still account for over 40% of commercial banking assets, their market share has declined in recent years. Loans to government and state-owned enterprises now constitutes some 20–30% of the total loan portfolio in the two banks, whereas that figure was some 60% about a decade ago.

5. The policy of the current government is not to proceed with the previously planned privatization of People's Bank (or of any other state-owned enterprise). The current policy

direction of Government is to commercialize the operations of the state-owned banks, including People's Bank, rather than privatize.

6. There are four relatively large private domestic banks: Commercial Bank of Ceylon Limited (CB), Hatton National Bank, Sampath Bank Limited (SB), and Seylan Bank. The CB has been consistently the most profitable domestic bank, due in large part to its much lower noninterest expenses and success in migrating customers to electronic transactions. Of the 11 foreign banks in Sri Lanka, only Hong Kong and Shanghai Banking Corporation and Standard Chartered, with 10 and nine branches, respectively, compete in the retail market. Collectively, the foreign-owned banks account for about 18% of commercial bank assets but only about 9% of loans, reflecting the much higher liquidity of the foreign banks. These indicators understate the importance of foreign banks, however, as they provide the majority of trade finance activities (for example, import letters of credit). Most medium to large businesses in Sri Lanka have a relationship with at least one of the foreign-owned banks, largely because of the need for letters of credit from banks with international reputation.

7. There are 14 licensed specialized banks. These comprise a diverse set of institutions and include savings banks, housing banks, development finance institutions, and regional development banks. By far the largest of the licensed specialized banks is NSB, which is the second-largest deposit-taking institution in the country, ranking behind the BOC. NSB's operations are narrowly focused, as it mostly provides savings accounts through its large network of branches, post offices, and savings shops. NSB invests about 80% of its total assets in government debt. This narrow bank function helps to keep operating costs and credit risk low compared to those of banks which must support the costs of developing investment opportunities and have much more robust systems for credit risk management and credit administration.

8. The licensed specialized banks also include development financing companies. Sri Lanka has two primary development finance companies: the Development Finance Corporation of Ceylon, now the DFCC Bank (DFCC), and the National Development Bank of Sri Lanka PLC (NDB). NDB<sup>1</sup> and DFCC were originally government-owned development finance institutions that were privatized in the 1990s, with the Government retaining a minority stake in each institution. Both DFCC and NDB have evolved from state-owned development finance institutions to becoming universal and cohesive financial services groups with the right to compete with commercial banks. They depend primarily on funding from bilateral and multilateral agencies to support their development lending activities. Reliance on donor organizations and a product base of project loans are not sustainable. Each bank endeavors to increase the mobilization of domestic deposits and has acquired a commercial bank license as a means of broadening its range of product offerings. As a result, both institutions have also become less concentrated on development-oriented projects and more commercially based. NDB and DFCC have been highly profitable and have much lower overhead costs than do the other commercial banks. The CB, DFCC, NDB, and SB are engaged in onlending of an ADB loan<sup>2</sup> to the SME sector. In keeping with the needs of SMEs, DFCC and NDB have been scaling up training facilities and creating specialized branches or divisions geared to serving SMEs.

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<sup>1</sup> Privatized with ADB support.

<sup>2</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans, Partial Credit Guarantee, and Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Sector Development Program*. Manila.

9. There are six regional development finance institutions: Kandurata, Rajaratna, Ruhuma, Sabaragamuwa, Uva, and Wayamba. These are mainly conduits for government-subsidized credit programs, small business lending, and microlending. They collectively have 194 branches and assets of SLRs13.5 billion, or just short of 5% of the assets of all licensed specialized banks. There are also three small private savings and development banks. The regional finance institutions have been mainly ineffectual because they lack basic lending and other skills. The Government is contemplating to merge the six regional institutions with the recently established Lanka Putra Bank so as to better serve the SME sector. However, it remains to be seen whether Lanka Putra Bank can fulfill its mandate to cater to the demands in the areas of infrastructure, SME sector, microfinance and development banking. Past experience from specialized SME banks in Sri Lanka and elsewhere points to their difficulties in delivering designed outcomes. As such, SME financing cannot be divorced from the mainstream financial institutions.

## **B. Achievements**

10. The banking sector in Sri Lanka is sounder and more resilient as a result of reforms undertaken over the past two decades. The benefits of reforms are borne out by banking sector performance indicators: the ratio of nonperforming loans (NPLs) to total loans has fallen, the capital adequacy ratio (CAR) has increased, and profitability has risen. Capital adequacy reflects the overall position of bank capital. Adequate capital helps in absorbing financial risks and protects depositors from potential losses that a bank might incur. In Sri Lanka, the average CAR of state-owned commercial banks increased from 2.9% in 2001 to 5.5% in 2004, and that of domestic private banks rose from 10.5% to 11.1%. While the CAR of foreign banks declined from 14.2% in 2001 to 12.4% in 2004, it is still well in excess of the 9% minimum requirement. The average CAR for licensed commercial banks further improved from 10.3% in 2004 to 12.4% in 2005. As a percentage of total loans, gross NPLs declined from 21.8% in 2001 to 12.6% in 2006 for state-owned banks, from 18.1% to 10.5% for domestic private banks in the period, and from 12.8% to 3.3% for foreign banks. The quality of banking supervision has improved since 2002, with all banks now being examined on-site at least once in a 2-year cycle. Together with increased depth in off-site analysis, this has greatly improved the Central Bank of Sri Lanka's ability to identify weaknesses in banks. Prudential standards also have been strengthened.

## **C. Remaining Issues**

11. Recent indicators point to improved bank soundness and performance in Sri Lanka. However, the reform process remains incomplete. Some segments of the banking sector and some individual banks remain vulnerable. In particular, the performance of state-owned banks has generally been weaker than that of private and foreign banks. Improving the performance of state-owned banks should remain a high priority on the reform agenda. The keys to financial sector development in Sri Lanka are to continue the broad thrust of reforms begun in the 1990s to strengthen the governance infrastructure and institutional framework, while also decreasing direct government intervention. Sustainable progress is dependent upon further improvements in the legal framework for financial services and for commercial transactions more generally, building financial market infrastructure, and strengthening and enforcing prudential norms.

12. The high cost of credit remains a significant policy concern. The spread between deposit and lending rates has widened since improved margins are needed by the weaker banks to earn enough to cover their accumulated loan losses and high operating expenses. Until weak banks (both state owned and private sector) are restructured or exit the market, competition will be limited, margins will remain high, and the relatively more efficient banks, even if

uncompetitive by international standards, will be highly profitable. Major potential reform areas involve (i) completing the financial sector legal reforms, including a securitization bill and anti-money laundering statute; (ii) reforming the state-owned financial institutions, addressing not only asset quality and capital issues but also modernization so that Sri Lankans will be able to take full advantage of electronic payments, ATMs, and credit and debit cards; (iii) stringently enforcing prudential standards for both public and private sector banks to avoid market distortions, higher costs for consumers, and extraordinary profits for well-run banks due to the weak banks' lack of competitiveness; and (iv) addressing the infrastructure weakness for financial services.

### EXTERNAL COORDINATION MATRIX

Name of Organization	Type of Assistance	Major Activities	Amount	Time Frame
<b>Small and Medium Enterprise (SME) Value Chain Cluster Development</b>				
<b>GTZ</b>	TA	TA to facilitate the establishment of SME value chain clusters in spices, rubber, construction, packaging, dye and mold making, and organic farming. The major activities include setting up core groups to facilitate the technology transfer of sector-specific know-how, certifications, branding, marketing, and linkage between firms. The TA also covers such crosscutting issues as e-commerce, product certification and accreditation, and green labeling. GTZ also carries out workshops, training, research work, and SME trade fairs.	TA grant of €1.5 million	Mid-2004 to mid-2008
<b>USAID</b>	TA	USAID has provided technical assistance to various industries to support the formation of SME value chain clusters. These industries include tea, rubber, spices, ceramics, information technology, and gems and jewelry. Specifically, USAID supported the establishment of industry associations to carry out marketing and research and development for all its members. Members of the cluster pay a fee for such benefits in common. USAID has also supported interaction between industry groups and the Government and donor agencies.	\$12 million	1999 to 2008
<b>Small and Medium Enterprise Regional Development Project (SMERDP) Risk Management</b>				
<b>IFC</b>	Matching grant for bank training	The IFC has recently set up its Sri Lankan branch of the SEDF. One major area of SEDF's work is capacity building for banks on risk management, process reengineering, streamlining procedures, and developing new products. Capacity on SME lending is an important component of the SEDF work. In 2006, SEDF Sri Lanka signed memoranda of understanding with five local banks on capacity building activities (with Commercial Bank of Ceylon Limited, DFCC Bank, Hatton National Bank, National Development Bank of Sri Lanka PLC, and Sampath Bank Limited). The costs are shared on an equal basis between banks and SEDF. Responding to the requests of some banks, IFC recently extended its training activities to SMEs on how to develop bankable projects and financial management.	Initial capacity building budget: \$10 million	Since May 2006
<b>Poverty Related SME/Microfinancing</b>				
<b>JBIC</b>	Soft loan	The Small and Micro Industries Leader and Entrepreneur Promotion Project (SMILE-III) aims to provide capital to small and micro industries through concessionary loans; develop managerial, accounting, and technical skills in these industries; and strengthen institutional capabilities of intermediary financial institutions. These are low-interest credit lines lent to the Government at the interest rate of 1.75% and then lent on to SMEs by eligible participating banks. The maximum loan size is SLRs20 million. There are no regional and	\$96 million equivalent	2005 to 2008

