



Completion Report

Project Number: 34320
Loan Numbers: 2040 / 2041 / 2042
May 2012

Sri Lanka: Rural Finance Sector Development Program

Asian Development Bank

CURRENCY EQUIVALENTS

Currency Unit – Sri Lanka rupees (SLRe/SLRs)

		At Appraisal	At Project Completion
		31 July 2003	7 May 2012
SLRe1.00	=	\$0.023	\$0.008
\$1.00	=	SLRs95.66	SLRs127.41

ABBREVIATIONS

ADB	–	Asian Development Bank
CBS	–	Centre for Banking Studies
CBSL	–	Central Bank of Sri Lanka
CRB	–	cooperative rural banks
EA	–	executing agency
IA	–	implementing agency
IT-MIS	–	information technology-management information system
MFI	–	microfinance institution
MIS	–	management information system
MOC	–	Ministry of Cooperatives
MOFP	–	Ministry of Finance and Planning
MPC	–	multipurpose cooperatives
MPDI	–	Ministry of Policy Development and Implementation
MRE	–	Ministry of Rural Economy
NGO	–	non-government organization
NDTF	–	National Development Trust Fund
PIU	–	Program Implementation Unit
PPTA	–	project preparatory technical assistance
RERF	–	Rural Economic Resuscitation Fund
RFSDP	–	Rural Financial Sector Development Program
RFI	–	rural financial institutions
RDB	–	rural development banks
SBS	–	Samurdhi Banking Society
SLRM	–	Sri Lanka Resident Mission

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BASIC DATA

A. Loan Identification

1.	Country	Sri Lanka
2.	Loan Numbers	2040, 2041, 2042
3.	Project (Program) Title	Rural Finance Sector Development Program and Project
4.	Borrower	Democratic Socialist Republic of Sri Lanka
5.	Executing Agency	Ministry of Finance and Planning
6.	Amount of Loan	
	2040-SRI	US\$50,000,000
	2041-SRI	US\$10,000,000
	2042-SRI	SDR7,005,000
7.	Project (Program) Completion Report Number	1320

B. Loan Data

1.	Appraisal	
	– Date Started	8 July 2003
	– Date Completed	31 July 2003
2.	Loan Negotiations	
	– Date Started	13 October 2003
	– Date Completed	15 October 2003
3.	Date of Board Approval	11 December 2003
4.	Date of Loan Agreement	21 January 2004
5.	Date of Loan Effectiveness	
	– In Loan Agreement	21 April 2004
	– Actual	12 May 2004
	– Number of Extensions	1
6.	Closing Date	
	– In Loan Agreement	30 June 2008
	– Actual	
	2040	30 June 2008
	2041	30 January 2009
	2042	14 February 2012
	– Number of Extensions	0
7.	Terms of Loan	
	2040	
	– Interest Rate	LIBOR and 0.60%
	– Maturity (number of years)	15.0 years
	– Grace Period (number of years)	3.0 years
	2041	
	– Interest Rate	LIBOR and 0.60%
	– Maturity (number of years)	25.0 years
	– Grace Period (number of years)	5.0 years
	2042	
	– Interest Rate	1.0% per annum during the grace period and 1.5% per annum thereafter
	– Maturity (number of years)	32.0 years
	– Grace Period (number of years)	8.0 years

8. Disbursements

a. Dates

2040

Initial Disbursement	Final Disbursement	Time Interval
21 May 2004	27 Feb 2006	1 yr, 9 mos.
Effective Date	Original Closing Date	Time Interval
12 May 2004	30 June 2008	4 yrs, 1 mo.

2041

Initial Disbursement	Final Disbursement	Time Interval
12 May 2004	30 Jan 2009	4 yrs, 8 mos.
Effective Date	Original Closing Date	Time Interval
12 May 2004	30 Jun 2008	4 yrs, 1 mo.

2042

Initial Disbursement	Final Disbursement	Time Interval
6 Aug 2004	9 October 2008	4 yrs, 2 mos.
Effective Date	Original Closing Date	Time Interval
12 May 2004	30 Jun 2008	4 yrs, 1 mo.

b. Amount

2040

US\$35,250,000
(US\$ equivalent)

Category No. (1)	Category or Subloan (2)	Original Allocation (3)	Partial Cancellations (4 = 3 - 5)	Last Revised Allocation (5)	Amount Disbursed (6)	Undisbursed Balance ¹ (7 = 5 - 6)
01	RFSP Program	49,750,000	14,750,000	35,000,000	35,000,000	0
02	Front End Fee	250,000	0	250,000	250,000	0
Total (loan currency)		50,000,000	14,750,000	35,250,000	35,250,000	0
Total US\$ Equivalent		50,000,000	14,750,000	35,250,000	35,250,000	0
		a	b	c	d	e

¹ For final cancellation.

a = US\$ equivalent per RRP

b = US\$ equivalent as of date of approval of cancellation

c = Total of (d + e)

d = Actual US\$ equivalent

e = US\$ equivalent as of report preparation

2041

US\$8,374,537.27
(US\$ equivalent)

Category No. (1)	Category or Subloan (2)	Original Allocation (3)	Partial Cancellations (4 = 3 - 5)	Last Revised Allocation (5)	Amount Disbursed (6)	Undisbursed Balance ¹ (7 = 5 - 6)
	No category	10,000,000	1,625,462.73	8,374,537.27	8,374,537.27	0
Total (loan currency)		10,000,000	1,625,462.73	8,374,537.27	8,374,537.27	0
Total US\$ Equivalent		10,000,000	1,625,462.73	8,374,537.27	8,374,537.27	0
		a	b	c	d	e

¹ For final cancellation.

a = US\$ equivalent per RRP

b = US\$ equivalent as of date of approval of cancellation

c = Total of (d + e)

d = Actual US\$ equivalent

e = US\$ equivalent as of report preparation

2042SDR7,005,000
(loan currency)US\$10,960,998
(US\$ equivalent)

Category No.	Category or Subloan	Original Allocation (SDR)	Partial Cancellations	Last Revised Allocation	Amount Disbursed	Undisbursed Balance ¹
(1)	(2)	(3)	(4 = 3 - 5)	(5)	(6)	(7 = 5 - 6)
01	Office Equipment	1,430,000	0	1,430,000	1,572,900	(142,900)
02	Vehicles	153,000	0	153,000	70,788	82,212
03	Training	1,585,000	0	1,585,000	230,631	1,354,369
04A	Consulting-Domestic	1,477,000	0	1,477,000	587,487	889,513
04B	Consulting-International	1,150,000	0	1,150,000	658,189	491,811
05	Proj Mgmt Supp	315,000	0	315,000	164,335	150,665
06	Interest Charge	166,000	0	166,000	41,418	124,582
07	Unallocated	729,000	0	729,000	317,324	411,676
99	Imprest Acct					
Total (loan currency)		7,005,000	0	7,005,000	3,643,072	3,361,928
Total US\$ Equivalent		10,000,000	0	10,960,998	5,576,533	5,384,465
		a	b	c	d	e

¹ For final cancellation.

a = US\$ equivalent per RRP

b = US\$ equivalent as of date of approval of cancellation

c = Total of (d + e)

d = Actual US\$ equivalent

e = US\$ equivalent as of report preparation

9. Local Costs (Financed)

LOCAL COST FINANCING MAX AMT : SDR 5,157,000.00

US\$ 8,131,667.49

– Amount (US Dollars) \$4,858,279

– Percent of Local Costs 59%

– Percent of Total Cost 87%

C. Project (Program) Data

1. Project (Program) Schedule

Item	Appraisal Estimate	Actual
Date of Contract with Consultants – Uniquet ^a		5 Jan 2005
Date of Award		15 Jul 2005
Completion of Work		7 Aug 2008
First Procurement		28 Nov 2006
Last Procurement		8 Dec 2009

^a A consortium of consultancy firms headed by UniQuest, with the Foundation for Economic Cooperation (FDC) and EML Consultants (Pvt) Ltd, Sri Lanka.

2. Project (Program) Performance Report Ratings

2040

Implementation Period	Ratings	
	Development Implementation Objectives	Progress
(i) From Jan 2004 to Oct 2006	S	S
(ii) From Nov 2006 to Sep 2008	PS	S
(iii) From Nov 2008 to Dec 2008	PS	PS

2041

Implementation Period	Ratings	
	Development Implementation Objectives	Progress
(i) From Jan 2004 to Nov 2006	S	S
(ii) From Dec 2006 to Nov 2007	PS	S
(iii) From Dec 2007 to Jan 2009	S	S

2042

Implementation Period	Ratings	
	Development Implementation Objectives	Progress
(i) From Jan 2004 to Oct 2006	S	S
(ii) From Nov 2006 to Sep 2007	PS	S
(iii) From Oct 2007 to Dec 2010	S	S

D. Data on Asian Development Bank Missions

Name of Mission	Date	No. of Persons	No. of Person-days	Specialization of Members^a
Loan Fact-Finding	16 Mar–11 Apr 2003	3	46	a, d, e
Appraisal	8–31 July 2003	4	96	a, c, d
Inception	5–9 July 2004	2	10	a
Review 1	4–11 April 2005	1	8	a
Review 2	16-27 June 2005	2	18	a
Review 3 (Special Program Administration)	27 October – 1 November 2005	1	6	a
Review 4	22–27 May 2006	2	12	a, d
Review 5	18 November – 3 December 2006	2	32	a, h
Review 6	17 June – 1 July 2007	1	15	a
Project Completion Report ^b	16–19 August 2011	2	8	d, h

^a a-rural/microfinance specialist, b-financial analyst, c-counsel, d-financial economist, e-procurement or consultant specialist, f-control officer, g-program officer, and h-analyst.

^b The PCR was prepared by Sona Shrestha, Senior Economist, SARD and Maria Lualhati Rueda, Associate Project Analyst, SAPF.

I. PROJECT DESCRIPTION

1. The objective of the Rural Financial Sector Development Program (RFSDP, or the Program) was to help establish a sustainable rural finance system through policy reforms and institutional strengthening. The RFSDP comprised a program loan and two project loans with complementary objectives. The design and monitoring framework is in Appendix 1.

2. The program loan, in the amount of \$50,000,000 from ADB's Ordinary Capital Resources aimed to support key policy and institutional reforms in the rural finance sector. The policy matrix is in Appendix 2. It included the following components:

- (i) **Conducive Policy, Legal, and Regulatory Framework.** The objective of this component was to introduce reforms aimed at developing an effective policy, legal and supervisory framework, and improving sector efficiency by curtailing the government's involvement in the provision of rural finance;
- (ii) **Institutional Reforms for Sustainability.** This component was aimed at institutional strengthening of key rural financial institutions (RFIs) through improved corporate planning, accounting and auditing practices, and financial restructuring;
- (iii) **Strengthening the Demand Side.** This component aimed to strengthen the demand-side through the Rural Economy Resuscitation Fund established to lead community initiatives such as farmers' information centers, small-scale irrigation, and marketing skills development; and
- (iv) **Expansion of Rural Finance in Conflict-Affected Areas in the Northern and Eastern Regions.** This component aimed to establish sustainable mechanisms for access to finance in conflict-affected areas of the North and Eastern regions.

3. The first project loan (Project 1) in the amount of \$10,000,000 from Ordinary Capital Resources provided a credit line for micro and small rural enterprises loans through RFIs that meet pre-specified eligibility criteria related to branch networks, performance ratios and management quality. To ensure appropriate targeting, the size of the sub-loans were limited to SLRs100,000 (approximately \$1,000 at Program approval). Ten percent of the credit line was allocated for the conflict-afflicted areas and 75 percent for rural entrepreneurs.

4. Asian Development Bank (ADB) approved a major change in implementation arrangement of Project 1 in February 2005, to help respond to the devastating effects of the tsunami that hit Sri Lanka in December 2004. Specifically, following the detailed needs assessment conducted in the immediate aftermath of the tsunami, \$7 million out of the \$10 million credit line under Project 1 was reallocated for emergency credit to help rehabilitation and reconstruction of livelihoods of affected households.

