SECTOR ASSESSMENT (SUMMARY): MICRO, SMALL, AND MEDIUM-SIZED ENTERPRISES FINANCING

Sector Road Map

A. Sector Performance, Problems, and Opportunities

1. For Sri Lanka to transition to a middle-income economy, it is vital for micro, small, and medium-sized enterprises (MSMEs), which are estimated to account for 52% of gross domestic product, to grow so they can provide more employment, bridge regional growth disparities, and ensure economic growth is inclusive. Although MSMEs have been recognized as an integral component of Sri Lanka’s economic and social fabric, a myriad of constraints, particularly limited access to finance, impede their ability to grow.

2. Banks and state ownership dominate Sri Lanka’s financial system. The absence of a competitive, diversified, and well-regulated financial market limits access to finance for MSMEs and their economic opportunities. Studies have revealed that MSMEs face difficulties accessing credit in Sri Lanka because of (i) MSMEs’ poor financial literacy, lack of market knowledge, and lack of transparency; (ii) the risk-averse banking culture, heavy reliance on collateral, lack of understanding of genuine MSME-oriented banking practices, and limited financial innovation; and (iii) insufficient mechanisms to improve information asymmetries in MSME banking.¹

1. Micro, Small, and Medium-Sized Enterprises

3. The gap analysis carried out as part of Asian Development Bank (ADB) technical assistance (TA) for small and medium-sized enterprises (SME) cluster development confirmed that most MSMEs have limited capacity to develop bankable projects even in relatively competitive export-oriented clusters such as food and information and communication technology.² MSMEs do not have sufficient business skills, such as marketing, production, operations management, financial planning and management, and entrepreneurship. They also do not have strong enough value chain links to give them access to market information, such as about clients’ needs or required products and service quality. Furthermore, most MSMEs do not know how to effectively communicate their business ideas to banks. Although several development partners have provided business development training directly to MSMEs, micro and small enterprises, especially those in rural areas and those led by women, really need capacity development.³

² ADB. 2016. Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project. Attached Technical Assistance (accessible from the list of linked documents in Appendix 2). Manila.
³ Development Coordination (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).
2. Financial Institutions

a. Banks

4. The banking sector continues to dominate the finance sector, accounting for 60% of total finance sector assets. The government has significant control over the banking system, with two state-owned commercial banks accounting for 35% of the system's total assets. At the end of 2017, the banking system consisted of 32 licensed banks—25 licensed commercial banks (including 12 branches of foreign banks) and 7 licensed specialized banks. The asset base of the banking industry expanded by SLR1.2 billion (or 13.8%) to SLR10.3 trillion in 2017. This increase was mainly because of an increase in lending of SLR890 billion, which was funded by a 17.5% growth in deposits. Despite the growth in business, the banking industry continued to manage its risks prudently by maintaining a comfortable level of liquidity and capital and ensuring credit quality. The gross nonperforming loan ratio was stable at about 2.5% during 2017. Profitability has been relatively low but stable with a return on assets of 1.3%–1.4% and interest margins of 3.5%–3.6% during 2013–2017.

5. However, the external environment may negatively affect the banking sector in the short term. Sri Lanka started implementing higher regulatory capital ratios, effective 1 January 2019, and many banks have raised or must raise capital to avoid a reduction in loan growth. In fact, each of the two systemically important state institutions, the Bank of Ceylon and the People's Bank, received SLRs5 billion ($30.8 million) capital increases at the end of 2017. Furthermore, distressed assets will require more provisions because Sri Lanka started to implement Sri Lanka Financial Reporting Standard 9 on financial instruments in 2018. In the long term, this accounting standard will increase banks' resiliency, but in the short term many banks will need to record higher provisions. The macroeconomic environment remains fragile because of a marginal fiscal position, large upcoming payments on foreign debt, limited currency reserves, and rising oil prices. The Central Bank of Sri Lanka (CBSL) has been tightening its monetary policy since 2016 to contain the possible buildup of demand-driven inflationary pressures in line with guidance from the International Monetary Fund. Under these circumstances, bank lending tends to become more conservative. For example, money supply growth and private sector credit decelerated to 14.7% year-on-year by December 2017 from with 21.9% in December 2016.

6. Micro, small, and medium-sized enterprise banking. Most banks regard MSME loans as a strategic priority in the medium and long term to avoid a price competition for the prime customer segment. Banks have been expanding their network and accessibility. In 2017, 43 new banking outlets opened, increasing the number of bank branches to 6,227. However, most banks are still risk averse in their lending and strongly conscious of their collateral. Inadequate collateral, a lack of understanding of genuine MSME-oriented banking practices, and limited financial innovation in factoring are serious issues for lending in Sri Lanka's MSME sector. The Regional Development Bank (RDB) is one of the few banks with an extensive branch network covering the entire island, whose mandate is to improve living standards by providing accessible and affordable financial services to micro and small segments in rural areas. The RDB's service delivery which is especially designed to cater to micro and small enterprises, such as frequent follow-up of customers by officers, makes RDB stand out among other banks.

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5 Regional Development Bank is a licensed specialized bank owned by the government.
6 Financial Analysis (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).
7 The Central Bank of Sri Lanka recognizes six licensed banks as systemically important. The other four are privately owned.
b. Nonbank Financial Institutions

7. Nonbank financial institutions (NBFIs) include 45 licensed finance companies (LFCs) and 6 specialized leasing companies (SLCs) with a combined network of 1,362 branches. The NBFI segment represents only 7.3% of the finance sector assets. In the past few years, the NBFI segment has experienced robust growth in total assets and time deposits with the asset quality being manageable and profitability being sufficiently high. The return on assets was 3.2% with an interest margin of 7.7% during 2017. However, some LFCs were distressed, and the CBSL enforced a resolution plan to improve their financial position. Since their funding structures entail significant refinancing risk, NBFIs need to improve their financial risk management to sustain their MSME lending.