Name of Organization	Type of Assistance	Major Activities	Amount	Time Frame
UNDP	Soft loan	industrial restrictions on lending. UNDP's work has been mainly on microfinance. The most recent work focuses on livelihood recovery for tsunami-affected households, especially women. The maximum amount of loan is equivalent to \$500, the interest rate is 6.5%, and the loan term is 6 months to 1 year.	\$4 million equivalent	2004 to 2007
<b>Enabling Environment</b>				
World Bank	Loan and TA in general, but current work is limited to policy dialogue.	The World Bank and Asian Development Bank's work on the Investment Climate Survey in Sri Lanka and a number of other countries is well known. The World Bank has also published an Access to Finance Study in Sri Lanka. An Economic Reforms Technical Assistance project will conclude in December 2007 that includes advice on financial sector reforms (banks, insurance, and securities).		Ongoing

GTZ = Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation), IFC = International Finance Corporation, JBIC = Japan Bank for International Cooperation, SMERDP = Small and Medium Enterprise Regional Development Project, SEDF = South Asia Enterprise Development Facility, SME = small and medium enterprise, TA = technical assistance, UNDP = United Nations Development Programme, USAID = United States Agency for International Development.

Source: Asian Development Bank estimates.

## ENVIRONMENTAL MANAGEMENT SYSTEM FRAMEWORK

### A. Introduction

1. The proposed Small and Medium Enterprise Regional Development Project (SMERDP or the Project) seeks to facilitate the development of SMEs outside the western province, with a specific emphasis on moderating regional disparities. The SMERDP consists of a project loan of SDR 32,226,000 (\$50.0 million equivalent) from ADB's Special Funds resources for extending credit through 4 private commercial or specialized banks (PCBs) to regional SMEs and SME value chain clusters.

2. The four private commercial or specialized banks (PCBs) eligible for credit facility under the SMERDP include Commercial Bank of Ceylon Limited (CB), DFCC Bank (DFCC), National Development Bank Limited of Sri Lanka PLC (NDB), and Sampath Bank Limited (SB). These banks are among the strongest and most mature financial institutions in Sri Lanka and are experienced in implementing credit line projects from donor agencies. CB, DFCC, NDB, and SB were also participating banks for ADB's Small and Medium Enterprise Sector Development Program (SMESDP)<sup>1</sup> loan in 2001. Past experience from similar credit lines (e.g., SMESDP) indicates that lending to SMEs is unlikely to involve significant adverse environmental impacts.

3. All the four banks adhere to the rules and regulations of Central Environmental Authority (CEA) of Sri Lanka. Their current environmental management systems (EMSs) are now under review. Improving and sustaining EMS implementation will benefit the Project and the banks.

### B. Implementation Arrangement of the Project

4. The Executing Agency (EA) for the Project is the Ministry of Finance and Planning (MOFP), and the implementation agencies are the four banks participating in the SMERDP. The MOFP thus has overall responsibility for ensuring that national environmental policies and regulations and ADB's environmental assessment requirements are adhered to by the four participating banks. MOFP will establish a project steering committee that will include representatives of the MOFP, Central Bank of Sri Lanka, and the PCBs. The committee will have the authority to make decisions essential to ensuring the Project's progress. As credit delivery institutions, the PCBs commit to updating or establishing and sustaining implementation of EMSs. To ensure successful EMS implementation, the PCBs will allocate appropriate staff resources and develop appropriate procedures (relevant to the types of subprojects to be funded and nature of their impacts) in order to screen subprojects, conduct due diligence, review environmental assessment reports, monitor and report on implementation, and evaluate the performance of the EMS for continual improvement. An annual environmental compliance monitoring report submitted by the PCBs through the project steering committee to ADB is required to support ADB's compliance oversight of the Project.

5. The MOFP, through the PSC and PCBs, will ensure that the environmental assessment will be undertaken in a manner including participation of the PCBs' clients. Consistent with the Government and ADB guidelines, stakeholder consultations will be documented in the environmental assessment documents. The PSC will ensure compliance with government regulations on environmental permits, licenses, and clearance. Release of any funds for specific

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<sup>1</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans, Partial Credit Guarantee, and Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Sector Development Program*. Manila

subprojects will be contingent upon prior issuance of necessary permits or licenses and clearance by relevant government authorities and/or by ADB, as required.

### C. Policies

6. A PCB's EMS embodies policies, procedures, and required capacity. The objectives of the environmental policy are to (i) protect the environment, (ii) encourage the efficient use of natural resources, and (iii) promote environmental improvement wherever possible. The national policies constitute the basis for EMS policies in the PCBs. All the participating banks will comply with national environmental policies, rules, and regulations. The Government's National Environment Act 1981 is supported by conservation laws including the (i) Coast Conservation Act of 1981, requiring environmental assessment for projects undertaken in coastal areas; (ii) Soil Conservation Act, which aims at erosion protection in areas highly susceptible to erosion; (iii) State Lands Ordinance provisions on control of water use from public sources; (iv) National Water Supply Board Act provisions on protecting water supply sources; (v) Fauna and Flora Protection Ordinance, which aims at conservation of forest and wildlife and provides the basic legal framework for environmental assessment in Sri Lanka; and (vi) Land Acquisition Act and National Involuntary Resettlement Policy. Other relevant regulations include bylaws related to pollution control, health and sanitation, and disposal of solid waste; the Geological Survey and Mining Bureau Act; Motor Traffic Act; Ministry of Defense and Police Policies; Agrarian Services Act; and Antiquities Ordinance.

7. The PCBs will ensure subprojects' compliance with national environmental policies and regulations as well as with ADB's applicable environmental assessment requirements. The national policies and ADB's environmental assessment requirements reinforce each other.

8. The PCBs will only invest in subprojects:
- (i) if their activities are outside of the Subproject Exclusion List (Supplementary Appendix F);
  - (ii) that take account of the environmental impacts of their operations and take steps to avoid, minimize, and mitigate any risks;
  - (iii) that are designed, implemented, and operated in compliance with all government environmental regulations and requirements, as well as with ADB's requirements, as applicable; and
  - (iv) that take account of relevant international environmental agreements.
9. The operational principles of a PCB's environmental policy include:
- (i) Ensuring that environmental safeguards as defined by the Environmental Protection Act, and rules and regulations issued by the Central Environmental Authority of Sri Lanka are integrated into project design prior to its financing and complied with during construction and operation.
  - (ii) Adopting a risk classification system in accordance with government procedure or international best practice.
  - (iii) Ensuring that no activities on the 'exclusion list' of activities are financed or fostered by the PCBs.
  - (iv) Where potential adverse social and environmental impacts are expected, the measures to prevent these from occurring in the first place are preferred to measures seeking minimization, mitigation, or compensation.
  - (v) Disclosing relevant information and consulting with project-affected people for subprojects with potential adverse environmental and social impacts.

- (vi) Where required to mitigate significant adverse environmental risk, ensuring that relevant international best practices, are integrated into project design, implementation, construction and operation.
- (vii) Encouraging project promoters and other project partners to adopt environmentally sound practices.
- (viii) Where subprojects have potential significant adverse impacts, ensuring independent compliance review by the PCB.
- (ix) Ensuring transparency in and commitment to continual improvement of its EMS.

