Sri Lanka: Rural Finance Sector Development Program

Independent Evaluation Department

Asian Development Bank
NOTE

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

Key Words

adb, asian development bank, cooperative rural bank, microfinance institution, rural enterprise, rural finance institution, rural finance sector development, sri lanka

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I. PROGRAM DESCRIPTION

A. Rationale

1. About 88% of poor households in Sri Lanka live in rural areas. The rural economy failed to provide job opportunities, especially during off-farm season. To spur the rural economy, a robust finance sector was necessary to efficiently mobilize and allocate resources and, therefore, facilitate exchange of goods and services. At the time of program preparation, the rural finance sector was highly fragmented and the operational and financial status of rural finance institutions (RFIs) had deteriorated due to weak governance, poor repayment rates, high transaction costs, weak supervision, and recurring losses. Instead of promoting good
governance and sustainability as core values, successive governments adopted ad hoc and short-term measures such as loans at below-cost interest rates, which only aggravated the weaknesses. As a result, rural households’ demand for credit was largely unmet.

2. The potential of rural finance to contribute to the diversification of new farm and nonfarm opportunities and value addition was not being realized. Bottlenecks in production and marketing such as inadequate physical rural infrastructure, lack of business support services, and low skills level reduced profitability; consequently, trapping the rural sector in low-risk and low-return investments. Thus, the gap between rural areas and urban areas widened, causing long-term negative effects on consumption and asset buildup among rural poor households. A sustainable rural finance system emphasizing a financial system development approach wherein rural finance market development is placed within the broader perspective of finance sector development was critical to building a more vibrant rural economy. Greater efficiency in delivering rural financial services realized by a sustainable rural finance system would reduce transaction costs and help make RFIs and rural enterprises viable, and thus contribute to creating jobs, expanding income, and reducing poverty. In view of this, the Rural Finance Sector Development Program was conceived to establish a sustainable rural finance system through policy adjustments, and improve the operations of RFIs.\(^1\)

B. Expected Impact

3. The program was envisaged to reduce poverty and facilitate economic growth in rural Sri Lanka. The program framework specified the following impact indicators: (i) reduction in poverty incidence from 25% to 20% by 2005; (ii) economic growth rate of 7% by 2005; and (iii) enhanced outreach and sustainability of the rural finance sector.

4. The shift to a financial-system-development approach was expected to attain greater outreach resulting in more clients served and their diverse needs met. While the program aimed to directly support 10,000 small and micro rural enterprises and 850 community subprojects, the more tangible benefit would accrue with the outreach expansion of RFIs using their own resources, estimated at 200,000 new clients during program implementation. The expanded outreach was expected to have a significant impact in generating jobs and increasing income. The strengthening of RFIs was envisaged to ensure that the impact of poverty reduction is felt beyond the life of the program.

C. Objectives or Expected Outcomes

5. The envisaged outcome of the program was to establish a sustainable rural finance system through policy, legal, regulatory, and institutional reforms. The outcome indicators were: (i) development of a policy framework for rural finance to decrease the government’s ad hoc interventions and direct involvement in providing rural finance services; (ii) development of an enabling legal and regulatory framework for rural finance; (iii) enhanced rural finance outreach and sustainability through governance reforms, mainstreaming rural finance industry best practice, and diversifying products and services; and (iv) increased ability of rural households to use rural finance through support for skills development and access to marketing networks.

6. The Rural Finance Sector Development Program comprised a program loan and two project loans with complementary objectives. The program loan component aimed to ensure (i) enhanced access by rural households to rural finance services; (ii) good governance of RFIs; (iii) the reduced role of the public sector; and (iv) the increased role of the private sector, including microfinance–nongovernment organizations in rural finance. The specific objective was to develop a sustainable rural finance system for providing efficient services, primarily to the middle and lower segments of the rural finance markets, toward significant income expansion and poverty impact.

7. The objectives of the two project loans were to strengthen key sector institutions for providing training in rural finance, efficient service delivery, sector supervision, and outreach expansion. Specifically, the first project loan (project 1) was to support the development of a rural enterprise through a credit line; while the second project loan (project 2) was to support building sector capacity, developing financial infrastructure, restructuring RFIs, and implementing the project.

