ECONOMIC ANALYSIS

1. The proposed project will strengthen the capital base of the Regional Development Bank (RDB). This will allow RDB to comply with increasing regulatory capital requirements and expand its portfolio of loans to micro and small enterprises (MSEs), particularly in rural areas. The unmet demand for these loans is large, and RDB is ideally positioned to meet it. RDB’s financial performance is generally satisfactory and will further benefit from the injection of long-term capital and capacity building provided under the project. The macroeconomic environment is also generally supportive of MSE lending. The project will generate other economic benefits such as safeguarding the financial stability of RDB and creating better access for MSEs to finance. This, in turn, will support employment generation and economic growth. The expected economic rate of return cannot be calculated because the subprojects the project will support have not been identified.

A. Unmet Demand for Micro and Small Enterprise Loans

2. Credit gap. The unmet credit demand of MSEs in Sri Lanka is estimated to be at least SLRs563.0 billion ($3.1 billion equivalent) (Table 1), excluding MSEs in agriculture, for which comparable data is not available. Demand is expected to grow over the project period in conjunction with medium to high gross domestic product (GDP) growth and sound finance sector development (paras. 8–10).

Table 1: Estimated Credit Demand for Micro and Small Enterprises

<table>
<thead>
<tr>
<th>Segment</th>
<th>Enterprises (number)</th>
<th>Fully Constrained (%)</th>
<th>Partially Constrained (%)</th>
<th>Average Loan (SLRs million)</th>
<th>Credit Gap (SLRs million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>935,736</td>
<td>30.9%</td>
<td>39.6%</td>
<td>1.0</td>
<td>474,418</td>
</tr>
<tr>
<td>Small</td>
<td>71,126</td>
<td>34.5%</td>
<td>30.6%</td>
<td>2.5</td>
<td>88,552</td>
</tr>
<tr>
<td>Total</td>
<td>1,006,862</td>
<td></td>
<td></td>
<td></td>
<td>562,970</td>
</tr>
</tbody>
</table>

*SLR = Sri Lanka rupee.

*a Data does not include micro and small enterprises in agriculture.

Sources: Sri Lanka’s Department of Census and Statistics and the International Finance Corporation.

3. The estimated credit gap is based on the following assumptions:

(i) The definition of MSEs is the same as that adopted for the census in fiscal year 2014,1 which is less inclusive than the new national definition (Table 2).2

(ii) The census estimated the number of total enterprises in Sri Lanka as 1.020 million in 2013. Of these, 91.8% were micro enterprises and 7.0% were small enterprises.

(iii) The International Finance Corporation’s Enterprise Finance Gap Survey in 2017 found that among Sri Lanka’s micro enterprises, 30.9% are fully constrained and 39.6% partially constrained (i.e., 70.3% have unmet funding demand).3 Among small and medium-sized enterprises, 34.5% are fully constrained and 30.6% are partially constrained. The project team used this ratio for small enterprises in the financial gap analysis.

(iv) The potential lending volume is calculated by multiplying the number of enterprises by the average loan size for fully-constrained enterprises. The potential lending volume for partially-constrained enterprises is computed by halving that for fully-

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constrained enterprises.\textsuperscript{4} Data on loan sizes is not available from official statistics but is estimated based on (a) the loan data of banks that participated in the Small and Medium-Sized Enterprise Line of Credit of the Asian Development Bank (ADB),\textsuperscript{5} which indicates that an average loan to women-led SMEs is SLRs1.0 million; and (b) Credit Information Bureau data that states the size of the average SME lease from nonbank financial institutions (more likely to serve smaller SMEs) is SLRs2.5 million.

\[
\text{Credit gap} = (30.9\% + 39.6\% \times 0.5) \times \text{SLR 1 million} = \text{SLRs 474,418 million.}
\]

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>Micro Enterprises</th>
<th>Small Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Census definition</strong> (used for gap analysis)</td>
<td>Industry and construction: up to 4 Trade: up to 3 Services: up to 4</td>
<td>Industry and construction: up to 25 Trade: up to 14 Services: up to 15</td>
</tr>
<tr>
<td><strong>New national definition</strong> (used for proposed project)</td>
<td>Manufacturing: up to 10 Services: up to 10</td>
<td>Manufacturing: up to 50 Services: up to 50</td>
</tr>
</tbody>
</table>

Sources: Sri Lanka’s Department of Census and Statistics and the Ministry of Industry and Commerce.