#### **D. Procedure**

10. The procedure below provides a basis for the PCBs to develop their own set of procedures and requirements to avoid, minimize, mitigate, manage, and monitor subproject impacts, as appropriate to the types and scale of subprojects, and regarding the nature, sensitivity, and magnitude of subprojects' impacts.

##### **1. Screening**

11. Please find below the necessary screening measures that need to be implemented by the PCB to ensure that the subprojects are not included in the exclusion list.

- (i) The PCB will screen the proposed subproject to ensure that it is not included in the Exclusion List.
- (ii) The PCB's safeguard officer will carry out a rapid environmental assessment and prepare a brief report to summarize the results, including issues identified that need to be addressed and the type and scope of environment assessments needing to be conducted to mitigate the potential impacts.
- (iii) Using project classification criteria, the proposed subproject will be classified according to the significance of environmental impacts. The category determines the level and type of environmental assessment (initial environmental examination or environmental impact assessment) to be conducted to address potential environmental impacts.

##### **2. Environment Assessment and Review**

12. Please find below the required environment assessment and review that has to be undertaken by the PCBs.

- (i) After reviewing the proposal, the PCB will recommend the level of environmental assessment to be prepared if a feasibility study has not been prepared for the subproject. If potential environmental impacts are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures, narrower scope assessments (e.g., initial environmental examination) may be conducted. If potential significant adverse impacts are diverse, irreversible, or unprecedented, a comprehensive environmental assessment, such as an environmental impact assessment (EIA), is needed. If an EIA is required, it must include an environmental management plan consisting of mitigation measures for identified environmental impacts, staffing, monitoring and reporting arrangements, and budget.

- (ii) If a feasibility study has been done and an environmental assessment report<sup>2</sup> has already been prepared, the PCB will conduct a desk review of the environmental assessment report to ensure the adequacy of the environmental management plan to manage the risks, as well as to ensure compliance with all government environmental regulations and requirements and, as applicable, ADB environmental assessment requirements.
- (iii) The PCB should ensure that clients comply with the requirement for consultation with project-affected people that is preceded by information disclosure to those people. Information relevant to a subproject's environmental issues is disclosed and consultation with subproject-affected people is done at the early stage of environmental assessment work so that the views of the affected people are taken into account in project design. For category A projects, consultation should be done twice, with the second consultation process occurring when the draft EIA report is available. Consultation will continue during implementation. As required, the PCB will establish a grievance mechanism as part of its project management system.
- (iv) The PCB will inform its client about the applicable Government and ADB environmental requirements.
- (v) If the subproject to be funded is an existing facility, the PCB will conduct an environmental audit to determine the nature and extent of all environmental areas of concern at the existing facility. The audit identifies and justifies appropriate measures to mitigate the areas of concern, estimate the cost of the measures, and recommend a schedule for implementing them.
- (vi) The PCB will conduct a site visit to validate or update the information or to verify the findings of an EA or audit report (if already available).
- (vii) The safeguard officer/project team will present the initial findings on the environment to the committee (e.g., Credit/Investment Committee) which is responsible for approving the full credit appraisal of the proposed subproject. The safeguard compliance officer, reporting to the Chief Compliance Officer, will provide an independent view of the risks and assigns an environmental risk rating for discussion by the Financial Committee and Credit Committee.
- (viii) For any category A and environmentally sensitive category B subproject, the PCB will be required to obtain ADB's clearance of the environmental assessment. For these category A and sensitive B subprojects, a summary environmental assessment must also be disclosed to the public, and a full round of public consultation must be completed, for a period of at least 120 days before the subproject is approved. A detailed environmental assessment report will be prepared for approval by ADB before the subproject is approved.
- (ix) The safeguard officer will conduct an indepth review of environmental plans including the budget. Review will also be made of clearances and permits from the CEA, and relevant local authority. The legal officer formulates legal agreements with the subproject sponsor on safeguards. The safeguard officer also assists the client in preparing tender documents to ensure implementation by contractors of agreed mitigation measures.
- (x) The results of due diligence from the previous steps are reflected in the feasibility and appraisal reports which highlight the recommended environmental management or corrective action plan to mitigate the risk.

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<sup>2</sup> Environment assessment report is a generic term that refers to initial environmental examination, environmental impact assessment, or an environmental audit report.

### **3. Monitoring and Supervision**

13. During subproject implementation, the PCBs will monitor and supervise implementation of subprojects with potential adverse environmental impacts. The review and monitoring activities of the PCBs, include, but are not limited to, the following activities:

- (i) Conducting site visits of projects with environmental risks and impacts. These visits occur during due diligence but more often occur at the implementation stage.
- (ii) Reviewing project performance on the basis of the client's commitments in the legal agreement, as reported by the client's monitoring reports, and, where relevant, reviewing with the client any performance improvement requirements.
- (iii) If changing project circumstances would result in adverse environmental impacts, revising the environmental management plan and working with the client to address those impacts.
- (iv) Requiring clients to notify the PCB immediately of any accidents and incidents (e.g., spillages) that have or are likely to have a material adverse effect on the environment, including any remedial action planned or taken by the company in response to the accident or incident.
- (v) If the client fails to comply with its environmental commitments, as expressed in the legal agreement, working with the client to bring it back into compliance to the extent feasible, and, if the client fails to reestablish compliance, exercising remedies when appropriate.

### **4. Reporting**

14. The PCBs will prepare and submit annual environmental compliance monitoring reports to ADB within 90 days after the close of their respective financial years.

15. In the event that a significant environment-related accident or incident occurs in a subproject, the PCB will notify the project steering committee and ADB immediately upon becoming aware of the matter and indicate the proposed corrective actions to be taken. Upon the request of ADB, the PCB will arrange access for ADB staff to visit subprojects to verify compliance with ADB's environmental policies.

### **E. Use of Independent Experts**

16. Financial intermediaries for subprojects with potential significant adverse impacts may commission independent environmental experts to conduct full or partial environmental audits if the information collected at screening or any other stage indicates potentially significant environmental risks and liabilities (e.g., due to regulatory noncompliance or site contamination).

### **F. Capacity**

17. The PCBs will endeavor to achieve high standards of EMS practice by recruiting staff or consultants with environmental management skills and through in-house or external training programs.<sup>3</sup> Some specialist staff will be required to drive the internal process. A senior member of the management team will be appointed to drive the program internally and take responsibility for designing, if applicable, and implementing the EMS. All activities related to the environment will be coordinated by a dedicated environment staff in the projects department.

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<sup>3</sup> The PCBs are encouraged to send representatives to participate in relevant training programs sponsored by ADB and IFC.

18. In addition, it is recommended that a separate function of the EMS compliance officer be established to assist the credit function in evaluating, monitoring, and managing all matters involving EMS risk.
19. By providing additional training, as required, the four participating banks will ensure that their safeguard officers are qualified to play their roles and to discharge their responsibilities.

**G. Guidelines and Handbook**

20. The PCBs are also to have available an environmental guidebook for clients to provide guidance on applicable environmental requirements and good practices.

## ELIGIBILITY CRITERIA AND DUE DILIGENCE OF PRIVATE COMMERCIAL BANKS

### A. Private Commercial or Specialized Bank (PCB) Eligibility Criteria

1. Based on the due diligence above, the PCBs complied with the following eligibility criteria:

2. **SME Lending Commitment and Capacity of PCBs.** Each PCB must have (i) a corporate mission statement regarding SME development and related lending policies and strategy, (ii) a track record of performance (of at least 5 years) on relevant SME sector lending, and (iii) a project pipeline for SME lending and projected annual disbursements under the Small and Medium Enterprise Regional Development Project (SMERDP).

3. **PCB Operational and Financial Eligibility Criteria.** Each PCB must be in compliance with all applicable prudential regulations and guidelines of the CBSL, including but not limited to those for (i) ratio of risk assets to capital (Risk Capital Tier 1), (ii) recognition of income, (iii) loan classification, (iv) debt provisioning, and (v) overall nonperforming loan ratio and nonperforming loan ratio for SME loans. Moreover, it must have a credit rating above A+ (investment grade of a high credit quality)<sup>1</sup>, as per the Sri Lanka long term national rating scale of Fitch Ratings Lanka or an equivalent rating by a credit rating agency acceptable to ADB. It must maintain at least investment grade throughout the life of the Project. Each PCB will also be required to provide a suitable covenant with respect to non-performing loans, as may be acceptable to ADB. ADB reserves the right to disallow disbursements from the credit facility of any PCB not conforming with any of the above criteria until such time as the PCB is able to satisfy the criteria. Such PCB shall be required to remedy any default of eligibility criteria within 6 months of default and in any event, within the disbursement period of SMERDP.