D. Components and Outputs

8. The program loan included five components: (i) conducive policies for rural finance that include establishing a high-level body to coordinate rural finance policies, shift away from state intervention in the sector, and adequate supervision; (ii) a supportive legal and regulatory framework that consolidates the fragmented, ineffective supervisory, and regulatory mechanisms in rural finance; (iii) institutional reforms of key RFIs to promote operational and financial sustainability through efficient operations, client-oriented practices, and good governance practices; (iv) strengthening the demand side through a functioning rural economic resuscitation fund that supports skills development, rural marketing networks, and community infrastructure; and (v) expansion of rural finance in conflict-affected areas.

9. Project 1 consisted of a component on rural enterprise development, supported through a credit line. Project 2 had the following components: (i) building sector capacity through support for the Centre for Banking Studies (CBS) as a center for excellence in rural finance; (ii) developing financial infrastructure through institutional development support for the Rural Finance Sector Development Agency (RFSD Agency); (iii) restructuring of RFIs; and (iv) project implementation support.

E. Provision of Inputs

10. The project was estimated to cost $70 million, comprising $50 million for the program loan and $20 million for two project loans—$10 million for onlending support and SDR7,005,000 ($10 million equivalent) for capacity building and implementation support. The first tranche of $15 million and the second tranche of $20 million for the program loan were disbursed. The third and fourth tranches were not disbursed because of noncompliance with several tranche release conditions.

11. Of the $10 million loan for onlending to RFIs, $8.4 million was disbursed, of which about $6.8 million was used to assist tsunami-affected victims. Of the $10.0 million equivalent for capacity building and project implementation support, $5.6 million was disbursed, of which $1.8 million equivalent (SDR1.2 million) was used for consultants’ inputs. There was no associated technical assistance supporting program implementation.
F. Implementation Arrangements

12. The Ministry of Policy Development and Implementation was the executing agency, responsible for coordinating with the Central Bank of Sri Lanka (CBSL), the Ministry of Cooperatives, the Ministry of Rural Economy, the Ministry of Samurdhi, and the Ministry of Finance and Planning on policy reforms. The implementing agencies were the Ministry of Rural Economy, the Ministry of Cooperatives, the National Development Trust Fund (NDTF), and the Ministry of Samurdhi. Program implementation units were established in these implementing agencies. In 2004, reassignments of ministry functions led the government to appoint the Ministry of Finance and Planning as executing agency. In addition, the Ministry of Agricultural Marketing Development, Hindu Affairs and Minister Assisting Education and Vocational Training, the Ministry of Samurdhi and Poverty Alleviation, and the Ministry of Small and Rural Industries were designated as implementing agencies. The CBSL and NDTF remained as implementing agencies.

13. The government only partially met the covenant on the use of counterpart funds from the first two tranches because the envisaged recapitalization support for cooperative rural banks (CRBs) through the CRB fund was not provided. The third and fourth tranches were canceled due to noncompliance with several tranche release conditions. The covenants of the two project loans were largely met. However, the covenants for the full utilization of the credit line, generation of detailed data on the RFIs’ performance, and submission of program completion report (PCR) by the program management unit were not met.²

II. EVALUATION OF PERFORMANCE AND RATINGS

A. Relevance of Design and Formulation

14. The PCR rated the program partly relevant. The program was in line with the government’s development objectives and with the medium term strategy of the Asian Development Bank (ADB) for Sri Lanka. The thrust to develop rural finance was appropriate in the context of poverty in Sri Lanka where 90% of poor households live in rural areas.

15. The objective of addressing key constraints to sector development—the lack of a conducive policy environment, limited access to credit, and weak institutional capacity—was appropriate. However, the design comprising a program loan and two project loans, and the wide range of areas for reform were too complex given the limited institutional capacities of the executing agency and the implementing agencies. The design attempted to address all major constraints with one program. Binding constraints should have been identified and proper sequencing of policy reforms should have been carefully adopted, taking into account the implementation capacities and prevailing political will to implement the reforms. This shortcoming in design reduced the program’s relevance. Further, this validation agrees with the PCR’s view that the program was too ambitious given the uncertain political climate during implementation, continuing security concerns, and the more immediate reconstruction challenges confronting the authorities. The new government that came into power in 2004 neither implemented the necessary reforms to establish an effective regulatory framework nor reduced its role in the sector by restructuring and privatizing key RFIs. This diminished the relevance of the program during implementation.