5. The objective of the second project loan (Project 2) in the amount of Special Drawing Rights (SDR) 7,005,000 from Special Funds resources was to strengthen institutional capacity of key RFIs, such as the rural development banks (RDBs), cooperative rural banks (CRBs), the National Development Trust Fund (NDTF),¹ and the Samurdhi Banking Society (SBS).² Another important objective of this Project was to support the establishment of a Rural Development Sector Development Authority—which would serve as the policy, regulatory and supervisory

¹ NDTF was established in 1992 under the World Bank's Poverty Alleviation Program, and until its recent merger with Sri Lanka Savings Bank, remained as an apex agency for micro-finance refinancing activities. NDTF was the primary lender to the microfinance NGOs.

² SBS is part of the Government's main poverty reduction program that provides subsidized credit through state-owned commercial banks.

agency for the rural finance sector). Project 2 also aimed to help strengthen the Centre for Banking Studies (CBS) under the Central Bank of Sri Lanka (CBSL) as “center for excellence”.

II. EVALUATION OF DESIGN AND IMPLEMENTATION

A. Relevance of Design and Formulation

6. Sri Lanka is primarily a rural economy with almost 80% of the population living in rural areas. Poverty is overwhelmingly a rural phenomenon, with close to 90% of the poor living in rural areas at the time of Program design. The Program, which aimed at promoting a more vibrant rural economy through a robust rural financial sector was therefore relevant, and in line with the Government’s development objectives.

7. Rural finance in Sri Lanka faced numerous challenges. A history of ad hoc public sector interventions had resulted in a proliferation of RFIs created as part of development partner projects, or by various government ministries and departments to channel credit to different groups of the population. The government’s role in the provision of rural finance, either through ownership or interference, was significant. Practices that deviated from best practices, including subsidized interest rates, had destroyed credit discipline and crowded out the private sector. In the absence of adequate regulation and oversight, many RFIs suffered from weak governance, high transactions costs, low repayment rates and recurring losses.

8. The Program objective of addressing key constraints to sector development—through policy reforms, credit line, and institutional strengthening—was appropriate in Sri Lanka’s development context. Guided by a program preparatory technical assistance (PPTA) that supported stakeholder consultations and a comprehensive sector assessment, Program design was also technically sound.³ However, the Program proved to be too complex given weak implementation capacities of the executing agency (EA) and the implementing agencies (IAs). Likewise, the Program outcomes were too ambitious in view of the uncertain political climate during implementation. Specifically, the Government that came into power in April 2004,⁴ soon after Program approval, reversed policy direction in areas that were at the core of the Program, namely the establishment of regulations and an oversight authority for the rural finance sector, and reducing government’s involvement in the sector through restructuring and privatization of key RFIs.

B. Key Outputs

9. As outlined above, the program loan supported key policy, legal and regulatory reforms to strengthen the rural finance sector. Due to non-compliance with the several of the tranche release conditions, the Government and ADB agreed to cancel the third (\$10 million) and fourth (\$5 million) tranches, leading to a partial cancellation of the program loan in June 2008. While certain outputs were achieved as part of the first and second tranche conditions, they were largely preparatory measures and intermediate steps to be subsequently implemented through the third and fourth tranches. Consequently, the Program outcome—sustainable rural finance system through policy, legal, regulatory, and institutional reforms—was not realized. The first project loan provided a credit line for on-lending to micro-small and rural enterprises. The second project loan was designed primarily as implementation support to the program loan and

³ Program preparation was supported by ADB. 2001. *Technical Assistance to Sri Lanka for Preparing the Rural Finance Sector Development Program*. Manila (TA-3707).

⁴ The opposition party, People’s Freedom Alliance defeated the ruling party, United National Party during the parliamentary election of April 2004.

related institutional strengthening, including through information technology-management information system (IT-MIS). As the program loan and the two project loans supported the same key objectives, the outputs for the three loans are presented jointly below.

Output 1. Conducive Policies, Legal and Regulatory Framework

10. Under the program loan, the Government established a high level forum to sensitize policy makers to good governance and best practices in rural finance. The forum initially provided a useful venue for the formulation of sector development strategy and policies.

11. One of the primary objectives of the program loan was to develop the legal and regulatory framework RFI. Accordingly, the Program proposed a Rural Finance Sector Development Act intended to cover regulation and supervision of RFIs. Likewise, the Program also proposed a separate regulatory body for non-bank rural financial institutions not under CBSL's purview, including CRBs, SBSs, microfinance institutions (MFIs) and microfinance nongovernment organizations (NGOs).⁵

12. A draft Rural Finance Sector Development Act was developed as part of the first tranche condition. However, it was not enacted as required for the second tranche condition. Instead, as requested by the Government in March 2005, ADB amended four related second tranche conditions such that an interim RFI supervisory unit would be established in the Non-bank Financial Institution Supervision Department of CBSL.⁶ It was agreed that CBSL would transfer, after a period agreed with Ministry of Finance and Planning (MOFP), the related expertise and staff members to the new rural finance regulatory agency. However, there has been no progress on this front since. The draft Micro-Finance Act, which is based on the RFSD Act supported by the Program, had not been adopted as of end-April 2012.

Output 2. Institutional Reforms for Sustainability

13. The RFSDP supported institutional strengthening of key RFIs including CRBs, RDBs, NDTF, and SBS, jointly accounted for nearly 65% of the microfinance market. The institutional reforms were aimed at promoting operational and financial sustainability through efficient operations, client-oriented products and services, and good governance practices.

14. **Cooperative Rural Bank Reforms.** CRBs are member-owned institutions that are part of multipurpose cooperatives (MPC). While CRBs could potentially play a key role in rural finance owing to their nationwide network, their performance is hindered by weak governance of parent MPCs. Specifically, politically motivated investments and poor portfolio management by MPCs had exposed member savings (mostly low income households) to significant losses. To address this, the Program sought to introduce measures to separate CRBs from MPCs, such the CRBs would become a distinct legal and financial entities with separate balance sheets.

15. As part of the implementation support, Project 2 conducted financial audits for 100 CRBs and developed corporate plan for 50 CRBs. However, there was limited progress in their implementation in large part due to disagreement between MOFP and Ministry of Cooperatives on the proposed delinking of the CRBs from MPCs. Project 2 also supported the procurement of management information system (MIS) hardware and software for a total of 210 rural branches of 48 MPCs.

⁵ Semi-formal institutions established or registered under various legislations but not subject to prudential supervision

⁶ ADB. 2006. *Progress Report on Tranche Release for the Rural Finance Sector Development Project*. Manila.

16. **Regional Development Bank Reforms.** The six RDBs were established in 1997 through the consolidation of district-based rural development banks. The state-owned RDBs were an important player in rural finance, with a combined market share of about 18 percent, and a broad customer in agriculture, livestock, small industries, and trade. However, having inherited a poor portfolio from the district-wise rural development banks, and owing to continued poor credit risk management, the RDBs had significant amounts of non-performing loans, ranging from 16% to 33% of total assets. RFSDP was to support restructuring and privatization of the RDBs to help enhance their financial sustainability and outreach. As a first step, and acknowledging the conflict of interest between its role as the majority shareholder and regulator of RDBs, CBSL reduced its shareholding in each of the six RDB from 80 percent to 20 percent, with the equity transferred to MOFP for divestment. The subsequent restructuring and privatization was not implemented, with the new Government clearly reiterating to ADB its “no privatization” policy.

17. With support from Project 2, the Government subsequently merged the 6 RDBs with the objective of boosting capital position, reducing administrative costs, and improving governance and transparency through consolidated balance sheet. It could be argued that the RDBs under a single structure are in a better position to pursue corporatization or privatization in the future, should the government choose to do so. However, this result falls short of that originally envisaged under this subcomponent.

18. **National Development Trust Fund Reforms.** NDTF was established in 1992 as an apex agency to provide technical and refinancing assistance primarily for microfinance NGOs. The reforms and capacity building under RFSDP aimed to transform NDTF into an effective apex agency through which micro-finance NGOs outreach would be expanded. As part of the first tranche conditions, NDTF was incorporated as a company, following which it appointed an independent board, and strengthened internal controls. Project 2 helped develop a corporate plan aimed at improving organizational structure, human resource management, and performance criteria for NDTF's partner organizations. The implementation of the plan was only partially implemented under the Program. In 2010—after the Program implementation period—the Government approved the merger of NDTF with Sri Lanka Savings Bank primarily as a measure to help the latter meet the CBSL's minimum capital adequacy requirements. The merger was conditional upon maintaining NDTF's original focus on rural finance. Accordingly Sri Lanka Savings Bank, had hitherto focused on urban borrowers in the country's commercial center in the Western province, has recently developed a medium-term strategy to expand outreach to low income households in rural areas.

19. **Samurdhi Banking Societies Reforms.** Established in 1995, the Samurdhi program⁷ is the Government's main poverty reduction scheme for welfare grants and community-based rural infrastructure development. The SBSs were introduced in 1997 as part of the Samurdhi program to promote rural savings and investment. The SBS program is the largest microfinance program in Sri Lanka and covers nearly 50% of all households. With an estimated 60% excess staff and generally inefficient operations, SBS operations were inefficient and costly to the government. RFSDP aimed to strengthen SBS's institutional capacity and transform them into sustainable financial intermediaries. Prior to the Program, district-based officers undertook both social and banking activities, with the result that government funds for social development and the profit/losses from the banking operations were difficult to separate. Accordingly, under the Program, the functional areas of social development (Maha Sangam activities) and banking operations were separated.

⁷ Samurdhi means welfare in Sinhala. The Samurthi Program is operated by the Samurdhi Authority of Sri Lanka, under the Ministry of Samurthi, Agriculture, and Livestock.

20. A notable contribution of this component was the installation of MIS hardware and software in the Samurdhi Authority head office and 106 pilot SBS branches. The MIS, which continues to be used by the institutions, reduces delays in accessing data in the previous system of manual data processing, and provides easy access to important indicators for portfolio quality, operational efficiency and financial statements.

Output 3. Strengthening Demand Side

21. RFSDP supported the strengthening the Rural Economic Resuscitation Fund (in the Ministry of Rural Economy) capacity for investing in small scale community based projects including skills development, marketing network, infrastructure and extension services. As a result of RFSDP support, the Rural Economic Resuscitation Fund Secretariat at the Ministry of Small and Rural Industries was made fully functional with in-house experts in rural infrastructure, social development, and community service. At the time of Program closing, approximately, 65 community development projects—such as community wells, food processing training centers, fish products sale center and agricultural plan nurseries, small irrigation—had been initiated and several additional projects had been identified for investment.

Output 4. Expansion of RF in Conflict-Affected Areas

22. The Program helped develop a policy framework for the development of sustainable finance in the conflict-affected areas through: (i) coordination among Government and development partner projects; (ii) institutional strengthening of financial institutions in the conflict areas; and (iii) the credit line (Project 1) of \$10,000,000 for on-lending support to RFIs for loans to micro and small rural enterprises loans. The credit line was essential to meet immediate financing needs as formal sources of rural finance had dried up during the conflict. To ensure appropriate targeting, the size of the subloans were limited to SLRS100,000 (approximately \$1,000 at Program approval). Ten percent of the credit line was allocated for the conflict-afflicted areas and 75% for rural entrepreneurs. The credit line was channeled through the NDTF, which was the main wholesale lender of rural financial institutions and micro-finance NGOs at the time of project design. The onlending rate from NDTF to participating RFI was set at the average weighted deposit rate calculated periodically by CBSL. The lending rate to the final borrowers was determined by RFIs. The requirements relating to the on-lending and relending rates were included as loan covenants in the loan agreements of Project 1.

23. Implementation of this subcomponent experienced some delays owing to the security situation in conflict-affected areas. As of 31 December 2006, NDTF had disbursed approximately SLRs183 million (or about US\$1.7 million) worth of credit to 3,906 conflict affected households through 21 partner microfinance NGOs.

Output 5. Emergency Support for Tsunami Affected Households.

24. ADB Management approved a major change in implementation arrangement in February 2005 to reallocate \$7 million out of the \$10 million credit line for emergency credit for rehabilitation and reconstruction of livelihoods of Tsunami affected households. Following the approval of implementation arrangement, this component was processed and implemented as part of a larger assistance package that also supported infrastructure rehabilitation, provision of shelter, legal assistance, water supply and sanitation, community development, and coastal resource management.⁸

⁸ ADB, 2005. *Tsunami-Affected Areas Rehabilitation Project*. Manila.