4. **PCB Corporate Governance.** Each PCB has to demonstrate compliance with the Code of Corporate Governance for Banks and Financial Institutions issued by the CBSL in 2002, which includes (i) corporate governance structures that promote effective identification, monitoring, and management of all material business risks; (ii) systems for ensuring compliance with all statutory and regulatory requirements; (iii) implementation of financial disclosure requirements for market participants and observers; and (iv) setting of corporate governance objectives, strategies, and techniques.

5. **SME Outreach.** Each PCB must have demonstrated capability for lending to SMEs outside Colombo, Gampaha, and Kalutara as evidenced by branch operations, lending data, as well as plans or availability for providing credit and advisory services. Collaboration between the PCBs and nongovernment organizations and other civil society institutions is also crucial, as this can facilitate and play an instrumental role in the outreach programs.

6. **SME Risk Management Procedures.** Each eligible PCB must have demonstrated capability for risk management and established risk management systems, processes, and procedures that cover, among other things, (i) SME credit risk appraisal; asset-liability management; management of forex exposure, interest rate, and liquidity risks; asset and property management; and risk insurance coverage; (ii) environmental and social safeguards management systems designed to identify, remedy, and monitor subprojects' compliance

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<sup>1</sup> That is a credit rating of at least AA-, i.e., investment grade of a very high credit quality, as per the Sri Lanka long-term national rating scale of Fitch Ratings Lanka.

according to ADB's environmental and social safeguard policies;<sup>2</sup> (iii) SME sales and advisory services training programs;<sup>3</sup> (iv) SME credit scoring for enhancing cash flow-based lending; (v) SME client segments software and hardware based on IT diagnostics and customized to the PCB's specific systems and reporting needs, including disaster recovery; (vi) an SME risk-grading framework enabling adoption of risk-based loan pricing; and (vii) compliance with ISO certification for efficient processes and procedures based on ISO standards.

7. Against benchmarks established by SEDF's technical assistance program to strengthen banks' risk management, SME risk management procedures in PCBs are being judged by assessing (i) management structure and organization, (ii) SME credit policies, (iii) SME credit approval processes, (iv) SME portfolio monitoring mechanisms, (v) SME bad debts management, and (vi) SME risk modeling.

8. **Eligible PCBs.** Based on application of the above criteria, the PCBs eligible for onlending of the credit line consist of CB, DFCC, NDB, and SB.<sup>4</sup> In addition to this appendix, further details on PCB due diligence are provided in Supplementary Appendix B.

## **B. Commercial Bank of Ceylon Limited (CB)**

9. **Background.** CB was established in 1969. It recorded high loan growth in 2005 and is currently the largest private sector bank in Sri Lanka, with assets of SLRs180.1 billion as of the end of 2005 (up from SLRs138 billion at end-2004). The bank's major shareholders are DFCC Bank (29.77%), International Finance Corporation (IFC) (14.99%), Al Mashal Investment Group (10%), and SLIC-Life Fund (5.33%).

10. **Corporate Governance.** CB has complied with a majority of the good corporate governance practices recommended by ICA of Sri Lanka and CBSL. CB employs so-called "enterprise governance," which is a combination of business governance and corporate governance to ensure that strategic goals are aligned and good management is achieved and leads to corporate success and value creation. The structures promote effective identification, monitoring, and management of material business risks. The procedures ensure implementation of financial disclosure requirements and compliance with statutory as well as regulatory requirements.

11. **SME Outreach and Branch Network.** The bank has 134 branches across the island and has a far-reaching presence in the country. Along with its growing branch network, exposure to SMEs has increased considerably since the mid-1990s. A significant portion of CB's new loans were SMEs and to a lesser extent consumers. Collectively, retail banking (which includes SME lending) and consumer banking accounted for around 45% of its total loan portfolio as of the end of 2005 (i.e., approximately SLRs56 billion).

12. The bank's SME loan profile indicates significant lending to areas outside Colombo, Gampaha, and Kalutara. For the last 2-1/2 years, the number of SME loans to districts outside Colombo, Gampaha, and Kalutara, has hovered around 81% of the total number of SME loans. Furthermore, the volume of SME loans outstanding in districts outside Colombo, Gampaha, and

<sup>2</sup> Each PCB will provide such written policies and procedures.

<sup>3</sup> Capacity building in these and other market demand-side activities are being strengthened in the PCBs through IFC's SEDF technical assistance program focusing on SME lending capacity.

<sup>4</sup> Sampath has a lending restriction regarding the killing of livestock.

Kalutara was around 70% of the total volume of SME loans outstanding during 31 December 2004 to 30 June 2006.

13. **Risk Management.** Historically, CB's risk management practices have been considered sound. CB's work procedures, system of controls, and management information system are considered to be of a relatively good standard. This is also reflected in its asset quality indicators. It has decided to set up a full-fledged independent risk management department in the Bank, with a view to undertaking an integrated approach to risk management. Once fully set up and operational, the bank's entire risk management process is expected to be in line with international best practices (i.e. Basel II compliant).

14. CB, along with the three other banks, has signed a memorandum of understanding (MOU) with IFC's South Asia Enterprise Development Facility (SEDF) that would lead to a technical assistance for capacity building in CB and include such measures as strengthening risk management processes and procedures.

15. **Rating.** CB is rated AA+ (investment grade of a very high credit quality) by Fitch Ratings Lanka.

### C. DFCC Bank (DFCC)

16. **Background.** DFCC was formed as a development finance institution with the objective of fostering economic growth in Sri Lanka. DFCC's core activity is the provision of long-term project finance and its total assets were SLRs45.04 billion as at end of FY2005. Though state support was injected through state-owned institutions, DFCC was formed as a so-called "private" entity and was listed on the Colombo Stock Exchange in 1956. Currently, DFCC is majority owned by the private sector, with the Stassens Group owning about 19% of DFCC's equity and Commercial Bank of Ceylon having a 13.5% stake. Other major shareholders include a major public sector shareholder, Bank of Ceylon, which owns 14.7%.

17. **Corporate Governance.** DFCC is guided by the guidelines issued by the Central Bank of Sri Lanka (CBSL), the Securities and Exchange Commission, and the Institute of Chartered Accountants (ICA) of Sri Lanka with regard to implementing best practices in corporate governance. The structures promote effective identification, monitoring, and management of material business risks. The procedures ensure implementation of financial disclosure requirements and compliance with statutory as well as regulatory requirements.

18. **SME Outreach and Branch Network.** DFCC has 11 full-fledged branches with professional staff in every province except for the northeast (two branches are coastal and the other nine are in major provincial towns). Each regional branch covers a wide catchment area, ranging from 50 to 100 kilometers from the provincial capitals. For the financial year that concluded at the end of March 2006, DFCC accommodated 2,000 new SME clients who had had no previous relationship with the bank, and a total credit of SLRs5.546 billion (i.e., 55% of total SME credit approval for the year) was approved for branches outside Colombo and Gampaha. The portfolio of SME loans outstanding has increased, on average, by SLRs1.2 billion for the last 2 years outside Colombo and Gampaha (as of March 2004, SLRs7.22 billion; as of March 2005, SLRs8.105 billion; and as of March 2006, SLRs9.55 billion).

19. **Risk Management.** Over the years, DFCC's risk management function has been refined and strengthened along the lines of modern risk management practices. DFCC's risk management framework has been considered to be relatively good in the local context.

Committees with defined responsibilities, along with well-structured and clearly articulated procedures and demarcated accountability contribute to the risk management framework. A centralized database incorporating data from branches further enhances the bank's risk management capabilities. In preparation for Basel II, a more sophisticated risk rating system developed with the aid of external consultants is to be implemented. Ultimately, the new rating system will enable rating transitions to be monitored in order to facilitate a transition to the Internal Ratings-Based (IRB) approach.

20. DFCC has signed an MOU with IFC's SEDF that would lead to technical assistance for further capacity building of DFCC and include such measures as strengthening the processes and procedures of risk management.

21. **Rating.** DFCC is rated AA (investment grade of a very high credit quality) by Fitch Ratings Lanka.

#### **D. National Development Bank of Sri Lanka PLC (NDB)**

22. **Background.** NDB of Sri Lanka was established in 1979 as a fully state-owned institution to provide project funding along with DFCC. In 1993, it was privatized with ADB support and 61% of the capital floated on the stock exchange. The state has adopted a hands-off approach towards both NDB of Sri Lanka and DFCC from the start, letting the banks make business decisions freely. As a result, the performance and financial health of both banks have been relatively good.