16. The change in implementation arrangement to reallocate project funds for emergency credit to help rehabilitate and reconstruct livelihoods of tsunami-affected households was imperative and appropriate. Overall, the validation rates the program less than relevant because of the design weaknesses stated in para. 15.

B. Effectiveness in Achieving Program Outcomes

17. The PCR rated the program less effective. The expected program outcome—a sustainable rural finance system through policy, legal, regulatory, and institutional reforms—was not realized. The outputs achieved as part of the first and second tranche conditions were mainly preparatory and intermediate measures to implement the third and fourth tranche conditions. These outputs were (i) establishing the policy forum to discuss policy issues, (ii) formulating a draft Rural Finance Sector Development Act (RFSD Act), (iii) establishing an interim RFI supervision unit in the Bank Supervision Department of the CBSL, (iv) preparing the restructuring and institutional strengthening plans for key RFIs, (v) operating the Rural Economic Resuscitation Fund, and (vi) providing microcredit to people in conflict-affected areas.

18. The objective of improving regulatory and supervisory framework was largely unmet. While the envisaged RFSD Act covering regulation and supervision of RFIs was developed as part of the first tranche condition, it was not enacted as required for in the second tranche. The envisaged outcome indicator of establishing the RFSD Agency as an independent agency to supervise and regulate RFIs was not realized. The policy forum review did not result in moving state intervention away from the rural finance sector because of the new government’s policy to maintain state ownership in RFIs.

19. In terms of support for institutional reforms of key RFIs, state-owned rural development banks were not restructured and privatized because of the new government’s “no privatization” policy. The plan to transform the NDTF into an effective apex agency was only partially implemented as the government decided in 2010 to merge the NDTF with the Sri Lanka Savings Bank. The envisioned outcome indicator of establishing the RFSD Act as a credible training institution particularly in rural finance; and (iii) the separation of functional areas for social development and banking operations of Samurdhi Banking Societies to achieve transformation into sustainable financial intermediaries.

20. The program helped strengthen the demand side by supporting small-scale community-based projects in skills development, marketing network, infrastructure, and extension services. The NDTF provided onlending support to RFIs for micro and small rural enterprises in conflict-affected areas. In February 2005, ADB approved the reallocation of $7 million out of the $10 million credit line for emergency credit for rehabilitating and reconstructing livelihoods of tsunami-affected households, which benefited approximately 10,000 households and helped microfinance institutions rebuild their operations.

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3 The Samurdhi Banking Societies (SBS) were introduced in 1997 as part of the samurdhi (welfare) program to promote rural savings and investment. The SBS program is the largest microfinance program in Sri Lanka covering nearly 50% of all households.
21. In sum, the program contributed to strengthening CBS, CRBs, the Samurdhi Authority, and the demand side of the sector. However, the envisaged improvement in the regulatory and supervisory framework was not realized; and reduction in state ownership of RFIs, which would have improved sector efficiency, was not achieved. For these reasons, the validation rates the program less than effective.

C. Efficiency of Resource Use in Achieving Outcomes and Outputs

22. The PCR rated the program less efficient. The envisaged improvement in sector efficiency was curtailed by the new government’s lack of political support. The new government backtracked on reforms related to restructuring and privatizing key RFIs, thus undermining targeted program outcomes and market efficiency. Only two of the four tranches of the program loan were released due to noncompliance to some tranche conditions caused by changes in government policy. Program implementation faced difficulties arising from weak implementation capacities of institutions and the government’s lack of ownership and political will to carry out the reforms.

23. The slow process of consultant selection, procurement, and documentation for liquidation of accounts delayed the implementation of project loan 2. The credit line reallocated for emergency credit was efficiently used to respond to urgent needs of those affected by the tsunami of December 2007. However, this validation notes that efficiency of RFI operations was not monitored during implementation; therefore, the RFIs’ efficiency in delivering financial services is not known. The validation rates the program less than efficient.