25. As agreed with the Government, the interest rate on the end borrower was capped at 6 percent, and the maximum loan amount was SLRs100,000 (approximately \$1000) to ensure focus on poor households. The relending rate from NDTF to the RFIs though was 3%. Given the immense demand for such assistance in the immediate aftermath of the Tsunami, the reallocated funds were fully disbursed by 20 October 2008. More than 20,000 affected households in nine affected districts⁹ benefited from the credit line.

26. Though not part of the original design, the credit line component of the RFSDP enabled ADB to respond swiftly and effectively to assist Government efforts in the rehabilitation and reconstruction of the affected peoples' livelihoods.

Output 6. Strengthening of Centre of Banking Studies as a center of excellence

27. In addition to supporting the implementation of the Program loan policy actions, Project 2 also helped build CBS capacity, with a particular focus on rural finance training. The capacity building exercise covered linkages with international training agencies, training trainers, upgrading CBS equipment, and library. The project delivered 20 training of trainers courses and 93 trainers were certified by CBS. Several of the training courses were translated into Tamil and Sinhala. Close to 1000 participants successfully completed the training courses during project period on various aspects of rural finance, including delinquency management and interest rate setting, accounting for microfinance institutions, financial analysis, and operational risk management.

C. Project Costs

28. The total project cost was estimated at US\$70 million equivalent comprising of US\$50 million for the program loan and US\$20 million for two project loans—US\$10 million for onlending support and SDR7,005,000 (US\$10 million equivalent) for implementation support and capacity building.

29. An equivalent amount of US\$10 million under loan 2041 was provided for onlending to RFIs through NDTF. Of the \$10 million, a total of \$8,374,537.27 was disbursed of which US\$434,051.01 was used to assist those affected by the tsunami.

30. Project costs under loan 2042 are summarized in Table 1 below.

Table 1: Projects Costs (Loan 2042) Financed by ADB

Allocation and Withdrawal of Loan Proceeds			
Item	At Approval Amount Allocated	At Closure Disbursed	
Office Equipment	1,430,000	1,573,000	
Vehicles	153,000	71,000	
Training	1,585,000	231,000	
Consulting Services	2,627,000	1,246,000	
Domestic			588,000
International			658,000
Project Management Support	315,000	164,000	
Interest Charge	166,000	41,000	
Unallocated	729,000	-	
Imprest Account		317,000	
Total SDR	7,005,000	3,643,000	
US\$ Equivalent	10,000,000	5,577,000	

Source: Asian Development Bank.

⁹ Ampara, Anuradhapura, Batticoala, Jaffna, Killiochchi, Mannar, Monergala, Mullaitivu, Polonaruwa, PattulamTriconmalee, and Vavuniya.

D. Disbursements

31. Initial disbursement of \$15 million under Loan 2040 was made in May 2004 upon loan effectiveness. The second tranche in the amount of \$20 million was disbursed on 27 February 2006. The third and fourth tranches were not disbursed due to non-compliance with several of tranche release conditions.

32. An imprest account was established for NDTF under Loan 2041 in July 2004. The first advance to the account of US\$1 million was made in August 2004. The account was fully liquidated in May 2008. A total of US\$8,374,537.27 was disbursed of which around US\$6.8 million was used to those affected by the tsunami.

33. The government established the imprest account under Loan 2042 in July 2004. The first advance to the account of US\$1 million was made in August 2004. Payments for consulting services and equipment purchases were made through direct payment procedures. Though the imprest account was fully liquidated in December 2009, the loan has remained open as relevant documents for the last withdrawal application are pending. Actual annual disbursement is shown in the table below.

Table 2: Disbursement by Year

2040

(\$'000)

Item	2004	2005	2006	2007	2008	2009	2010	2011	Total
RFSP	15,000	-	20,000	-	-	-	-	-	35,000
Program									
Front End	250	-	-	-	-	-	-	-	250
Fee									
Total	15,250	-	20,000	-	-	-	-	-	35,250

2041

(\$'000)

Item	2004	2005	2006	2007	2008	2009	2010	2011	Total
Front End	50	-	-	-	-	-	-	-	50
Fee									
Capitalization	4	43	174	279	-	-	-	-	500
NDTF	1,000	2,296	973	1,842	1,714	-	-	-	7,825
Total	1,054	2,339	1,147	2,121	1,714	-	-	-	8,375

2042

(SDR'000)

Item	2004	2005	2006	2007	2008	2009	2010	2011	Total
Office Equipment	-	-	35	552	957	29	-	-	1,573
Vehicles	-	-	-	71	-	-	-	-	71
Training	-	-	13	-	-	218	-	-	231
Consulting-Domestic	-	228	31	233	96	-	-	-	588

Item	2004	2005	2006	2007	2008	2009	2010	2011	Total
Consulting- International	-	141	282	199	36	-	-	-	658
Project Management Support	-	-	50	-	-	114	-	-	164
Interest Charge	-	6	10	15	10	-	-	-	41
Unallocated	-	-	-	-	-	-	-	-	-
Imprest Account	79	-	94	144	-	-	-	-	317
Total SDR	79	375	515	1,214	1,099	361	-	-	3,643
US\$ Equivalent	116	544	763	1,870	1,757	527	-	-	5,577

E. Program Schedule

34. The original closing date for RFSDP was 30 June 2008. The actual closing date for the three loans was 30 June 2008 with no extension. However, for the program loan only two of the four tranches were released due to non-compliance to a number of tranche conditions caused by changes in government policy.

35. Loan 2041 and Loan 2042 were closed on 30 January 2009 and 14 February 2012, respectively.

F. Implementation Arrangements

36. The Ministry of Policy Development and Implementation (MPDI) was the EA, responsible for coordination with the CBSL, Ministry of Cooperatives, Ministry of Rural Economy, Ministry of Samurdhi, and MOFP. A Program Management Unit was established in MPDI, and was headed by a program director and assisted by two directors and four full time staff, recruited under Project 2. The implementation agencies included: Ministry of Rural Economy, Ministry of Cooperatives, NDTF, and Ministry of Samurdhi. Each IA established a Project Implementation Unit (PIU) headed by a program director and supported by one specialist staff. To facilitate interagency coordination, MPDI established a program steering committee, comprising heads of the PIU and a representative each from the Ministry of Finance and MPDI.

37. Following a reassignment of Ministry functions and designations in 2004, the Government appointed the MOFP as the EA. In addition, Ministry of Agricultural Marketing Development, Hindu Affairs and Minister Assisting Education and Vocational Training, Ministry of Samurdhi and Poverty Alleviation, and Ministry of Small and Rural Industries were designated as IAs in place of Ministry of Cooperatives, Ministry of Samurdhi and Ministry of Rural Economy, respectively. CBSL and NDTF continued as IAs.

G. Conditions and Covenants

38. RFSDP became effective on 12 May upon fulfillment of the first tranche conditions and conditions for loan effectiveness. The program loan agreement included standard covenants, including those related to auditing, program management, program review and evaluation, and safeguard polices. These were complied with in line with the requirements and relevant ADB

policies. The program loan also included a covenant on the use of counterpart funds from the first two tranches. Specifically, the Borrower was to utilize the counterpart funds to make grants as follows:

- (i) Tranche 1: \$3 million to the rural finance supervisory body that was to be established under the Program; \$ 5 million to RERF, and \$5 million for CRB Fund.
- (ii) Tranche 2: \$7 million for the rural finance supervisory body that was to be established under the Program; \$5 million for RERF, and \$5 CRB Fund.

39. However, the Government did not provide recapitalization support for CRBs through the CRB Fund. Therefore, this covenant was only partially met.

40. The covenants for Project 1 and Project 2 were largely met. In December 2006, ADB received information about potential misuse of loan proceeds, which would have violated related loan covenants. However, an external audit of NDTF, initiated by ADB's Office of Auditor General, cleared NDTF of breach of ADB policies. Details of conditions and covenants are presented in Appendix 3.

H. Related Technical Assistance

41. Program preparation was supported by the PPTA TA 3707: SRI-Preparing the Rural Finance Sector Development Program. The TA in the amount of \$550,000 was approved by ADB on 24 August 2001, and was physically closed in 29 December 2003. The PPTA was well designed, and was effective in facilitating policy dialogue with authorities, stakeholder consultations including a number of workshops and field visits and technical inputs from consultants.

I. Consultant Recruitment and Procurement

42. The consultant recruitment followed ADB's Guidelines on the Use of Consultants. The quality and cost-based selection method and simplified procedures were used in the engagement of firms. A consortium of consultancy firms headed by UniQuest Pty Ltd., Australia with the Foundation for Economic Cooperation and EML Consultants (Pvt) Ltd., Sri Lanka was engaged. Consulting services were responsible for: (i) building sector capacity, (ii) restructuring of rural finance institutions, (iii) developing regulatory and supervisory framework for rural finance, and (iv) project implementation support.

43. Procurement of equipment was subject to the provisions of ADB's Guidelines for Procurement. Hardware and software were purchased to provide MIS solutions to selected CRBs and SBS branches. HB Informatics supplied the hardware for CRBs and PC House to SBS branches while Softwatch Infosys supplied the software solutions to both CRBs and SBS branches.

J. Performance of Consultants, Contractors, and Suppliers

44. Consultant performance is rated *satisfactory*. There were some delays in the submission of progress reports initially, and the quality of reports was lower than expected. This was to a certain extent due to inadequate guidance and supervision of the consultants by the EA and IAs. This prompted ADB and the Government to restructure the consultant inputs by focusing on key Program outputs and reducing the number of consultants to enable better coordination and supervision. Subsequently, the quality and timeliness of consultant reports improved.

considerably. Important outputs such as the draft Rural Finance Sector Development Act and corporate plans for the RFIs are of good quality. The training provided to RFIs and the CBS were relevant, and received positive feedback from the participants. Appropriate hardware and essential software operation system software were installed in line with the requirements in the terms of reference.

K. Performance of the Borrower and the Executing Agency

45. The Borrower and EA's performance is rated *partly satisfactory*. EA's initial performance with regards to preparatory steps such as opening the imprest account, establishing the Program Management Unit and PIU was satisfactory. However, the consultant selection and procurement process was at times protracted, resulting in delays in project implementation. Likewise, significant delays were experienced in obtaining documentation for liquidation of accounts for project loan 2, despite several requests and clarifications from ADB during 2008–2011.

46. The implementation of the program loan was adversely affected as the reform process stalled relatively early during implementation. Given the wide range of reform areas and complexity of the Program more generally, the EA was not able to effectively guide the reform process and to coordinate among the many IAs. While this is in large part attributable to capacity constraints, the Program would have benefited had there been some reform champions in EA and/or IAs. Indeed, the new Government that came into power in April 2004 did not have ownership of the Program, and backtracked on some of the reform areas initiated under the previous government. Notably, reforms related to the establishment of an effective regulatory framework and the restructuring and privatization of key RFIs were not implemented, thereby undermining the Program outcomes.

L. Performance of the Asian Development Bank

47. The performance of ADB during program implementation is rated *satisfactory*. Following inception mission in July 2004, ADB fielded six review missions between April 2005 and July 2007, for a total of 91 person-days. The missions were effective in providing technical inputs, monitoring implementation progress, and addressing specific implementation issues as they arose. Processing of Government's requests—including changes to the implementation arrangements, and review and approvals related to consultant selection, procurement, and disbursement matters—were generally timely.

48. When the Review Mission fielded during November 2006 received information regarding the suspected potential misuse of loan proceeds by NDTF, ADB took the appropriate step by consulting the Office of the Auditor General, Office of the General Counsel and Controller's Department. This resulted in an external audit of NDTF, which concluded that there had been no breach of ADB policies. ADB's decision to reallocate some of the resources under the credit line to meet the urgent needs brought on by the devastating Tsunami of December 2004 was swift and appropriate. Likewise, when it became sufficiently clear that the new Government had little ownership of the Program and that that meaningful progress in the reform process was unlikely, ADB made the appropriate decision to partially cancel the Program loan. This helped concentrate EA and IA efforts as well as consultant inputs to activities related to IT-MIS installation and capacity building, which enhanced the outcomes under project loan 2.