23. **Corporate Governance.** NDB supports the recommendations of the Committee on Financial Aspects of Corporate Governance initiated by ICA of Sri Lanka, including the aspects referred to by the Securities Exchange Commission. NDB has adopted (i) an appropriate structure for the Board of Directors and for appointments to the Board; (ii) internal controls systems including internal and external audits, as well as risk management functions independent of the business lines; (iii) effective internal and external information flows and appropriate financial reporting; and (iv) appropriate financial and managerial incentives tied to accountability and responsibility.

24. **SME Outreach and Branch Network.** NDB's branch network expanded to 24 branches in FY2005 from 13 in FY2004. As of the end of June 2006, NDB's branch network had increased to 33 branches, out of which 13 are solely dedicated to SME lending. The expanded branch network will support growth in its consumer and SME segments. It is estimated that 26 branches are committed to both SME and consumer segments. Direct SME credit approvals for 2005 through the branches stood at SLRs2.425 billion for 844 projects, an increase of 26% over the previous year's figure of SLRs1.917 billion for 794 projects. The SME credit portfolio was at SLRs4.127 billion in 2005, an increase of 14% over the 2004 figure of SLRs3.608 billion. As of the end of June 2006, SME lending volume was around 21% of total lending volume, and the total number of facilities and loans offered to SMEs was 74% of the total number of facilities and loans offered by NDB.

25. As of the end of June 2006, NDB's SME loan profile indicated significant lending to areas outside Colombo, Gampaha, and Kalutara. Around 6.6% of the SME facilities offered by the Colombo branch were distributed to districts outside Colombo, Gampaha, and Kalutara. Similarly, 10.3% of the total SME lending volume of the Colombo branch was distributed to districts outside Colombo, Gampaha, and Kalutara. Furthermore, the total number of facilities and loans offered to SMEs outside Colombo, Gampaha, and Kalutara represented 69% of SME

facilities and loans. The SME lending volume outside Colombo, Gampaha, and Kalutara was around 55% of total SME lending volume.

26. **Risk Management.** NDB's risk management procedures have improved since FY2001, both in terms of the framework and its application. Management has emphasized maintaining asset quality and earning an adequate return on equity. In preparation for Basel II compliance, the bank intends to implement a more sophisticated risk rating system developed with the aid of external consultants. It will enable rating transitions to be monitored in order to facilitate a transition to the IRB approach. Following modern credit risk management practices, NDB is taking an overall portfolio view in managing risk. However, it will review large exposures and high-risk deals on a transaction basis. NDB's risk appetite is conservative in the area of project lending, as demonstrated by single borrower limits set at 20% of equity for a company and 25% for a group, compared with the regulatory prudential limit of 30% of equity.

27. NDB, along with the three other banks, has signed an MOU with IFC's SEDF that would lead to technical assistance for capacity building at NDB and which would include such measures as strengthening risk management processes and procedures.

28. **Rating.** NDB is rated AA (investment grade of a very high credit quality) by Fitch Ratings Lanka.

#### **E. Sampath Bank Limited (SB)**

29. **Background.** This bank is the smallest of the six major domestic banks, with assets as of the end of December 2005 totaling SLRs87.5 billion, but it ranks relatively well by such indicators as profitability and efficiency. The bank's network at end-2005 comprised 84 branches and 95 ATMs, supported by such other delivery channels as telebanking and internet banking. SB is considered a technologically advanced bank in the local context.

30. **Corporate Governance.** SB is committed to strong corporate governance, which is reflected in its structure, processes, and governance procedures. It has adopted practices to fulfill its objectives of transparency, integrity, disclosure, and accountability in all dealings. SB has implemented (i) an appropriate structure for the Board of Directors and appointments to the Board; (ii) effective internal controls systems that include internal and external audits, as well as risk management functions independent of the business lines; (iii) unimpeded internal and external information channels and appropriate financial reporting; and (iv) appropriate financial and managerial incentives tied to accountability and responsibility.

31. **SME Outreach and Branch Network.** Over the last 5 years, SB's network has doubled, and the bank had 83 branches as of the end December 2005. The well disbursed network of SB's branches across the island will facilitate SME lending outside the Colombo area. SB has been actively involved in SME credit lines through Japan Bank for International Cooperation, Asian Development Bank, and other donors.

32. **Risk Management.** SB, along with other Sri Lanka banks, is in the process of implementing an enterprise-wide risk management approach and putting into place the building blocks necessary to function within a Basel II environment (i.e., building a database of credit history to evaluate probability of default, rating transitions, and loss experience). Given SB's robust IT infrastructure, the bank is positioned well to successfully implement the measures.

33. SB, along with the three other banks, has signed an MOU with IFC's SEDF that would lead to technical assistance for capacity building in SB that would include such measures as strengthening risk management processes and procedures.
34. **Rating.** SB is rated AA- (investment grade of a very high credit quality) by Fitch Ratings Lanka.



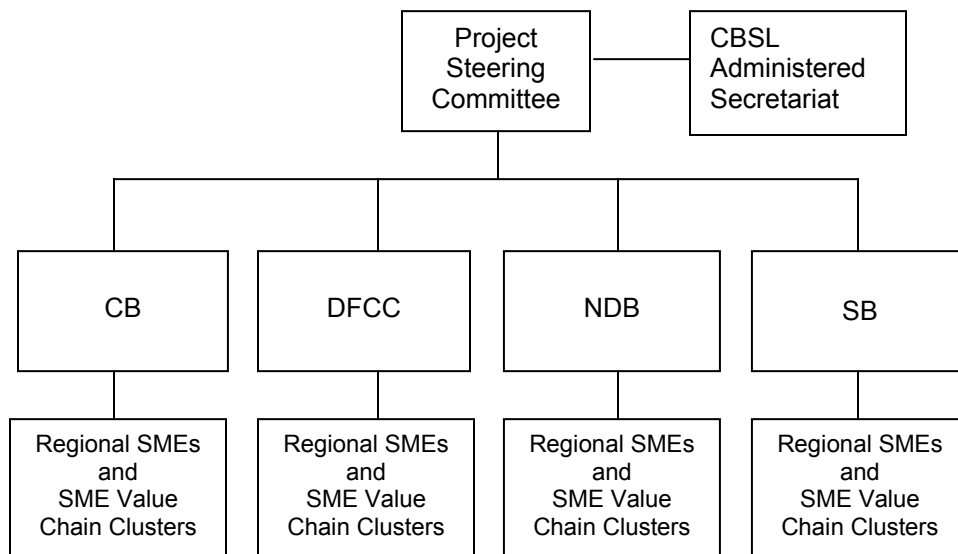
**IMPLEMENTATION SCHEDULE AND ARRANGEMENTS**

**Table A8: Implementation Schedule**

Item	2008	2009	2010
A. Loan Effectiveness	■		
B. Establishment of PSC and PIUs	■		
C. Small and Medium Enterprise Regional Development Project			
1. First Year Disbursement (\$20.0 million)	■		
2. Second Year Disbursement (\$15.0 million)		■	
3. Third Year Disbursement (\$15.0 million)			■
D. Project Steering Committee Annual Review / Midterm Review		■	■
E. ADB Review Missions		■	■

ADB = Asian Development Bank, PIU = project implementation unit, PSC = project steering committee.  
 Source: ADB estimates.

**Figure A8: Implementation Arrangements**



ADF = Asian Development Fund, CB = Commercial Bank of Ceylon Limited, CBSL = Central Bank of Sri Lanka, DFCC = DFCC Bank, EA = executing agency, MOFP = Ministry of Finance and Planning, NDB = National Development Bank of Sri Lanka PLC, SB = Sampath Bank Limited, SME = small and medium enterprise.