4. The assumptions are conservative and likely underestimate the actual unmet demand for credit because the assumptions (i) do not include agriculture, (ii) adopt a much narrower definition of MSEs than the new national definition, and (iii) assume that the share of unmet demand among small enterprises is the same as for medium-sized companies when the opposite is likely to be true.

5. **Targeted segments.** Credit demand from women-led MSEs is estimated at SLRs132.1 billion ($0.7 billion) based on the assumption that 26.3% of microenterprises and 8.3% of the small-enterprises are women-led.\textsuperscript{6} Given this demand and RDB’s successful track record of serving these segments, the requirement that 500 subloans directly financed by the subordinated loan must be to women-led MSEs is feasible.

6. **Credit gap.** Although no regional data is available on the credit gap, the project team expects it to be concentrated outside of Colombo, which is where the proposed project is targeting, for three reasons. First, household poverty is lower in Colombo than in other parts of the country.\textsuperscript{7} Wealthier households are more likely to manage businesses that can access bank financing. Second, Colombo has a bank branch for every 3,028 inhabitants. Other areas have much lower branch penetration. Third, an estimated 70% of economic activity occurs outside Colombo District. Thus, smaller branches support most economic activity, suggesting that many of the underserved or unserved MSEs are in these areas (Table 3).

7. RDB is well positioned to bridge this credit gap. Its mandate as a state-owned and licensed specialized bank is to improve rural living standards by providing accessible and affordable financial services. Its focus includes agriculture, industry, livestock, fisheries, and the empowerment of women. Data collected from ADB’s SME credit line confirm that RDB outperforms other banks in serving MSEs, women, and rural clients. RDB loans are small and geographically

\textsuperscript{4} For example, the credit gap for micro is computed as follows: 935,736 \times (30.9\% + 39.6\%\times 0.5) \times \text{SLR 1 million} = \text{SLRs 474,418 million.}

\textsuperscript{5} ADB. 2016. Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprise Line of Credit Project. Manila.

\textsuperscript{6} Sri Lanka’s Department of Census and Statistics and International Finance Corporation. The credit gap for women-led micro is computed as follows: \text{SLRs 474,418 \times 26.3\% + SLRs 88,552 \times 8.3\% = SLRs 132,120 million.}

diverse because the bank has a large branch network. This partly explains why RDB has weaker financial metrics than other banks.\(^8\)

<table>
<thead>
<tr>
<th>Item</th>
<th>Poverty Head Count Index (%) 2016</th>
<th>Population/Branch (no. of people) 2016</th>
<th>GDP Total (SLRs billion) 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Province</td>
<td>1.7</td>
<td>4,800</td>
<td>4.611</td>
</tr>
<tr>
<td>Colombo District</td>
<td>0.9</td>
<td>3,028</td>
<td>...</td>
</tr>
<tr>
<td>Gampaha</td>
<td>2.0</td>
<td>7,483</td>
<td>...</td>
</tr>
<tr>
<td>Kalutara</td>
<td>2.9</td>
<td>7,784</td>
<td>...</td>
</tr>
<tr>
<td>Outside of Colombo</td>
<td>7.4</td>
<td>6,686</td>
<td>...</td>
</tr>
<tr>
<td>Outside of Western Province</td>
<td>8.6</td>
<td>6,502</td>
<td>6,572</td>
</tr>
<tr>
<td>Total</td>
<td>4.1</td>
<td>5,883</td>
<td>11,183</td>
</tr>
</tbody>
</table>


### B. Macroeconomic and Sector Environment

8. Recent studies confirmed that external factors such as the macroeconomic and finance sector environment play a significant role in encouraging and/or discouraging bank lending to smaller companies.\(^9\) Based on the survey results of 91 banks in 45 countries, banks see lending to smaller companies as highly profitable but view macroeconomic instability and competition as the main obstacles.\(^10\) More specifically, the survey found (i) the link between GDP growth and lending to smaller companies is significant and positive; (ii) high inflation has strong negative effects on lending to smaller enterprises, as does high domestic borrowing by the government, which tends to crowd out credit to MSEs in particular; and (iii) the finance sector reforms are typically associated with higher lending to MSEs.