49. ADB performance would have been enhanced through closer coordination between the project team and Sri Lanka Resident Mission (SLRM). SLRM staff provided valuable support by

facilitating communication between ADB and the Government. However, given the complexity of the Program, and capacity constraints of the EA and IAs, ADB should have made better use of SLRM on project implementation matters.

III. EVALUATION OF PERFORMANCE

A. Relevance

50. The Program is rated as *partly relevant*. The overall thrust of the Program, with its focus on rural finance development, was appropriate given that poverty in Sri Lanka is largely a rural phenomenon where 90 percent of the poor households live. Supported by a PPTA,¹⁰ and formulated through extensive stakeholder consultations, the Program was in line with the Government's longer-term development objectives of promoting growth of agriculture and rural enterprises through an efficient rural financial sector. The Program was also in line with ADB's medium term strategy for Sri Lanka, and was included in the Sri Lanka Country Strategy and Program 2002–2005.

51. However, the Program design, comprising a program loan and two project loans, and covering a wide range of complex reform areas, proved too complex vis-à-vis the implementation capacity of the EA and IAs. Further, Program objectives were too ambitious in view of the country's recent history of conflict and the more immediate reconstruction challenges being faced by the authorities, lingering security concerns, and the uncertain political environment at the time.

52. The major change in implementation arrangements approved by ADB is to reallocate project funds for emergency credit for tsunami relief, as requested by the Government of Sri Lanka, was appropriate and necessary.

B. Effectiveness and Efficiency in Achieving Outputs and Outcomes

53. The Program was *less effective* and *less efficient* achieving its outputs and outcome. As highlighted above, the Program encountered several setbacks starting relatively early in the implementation period. There were a number of contributing factors, including complexity of design, capacity constraints, and relatively weak Program ownership on the part of the Government. As a result, several of the outputs were not achieved which in turn undermined the Program outcome. Specifically, the primary objectives of improving regulatory and supervisory framework and improving sector efficiency by curtailing state ownership of RFIs, were largely unmet.

54. One of the Program's notable contributions was to enhance CBS's capacity as a credible training institution covering a wide range of financial sector issues, including those pertaining to rural finance. Starting 2007, CBS has expanded its training programs outside of Colombo into several rural areas, thereby helping fill a crucial gap. The establishment of IT-MIS in pilot CBRs and in the Samurdhi Authority was also an important contribution, which has helped improve their operations and client services. The program also helped strengthen the demand-side by supported several community initiatives such as community irrigation, fisheries, food processing etc.

¹⁰ ADB. 2000. *Technical Assistance to Sri Lanka for Preparing the Rural Finance Sector Development Program*. Manila.

55. Though not anticipated at the design phase, the credit line component of RFSDP enabled ADB to effectively and efficiently respond to the urgent need brought on by the Tsunami of December 2007. As part of ADB's emergency assistance to Sri Lanka, ADB was able to make necessary adjustments to the terms of lending¹¹ and beneficiary targeting to the already well established mechanism for the credit line component. Approximately, 10,000 householders benefited from this support. The assistance helped both the households and MFIs to rebuild their operations. Without this intervention, MFIs in affected areas would likely have ceased to operate.

56. Despite these achievements, however, the outputs and outcome of the RFSDP fell significantly short of those expected at Program approval.

C. Preliminary Assessment of Sustainability

57. Sustainability of Program outcomes is assessed to be *less likely*. As highlighted above, the Program outcome and many of its outputs were not achieved during program implementation, and little progress has been made since. The operational efficiency and financial sustainability of some RFIs including RDBs, CBSs, and SBSs have been enhanced through reform and capacity building measures supported by the Program. However, the absence of an effective regulatory and supervisory framework remains a fundamental weakness. The Government is in the process of finalizing a draft Microfinance Act—based on the draft prepared under the Program, with the expectation of submission to Parliament. Specifically, the Act will provide for the establishment of an authority for the purpose of licensing, regulation, and supervision of rural and microfinance institutions not under CBSL's purview. That the submission of the draft law has been pending for over four years, however, indicates this is not a key priority. Furthermore, in the absence of a strong political will and reform champions, less likely that the implementation will be effective and timely, even if the Act were to be adopted.

IV. OVERALL ASSESSMENT AND RECOMMENDATIONS

A. Overall Assessment

58. The development objective of RFSDP was relevant at appraisal and continues to be so in that a robust rural financial sector is essential for a vibrant rural economy, and for the country's economic growth and development more generally. Program implementation was beset by implementation difficulties, however, owing to the fact that the Program design was too complex vis-à-vis implementation capacities, and the reform agenda too ambitious relative to Government ownership and political will. The decision to extend the IAs for the program, as noted in para. 37, without concomitant ownership is likely to have increased the downside risks to effective and timely implementation. As a result, many of the Program outputs and outcomes were not achieved. Program sustainability is less likely for the reasons outlined in paras. 53 and 54.

59. The program loan component of the RFSDP was unsuccessful as many of the policy actions and therefore program outcome were not met. Project 1 was successful in that the on-lending support helped meet some of the immediate financing needs of small rural enterprises,

¹¹ While under the original credit line, participating RFIs set the lending rate to the final borrowers, the lending rate for Tsunami affected households was capped at 6%, on par with the new tsunami related credit facility introduced by CBSL.

especially in the conflict-affected regions, as well as of low-income households affected by the tsunami. Project 2, was only partly successful in achieving its objectives. While it helped strengthen capacity of key institutions, such as the CBS and several CRBs, it did not meet one of its primary objectives of supporting the establishment of the RFSDA. Based on these assessments of the three components, the RFSDP as a whole is rated as “partly successful”.¹²

B. Lessons

60. **Program complexity and timing.** Overly ambitious and complex projects are less likely to be successful. The Program objectives had a strong rationale and the design was technically sound. However, in view of the weak implementation capacity of the EA and the IAs, the Program would likely have yielded better results with a more focused and prioritized set of policy actions and project activities. Moreover, the RFSDP was approved only three months prior to the April 2004 parliamentary election. While the election outcome and subsequent policy direction could not have been fully anticipated at the time, there was sufficient uncertainty regarding continued political support to warrant reconsideration of the timing of Board consideration.

61. **Program Tranches** The program loan tranches were front-loaded, with \$35 million of the total program amount of \$50 million programmed for the first two tranches. As highlighted above, the first two tranches were largely preparatory measures and intermediate steps. Had the program been back-loaded with relatively larger amounts allocated to the third and fourth tranches, it is possible that the authorities would have been more inclined to implement some of the more difficult reform measures

62. **Timing of the PCR preparation.** Timely PCR is important for maintaining policy dialogue and assessing the need for follow-up actions and future assistance. PAI No. 6.07A recommends that the PCR be prepared between 1–2 years after project completion. In the case of RFSDP program loan, the second (and final) tranche was released in February 2006. The bulk of activities under Project 1 and Project 2 were completed in 2008. Given that considerable time has lapsed since Program implementation ended, and significant staff turnover in the EA and IAs since, the authorities were not able to contribute meaningfully to Program assessment. PCR preparation would have benefited from the insights of officials directly involved in program implementation.

C. Recommendations

1. General

63. **Program design should be focused and in line with implementation capacity.** The tendency to try to address all major constraints within one program should be avoided. The sector assessment conducted during program preparation should not only assess impediments to sector development, but also identify the most binding constraints and proper sequencing of reforms, and should carefully assess implementation capacities and political will.

64. **Program Modality.** A related recommendation is that in cases where there are considerable uncertainties related to, for example, possible political changes and continued

¹² Based on the guidelines of ADB's Independent Evaluation Department: <http://www.adb.org/Documents/Guidelines/Evaluation/PPER-PSO/default.asp>. The aggregate rating for represents a simple average of the ratings for the three loans included in the RFSDP.

commitment to reform, a cluster program modality may be considered. In a standard program loan, all the tranche conditions are pre-specified at program approval. In a cluster program modality, the binding constraints and program objectives are specified when the first subprogram is approved. However, the specific policy actions towards achieving the broad program objectives can be determined at the processing stage of each of the subsequent subprograms. Likewise, except under exceptional circumstances, PCR preparation should not be delayed beyond two years of project completion. PCR preparation can benefit greatly from insights provided by government officials and ADB staff directly involved in program design and implementation.

2. Program-Related

65. **Further action or follow-up.** As mentioned in para. 57 the Government intends to pursue the enactment of the draft Microfinance Act. The draft Act has its origins in the Program, and will play a critical role in the further development of the sector. While ADB is not currently engaged in this sector, it would nonetheless be important to follow developments in the context of policy dialogue related to the financial sector.

66. **Timing of the program performance evaluation report.** Program activities were largely completed in 2009, and there are no issues outstanding (subject to the closing of project 2 account). Preparation of the project performance evaluation report can start at any time.

PROGRAM FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Goal Reduce poverty level and facilitate economic growth in rural Sri Lanka	Reduce poverty incidence from 25% to 20% by 2005 Attain economic growth rate of 7% by 2005 Enhance outreach and sustainability of rural finance (RF) sector	<ul style="list-style-type: none"> • Economic reform program assessment • Program reports • Program reviews (semiannual, annual, and midterm) • Impact monitoring report • Project completion report (PCR) • Asian Development Bank (ADB) review mission 	Peace and absence of civil strife
Purpose Establish a sustainable RF system through policy, legal, regulatory, and institutional reforms	Develop policy framework for RF sector to decrease Government of Sri Lanka's ad hoc interventions and direct involvement in provision of RF services Develop enabling legal and regulatory framework for RF sector Enhance RF outreach and sustainability through governance reforms, mainstreaming of RF industry best practice, and diversification of products and services Increase ability of rural households to utilize RF through support for skill development and access to marketing networks	<ul style="list-style-type: none"> • Program reports • Project reviews • Audit reports • ADB review missions • PCR • Project performance audit report (PPAR) 	Government's commitment to pursue economic policy reforms that enable RF institutions (RFIs) to operate autonomously within a liberalized financial policy regime Active participation of non-government organizations (NGOs) as social service providers
Outputs (i) Conducive policies for RF development (ii) Legal framework for supervising RFIs	Policy letter and policy matrix implemented Independent and autonomous RFIs operating in a competitive Supervisory and regulatory system for RFIs instituted through enactment of Rural Finance Sector	<ul style="list-style-type: none"> • Program reports • Audit reports • ADB review missions <ul style="list-style-type: none"> • Program reports • Project reviews • ADB review missions 	Government maintains its commitment to facilitate the operations of RF markets Government's commitment to enforce the legal framework

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
	Development Act (RFSD Act) and establishment of Rural Finance Sector Development Agency (RFSDA)		
	500 RFIs audited and 200 licensed by end-2007, provided they are eligible		
(iii) Facilitating the recovery of dues from RFI defaulters	Effective debt recovery policies adopted by RFIs Effective use of debt recovery instruments by RFIs for collecting dues from willful defaulters	<ul style="list-style-type: none"> • Program reports • Program reviews • Audit reports 	Government's commitment to enforce strict repayment culture.
(iv) Cooperative Rural Bank (CRB) reforms	Financial viability of RBs improved with at least 30% of CRBs meeting and maintaining full financial self-sufficiency by end-2007 At least 100 CRBs restructured	<ul style="list-style-type: none"> • Program reports • Program reviews • Audit reports • ADB review missions 	Ministry of Cooperatives (MOC) commitment for CRB restructuring
(v) Regional Development Banks (RDB) Reforms	Financial viability of RDBs improved with at least 4 RDBs meeting full financial self-sufficiency by end-2007	<ul style="list-style-type: none"> • Program reports • Program reviews • Audit reports • ADB review missions 	RDBs' consent and commitment for restructuring
(vi) National Development Trust Fund (NDTF) Reform	Capacity and outreach of NDTF improved to transform it into an effective microfinance (MF) apex agency with 150 active MF-NGO partner organizations by end-2007	<ul style="list-style-type: none"> • Program reports • Program reviews • Audit reports • ADB review missions 	Sustained willingness by NDTF to reform
(vii) Samurdhi Banking Societies (SBS) Reforms	Governance and sustainability strengthened to make SBS an effective poverty reduction instrument with 50% reduction in subsidy dependence by end-2007	<ul style="list-style-type: none"> • Program reports • Program reviews • Audit reports • ADB review missions 	Willingness of Ministry of Samurdhi (MOS) to act on the results of the diagnostic study and portfolio audit