D. Preliminary Assessment of Sustainability

24. The PCR rated the program less likely sustainable. The validation also rates the program less than likely sustainable. Many program outputs and outcomes were not realized and little progress has been made. The institutional reforms and capacity-building measures supported by the program helped strengthen some RFIs, but without a regulatory and supervisory framework in place, these institutions are less than likely to be sustainable. The draft Microfinance Act that was based on the draft RFSD Act prepared under the program is envisaged to establish a regulatory authority for rural and microfinance institutions not within the scope of the CBSL. However, progress in enactment of the proposed act has been slow and is not highly prioritized by Parliament. Data on the sustainability of RFIs were not generated by the project performance management system; hence, the sustainability of RFIs cannot be clearly established.

E. Impact

25. The PCR did not give a general assessment on the program’s impact following PAI 6.07A guidelines. The validation rates the overall program impact moderate. The extent to which the program has led to poverty reduction is not known. The goal of the program was to reduce poverty but no baseline was established on the income or poverty levels of households. The program was to facilitate economic growth but attainment of the growth target of 7% by 2005 was not discussed in the PCR. The envisaged improvement in the rural financial system was not realized because the regulatory and supervisory framework called for was not fully set in place. The credit line component under project 1 enhanced outreach in

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rural areas by providing credit to 3,906 households in conflict-affected areas and more than 10,000 tsunami-affected households to support livelihood and enterprise activities. Project 2 strengthened the capacity of the CBS for rural finance training, and the assistance for establishing an information technology–management information system helped improve the operations of CRBs and the Samurdhi Authority.

III. OTHER PERFORMANCE ASSESSMENTS

A. Performance of the Borrower and Executing Agency

26. The PCR rated the performance of the borrower and executing agency partly satisfactory. The executing agency was not able to effectively lead project implementation and coordinate the implementing agencies toward the envisaged outcome. Of the four program loan tranches, only two tranches were disbursed because of failure to comply with several tranche release conditions. The new government that came into power in 2004 did not have ownership of the program. The policy direction was reversed in core program areas, specifically in establishing the RFSD Agency to regulate the rural finance sector and reducing the government’s role through restructuring and privatizing key RFIs. The validation rates the performance of the borrower and executing agency less than satisfactory.

B. Performance of the Asian Development Bank

27. The PCR rated ADB’s performance satisfactory. ADB fielded six review missions and one program completion review mission. A program preparatory technical assistance guided program preparation and conducted a comprehensive assessment of the sector and stakeholder consultations. Review missions provided appropriate technical inputs, effectively monitored implementation progress, and addressed implementation issues. ADB response to government requests was generally timely. ADB responded appropriately to verify suspected potential misuse of loan proceeds by the NDTF (PCR, para. 48). The decision to reallocate some resources in the credit line component in response to urgent needs of tsunami-affected people was timely and appropriate. ADB’s decision to partially cancel the program loan was appropriate and timely in view of the new government’s lack of ownership and unlikely progress toward achieving program outcomes. However, implementation difficulties could have been avoided had capacity constraints, a sequenced approach to the wide range of areas for reform, and an uncertain political climate been adequately considered in the program design. While these were weaknesses in the design, ADB nonetheless provided adequate supervision and timely response to issues during implementation. The validation rates ADB performance satisfactory.

C. Others

28. ADB responded appropriately to act on information received during the November 2006 review mission regarding the NDTF’s suspected potential misuse of loan proceeds. An external audit of the NDTF was undertaken, which concluded that ADB policies were not violated. Project 2 audit reports for 2004 to 2006 were available but audit reports for 2007 and 2008 were missing (Appendix 3, PCR). The program had no significant negative effects on resettlement and the environment.

IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

A. Overall Assessment and Ratings

29. The PCR rated the program partly successful. The validation also rates the program less than successful (see table). The program loan was not successful in realizing the envisaged outcome of a sustainable rural finance system through policy, legal, and institutional reforms. Project loan 1 was successful in realizing the envisioned onlending support to the financing needs of livelihood and rural enterprises. Project loan 2 did not achieve the objective of establishing the RFSD Agency, although the capacities of the CBS and CRBs were strengthened.