9. The macroeconomic environment in Sri Lanka is generally conducive to MSE lending with medium to high GDP growth and the progress being made in reducing inflation, budget deficits, and domestic borrowing by the government. Sri Lanka’s economy grew at an average of 5.8% during 2010–2017, reflecting a peace dividend after the end of the civil conflict in 2009 and a determined policy thrust towards reconstruction and growth. However, there have been some signs of a slowdown since 2013. The GDP growth rate during 2013–2017 is 4.2%. Regional disparities remain. Economic growth is generally higher in poorer regions with catch-up potential.\(^11\) Inflation declined from 7.1% during 2011–2013 to 3.7% during 2014–2016; the increase to 7.7% in 2017 was a result of higher food prices caused by a natural disaster that affected agriculture. At 84.6% of GDP in 2017, the overall public sector debt remains high in Sri Lanka compared to its regional peers.\(^12\) However, a fiscal reform initiative reduced the fiscal deficit from 7.6% of GDP in 2015 to 5.5% in 2017. The fiscal and monetary reforms are supported under an International Monetary Fund program that aims, among others, to transition towards inflation targeting, enhance

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\(^8\) Financial Analysis (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).


\(^11\) Nominal GDP growth in 2017: Sri Lanka, 8.1%; Uva Province, 12.4%; Northern Province, 9.5%; Eastern Province, 8.9%; North Western Province, 8.5%; Sabaragamuwa Province, 8.2%; Southern Province, 7.6%; Western Province, 7.6%; Central Province, 7.5%; North Central Province, 6.7%. Real growth rates are not available for provinces.

\(^12\) Based on the latest available data on World Bank. *World Development Indicators* (accessed 28 October 2018): India 50.3% (2013), Indonesia 31.4% (2016), Malaysia 52.7% (2016), Philippines 45.4% (2014), and Thailand 35.3% (2015).
public financial management, and reduce public debt relative to GDP.\textsuperscript{13} These reforms should help provide a generally supportive environment for MSE lending over the project period. The risks to be monitored include monetary conditions,\textsuperscript{14} weaker than expected budget revenues because of implementation delays in fiscal reform, volatile food prices, a weaker performance of nonfinancial state-owned enterprises, and the reacceleration of credit growth in real estate. Sri Lanka also remains prone to weather-related natural disasters that can affect macroeconomic stability.

10. The domestic finance sector has benefited from the better macroeconomic environment, and structural reforms have been strengthening its competitiveness. Important reforms include registering movable collateral at the Credit Information Bureau of Sri Lanka since 2010, tripling the coverage of the deposit insurance to the SLR600,000 (about $3,300) scheme in several steps since 2014, launching the first phase of the Basel III capital standards in July 2017, and establishing a new Resolution and Enforcement Department in the central banks in January 2018. Banks, which account for two-thirds of finance sector assets, are increasingly diversifying their industry and regional profile in competition with each other. Credit has grown quickly since 2016 but the Sri Lanka’s bank credit to private sector to GDP ratio is within a reasonable range as compared with other emerging economies,\textsuperscript{15} and financial soundness indicators remain healthy for the banking sector. The nonbank finance sector is more problematic, with 10 out of 52 institutions being either in negative equity or showing other financial strains.\textsuperscript{16}

C. Economic Impact

11. An economic analysis of individual subprojects under the proposed project cannot be carried out in advance because they are small (the maximum subloan is SLRs50 million) and other details, such as sector and tenor, are not available in advance. However, RDB has agreed to assess the viability of subprojects during project implementation. The project’s expected outputs also allow for some general conclusions about the economic benefits that RDB, MSEs, and the finance sector will accrue.

12. Economic impact on the Regional Development Bank. The proposed project will allow RDB to comply with the revised Basel III capital requirements that started on 1 January 2019. Because the proposed subordinated loan is less costly than other forms of capital, it will help RDB to meet capital requirements without exasperating expenses. The loan maturity of 12.75 years and its option to fix the interest rate will allow RDB to extend its subloan maturities without increasing maturity mismatches or interest rate risks. Longer loan maturities will reduce RDB’s operational costs, which are typically higher for short-term loans. The subordinated loan can also be leveraged: besides the $50 million of subprojects the ADB loan will fund, the loan will also help RDB meet

\textsuperscript{13} In June 2016, the International Monetary Fund (IMF) approved a 3-year, $1.5 billion Extended Fund Facility. In June 2018, the IMF completed the fourth review and approved the disbursement of the fifth tranche of $252 million. As of October 2018, $1.014 billion of the program had been disbursed. International Monetary Fund (IMF). 2018. Sri Lanka: 2018 Article IV Consultation and the Fourth Review under the Extended Arrangement under the Extended Fund Facility—Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka. \textit{IMF Country Report No. 18/175}. Washington, D.C.