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
(viii) Redefining Rural Economy Resuscitation Fund (RERF)	Social and physical infrastructure environment in rural communities improved to maximize the effects of RF services by financing 850 community subprojects	<ul style="list-style-type: none"> • Project reports • Impact monitoring reports • Audit reports • ADB review missions 	No politicization of RERF operations
(ix) Expansion of RF services in the conflict affected areas	<p>Sustainable RF system including commercial banks and MF-NGOs established and providing efficient and viable RF services in the conflict affected areas</p> <p>10% of RERF and 10% of rural enterprise development credit line implemented in the conflict-affected areas</p>	<ul style="list-style-type: none"> • Project reports • Project reviews • Impact monitoring reports • Audit reports • ADB review missions • PCR • PPAR 	Secure environment and effective credit demand in the conflict-affected areas
(x) Development of RF related training capacity of Center for Banking Studies (CBS)	<p>Best RF operational practices disseminated to RFIs—100 CRBs, 200 SBS, 4 RDBs, 100 MF-NGOs, and 3 commercial banks</p> <p>Effective microfinance modalities adopted by RFIs in the conflict affected areas</p>	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions 	Government's commitment to ensure enabling environment for RFIs
(xi) Rural enterprise development	10,000 rural small and micro enterprises enlarged or established by 2007	<ul style="list-style-type: none"> • Project reports • Project review • ADB review missions • Impact monitoring report • PCR • PPAR 	Favorable rural economic environment without civil strife
(xii) Institutional development support for Central Bank of Sri Lanka (CBSL), MOC, Ministry of Policy Development and Implementation (MPDI), Ministry for Rural Economy (MRE), NDTF, RFSDA, MOS, and RFIs	<p>Better accounting and information standards implemented among RFIs</p> <p>Efficient RFI supervision and regulation functions established</p> <p>Proper administration of community based public-private investments established</p>	<ul style="list-style-type: none"> • Project reports • Project review • Audit reports • ADB review missions 	Commitment and cooperation of the organizations are maintained

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
(xiii) Program/Project implementation support	Effective project management exercised	<ul style="list-style-type: none"> • Project reports • Project review • ADB review missions 	Capable and adequate Program/Project staff are appointed
Activities 1. Establishing conducive policies which include phased reform plans for RFIs; redefined role of the Government; decreasing ownership of RFIs by CBSL; effective supervision and regulation for deposit protection; and promoting larger private sector role in RF 2. Adopting the Act for RFI supervision, establishing RFSDA which functions as a supervisory body for RFIs, and providing institutional supports for RFSDA 3. Implementing Action Plan for facilitating repayment from RFI defaulters 4. Developing a framework for CRB reforms covering governance, organization, human resources, business process, and products and services	Conducive policies adopted High-level coordinating body for the RF sector policies established RFI reforms initiated RF sector supervision and regulation improved The RFSD Act enacted RFSDA established and regulatory guidelines and standards finalized, and panel of auditors appointed Licensing and supervision of 200 RFIs carried out by RFSDA by end-2007 Audit and inspection of 500 RFIs conducted by end-2007 Action Plan implemented MOC adopts CRB Restructuring Policy, Model Restructuring Plan, and CRB Fund Rules At least 100 participating CRBs capitalized and become distinct financial entities under the Cooperative Societies Act of 1972 by end-2007	• Government-provided policy framework • Project reports • Project reviews • ADB review missions • Program report • Project review • ADB review missions • Program report • Project review • ADB review missions • Project reports • Project reviews • ADB review missions	No political interference in policy formulation The Government's commitment to enforce RFSD Act No political interference in implementing the Action Plan MOC and CRBs' commitment to fully implement the restructuring plans

Activities			
5. Developing a comprehensive institutional strengthening plan for RDBs	Divestment of 80% of CBSL equity in at least 4 RDBs by end-2007 MRE, with CBSL assistance, develop RDB restructuring plans and capitalize RDBs, as required	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions • Program reports • Program reviews 	Early divestment of CBSL stake in RDBs
6. Developing NDTF corporate plan covering strategy, operational policies, and financing guidelines	NDTF incorporated as a company limited by guarantee NDTF Corporate plan developed by June 2004	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions • Program reports • Program reviews 	No political interference in the process Commitment and capability of new management
7. Developing SBS institutional strengthening plan	Diagnostic study and portfolio audit completed Institutional strengthening plan developed covering governance, and operational policies, and guidelines by June 2004 Adequate capitalization and loan loss provisions made	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions • Program reports • Program reviews 	MOS's sustained commitment to reforms
8. Expanding the scope of RERF trust and institutionalizing its operations	Trust deed amended and enhanced RERF Secretariat established and fully operative by June 2004 RERF finances 850 community projects implemented by approved service providers by end-2007	<ul style="list-style-type: none"> • ADB review missions • Impact monitoring reports 	No politicization of RERF Clear and transparent RERF disbursement policies
9. Strengthening CBS to emerge as a center for disseminating RF best practices and designing innovative approaches to RF in post-conflict areas	CBS staff and management adopt the vision and mission and qualified staff placed	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions 	CBSL's commitment to provide adequate human resources
10. Capacity building for enabling RFIs to enhance outreach in conflict affected areas	Capacity development needs are identified and training is provided	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions 	Government's sustained commitment to develop a liberalized and competitive financial sector

Activities			
11. Institutional strengthening of RFIs and RFSDA	CRB Restructuring Plans, RDB Restructuring Plans, NDTF Corporate Plan, RFSDA Implementation Plan, and SBS Institutional Strengthening Plan fully implemented by end-2007	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions 	Government's sustained commitment to develop a liberalized and competitive financial sector
12. Capacity development programs for RFIs, CBSL, RFSDA, MOC, MPDI, MRE, and MOS	Capacity development needs are identified and training is provided	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions 	Trained staff retained within the organizations
13. Establishing a project management unit and project implementation units	Project management unit established within MPDI and project implementation units established at CBSL. MRE (RERF, RFSDA, RDB) MOC, MOS, and NDTF	<ul style="list-style-type: none"> • Project reports • Project reviews • ADB review missions 	<p>Capable and adequate staff are appointed</p> <p>Coordination is complete and effective</p>
14. Onlending support to RFIs for providing credit for rural small enterprises and micro enterprises	10,000 rural small and micro enterprises received loans by end-2007	<ul style="list-style-type: none"> • Project reports • Project reviews • Audit reports • PCR • PPAR 	Government pursues financial sector reform that support RFI operations in rural areas
Inputs			
Program Loan Legal framework for RFI supervision and regulation (Activities 1, 2, 3)	\$10 million—ordinary capital resources	<ul style="list-style-type: none"> • Project reports • Audit reports • ADB review missions 	
RFI Restructuring (Activities 4, 5, 6, and 7)	\$30 million—ordinary capital resources		
Demand Side Development (Activity 8)	\$10 million—ordinary capital resources		
Total			
Project Loan Institutional Strengthening (Activities 9, 10, 11, 12, and 13)	\$50 million \$10 million—special funds resources		
Rural Enterprise Development (Activity 14)	\$10 million—ordinary capital resources		
Counterpart Contribution	\$7.79 million		
Total	\$27.79 million		

POLICY MATRIX

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
<p>The goal of the Rural Finance Sector Development Program (RFSDP) is to enhance outreach of sustainable rural finance (RF) services. The objective of the RFSDP is to establish a sustainable RF system through policy adjustments to eliminate structural constraints to growth of the RF sector and to improve the operations of RF institutions (RFIs). Institutionalizing policies that emphasize good governance will yield considerable benefits in terms of fostering a long-term sector wide perspective for sustainability. The investments in RF sector will generate adequate returns in terms of rural growth and value addition in the rural sector. To achieve this, the Government of Sri Lanka will initiate actions relating to:</p> <p>(i) conducive policies, (ii) supportive legal and regulatory framework, (iii) institutional reforms for sustainability, (iv) strengthening the demand side, and (v) expansion of RF in conflict-affected areas.</p>					
A. Conducive Policies					
Adopt a conducive policy framework for RF sector development.	Critical policy issues have to be addressed to develop a sustainable RF sector. This requires an RF paradigm where the role of the Government should be to facilitate the functioning of the RF markets through conducive policies, adequate supervision, and institutional reforms.	The Government policy for the RF sector includes: (i) high level body to coordinate RF sector policies; (ii) improving RF sector supervision and regulation; (iii) leveling the playing field for recovery of dues; (iv) phasing out Central Bank of Sri Lanka (CBSL) role in RF that raises conflict of interest; (v) instituting fundamental RFI reforms; (vi) refraining from debt relief and discouraging debt repayment; (vii) granting autonomy to price their services; (viii) enhancing investments to address real	Policy review of RF sector development in consultation with the Asian Development Bank (ADB) to address other emerging sector issues within the scope of the RFSDP and shall recommend appropriate action, if any required (CBSL; Ministry of Cooperatives (MOC); Ministry of Finance (MOF); Ministry of Policy Development and Implementation (MPDI); Ministry of Rural Economy (MRE); Ministry of Samurdhi (MOS)	Policy review of RF sector development in consultation with ADB to review the implementation of the recommendations made under the second tranche policy review and shall undertake further policy review to address other emerging RF sector issues within the scope of the RFSDP. (CBSL, MOC, MOF, MRE, MPDI, and MOS)	Policy review of RF sector development in consultation with ADB to review the implementation of the recommendations made under the third tranche policy review and shall undertake further policy review to address other emerging RF sector issues within the scope of the RFSDP. (CBSL, MOC, MOF, MRE, MPDI, and MOS)

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
		sector issues; and (ix) promoting linkages between RFIs, nongovernment organizations (NGOs), and community-based organizations. (Policy letter).			
B. Supportive Legal and Regulatory Framework					
(i) Rural Finance Sector Development Act (RFSD Act)					
Develop the RF sector for efficient service delivery through a supporting supervisory mechanism.	Need for a legal framework for the supervision of RFIs through prudential and nonprudential norms for good governance, transparency, and disclosure is widely felt. Lack of enforcement of financial prudence in RF sector has endangered depositors' interest and encouraged proliferation of weakly governed unsustainable RFIs.	The RFSD Act will provide for the establishment of a Rural Finance Sector Development Agency (RFSDA) for the supervision and regulation of RFIs that are not supervised by CBSL. (Cabinet approved law)	<p>The RFSD Act (Enacted law).</p> <p>Establishment of the Board of Directors of RFSDA (MRE notification).</p> <p>Recruitment of RFSDA staff. (List of Staff)</p> <p>Adoption, and if, necessary, notification of operating plan, guidelines, and rules as required under the RFSD Act. (RFSDA progress report)</p>	<p>Formulation of guidelines for RFI supervision, regulation, accounting, prudential and nonprudential standards, and framework for outsourcing. (RFSDA progress report).</p> <p>Prepare a list and engage a panel of auditors for supervision and regulation of RFIs. (RFSDA progress report)</p> <p>Commence supervision and licensing of RFIs. (RFSDA progress report)</p>	<p>Licensing of at least 200 RFIs provided such RFIs are eligible under the RFSD Act. (RFSDA progress report)</p> <p>Continuing due diligence and supervision and regulation of RFIs. (RFSDA progress report)</p> <p>Review of RFSDA operations. (MRE, MOF, and ADB)</p>

