



Progress Report on Tranche Release

Program Number: 34320
Loan Number: 2040
February 2006

The Democratic Socialist Republic of Sri Lanka: Rural Finance Sector Development Program

CURRENCY EQUIVALENTS

(as of 31 January 2006)

Currency Unit	—	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.01
\$1.00	=	SLRs102.21

For the purpose of calculations in this report, the rate for \$1.00 = SLRs101 has been used.

ABBREVIATIONS

ADB	—	Asian Development Bank
CBSL	—	Central Bank of Sri Lanka
CRB	—	cooperative rural bank
MOAMD	—	Ministry of Agricultural Marketing Development
MOFP	—	Ministry of Finance and Planning
MOSRI	—	Ministry of Small and Rural Industries
MOSPA	—	Ministry of <i>Samurdhi</i> and Poverty Alleviation
MPC	—	multipurpose cooperative
NDTF	—	National Development Trust Fund
NGO	—	nongovernment organization
RDB	—	regional development bank
RERF	—	Rural Economy Resuscitation Fund
RF	—	rural finance or rural financial
RFI	—	rural finance institution
RFSD Act	—	Rural Finance Sector Development Act
RFSDA	—	Rural Finance Sector Development Agency
RFSDP	—	Rural Finance Sector Development Program
RRP	—	report and recommendation of the President
SBS	—	<i>samurdhi</i> banking society

NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends.
- (ii) In this report, “\$” refers to US dollars.

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I. INTRODUCTION

1. The Asian Development Bank (ADB) approved the Rural Finance Sector Development Program (RFSDP)¹ in an amount of \$70 million to the Democratic Socialist Republic of Sri Lanka on 11 December 2003. The RFSDP comprises the Rural Finance Sector Development Program (the program loan) for \$50 million and two rural finance sector development projects (the project loans) for \$10 million and SDR7.005 million. The RFSDP became effective on 12 May 2004. The program loan is to be released over 4 years in four tranches. The first tranche of \$15 million was released upon loan effectiveness. The second (\$20 million) is to be released within 12 months of the first tranche, the third (\$10 million) within 18 months of the second, and the fourth (\$5 million) within 18 months of the third.

2. The RFSDP is designed to promote economic growth and reduce poverty. The goal is to enhance outreach of sustainable rural finance (RF) services. The specific objectives are to establish a sustainable RF system through policy adjustments and improve the operations of rural finance institutions (RFIs) to foster long-term sector-wide sustainability. The program loan has five components: (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. The legal and regulatory framework is to create a system for effective supervision of RFIs and legal provision for enhancing the participation of microfinance nongovernment organizations (NGOs) and other private sector initiatives in RF. The institutional reforms cover major RFIs in Sri Lanka: cooperative rural banks (CRBs), regional development banks (RDBs), the National Development Trust Fund (NDTF), and *samurdhi*² banking societies (SBSs). In addition, the reform enhances the Government's Rural Economy Resuscitation Fund (RERF) to support skills development, infrastructure, and marketing facilities for rural communities.

3. ADB missions reviewed the RFSDP implementation in July 2004, April 2005, and June 2005. Overall, substantial progress has been made especially in institutional reforms.

II. MACROECONOMIC DEVELOPMENTS AND THEIR IMPLICATIONS FOR THE PROGRAM

4. A dynamic and efficient RF sector is needed to support economic growth and allow most of the rural population to participate in and share the benefits of growth. In line with the Government's structural economic reforms, the RFSDP emphasizes good governance and institutional reforms for (i) market-based financial sector development with private sector participation, (ii) reduced Government intervention in RFI operations, and (iii) enhanced financial service outreach to promote rural enterprises.

5. Benefiting from continued economic reforms, Sri Lanka has experienced strong economic growth for the last few years.³ The financial sector has expanded and remained resilient despite several internal and external shocks.⁴ The financial services of commercial

¹ ADB. 2003. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program*. Manila. While "RFSDP" indicates the program loan (2040) and the two project loans (2041 and 2042 [SF]), in this report, it refers to the implementation of the program loan.

² Means prosperity.

³ This is reflected in gross domestic product growth of 6.0% in 2003, 5.4% in 2004, and 5.2% (estimate) in 2005.