\textsuperscript{14} Although the Central Bank of Sri Lanka reduced the policy rate in April 2018, there are still monetary conditions and they are expected to remain tight because of the United States monetary contraction and the resulting pressure on Sri Lanka’s current account.

\textsuperscript{15} Based on the latest available data on World Bank. World Development Indicators (accessed 28 October 2018): Sri Lanka 45.6% (2016), India 49.5% (2016), Indonesia 32.4% (2017), Malaysia 123.9% (2017), Philippines 47.8% (2017), and Thailand 111.6% (2017).

capital requirements for additional $320 million of lending. Additional lending should help RDB expand its outreach to new clients, which should diversify RDB’s loan portfolio and improve net interest margins. However, without the ADB loan, RDB would have to shrink its loan portfolio to comply with enhanced capital requirements. This would be in line with global concerns that the impact of Basel III can be negative for SME lending.\textsuperscript{17}

13. **Economic impact on borrowers.** Banks and, consequently, MSEs have little access to long tenors and fixed interest rates. The proposed subordinated loan will make such financing available to RDB, which will in turn help MSEs to undertake capital investments that have longer payback periods. The onlending requirements of the loan, which state at least 500 subloans must go to women-led MSEs and all subloans outside Colombo must go to MSEs, will also have direct poverty reduction impacts, especially outside Colombo, and boost regional economic growth. Poverty affects 6.7% of households outside Colombo and only 1.4% in Colombo (Table 3).

14. With 5.7 years as the estimated duration of an MSE loan, banks can reuse the funds 2.2 times on average during the 12.75-year borrowing period. Therefore, ADB’s subordinated loan of $50.0 million is expected to catalyze $150.3 million of MSE subprojects,\textsuperscript{18} which will generate 2,384 subprojects,\textsuperscript{19} and create new employment for about 7,048 people.\textsuperscript{20}

15. The impact on borrowers will likely be larger than the loan size of $50.0 million because the ADB loan will help RDB meet capital requirements for additional $533 million of lending, which can be financed by additional deposit taking. With an assumed average deposit tenor of 1 year and an average loan maturity of 2 years, this would catalyze an additional $217.3 million of loans, 3,072 projects, and 10,189 jobs.

16. **Economic implication of Basel III compliance on the banking sector.** The project will also support RDB’s compliance with the Basel III requirements, which is important for the broader stability of the Sri Lankan banking sector. The implementation of Basel III in Sri Lanka, which started on a staggered basis in July 2017, will address several of the issues related to banking stability because it requires banks to hold additional capital against their risk-weighted assets. It will be important for the Central Bank of Sri Lanka, the banking regulator, to ensure all banks continue to meet the implementation targets set forth so they are up to the new standards by 2019. The regulator can also improve its capacity to evaluate banks’ internal capital adequacy assessment processes and set specific minimum capital adequacy ratios for bank and finance companies in compliance with the principles of Basel III. The inability of a major lending institution to comply with enhanced capital requirements could seriously undermine confidence in the regulator and the banking sector.


\textsuperscript{18} Under ADB’s SME credit line, the subproject tenor of RDB for MSE loans had a weighted average of 5.76 years ($50.0 million ADB funding + 17.9 million estimated average MSE equity contribution) x (12.75 years) / (5.76-year estimated average loan duration) = $150.3 million.

\textsuperscript{19} Based on SME credit line data, RDB’s average subloan size for MSE loans was SLRs8.426 million (equivalent to $46,144) ($50 million ADB funding x 2.2 turnover ratio / $46,144) = 2,384.

\textsuperscript{20} Based on SME credit line data, the average loan duration of employees of RDB borrowers was 33.2, and the average total project cost to annual turnover was around 10%. Assuming the average asset turnover ratio of MSEs is 1 and the number of employees will increase in proportion to asset size, each subproject increases employment by 20% (33.2 employees x 20% x 2125 subprojects = 7048 employees).