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
				Review of RFSDA operations. (MRE, MOF, and ADB)	
(ii) Enhancing Legal Basis for Repayments					
Facilitate the efforts of RFIs for collection of dues.	Access to competitive financing for small-scale borrowers, including those in the rural economy, became restricted due to reluctance of banks to extend their outreach in view of the risk of defaults and lack of expeditious means for dealing with defaulters.		CBSL, MOC, MOF, MRE, MPDI, and MOS shall, in consultation with ADB, review the legal and institutional framework for recovery of debts from RFI defaulters and shall prepare and finalize an action plan (Action Plan) to facilitate expeditious recovery of debts from such defaulters, consistent with the principles of due process and the need to protect poor defaulters who are unable (as opposed to unwilling) to pay, and provide ADB with a copy of the Action Plan. (Action Plan)	<i>CBSL shall implement the Action Plan and provide ADB with a progress report thereon. (CBSL Progress Report)</i>	<i>CBSL, MOC, MOF, MRE, MPDI, and MOS shall, in consultation with ADB, review the effectiveness of the Action Plan implemented to expedite recovery of debts from RFI defaulters, and shall recommend any further remedial actions necessary to improve recovery or remove any difficulties that may have arisen, which recommendations shall be implemented by the CBSL. (CBSL Progress Report)</i>
(iii) Institutional Reforms for Sustainability					
C. Cooperative Rural Banks (CRBs)					
Upgrade CRBs into model RFIs with sustainability and good governance as core principles.	As a group, the CRBs are the largest RFI in terms of outreach and volume of business. However, weak governance and	Adoption of CRB Restructuring Policy including Model Restructuring Plan. (CRB Restructuring Policy and Plan)	Implement the first phase of restructuring of 25 CRBs by (i) establishing the restructuring task forces at multipurpose cooperative societies (MPCSs); (ii) assessing	Review of Second Tranche CRB Restructuring Plan implementation. (MOC Progress Report)	Implement the third phase of restructuring, where number of CRBs will be decided in consultation with ADB, by following the procedure outlined in

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
	politicization have affected their performance and sustainability. Fundamental changes are required for upgrading governance, organization, human resources, business process, products, and services.	<p>Establish a CRB Restructuring Committee at MOC. (MOC will notify to MPDI)</p> <p>Finalization of operating guidelines of CRB Fund. (MOC will notify to PDI)</p> <p>Establishment of CRB Fund at MOF. (MOC will notify to MPDI)</p>	<p>assets and liabilities of such CRBs, preparing the balance sheets and income statements of such CRBs, and determining their capital requirements; (iii) developing the Second Tranche CRB Restructuring Plan based on Model Restructuring Plan; (iv) reaching an agreement on the Second Tranche CRB Restructuring Plan with such CRBs; and (v) providing capitalization support for such CRBs (the Procedure) (MOC Progress Report).</p>	<p>Implement the second phase of restructuring of additional 75 CRBs by following the procedure outlined in second tranche. (MOC progress report)</p>	<p>second tranche. (MOC progress report)</p> <p>Monitoring of Restructuring Plan implementation. (MOC progress report)</p> <p>Assessment of the need to continue the CRB Fund. (MOC progress report)</p>
D. Regional Development Banks (RDBs)					
Transform RDBs into sustainable and efficient RFIs.	The RDBs represent a significant formal financial sector presence in the rural areas and there is considerable potential for them to contribute to rural economic growth. Comprehensive reform starting with divestment is required to enhance outreach and long-term sustainability.	<p>Transfer of CBSL equity in RDBs to MOF for initiating divestment. (CBSL letter)</p> <p>Information memorandum for divestment for all the 6 RDBs. (Information memorandum, CBSL)</p> <p>Assigning 2 CBSL officers to assist MRE, the nodal ministry for RDBs. (MRE letter)</p>	<p>RDBs shall register the transfer of CSBL's equity to MOF and provide relevant documents evidencing the same. (MRE letter)</p> <p>MOF transfers equity in RDBs acquired from CBSL to the Public Enterprise Reforms Commission. (MOF letter)</p>	<p>Release of the information memorandum and divestment of 2 DBs. (MRE report)</p> <p>Preparation and adoption of Third Tranche Restructuring Plan for 2 RDBs covering: (i) governance; (ii) human resources; (iii) business processes; (iv) management information system; (v) auditing and accounting; and (vi) performance</p>	<p>Release of information memorandum and undertake divestment of 2 RDBs. (MRE report)</p> <p>Preparation and adoption of Fourth Tranche Restructuring Plan for these 2 RDBs following the procedure outlined in Third Tranche. (Restructuring Plan)</p> <p>Implementation of Fourth Tranche Restructuring Plan. (MRE progress report)</p>

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
				benchmarks. (Restructuring Plan) Implementation of the Third Tranche Restructuring Plan. (MRE progress report)	
E. National Development Trust Fund (NDTF)					
Enhance the legal, financial, and operational scope of NDTF.	NDTF provides technical and refinance assistance to RFIs. NDTF's potential contribution to RF sector is constrained by limitations inherent in its legal structure, institutional capacity constraints, and weak capacity of its partner organizations. Changes in the constitution, organization, and operating procedures of NDTF will be required for it to play an enhanced and active sector development role.	Incorporation under the Companies Act No. 17 of 1982. (Memorandum and articles of Association) Constitution of Board, appointment of Chairperson, and Managing Director in accordance with provisions of the Company Act. No. 17 of 1982. (NDTF notification) Approval of MOF to transfer the Government contribution of \$5 million made in 1991 to the Credit Risk Fund of NDTF (trust) along with the interest thereon aggregating SLRs800 million equivalent to the new company. (MOF letter)	Development and adoption, in consultation with ADB, of the NDTF Corporate Plan covering: (i) strategy; (ii) organization and human resources development; (iii) operating policies and guidelines for financial activities; (iv) policies and procedures for nonfinancial activities; (v) partnership arrangements; and (vi) performance benchmarks and implementation schedule. (NDTF Corporate Plan and board resolution indicating its adoption).	Implementation of the NDTF Corporate Plan. (NDTF progress report) Achievement of performance targets outlined in the NDTF Corporate Plan. (NDTF progress report)	Complete implementation of the NDTF Corporate Plan and achievement of performance targets. (NDTF progress report)

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
F. Samurdhi Banking Societies (SBS)					
Initiate institutional reforms for sustainability.	Within the overall ambit of the Samurdhi Program, the SBS provide a critical link to poverty reduction through household income generating activities. Significant as their achievements are, SBS have yet to become sustainable. Broad-based institutional reforms are necessary for ensuring the sustainability of SBS.	Completion of portfolio analysis and diagnostic reviews. (Portfolio analysis and diagnostic review)	Review of institutional strengthening options in consultation with ADB. (Review outcome) Development and adoption of a Samurdhi Institutional Strengthening Plan covering: (i) governance, (ii) organization and human resources; (iii) operational policies and guidelines; (iv) management information system, accounting, and auditing; (v) business and viability projections; and (vi) implementation schedules. (Samurdhi Institutional Strengthening Plan)	Implementation of Samurdhi Institutional Strengthening Plan and achievement of indicated milestones. (SBS progress report)	Completion of Samurdhi Institutional Strengthening Plan and attainment of agreed performance indicators. (SBS progress report)
G. Strengthening the Demand Side					
Enhance effectiveness and outreach of RF through community based rural sector investments.	Sustained social preparation including skill development and access to basic infrastructure is necessary to benefit from access to RF for the rural poor, especially women.	A Rural Economy Resuscitation Fund (RERF) has been established for accelerating rural economic growth. RERF will support community led development initiatives for skills development, rural marketing networks, and community	RERF operates in terms of Guidelines for Investment and Operations (Guidelines). (RERF progress report—MRE) RERF operations audited and outcome submitted to ADB. (RERF audit report—MRE)	RERF operates in terms of the Guidelines. (RERF progress report—MRE) RERF operations audited and outcome submitted to ADB. (RERF audit report - MRE)	RERF operates in terms of the Guidelines. (RERF progress report—MRE) RERF audited and outcome submitted to ADB. (RERF audit report—MRE) Review of RERF operations. (RERF review report—MRE)

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
	Although returns from Increased social and rural infrastructure are high, investments are limited due to externalities and high costs.	<p>infrastructure in collaboration with NGOs and other service providers. RERF usage will be coordinated with RFI operations . (RERF trust deed—MRE)</p> <p>Guidelines on eligible purposes, appraisal, partnership arrangements with service providers, and monitoring. This includes 10% of RERF investments in conflict-affected areas. (RERF Guidelines—MRE)</p>	Review of RERF in operations. (RERF audit/review report—MRE)	Review of RERF operations. (RERF review report—MRE)	
H. Expansion of RF in Conflict-Affected Areas					
Enhancing the access of sustainable RF in the conflict-affected areas of north and the east.	The challenge in the conflict-affected areas is to support the establishment of an institutional structure that will be able to provide quality financial services on permanent basis as well as meeting the immediate financing needs of rural households.	A policy framework for the development of sustainable RF in the conflict-affected areas including: (i) coordination with overall Government and donor plans; (ii) institutional strengthening support for expansion of RF	<p>Review of RERF investments in the conflict affected areas. (RERF progress report—MRE)</p> <p>Outreach expansion. (Project progress report)</p>	<p>Review the impact of RFSDP in the conflict affected areas. (Project progress report—MPDI)</p> <p>Continued RERF investments and outreach expansion. (Project progress report—MPDI)</p>	<p>Review the impact of RFSDP in the conflict affected areas. (Project progress report—MPDI)</p> <p>Continued RERF investments and outreach expansion. (Project progress report—MPDI)</p>

Objectives	Rationale	First Tranche/Actions Compiled December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
	The need for simultaneous investments for the development of the rural economy is also critical for a sustainable RF sector.	services; and (iii) allocations in RERF and RFSDP credit line. (Policy letter)		Institutional strengthening of RFIs and commercial banks in the conflict-affected areas. (Project Progress Report—MPDI)	Institutional strengthening of RFIs and commercial banks in conflict affected areas. (Project Progress Report—MPDI)

STATUS OF COMPLIANCE WITH LOAN COVENANTS

Covenant	Reference in Loan Agreement	Status of Compliance
Loan 2040 (Program Loan) – Non-release conditions		
1. The Borrower shall ensure: (a) that the objectives achieved, policies adopted and actions taken prior to the date of this Loan Agreement, as set forth in the Policy Letter will continue to be in full force and effect for the duration of the Program period and subsequently; and (b) proper and timely achievement, adoption, compliance and implementation of the objectives, policies and actions to be achieved, adopted, complied with and implemented as set forth in the Policy Letter and shall ensure that once achieved, adopted, complied with and implemented, such objectives, policies and actions shall continue to be in full force and effect during and subsequent to the Program period.	Schedule 5 para. 1 Loan Agreement	Partially complied. Required policy actions did not materialize.
2. The MPDI shall be the Program Executing Agency and shall coordinate with CBSL, MOF, MOC, MRE and MOS on policy reforms. The MPDI shall have established a Program/Project Management Unit (PMU), headed by a Program/Project Director, who shall be an Additional Secretary of the MPDI. The Program/Project Director shall be assisted by two (2) directors and four (4) full-time staff members, with qualifications and experience acceptable to ADB, for the coordination, monitoring, supervision and implementation of the Program/Project.	Schedule 5 para. 2 Loan Agreement	Complied. Due to changes in the Government, the Ministry of Finance and Planning (MOFP) became the executing agency. Amendments to the Loan and Project Agreement on the change in executing agency as well as implementing agencies were not required in view of the suffix "or any legal successor thereof."
3. MRE shall be the implementing agency for RERF, RDBs and the Agency; MOC shall be the implementing agency for CRBs; NDTF for NDTF restructuring; and MOS for SBS. Each implementing agency shall have established a Program/Project Implementation Unit (PIU). Each PIU shall have a Program/Project Director supported by one (1) specialist staff member, with qualifications and experience acceptable to ADB. For inter-agency coordination, the MPDI shall have established a Program/Project Steering Committee (PSC) comprising of the heads of the PIUs including a representative each from the	Schedule 5 para. 3 Loan Agreement	Complied. During the Inception mission (5-9 July 2004), MoAMD, MoSRI, MoSPA replaced MOC, MRE, and Ministry of Samurdhi as Implementing Agencies. A Change in Implementation Arrangements was approved by Management on 9 July 2004. CBSL and NDTF remained as Implementing Agencies

Covenant	Reference in Loan Agreement	Status of Compliance
MOF and MPDI. The PSC shall be headed by a chairperson selected amongst its members and shall conduct its meetings quarterly.		
4. The Borrower shall keep ADB informed of, and the Borrower and ADB shall, from time to time, exchange views on the progress made in carrying out the Program.	Schedule 5 para, 4 Loan Agreement	Complied.
5. The Borrower shall continue timely policy dialogue with ADB on problems and constraints encountered during implementation of the Program and on desirable changes to overcome or mitigate such problems and constraints, and on further reforms to strengthen the rural finance sector.	Schedule 5 para, 5 Loan Agreement	Complied.
6. The Borrower shall keep ADB informed of policy discussions with other multilateral and bilateral agencies that have implications for the implementation of the Program, and shall provide ADB with an opportunity to comment on any resulting policy proposals. The Borrower shall take ADB's views into consideration before finalizing and implementing any such proposals.	Schedule 5 para, 6 Loan Agreement	Complied.
7. Upon release of the First Tranche, the Borrower shall utilize the Counterpart Funds to make grants as follows: (i) \$3,000,000 for the Agency; (ii) \$5,000,000 for RERF; and (iii) \$5,000,000 for CRB Fund.	Schedule 5 para. 7 (a) Loan Agreement Reference to Attachment 2 to Schedule 3 (Conditions for Release of the Second Tranche) Section C Para. 7	Partially complied. (i) As mentioned in the main text, the Agency was not established. (ii) Complied. (iii) Complied.
8. The Borrower shall utilize the unallocated \$2,000,000 of the Counterpart Funds of the First Tranche in consultation with ADB.	Schedule 5 para. 7 (b) Loan Agreement	Partially complied. Please refer to #7.
9. Upon release of the Second Tranche, the Borrower shall utilize the Counterpart Funds to make grants as follows:	Schedule 5 para. 7 (c) Loan Agreement	Partially complied. Please refer to #7.