8. NBFIs play a secondary role in MSME lending. First, their loan products correspond to the demands of many MSMEs, such as for finance leases, hire purchases, revolving loans, secured term loans, factoring, and microfinance. Second, LFCs and SLCs, along with microfinance institutions, often serve as the entry point into formal finance and provide MSMEs with an opportunity to develop credit history and financial acumen. However, the capacity of NBFIs and microfinance institutions to provide long-term financing for MSMEs for business expansion is limited because of their funding structure and the absence of sound government regulations.

3. Market Infrastructure

9. The market infrastructure for SME banking has made some progress in the following areas.

(i) **Credit information systems.** The Credit Information Bureau of Sri Lanka (CRIB) issues reports containing credit information to over 90 member institutions (including all licensed banks, LFCs, and SLCs) and the public through its credit information management system. Member institutions are required to submit transaction data on their borrowers to the CRIB every month. The CRIB plans to upgrade its information management system to meet future demand (e.g., by including credit data from microfinance institutions).

(ii) **Collateral and bankruptcy law.** The CRIB established an electronic searchable collateral registry and issued operational regulations. The system enables lenders to use movable property as collateral. Statutory changes are needed to make the system more effective. A new Secured Transactions Act is being prepared with the support from the World Bank.

(iii) **Property registration.** In 2012, the government strengthened property rights by introducing an electronic system at the land registry in Colombo, which made registration of property faster.

(iv) **Insolvency resolution.** Creditors generally have strong participatory rights during bankruptcy, and creditors that extend new credit after the commencement of bankruptcy can be given a senior status to other creditors.

10. MSMEs’ access to finance could be further enhanced by (i) encouraging financial institutions to utilize the collateral registry for movable assets, (ii) establishing a credit guarantee institution to promote non-collateralized lending to SMEs, and (iii) developing a credit risk

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8 The CRIB was established in 1990 in the form of a public–private partnership, whereby the CBSL holds the majority of equity while commercial banks and other lending institutions hold the rest.
database that would be shared with banks to refine their internal risk rating models for mainstreaming risk-based pricing.\(^9\)

**B. Government’s Sector Strategy**

11. The government has been taking a holistic approach to creating an MSME development ecosystem. The government adopted the National Policy Framework for SME Development in early 2017.\(^{10}\) Recently, the government implemented several fiscal incentives to promote MSME sector development, such as cutting the profit tax on MSMEs to 10% (2011 budget) and reducing electricity tariffs for MSMEs by 25% (2015 budget).

12. The government has also made efforts to improve MSME access to finance with several financial schemes, such as grants, interest subsidies, refinancing, and credit guarantees. The Ministry of Finance and Economic Affairs (MOF) and CBSL implemented most of the financing schemes. The government also established a special SME board on the Colombo Stock Exchange in July 2018. The MOF initiated eight concessionary interest subsidy schemes in March 2017. The 2018 budget also introduced a credit program to support enterprise development, particularly MSMEs, where 16 existing and proposed credit schemes were collectively named Enterprise Sri Lanka. These include 11 interest subsidy loan schemes, 3 donor funded refinancing loan schemes, and 2 financial and nonfinancial support programs. The technical assistance attached to this project will evaluate the effectiveness of these government finance schemes.\(^{11}\)

**C. ADB Sector Experience and Assistance**

13. ADB has engaged with the MSME finance sector in Sri Lanka since 1981. Since 2016, ADB originated four projects to provide comprehensive support for MSMEs—two SME credit lines for $100 million (original) and $75 million (additional financing) and two TA grants. The original credit line exceeded its inclusive lending targets, which focus on previously unbanked MSMEs, women-led MSMEs, and MSMEs located outside Colombo, and was fully disbursed ahead of schedule in early 2018. One of the TA projects (i) provides capacity building for export-oriented MSME clusters to connect them with global value chains, and (ii) supports the establishment of a MSME credit guarantee institution. The other TA researched how to improve MSMEs’ access to venture capital. ADB’s support to RDB builds on and draws lessons from the previous and ongoing ADB projects.\(^{12}\)

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\(^9\) This will be the focus of another ADB project programmed for 2019.


\(^{11}\) Technical Assistance Report (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).

\(^{12}\) Summary of Asian Development Bank’s Support for Small and Medium-Sized Enterprise Finance Sector in Sri Lanka (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).
PROBLEM TREE

Effect

Core Problems

Causes

Demand-Side Issues

Few SME projects are commercially viable

Limited participation of SMEs in commercial value chain

Limited business development service

Inability of SMEs, particularly women-led SMEs, to meet requirements of FIs

SMEs assets do not easily qualify as collateral

Low financial literacy and lack of financial records

Supply-Side Issues

Limited capacity of FIs in lending to SMEs

Few FIs strategically focus on medium-sized enterprises

FIs have financial and operational constraints

Limited capital

Lower earnings due to inefficient operations and risk management

Limited noncollateral-based financing for SMEs

Limited expertise of FIs in cash-flow based lending

Lack of efficient credit guarantee scheme

Legend:

Within proposed project scope

Within ongoing projects scope

FIs = financial institutions (bank and nonfinancial institutions), SMEs = small and medium-sized enterprises.