## SUMMARY OF POVERTY REDUCTION AND SOCIAL STRATEGY

### A. Linkages to the Country Poverty Analysis

<b>Is the sector identified as a national priority in country poverty analysis?</b>	<input checked="" type="checkbox"/> Yes  <input type="checkbox"/> No	<b>Is the sector identified as a national priority in country poverty partnership agreement?</b>	<input checked="" type="checkbox"/> Yes  <input type="checkbox"/> No
<p><b>Contribution of the sector or subsector to reduce poverty in Sri Lanka:</b></p> <p>The Small and Medium Enterprise Regional Development Project (SMERDP) seeks to enhance small and medium enterprise (SME) development by addressing barriers to growth faced by SMEs. The Project's main thrust is to foster partnership and clustering between firms at different levels of value chains of different sizes. This is an integrated approach that tackles SMEs' development constraints in the areas of finance, information, marketing, management, and inputs. The development of such SME value chain clusters will boost opportunities for SMEs to engage in commercially viable business activities. The experience of a number of countries has demonstrated the soundness and efficacy of this approach. By this approach, the Project will facilitate development of a competitive SME sector that is capable of growth and expansion, and it will directly contribute to poverty reduction. Furthermore, a dynamic SME sector will generate employment, contribute to reducing direct government budget support to SMEs and free up resources for infrastructure and social development. All these factors will lead to reduced poverty.</p>			

### B. Poverty Analysis

**Targeting Classification:** General intervention

<p><b>What type of poverty analysis is needed?</b></p> <p>The SMERDP is indirectly pro-poor in supporting the three components of ADB's poverty reduction strategy: pro-poor sustainable economic growth, good governance, and social development. Pro-poor sustainable economic growth is to be achieved through the Project's focus on measures to improve SME growth and development in the nonurban and rural areas that have the highest incidence of poverty in the country. The SMERDP is timely, as economic growth and development have stagnated in the nonurban and rural areas. To facilitate good governance, the SMERDP is strengthening a number of organizations' governance structures, namely those of the four private commercial or specialized banks (PCBs) involved. This will contribute to the flow of improved services from these organizations to SMEs. By paying particular attention to the development of rural SMEs, the SMERDP will improve the incomes of rural households and increase employment opportunities for rural residents, including women, through establishing new SMEs or expanding existing SMEs. That, in turn, will foster social development.</p>
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### C. Participation Process

<b>Is there a stakeholder analysis?</b>	<input checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
<p>Widespread consultations were held with stakeholders, including SMEs, large corporations, banks and other financial institutions, nongovernment organizations, research institutions, SME business service providers, government departments, the Central Bank of Sri Lanka, and various donor organizations. The feedback from all these stakeholders has been carefully analyzed and reflected in the design of the loan.</p>		
<b>Is there a participation strategy?</b>	<input checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
<p>The SMERDP aims to employ a consultative approach throughout its processing and implementation stages to ensure effective participation of stakeholders, generation of high quality action plans and recommendations, and that the SMERDP delivers the desired economic and social outcomes. The action plans relate to conceptualization of SME value chain clusters to foster bankable projects and redress the geographically skewed SME lending. SMERDP is the vehicle to ensure implementation of the action plans.</p>		

**D. Gender Development****Strategy to maximize impacts on women:**

The SMERDP addresses constraints faced by SMEs through an integrated approach that centers on forming partnerships between firms at the various levels of the value chains. The SMERDP pays particular attention to the development of rural and nonurban SMEs. By so doing, women who generally receive no wage income as household workers will be given the opportunity to be employed and to establish their own businesses.

Has an output been prepared?  Yes  No

**E. Social Safeguards and Other Social Risks**

Item	Significant/ Not Significant/ None	Strategy to Address Issues	Plan Required
<b>Resettlement</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	SMERDP will not trigger safeguards as it will not acquire any private land that will involve any adverse impacts on people.	<input type="checkbox"/> Full <input type="checkbox"/> Short <input checked="" type="checkbox"/> None
<b>Affordability</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Labor</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Indigenous Peoples</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	SMERDP will not trigger indigenous peoples issues as the subproject sites do not cover indigenous areas in Sri Lanka. The ethnic minorities who will share the benefits, i.e. Tamils and Moors, are well mainstreamed into the larger community.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Other Risks and/or Vulnerabilities</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No

ADB = Asian Development Project, PCB = private commercial or specialized bank, SMERDP = Small and Medium Enterprise Regional Development Project, SME = small and medium enterprise.

## FINANCIAL MANAGEMENT ASSESSMENT

### A. Executive Summary

1. The objective of the financial management assessment is to determine whether the entities implementing the project components have acceptable financial management arrangements—including procedures for making payments, accounting treatment of transactions, financial reporting, audit of financial statements, and internal control procedures—to avoid misuse or misappropriation of funds and assets. The assessment indicates that the project is being prepared in an area of low financial management risk, as the entities that will implement the Small and Medium Enterprise Regional Development Project (SMERDP) have successfully undertaken (or are currently undertaking) similar lines of credit from numerous donor agencies (including the World Bank and Asian Development Bank (ADB)).

2. The Executing Agency (EA) for the SMERDP will be the Ministry of Finance and Planning (MOFP). Each eligible private commercial or specialized bank (PCB) will be an implementing agency (IA) and will establish a project implementation unit (PIU) in its relevant operational department. MOFP will establish a project steering committee (PSC) that will oversee implementation of the Project. The PSC will comprise six members, including representatives of the MOFP, Central Bank of Sri Lanka (CBSL), and the four PCBs. The PSC will be chaired by the Secretary of MOFP or, in his absence, Deputy Secretary of MOFP. The PSC may, from time to time, co-opt representatives from other relevant agencies. CBSL will form and provide a secretariat to the PSC that will be responsible for coordinating the inputs of all PIUs, including benefit and impact monitoring reports, for consideration by the PSC. The responsibility for major payments, accounting, and conduct of audit will remain with the PSC secretariat.

### B. Summary Project Description and Introduction to the Financial Management Assessment

3. The proposed SMERDP seeks to facilitate the development of SMEs outside the western province of Sri Lanka, with the specific objective of reducing regional economic disparities. The SMERDP consists of a project loan of SDR 32,226,000 (\$50.0 million equivalent) from ADB's Special Funds resources for extending credit through four PCBs to regional SMEs and SME value chain clusters.

4. Given the objective of the financial management assessment above, the arrangements are considered acceptable if the EA and PCBs are capable of making timely payments as they become due, recording correctly all transactions and balances, supporting the preparation of regular and reliable financial statements, and are subject to appropriate auditing. The financial management assessment also provides stakeholders an opportunity to discuss any issues related to the proposed funds flow and financial management structure and finalize actions required to ensure sound financial management arrangements exist before loan effectiveness. The financial management and accounting questionnaire was completed with the help of the EA, IA, and CBSL staffs, and the final version is attached with the report.

### C. Country Issues and Risks

5. The framework for public financial accountability in Sri Lanka is founded on the principles of governance associated with the model inherited from the British. This framework is widely accepted as appropriate for the country. The primary accountability institutions and

organizations for financial management, control, audit, and legislative scrutiny, however, need to evolve in line with the changes in the more advanced democracies of a similar background.

6. Financial accountability at the subnational level is less developed than at the center. For example, the control over funds is subject to less public scrutiny and financial reporting is less regular. In addition, provincial and local governments' dependency on the central government for funds, results in duplication of effort and resources. However, results based budget indicators at the sub-national level are under preparation through the fiscal program of the Government with ADB. On the other hand, some state owned enterprises experience inefficiencies. The Government is attempting to address these issues through various interventions that are part of programs of Government with ADB.

#### **D. Institutional Arrangements**

7. The EA for the SMERDP will be the MOFP. Each eligible PCB will be an IA, establishing a PIU in its relevant operational department not later than one month after loan effectiveness. MOFP will establish a PSC, not later than one month after loan effectiveness, that will oversee implementation of the SMERDP. The PSC will comprise 6 members, including representatives of the MOFP, CBSL, and the 4 PCBs. The PSC will be chaired by the Secretary of MOFP or, in his absence, Deputy Secretary of MOFP. The committee will have the authority to make decisions that are essential to ensure the progress of SMERDP. The PSC may, from time to time, co-opt representatives from other relevant agencies. The committee will meet as needed, but at least once every 2 months and will be responsible for the overall guidance to the PCBs and the direction of SMERDP as well as on matters related to financial reporting and disbursements.

8. CBSL will form and provide a secretariat to the PSC that will be responsible for coordinating the inputs of all PIUs, including benefit and impact monitoring reports for consideration by the PSC. The PCB PIUs will be responsible for (i) coordinating with relevant PCB departments to ensure appraisal and management of subloans; (ii) ensuring that ADB information and reporting requirements related to PCBs and subloans are met; and (iii) ensuring that all necessary submissions of accounts, related financial statements, and disbursement records are duly submitted through CBSL to the PSC.