⁴ Including the fiscal deficit, inflation, fluctuation in aid flows, and increased fuel prices.

banks have expanded. The two major state-owned banks have initiated restructuring programs to improve their performance.

6. The expansion of commercial banking operations is reflected in the significant increase in deposits, loans and advances, and in the expansion of banking service outlets. During 2004, the number of licensed commercial banks operating in the country remained unchanged at 22, while the branch network and other service outlets expanded from 1,817 at the end of 2003 to 1,890 by the end of 2004. Banking density, or the number of bank branches per 100,000 people, improved from 6.9 in 2003 to 7.1 in 2004. However, the interest rate spread, measured by the difference between the interest yield and the cost, which is an indicator of the efficiency of financial intermediation, was high at around 4% in 2004. The high interest rate spread was the result of high operational costs, legal and other procedural bottlenecks in dispute resolution, high nonperforming assets, mobilizing long-term deposits at relatively high fixed rates, as well as rigidities in the financial market structure.

7. The Government's 2005 budget commits to restructuring the two state-owned banks to put them on a sound financial footing and make them commercially viable. A strategic plan for the Bank of Ceylon outlines a restructuring program to achieve certain benchmark targets in asset reconstruction, system upgrade, human resource development, and capital augmentation. A business restructuring plan has been formulated for the People's Bank with an ADB loan.⁵ The loan supports the phased-in recapitalization of the bank to meet minimum core capital requirements, based on certain agreed-on financial targets.

8. While its direct involvement in financial institutions has been gradually diminishing, the Government maintains policies to enhance access to finance through publicly sponsored programs. In March 2005, a Government-owned SME bank was granted a license to operate as a specialized bank.

9. On 26 December 2004, the tsunami hit over two-thirds of Sri Lanka's coastline and caused catastrophic destruction and loss of life. About 1 million to 2 million people out of 19 million were affected. However, the tsunami's impact on the national economy was moderate, lowering gross domestic product growth from 5.4% in 2004 to an estimated 5.2% in 2005. The tsunami has not destabilized the financial sector, but RFIs in the affected areas⁶ experienced the physical destruction of facilities, loss of staff, and liquidity constraints because their clients died or their surviving clients could not repay the loans. No financial institution could immediately provide the RFIs' services, and access to credit by the affected people was severely disrupted.

10. Despite strong growth over the last few years, widespread poverty persists. Sri Lanka is primarily a rural economy, with almost 80% of the population living in rural areas. Economic growth for the last few years, however, benefited the urban more than the rural sector. Low productivity and growth in agriculture is a reason why rural incomes have lagged far behind urban incomes. Poverty is strongly associated with access to markets and services and connectivity with urban centers, and the poorest areas of the country are the most underserved.

11. The RFSDP's objective is to establish a sustainable RF system to eliminate structural constraints on rural growth to complement the Government's ongoing financial sector reforms. Progress in institutional reforms under the RFSDP indicates that the Government is strongly

⁵ Supported under ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Financial Markets Program for Private Sector Development*. Manila (\$60 million).

⁶ At the time of the tsunami, it was estimated 200–300 RFI outlets were operating in the areas.

committed to reform. With the changing political environment, the challenge is to promote private sector participation in RF through policies and a legal framework while phasing out the Government's inappropriate direct financial intermediation role in RF.

III. STATUS OF TRANCHE CONDITIONS

12. The status of compliance with second-tranche conditions of the RFSDP is summarized in Table 1, with details in Appendix 1.