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<tr>
<th>Criteria</th>
<th>PCR</th>
<th>IED Review</th>
<th>Reason for Disagreement/Comments</th>
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<tbody>
<tr>
<td>Relevance:</td>
<td>Partly relevant</td>
<td>Less than relevant</td>
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<td>Effectiveness in Achieving Outcome:</td>
<td>Less effective</td>
<td>Less than effective</td>
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<td>Efficiency in Achieving Outcome and Outputs:</td>
<td>Less efficient</td>
<td>Less than efficient</td>
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<tr>
<td>Preliminary Assessment of Sustainability:</td>
<td>Less likely</td>
<td>Less than likely</td>
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<tr>
<td>Overall Assessment:</td>
<td>Partly Successful</td>
<td>Less than successful</td>
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<tr>
<td>Borrower and Executing Agency:</td>
<td>Partly satisfactory</td>
<td>Less than satisfactory</td>
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<tr>
<td>Performance of ADB:</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
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<tr>
<td>Impact:</td>
<td>Not rated</td>
<td>Moderate</td>
<td>The extent to which the program had led to poverty reduction is not known (para. 25).</td>
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<tr>
<td>Quality of PCR:</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>The PCR is clear and concise. The ratings are sound (para. 33).</td>
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ADB = Asian Development Bank, IED = Independent Evaluation Department, PCR = program completion report.

Note: From May 2012, IED views the PCR's rating terminology of "partly" or "less" as equivalent to "less than" and uses this terminology for its own rating categories to improve clarity.

Source: ADB Independent Evaluation Department.

B. Lessons

30. This validation agrees with the lesson stated in the PCR on complexity of program design and timing of implementation. Additional lessons can be drawn from program implementation. First, government commitment and buy-in is important in a reform program such as Rural Finance Sector Development Program. There should have been strong commitment of the government and stakeholders to develop the sector and achieve sustainable rural finance. Second, adequate assessment of institutional capacity of implementing agencies at formulation would have been needed to effectively address constraints. Third, in the context of Sri Lanka
where the areas of reform are complex, the use of a sequenced approach to reforms would have been more appropriate.

C. Recommendations for Follow-Up

31. This validation gives the same recommendations as the PCR: (i) focus program design on the most binding constraints, proper sequencing of reforms, and careful assessment of implementation capacities and political will; and (ii) use cluster program modality where program objectives can be determined at the processing stage of each subsequent subprogram. This validation concurs with the recommendation to pursue the enactment of the Microfinance Act and follow developments in the sector in the context of policy dialogue. In addition, this validation recommends systematic monitoring of sector performance.

V. OTHER CONSIDERATIONS AND FOLLOW-UP

A. Monitoring and Evaluation Design, Implementation, and Utilization

32. The program design called for the executing agency to establish and maintain a project performance management system (PPMS), which generates reports on the financial indicators of RFIs, the number of borrowers by gender and poverty classification, the size of transactions, and social intermediation outreach. Implementing agencies were expected to periodically monitor the socioeconomic indicators of borrowers such as income, asset holdings, and employment status to measure poverty outreach and poverty reduction impact of the program. During program implementation, the data produced by the PPMS was limited. Basic data regarding RFIs were generated but not all details as specified in the program design were available. This can be attributed to the weak institutional capacity of the executing agency and implementing institutions. Further, baseline data on households were not established for assessment of poverty impact.

B. Comments on Program Completion Report Quality

33. The quality of the PCR is satisfactory. Overall, the PCR is clear and concise, and its ratings sound. The lessons and recommendations are sound and drawn from the analyses and findings of the report. However, a general assessment of program impact following PAI 6.07A guidelines was not made. It was likely that impact was not apparent at the time of PCR preparation because of noncompliance with the conditions for disbursing the third and fourth tranches. Effectiveness and efficiency were assessed jointly in one section. It would have been more clear, informative, and insightful if these were assessed separately in the report following PAI 6.07A guidelines.

C. Data Sources for Validation

34. Sources for this validation were the back-to-office mission reports, the PCR, the report and recommendation of the President, program-processing documents, and progress report.

D. Recommendation for Independent Evaluation Department Follow-Up

35. This validation recommends conducting a program performance evaluation any time. Program activities have been completed and sufficient time has lapsed for program impact to be more apparent.