#### **E. Funds Flow Arrangements**

9. The coursing of project loan funds will be undertaken through CBSL to the eligible PCBs for regional SME lending. CBSL was deemed appropriate because of (i) CBSL's ready access to information pertaining to the continued eligibility of the PCBs, including financial soundness and capabilities of PCBs for providing credit to the SME sector; (ii) the strengthening of CBSL's regulatory and supervisory capacity under the World Bank's Central Bank Strengthening Project that encompasses support for (a) CBSL reorganization and restructuring by reforming human resources policies, outsourcing and training, and skills upgrading of audit and other departments, (b) training and technical support for the payments and securities clearing and settlements system, and (c) financial market regulation and development; (iii) CBSL's role in setting corporate governance standards for banks;<sup>1</sup> and (iv) CBSL's key role through its recently established Financial Intelligence Unit to combat money laundering and terrorist financing.

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<sup>1</sup> Central Bank of Sri Lanka. 2002. *Code of Corporate Governance for Banks and Financial Institutions*. Colombo.

10. A project imprest account will be opened and maintained at CBSL for the SMERDP. CBSL will inform MOFP about receipt of ADB funds into the imprest account (which is in foreign currency). MOFP then will direct CBSL to convert and transfer the requested amount in equivalent local currency. The PSC will advise CBSL to release funds to a second-generation imprest account set up in each IA to draw their equitable share from the first-generation imprest account. The requisition forms submitted by the PSC would require joint signatures. One signatory will be the project director of the PSC secretariat and the other signatory will be any one of the other three PSC secretariat staff.

## **F. Staffing Arrangements**

11. The PSC's financial management infrastructure will be adequate to provide the requisite financial management arrangements for the Project because qualified regular CBSL staff will be employed for the various positions within the PSC secretariat. The position of project director at the PSC secretariat will be assigned to the director of the Regional Development Department at CBSL while the position of alternate project director will be assigned to the deputy director of the Regional Development Department. The project director at the PSC secretariat will (i) liaise with the PSC, (ii) liaise with all PIU project directors, and (iii) be responsible for the overall supervision of the PSC secretariat. The major responsibilities of the alternate project director will include overseeing the budgeting, accounting, and reporting of all financial transactions related to implementing the Project under the overall supervision of the project director. For the reporting of all financial transactions, the alternate project director will be assisted by the appointment of a finance officer from CBSL's Regional Development Department. For the budgeting and accounting, the alternate project director will be assisted by the appointment of an accounts officer from CBSL's Regional Development Department.

12. Since all four PCBs have undertaken (or are currently undertaking) similar lines of credit from numerous donor agencies (including ADB), and as qualified regular PCB staff will be employed that have the relevant experience, the financial management infrastructure of the four PCB PIUs will be adequate to provide the requisite financial management arrangements for the Project. Each PCB will establish a PIU in its relevant operational department (i.e., the SME department). The director of the SME department in each PCB will be the project director of each PIU while the position of alternate project director will be assigned to the deputy director of the SME department. The project director for each PIU will (i) liaise with the PSC, (ii) liaise with the project director of the PSC secretariat as well as project directors of other PIUs, and (iii) be responsible for overall supervision of the PIU. Under the overall supervision of the project director, the major responsibilities of the alternate project director in each PIU will include overseeing the budgeting, accounting, and reporting of all financial transactions related to implementing the allocated funds of the PCB. For the reporting of all financial transactions, the alternate project director will be assisted by the appointment of a finance officer from the PCB SME department. For the budgeting and accounting, the alternate project director will be assisted by the appointment of an accounts officer from the PCB's SME department.

## **G. Accounting Policies and Procedures and Financial Reporting**

13. The PCBs employ accrual-based accounting, with cash accounting only for nonperforming loans as mandated by CBSL's prudential requirements. The PCBs follow Sri Lanka Accounting Standards, which correspond with international accounting standards. CBSL utilizes an accrual basis of accounting and follows International Financial Reporting Standards. MOFP uses cash-basis accounting, but it is planning a migration to full accrual accounting in the next 3 to 4 years.

14. The PCBs will have their accounts and financial statements (balance sheet, income statement, and statement of sources and applications of funds) audited annually in accordance with sound internationally accepted auditing standards by independent external auditors acceptable to ADB. The PCBs will submit, through CBSL, to the EA and ADB their audited accounts and financial statements not later than 6 months after the end of the fiscal year. In addition, the PCBs will submit semiannual unaudited accounts to CBSL.

15. Through CBSL, the EA will (i) maintain consistent records and accounts adequate to identify goods and services financed from proceeds of the SMERDP, (ii) ensure separate accounts for each project loan under an IA, (iii) ensure accounts and related financial statements are audited annually in accordance with international accounting standards by auditors acceptable to ADB, and (iv) submit to ADB certified audited accounts and financial statements within 9 months after the end of the fiscal year.

16. SMERDP reports prepared by the PSC secretariat based on inputs from PIUs will be provided quarterly for the PSC, EA, and ADB. The reports will contain (i) descriptions of the progress made during the period, (ii) changes to the implementation schedule, if any, (iii) problems/difficulties encountered and the remedial actions taken, (iv) the work to be carried-out in the next period, and (v) a summary financial account for the loan with expenditures to date. Within 3 months of the Project's completion, the EA, through the PCBs, will furnish to the ADB a project completion report containing a detailed evaluation of social and economic impact, as well as other details as may be requested by the ADB.

## **H. Information Systems**

17. Since CBSL and all four PCBs have undertaken (or are currently undertaking) similar lines of credit from numerous donor agencies (including ADB), the management organization and processing systems of CBSL and the PIUs can produce satisfactory project financial reports that meet the requirements of SMERDP financial reporting. These systems ensure the confidentiality, integrity, and availability of the data. The staff is adequately trained to maintain the systems. The accounting practices at MOFP have been computerized by employing software known as the Computerization Integrated Government Accounting System (CIGAS) and that has been in use since its introduction in 1995.

## **I. Audit Arrangements**

18. The project accounts will also be audited by CBSL's internal auditor and the Auditor General. The audited project financial statements will be submitted to ADB within 9 months of the end of the Government's fiscal year or such other date as ADB may agree.

## **J. Disbursement Arrangements**

19. PSC will be responsible for preparing disbursement projections, collecting supporting documents, preparing withdrawal applications, and sending them to ADB in accordance with ADB's *Loan Disbursement Handbook* (2007, as amended from time to time). To facilitate the timely release of loan proceeds and to expedite project implementation, the Government will, immediately after the loan becomes effective, open and maintain a project imprest account with CBSL for the SMERDP to be managed by the PSC. The initial advance to the imprest account will be 6 months' worth of estimated expenditures, or 10% of the loan amount, whichever is lower. To facilitate implementation a second-generation imprest account will be set up in each

PCB to draw its equitable share from the first-generation imprest account. ADB's statement of expenditures procedure will be used to liquidate advances from the imprest accounts. The maximum individual payment permitted under the SOE procedure is \$200,000 equivalent.

## K. Action Plan

**Table A10: Action Plan**

No.	Actions Required	Target Dates
1.	Set up the project steering committee and the PCBs' project implementation units and ensure that adequate financial management arrangements are in place	Within one month after loan effectiveness
2.	Adopt and implement Asian Development Bank's accounting policies and procedures for the Project	By effectiveness

PCB = private commercial or specialized bank.

Source: Asian Development Bank.

## L. Financial Covenants

20. The Government of Sri Lanka, through the PSC, shall submit audited annual financial statements of the project to ADB no later than 9 months of the end of the fiscal period to which they relate.

## M. Supervision Plan

21. The PSC will have the authority to make decisions that are essential to ensuring the progress of the SMERDP. The committee will meet as needed, but at least once every 2 months. It will be responsible for overall guidance to the PCBs and direction of the SMERDP as well as on matters related to financial reporting and disbursements.

## N. Conclusion and Recommendations

22. MOFP, CBSL, and all four PCBs have successfully undertaken (or are currently undertaking) similar lines of credit from numerous donor agencies (including the World Bank and ADB). As a result, the financial management capacities of the EA, CBSL, and the IAs are developed to a satisfactory level to ensure smooth functioning of the SMERDP.

## GOVERNANCE AND ANTICORRUPTION RISK ASSESSMENT

1. This assessment considers (i) relevant governance issues in the Small and Medium Enterprise Regional Development Project (SMERDP); (ii) relevant risk analysis of the SMERDP; (iii) controls for corruption at the sector and project levels; and (iv) recommendations on how the findings of the assessment can be incorporated into the design of the Project.