Covenant	Reference in Loan Agreement	Status of Compliance
(i) \$7,000,000 for the Agency; (ii) \$5,000,000 for CRB Fund; and (iii) \$5,000,000 for RERF.		
10. The Borrower shall utilize the unallocated \$3,000,000 of the Counterpart Funds of the Second Tranche in consultation with ADB.	Schedule 5 para. 7 (d) Loan Agreement	Partially complied. Please refer to #7.
11. Notwithstanding any other provision of this Loan Agreement, if there is a significant shortfall in the achievement of the Performance Indicators, ADB will carry out a special financial and operational review and reach an agreement with the Borrower regarding the implementation of recommendations of such mission, and until such agreement has been reached, the Borrower may not make withdrawals from the Deposit Account.	Schedule 5 para. 8 Loan Agreement	Complied. Government was advised by the Mission during a review mission on 17 June–1 July 2007 that if no action was taken to comply with third tranche release conditions, the Program will be lapsed to end December 2007 and closed June 2008.
12. The Borrower shall assist the Agency in the licensing, supervision and regulation of the RFIs and shall ensure that adequate funds are provided to the Agency in a timely and efficient manner to ensure its successful functioning.	Schedule 5 para. 9 Loan Agreement	Not complied. The Rural Finance Sector Development Act did not materialize.
13. The Borrower shall promptly inform ADB of any changes in the board of directors or senior management of the Agency and shall ensure that any such changes shall be made in accordance with the provisions of the Act.	Schedule 5 para. 10 Loan Agreement	Not complied. Please refer to #12.
14. The Borrower shall ensure that the RERF and CRB Fund operations are conducted, in an efficient and transparent manner, to the satisfaction of ADB. Any amendment to the RERF Trust Deed and/or CRB Fund Rules shall be subject to ADB's prior approval. The Borrower shall promptly inform ADB of any changes in the management of RERF and/or CRB Fund.	Schedule 5 para. 11 Loan Agreement	Complied.
15. The Borrower shall acquire and install forensic accounting capability to ensure tracking and minimizing corruption in the implementation of the Program.	Schedule 5 para. 12 Loan Agreement	Complied.
16. If requested by ADB the Borrower shall undertake an audit of the use of Loan proceeds. Further, ADB retains the right to (i) audit any account relating to the Program; and (ii) verify the validity of the certification issued by the Borrower for each withdrawal	Schedule 5 para. 13 Loan Agreement	Complied.

Covenant	Reference in Loan Agreement	Status of Compliance
application.		
17. The PMU shall establish and maintain a Program Performance Management System for the monitoring and evaluation of the Program during and after implementation. Such system shall include database on the status of policy measures.	Schedule 5 para. 14 Loan Agreement	Complied.
18. The PMU shall provide ADB with quarterly progress reports on policy and institutional reforms. ADB shall monitor implementation of the Program through periodic reviews and progress reports. ADB shall conduct annual reviews throughout the implementation of the Program to identify further actions required for the continued development of the rural finance sector.	Schedule 5 para. 15 Loan Agreement	Complied.
19. The Borrower and ADB shall conduct a comprehensive midterm review at the end of the second year of the Program to evaluate the progress of reform measures and the impact of such reforms on the rural finance sector. ADB shall advise the Borrower on remedial measures, which should be taken to mitigate any problems identified as a result of such review.	Schedule 5 para. 16 Loan Agreement	Complied. While there was no midterm review as such, 6 review missions were fielded during program implementation. The missions reviewed all aspects of program implementation as identified emerging issues and remedial actions.
20. Without limiting the generality of Section 4.05 of this Loan Agreement or paragraphs 4 to 6 of Schedule 5, the MPDI shall assist ADB by providing relevant data and information in such detail as ADB may require to facilitate review by ADB of the progress in the implementation of the Program.	Schedule 5 para. 17 Loan Agreement	Complied.
21. The Borrower shall carry out the Program in accordance with all environmental laws and regulations of the Borrower and with ADB's <i>Environment Policy</i> .	Schedule 5 para. 18 Loan Agreement	Complied. Review missions did not identify any problems in this regard.
Loan 2041 (Project Loan)		
1. The Borrower shall relend the proceeds of the Loan to NDTF for onlending to RFIs, at the average weighted deposit rate calculated periodically by the CBSL, under the Subsidiary Loan Agreement upon terms and conditions satisfactory to ADB. The participating RFIs shall onlend to Subborrowers at an interest rate that provides adequate spread to cover their transaction costs and shall ensure that	Section 3.01(a) Loan Agreement	Complied. NDTF has also provided lending to those affected by the Tsunami.

Covenant	Reference in Loan Agreement	Status of Compliance
sufficient surplus is left with the Subborrowers after meeting debt-servicing needs.		
2. Except as otherwise agreed, the MOFP shall establish immediately after the Effective Date, an imprest account at CBSL. The imprest account shall be established, managed, replenished and liquidated in accordance with ADB's "Loan Disbursement Handbook" dated January 2001, and ADB's "Interim Guidelines" for Disbursement Operations, LIBOR-based Loan Products" dated July 2002, in each case as amended from time to time, and detailed arrangements agreed upon between the Borrower and ADB. The initial amount to be deposited into the imprest account shall not exceed the amount equivalent to six months' estimated Project expenditures or ten percent (10%) of the total, whichever is less.	Schedule 3 Loan Agreement para. 2 (a)	Complied.
3. MPDI shall be the Project Executing Agency and shall coordinate the implementation of the Project.	Schedule 5 para. 1 Loan Agreement	Complied. Due to changes in the Government, the Ministry of Finance and Planning (MOFP) became the executing agency. Amendments to the Loan and Project Agreement on the change in executing agency as well as implementing agencies were not required in view of the suffix "or any legal successor thereof."
4. NDTF shall be the implementing agency for the Project.	Schedule 5 para. 2 Loan Agreement	Complied.
5. The Borrower shall ensure that NDTF onlends proceeds of the Loan pursuant to the Participatory Loan Agreements to RFIs selected in accordance with the eligibility criteria agreed between the Borrower and ADB.	Schedule 5 para. 3 Loan Agreement	Complied.
6. The Borrower shall ensure that, except as the Borrower and ADB may otherwise agree, the maximum amount of onlending from any RFI to any Subborrower shall not exceed Sri Lanka Rupees One Hundred Thousand (SLRs 100,000).	Schedule 5 para. 4 Loan Agreement	Complied.
7. The Borrower shall ensure that NDTF shall allocate: (i) seventy five percent (75%) of the credit line for women entrepreneurs; and (ii) ten percent (10%) of the credit line for conflict-	Schedule 5 para. 5 Loan Agreement	Complied.

Covenant	Reference in Loan Agreement	Status of Compliance
affected areas.		
8. The re-ending and onlending arrangements shall be reviewed jointly by the Borrower, ADB, and NDTF every six (6) months or as needed, and if so required shall be adjusted accordingly.	Schedule 5 para. 6 Loan Agreement	Complied.
9. The Borrower shall allocate and make available, in a timely manner, sufficient funds from its budget for each fiscal year for the implementation of the Project.	Schedule 5 para. 7 Loan Agreement	Complied.
10. Notwithstanding any other provision of this Loan Agreement, if there is a significant shortfall in the achievement of the applicable Performance Indicators by NDTF, ADB shall carry out a special financial and operational review of NDTF and reach an agreement with the Borrower and NDTF regarding the implementation of recommendations of such mission, and until such agreement has been reached, the Borrower may not make withdrawals from the Loan Account.	Schedule 5 para. 8 Loan Agreement	Partially complied. Credit line was not fully utilized. US\$1,625,462.73 was cancelled.
11. The Borrower shall ensure that independent auditors acceptable to ADB annually audit NDTF and shall furnish within nine (9) months after the close of the fiscal year to which they relate, certified copies of such audited accounts and financial statements and the report of the auditors relating thereto (together with the auditors' opinion) in English to the Borrower and ADB.	Schedule 5 para. 9 Loan Agreement	Not complied.
12. The Borrower shall cause NDTF to ensure that each RFIs in receipt of a credit facility under the Project shall maintain separate records and accounts, adequate to identify goods and services financed out the credit facility to disclose the use thereof following sound accounting principles, and shall require it to have such accounts and records audited annually by auditors of NDTF, and shall furnish within nine (9) months of the close of the financial year certified copies of the audit together with the auditors' opinion in English to the Borrower.	Schedule 5 para. 10 Loan Agreement	Complied. NDTF disbursement procedure included proper accounting and audit of its partner RFIs.
13. The PMU shall submit reports to ADB concerning the use of Loan proceeds, Project administration, and financial management. The reports shall include (i) quarterly and annual Project implementation reports; (ii) a midterm review report; and (iii) a Project completion	Schedule 5 para. 11 Loan Agreement	Partially complied. PMU was unable to submit the Project completion report.

Covenant	Reference in Loan Agreement	Status of Compliance
<p>report to be submitted not later than six (6) months after Project completion. The reports shall cover: (i) expenditures, (ii) activities financed by NDTF, (iii) highlights of audit reports of NDTF and RFIs which are recipients of the Loan proceeds, (iv) rural enterprises development, and (v) progress on rural finance expansion in conflict-affected areas. The PIU shall submit information, analysis and periodic reports on the progress of the Project to the PMU.</p>		
<p>14. ADB and the Borrower shall periodically review Project implementation. The reviews shall include: (i) evaluation of the Project scope and implementation arrangements; (ii) consultation with NDTF and RFIs which are recipients of the Loan proceeds; and (iii) progress with the policy reform agenda. ADB shall also field regular review missions, review at the end of year two (2) shall be undertaken to evaluate actual physical and financial progress. Based on this review, modifications and improvements shall be considered by ADB and the Borrower.</p>	<p>Schedule 5 para. 12 Loan Agreement</p>	<p>Complied.</p>
<p>15. In case of natural calamities and unforeseen circumstances that affect the equity and liquidity of RFIs, ADB shall be consulted immediately and a remedial action plan, acceptable to ADB, shall be prepared within one (1) month thereafter, and subsequently implemented to the satisfaction of ADB.</p>	<p>Schedule 5 para. 13 Loan Agreement</p>	<p>Complied.</p>
<p>16. MOFP shall, on the basis of data provided by NDTF, establish and maintain the Project performance management system (PPMS), in a manner and within a timeframe acceptable to ADB. The PPMS shall generate semi-annual and annual reports based on information provided by NDTF. The PPMS shall comprise (i) financial and efficiency indicators of RFIs; (ii) details concerning the number of borrowers by gender, poverty classification, type of services, and the size of transactions; and (iii) social intermediation outreach. NDTF shall periodically monitor the socio-economic indicators of borrowers such as income, asset holding, and employment status to measure poverty outreach and alleviation impacts of the Program/Project. RFI restructuring and institutional strengthening plans shall provide financial benchmarks.</p>	<p>Schedule 5 para. 14 Loan Agreement</p>	<p>Partly complied.</p> <p>While NDTF maintained basic information regarding RFIs and borrowers, not all the details as specified in the covenant were available.</p>