2. **Relevant Governance Issues in SMERDP.** Governance issues with respect to the Government's SMERDP can be considered along the following lines: (i) regional inequality and small and medium enterprises (SMEs), (ii) legislative and policy framework, (iii) institutional dimensions, and (iv) accountability and transparency.

3. **Regional Inequality and SMEs.** Regional inequality is a major developmental challenge in Sri Lanka. Further, such regional divergence has increased steadily since the early 1990s. There is potential for SME-driven growth to correct regional disparities in specific sectors where performance has been relatively unsatisfactory in terms of quality, waste, and distribution.

4. **Legislative and Policy Framework.** The Government's past measures for supporting regional enterprises and SMEs have focused on the state's trying to substitute the role of markets by subsidizing or controlling interest rates and facilitating lending through state-owned financial enterprises. Such a policy has not been sustainable and effective. More recently, the Government has accepted that financing of SMEs should be left to the market with private sector engagement whereby bankable and commercially feasible SME projects are funded and established.

5. **Institutional Dimensions.** SMEs are institutionally weak as business enterprises because of limited production and technical capacity, inadequate market support services, small size of operation, lack of access to business information, and low-quality products.

6. **Accountability and Transparency.** The accounting systems and information disclosure of SMEs will have to be improved to remove information opaqueness, since the Government is facilitating the conversion of the manual format at Credit Rating Information Bureau (CRIB) to a web-based electronic-enabled system by the end of 2007 to ensure availability of credit history for all SMEs at the CRIB.

### A. Risks, Their Severity, and Risk Mitigation Measures

7. **Underlying Assumptions.** The main assumptions in the risk analysis are that (i) the Government will stay the course in its objective and intention for regional SME development, (ii) the legal and institutional reforms brought about to date will be sustained in the immediate future, (iii) effective institution building and capacity development in key agencies will continue, and (iv) the Government shares the view that this assessment presents a thorough review of SME development risks.

8. **Risk Specification.** The potential risks can be grouped into several categories:

- (i) Legal risks include, for example, lack of legal provisions to deal with disputes on SME loans and debt recovery as well as inadequate legislation on secured transactions.
- (ii) Policy risks include, among others, reluctance of private sector banks to lend to regional SMEs since they are considered risky ventures.

- (iii) Institutional risks include weak managerial and technical capacity and skills in SMEs, including reluctance of management graduates to work in regional SMEs.
- (iv) Regulatory risks include weak implementation of governance code and standards by Central Bank of Sri Lanka (CBSL) and banks.

9. **Risk Severity.** The risks highlighted in the paragraphs above are not all equally severe for regional SME development and the Project. Table A11.1 provides a risk severity matrix, which gives an indication of the four types of risks based on severity.<sup>1</sup>

**Table A11.1: Risk Severity Matrix**

		Impact (I)				
		5 Very High	4 High	3 Moderate	2 Low	1 Very Low
Likelihood of event occurring (L)	5 Very likely	<b>Type I</b> <ul style="list-style-type: none"> <li>• Weak managerial and technical capacity and skills in SMEs, including reluctance of management graduates to work in regional SMEs</li> </ul>		<b>Type II</b>		<b>Type III</b>
	4 Likely	<ul style="list-style-type: none"> <li>• Lack of legal provisions to deal with disputes on SME loans and debt recovery</li> </ul>	<ul style="list-style-type: none"> <li>• SME authority not adequately institutionalized to lead SME development</li> </ul>			
	3 Moderately likely	<ul style="list-style-type: none"> <li>• Reluctance of private sector banks to lend to regional SMEs, including investment in medium- and long-term loans, since they are considered risky ventures</li> <li>• CBSL's ongoing internal reform programs discontinued, adversely affecting SME development</li> <li>• Weak implementation of governance code and standards by CBSL and banks</li> </ul>	<ul style="list-style-type: none"> <li>• System at CRIB does not capture credit history below current threshold</li> <li>• Inadequate legislation on secured transactions</li> </ul>			<b>Type IV</b>
	2 Unlikely					

CBSL = Central Bank of Sri Lanka, CRIB = Credit Rating Information Bureau, SME = small and medium enterprise.  
Source: Asian Development Bank.

10. **Proposed Mitigation Measures.** Some of the mitigating measures for the primary risks are presented in Table A11.2.

**Table A11.2: Risks and Proposed Mitigation Measures**

Risk	Proposed Mitigation Measures
Weak managerial and technical capacity and skills in SMEs, including reluctance of graduates to work in regional SMEs	<ul style="list-style-type: none"> <li>• Subcontracting with large firms for technical assistance and technology transfer</li> <li>• Further expansion of SME value chain clusters in selected strategic industries</li> </ul>
Weak capacity of banks to support development of regional SMEs and	<ul style="list-style-type: none"> <li>• With implementation of new system at CRIB, data collection by banks will be initiated</li> </ul>

<sup>1</sup> The degree of severity is calculated as the product of the range of likelihood of the risk occurring and the potential impact of such a risk.

Risk	Proposed Mitigation Measures
SME value chain clusters, as well as to sustain such strategic partnership	<ul style="list-style-type: none"> <li>• Capacity building on assessing credit based on cash flows and risk management, risk-based loan pricing, and credit scoring</li> <li>• With amendment to secured transactions act, banks will move towards lending based on movable property</li> </ul>
Reluctance of private sector banks to lend to regional SMEs, including investment in medium- and long-term loans, since they are considered risky ventures	<ul style="list-style-type: none"> <li>• Expansion of credit information to potential creditors, and reform in secured transactions</li> <li>• Development of bankable regional SME projects and SME value chain clusters</li> <li>• Funds to be provided to PCBs under the Project</li> </ul>
The Government's policy on funding development of regional SMEs by banks is inadequate	<ul style="list-style-type: none"> <li>• Collaboration between CBSL and the four banks for funding development of regional SMEs under the Project</li> </ul>
CRIB system does not capture credit history below current threshold	<ul style="list-style-type: none"> <li>• Development of credit scoring systems for SMEs by credit rating agencies</li> <li>• Modernization of registry being planned</li> </ul>
Inadequate secured transaction legislation	<ul style="list-style-type: none"> <li>• Government considering new law and also to establish a national system of registry under ongoing Financial Market for Private Sector Development<sup>a</sup></li> </ul>
Lack of legal provisions to deal with disputes on SME debt recovery	<ul style="list-style-type: none"> <li>• Government considering amendment to Mediation Act</li> </ul>
SME authority (i.e., Ministry of Enterprise Development and Investment Promotion) not adequately institutionalized to lead SME development	<ul style="list-style-type: none"> <li>• Rules and regulations, strategies and work plans, as well as roles and responsibilities of the Ministry of Enterprise Development and Investment Promotion need to be approved and implemented</li> </ul>
Weak implementation of governance code by CBSL and banks	<ul style="list-style-type: none"> <li>• Operationalization of corporate governance in selected PCBs in accordance with CBSL corporate governance standards</li> </ul>
CBSL's ongoing internal reform programs discontinued, adversely affecting SME development	<ul style="list-style-type: none"> <li>• Continuous engagement by donor agencies on the reforms</li> <li>• CBSL will monitor and supervise participating banks</li> </ul>

CBSL = Central Bank of Sri Lanka, CRIB = Credit Rating Information Bureau, PCB = private commercial or specialized bank, SME = small and medium enterprise.

<sup>a</sup> ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Financial Markets Program for Private Sector Development*. Manila.

Source: Asian Development Bank.

## B. Controls for Corruption

11. Effective adoption and implementation of the Code of Corporate Governance by the PCBs will be critical to ensure good governance and to check corrupt practices while lending to SMEs under the Project. To minimize the inherent investment risks in lending to regional SME projects, PCBs will need to adhere to strict internal controls, checks and balances, and risk management procedures. The regulatory and supervisory role of CBSL over the PCBs will be equally important to ensure corruption-free business practices.

## C. Recommendations

12. To enhance the design and implementation of the SMERDP, it is recommended to:
- (i) incorporate good governance and anticorruption provisions in loan assurances,
  - (ii) get stakeholder concurrence of governance and corruption risk mitigation strategies,
  - (iii) acquire information during review missions on revised structures and processes within SMERDP to assess progress in managing governance and corruption risks, and

- (iv) revisit this assessment at a suitable opportunity in the project period to assess how conditions may have been more (or less) favorable for effective implementation.