Covenant	Reference in Loan Agreement	Status of Compliance
17. The Borrower shall ensure that its and NDTF's lending operations shall be carried out in accordance with all environmental laws and regulations of the Borrower and with ADB's <i>Environment Policy</i> . Each Participatory Loan Agreement shall include a provision that lending operations of the RFI in receipt of the credit facility shall comply with applicable environmental laws and regulations of the Borrower and with ADB's <i>Environment Policy</i> .	Schedule 5 para. 15 Loan Agreement	Complied.
18. The Borrower shall ensure that no persons shall be negatively affected in terms of ADB's <i>Policy on Involuntary Resettlement</i> and ADB's <i>Policy on Indigenous People</i> .	Schedule 5 para. 16 Loan Agreement	Complied.
Loan 2042 (Project Loan)		
1. The Borrower shall: (i) cause the proceeds of the Loan to be applied to the financing of expenditures on the Project in accordance with the provisions of this Loan Agreement; (ii) make proceeds of the Loan in the amount equivalent to SDR650,000 available to CBSL, as a grant; (iii) make proceeds of the Loan in the amount equivalent to SDR334,000 available to NDTF, as a credit facility; (iv) cause each of CBSL and NDTF to apply the proceeds of the Loan to the financing of expenditures on the Project; and (v) make proceeds of the Loan in the amount equivalent to SDR 6,021,000 available to the Project Executing Agency.	Section 3.01 Loan Agreement	Complied.
2. The Borrower shall make arrangements satisfactory to ADB for insurance of Project facilities to such extent and against such risks and in such amounts as shall be consistent with sound practice.	Section 4.01 (a) Loan Agreement	Complied.
3. The Borrower shall make available, promptly as needed, the funds, facilities, services and other resources, which are required, in addition to the proceeds of the Loan, for the carrying out of the Project and for the operation and maintenance of the Project facilities.	Section 4.02 Loan Agreement	Complied.
4. In the carrying out of the Project, the Borrower shall cause competent and qualified consultants, acceptable to ADB, to be employed to an extent and upon terms and conditions satisfactory to the Borrower and ADB.	Section 4.03 (a) Loan Agreement	Complied.
5. The Borrower shall ensure that the activities	Section 4.04	Partially complied.

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of its departments and agencies with respect to the carrying out of the Project and operation of the Project facilities are conducted and coordinated in accordance with sound administrative policies and procedures.	Loan Agreement	Implementation coordination was affected due to capacity constraints.
6. Without limiting the generality of the foregoing, the Borrower undertakes to insure, or cause to be insured, the goods to be imported for the Project and to be financed out of the proceeds of the Loan against hazards incident to the acquisition, transportation and delivery thereof to the place of use or installation, and for such insurance any indemnity shall be payable in a currency freely usable to replace or repair such goods.	Section 4.05 (b) Loan Agreement	Complied.
7. The Borrower shall maintain, or cause to be maintained, records and accounts adequate to identify the goods and services and other items of expenditure financed out of the proceeds of the Loan, to disclose the use thereof in the Project, to record the progress of the Project (including the cost thereof) and to reflect, in accordance with consistently maintained sound accounting principles, the operations and financial condition of the agencies of the Borrower responsible for the carrying out of the Project and operation of the Project facilities, or any part thereof.	Section 4.06 (a) Loan Agreement	Complied.
8. The Borrower shall (i) maintain, or cause to be maintained, separate accounts for the Project; (ii) have such accounts and related financial statements audited annually, in accordance with appropriate auditing standards consistently applied, by independent auditors whose qualifications, experience and terms of reference are acceptable to ADB; (iii) furnish to ADB, as soon as available but in any event not later than nine (9) months after the end of each related fiscal year, certified copies of such audited accounts and financial statements and the report of the auditors relating thereto (including the auditors' opinion on the use of the Loan proceeds and compliance with the covenants of this Loan Agreement as well as on the use of the procedures for imprest	Section 4.06 (b) Loan Agreement	Partially complied. Audit reports for 2004,2005 and 2006 are available. Audit reports for 2007 and 2008 are missing.

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account/statement of expenditures, all in the English language; and (iv) furnish to ADB such other information concerning such accounts and financial statements and the audit thereof as ADB shall from time to time reasonably request.		
9. The Borrower shall enable ADB, upon ADB's request, to discuss the Borrower's, CBSL's (in case of CBSL only to the extent pertaining to the utilization of the Loan proceeds) and NDTF's financial statements for the Project and their financial affairs related to the Project from time to time with the Borrower's, CBSL's and NDTF's auditors, and shall authorize and require any representative of such auditors to participate in any such discussions requested by ADB, provided that any such discussion shall be conducted only in the presence of authorized officer(s) of the Borrower, CBSL and NDTF unless the Borrower, CBSL and NDTF shall otherwise agree.	Section 4.06 (c) Loan Agreement	Complied. It has to be noted that no request from ADB in this regard has been issued.
10. The Borrower shall furnish, or cause to be furnished, to ADB all such reports and information as ADB shall reasonably request concerning (i) the Loan, and the expenditure of the proceeds and maintenance of the service thereof; (ii) the goods and services and other items of expenditure financed out of the proceeds of the Loan; (iii) the Project; (iv) the administration, operations and financial condition of the agencies of the Borrower responsible for the carrying out of the Project and operation of the Project facilities, or any part thereof; (v) financial and economic conditions in the territory of the Borrower and the international balance-of-payments position of the Borrower; and (vi) any other matters relating to the purposes of the Loan.	Section 4.07 (a) Loan Agreement	Not complied.
11. Without limiting the generality of the foregoing, the Borrower shall furnish, or cause to be furnished, to ADB quarterly reports on the carrying out of the Project and on the operation and management of the Project facilities. Such reports shall be submitted in such form and in such detail and within such a period as ADB shall	Section 4.07 (b) Loan Agreement	Complied.

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reasonably request, and shall indicate, among other things, progress made and problems encountered during the quarter under review, steps taken or proposed to be taken to remedy these problems, and proposed program of activities and expected progress during the following quarter.		
12. Promptly after physical completion of the Project, but in any event not later than three (3) months thereafter or such later date as may be agreed for this purpose between the Borrower and ADB, the Borrower shall prepare and furnish to ADB a report, in such form and in such details as ADB shall reasonable request, on the execution and initial operation of the Project, including its cost, the performance by the Borrower of its obligations under this Loan Agreement and the accomplishment of the purposes of the Loan.	Section 4.07 (c) Loan Agreement	Not complied. No report was submitted.
13. The Borrower shall enable ADB's representatives to inspect the Project, the goods financed out of the proceeds of the Loan, and any relevant records and documents.	Section 4.08 Loan Agreement	Complied.
14. The MOFP shall establish immediately after the Effective date, an imprest account at the CBSL.	Schedule 3 para. 8 (a) Loan Agreement	Complied.
15. MPDI shall be the Project Executing Agency and shall coordinate the implementation of the Project.	Schedule 6 para. 1 Loan Agreement	Complied. Due to changes in the Government, the Ministry of Finance and Planning (MOFP) became the executing agency. Amendments to the Loan and Project Agreement on the change in executing agency as well as implementing agencies were not required in view of the suffix "or any legal successor thereof."
16. CBSL shall be the implementing agency for Building Rural Finance Sector Capacity as described in Part A of Schedule 1 to this Loan Agreement. MRE shall be the implementing agency for Part B of Schedule 1 to this Loan Agreement. For Part C of Schedule 1 to this Loan Agreement, MRE shall be the implementing agency for the RDB Restructuring Plan, MOC shall be the	Schedule 6 para. 2 Loan Agreement	Complied. During the Inception mission (5-9 July 2004), MoAMD, MoSRI, MoSPA replaced MOC, MRE, and Ministry of Samurdhi as Implementing Agencies. A Change in Implementation Arrangements was approved

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implementing agency for the CRB Restructuring Plan, MOS shall be the implementing agency for the Samurdhi Institutional Strengthening Plan and NDTF shall be the implementing agency for the NDTF Corporate Plan and for the provision of onlending to divested RDBs.		on 9 July 2004. CBSL and NDTF remained as Implementing Agencies
17. The Borrower shall allocate and make available, in a timely manner, sufficient funds from its budget for each fiscal year for the implementation of the Project.	Schedule 6 para. 3 Loan Agreement	Partially complied. Though the Agency was not established as mentioned in the main text, counterpart funds were utilized for RERF and CRB.
18. The Borrower shall ensure that independent auditors acceptable to ADB annually audit the Project accounts, including the imprest account, in the Project Executing Agency, MRE, MOC, MOS and NDTF (Implementing Agencies) and furnish within nine (9) months after the close of the fiscal year to which they relate, certified copies of such audited accounts and financial statements and the report of the auditors relating thereto (together with the auditors' opinion) in English to the Borrower and ADB.	Schedule 6 para. 4 Loan Agreement	Partially Complied. Audit report for 2004,2005 and 2006 are available. Audit report for 2007 and 2008 are missing.
19. The PMU shall submit reports to ADB concerning the use of Loan proceeds, Project administration, and financial management. The reports shall include (i) quarterly and annual Project implementation reports; (ii) a midterm review report to be submitted in accordance with paragraph 6 of this Schedule; and (iii) a Project completion report to be submitted not later than six (6) months after Project completion. Consolidating inputs from the Implementing Agencies, the reports shall cover: (i) expenditures, (ii) activities financed by NDTF, (iii) the highlights of audit reports of the Implementing Agencies, (iv) training activities and their impact; (v) institutional strengthening; (vi) rural enterprises development, and (v) progress on rural finance expansion in conflict-affected areas. The PIUs shall submit information, analysis and periodic reports on the progress of the Project to the PMU.	Schedule 6 para. 5 Loan Agreement	Partially complied. No project completion report was submitted.
20. ADB and the Borrower shall periodically review Project implementation. The reviews	Schedule 6 para. 6 Loan	Complied. 6 review missions were fielded

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shall include evaluation of the Project scope and implementation arrangements, consultation with the Implementing Agencies and participating RFIs, implementation of RFI restructuring, progress with the policy reform agenda and capacity building measures. ADB shall also field regular review missions, including mid-term, and Project completion review missions. The Borrower shall undertake a comprehensive mid-term review at the end of year two (2) to evaluate actual physical and financial progress. Based on this review, modifications and improvements shall be considered by ADB and the Borrower.	Agreement	during project implementation. The missions reviewed all aspects of program implementation as identified emerging issues and remedial actions.
21. In case of natural calamities and unforeseen circumstances that affect the equity and liquidity of RFIs, the Borrower shall consult ADB immediately and a remedial action plan, acceptable to ADB, shall be prepared within one (1) month thereafter, and subsequently implemented to the satisfaction of ADB.	Schedule 6 para. 7 Loan Agreement	Complied.
22. MOFP shall, on the basis of data provided by the Implementing Agencies, establish and maintain the Project performance management system (PPMS), in a manner and within a timeframe acceptable to ADB. The PPMS shall generate semi-annual and annual reports based on information provided by the Implementing Agencies. The PPMS shall comprise (i) financial and efficiency indicators of RFIs; (ii) details concerning the number of borrowers by gender, poverty classification, type of services, and the size of transactions; and (iii) social intermediation outreach. The Implementing Agencies shall periodically monitor the socio-economic indicators of borrowers such as income, asset holding, and employment status to measure poverty outreach and alleviation impacts of the Program/Project. RFI restructuring and institutional strengthening plans shall provide financial benchmarks.	Schedule 6 para. 8 Loan Agreement	Partially complied. Basic information regarding RFIs were provided but not all the details as specified in the covenant were available.
23. The Borrower shall ensure that the lending operations of the RFIs availing Project support shall be carried out in accordance with all environmental laws and regulations of the Borrower and with ADB's Environment Policy.	Schedule 6 para. 9 Loan Agreement	Complied.
24. Borrower shall ensure that no persons shall	Schedule 6 para. 10	Complied.

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be negatively affected in terms of ADB's <i>Policy on Involuntary Resettlement</i> and ADB's <i>Policy on Indigenous People</i> .	Loan Agreement	