Table: Status of Compliance of Second-Tranche Release Conditions

Conditions	Status
A. Conducive Policies	
1. CBSL, MOAMD, MOFP, MOSRI, and MOSPA ⁷ shall, in consultation with ADB, undertake policy review of rural finance sector development to address other emerging rural finance sector issues and shall recommend appropriate actions, if any, required.	Complied with.
B. Supportive Legal and Regulatory Framework	
2. The Borrower shall enact and bring into force the Act.	Amendment is proposed (paras. 15–17).
3. MOFP shall notify the establishment of the Board of Directors of RFSDA.	Amendment is proposed (paras. 15–17).
4. MOFP shall ensure recruitment of 10 staff members of RFSDA and provide ADB with a list of such members.	Amendment is proposed (paras. 15–17).
5. MOFP shall adopt and notify, if necessary, the operating plan, guidelines and the rules as required under the Act and present to ADB a progress report thereon.	Amendment is proposed (paras. 15–17).
6. CBSL, MOAMD, MOFP, MOSRI, and MOSPA 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.	Complied with.
C. Institutional Reforms for Sustainability	
(i) CRBs	
7. MOAMD shall implement the first phase of the restructuring of 25 CRBs by (i) establishing the restructuring task force at such CRBs, (ii) assessing the assets and liabilities of such CRBs, (iii) developing the Second Tranche CRB Restructuring Plan with such CRBs and (iv) providing support for capitalization. Provide ADB with a progress report thereon.	Substantially complied with.
(ii) RDBs	
8. RDBs shall register the transfer of CBSL's equity to MOFP and MOFP shall provide ADB with relevant documents evidencing the same.	Complied with.
9. MOFP shall transfer the equity in RDBs acquired from CBSL to the Public Enterprises Reforms Commission.	Complied with.
(iii) NDTF	
10. NDTF shall, in consultation with ADB, develop and adopt the NDTF Corporate Plan covering (i) strategy, (ii) organization and human resource development, (iii) operational policies and guidelines for financial activities, (iv) policies and procedures for non-finance activities, (v) partnership arrangements, and (vi) performance benchmarks and implementation schedule, and provide ADB with the NDTF Corporate Plan and a resolution of the Board of NDTF confirming adoption and ratification thereof.	Complied with.

⁷ After the change in Government in April 2004, the reassigned subjects and functions of the ministries were announced. The Ministry of Policy Development and Implementation, the erstwhile Executing Agency of the RFSDP, was discontinued, and the Ministry of Finance and Planning (MOFP) appointed as the Executing Agency. The implementing agencies (the ministries of cooperatives, rural economy, and *samurdhi*) were succeeded, respectively, by the ministries of agricultural marketing development, small and rural industries, and *samurdhi* and poverty alleviation. On 9 July 2004, ADB approved a major change in implementation arrangements to accommodate the changes in the Government's organizational structure.

Conditions	Status
(iv) SBS	
11. MOSPA shall review the options for strengthening SBS and provide ADB with the outcome of such review.	Complied with.
12. MOSPA shall develop and adopt a <i>samurdhi</i> institutional strengthening Plan covering (i) governance, (ii) organization and human resources, (iii) operational policies and guidelines, (iv) MIS, (v) accounting and auditing, (vi) business and viability projections, and (vii) implementation schedules, and provide to ADB a copy of the <i>Samurdhi</i> Institutional Strengthening Plan.	Complied with.
D. Strengthening the Demand Side	
13. MOSRI shall provide ADB with a progress report demonstrating operations of RERF in accordance with the investment and operational guidelines.	Complied with.
14. MOSRI shall audit and review the operations of RERF and provide ADB with an audit and review report thereon.	Complied with.
E. Expansion of Rural Finance in Conflict-Affected Areas	
15. MOSRI shall review the progress of the RERF investments in the north and the east and provide ADB with a progress report thereon.	Complied with.
16. MOSRI shall provide ADB with a progress report pertaining to outreach expansion.	Complied with.

ADB = Asian Development Bank, CRB = cooperative rural bank, CBSL = central bank of Sri Lanka, MIS = management information system, MOAMD = Ministry of Agricultural Marketing Development, MOFP = Ministry of Finance and Planning, MOSRI = Ministry of Small and Rural Industries, MOSPA = Ministry of *Samurdhi* and Poverty Alleviation, NDTF = National Development Trust Fund, RDB = regional development bank, RERF = Rural Economy Resuscitation Fund, RFI = rural finance institution, RFSDA = Rural Finance Sector Development Agency, SBS = *samurdhi* banking society.

IV. PROGRAM IMPLEMENTATION

A. Conducive Policies

13. An enabling environment is crucial to develop sustainable RF. The need for a high-level forum to sensitize policy makers to good governance and best practices of RF has long been recognized. The policy review organized under the RFSDP is the first such initiative, and high-level representatives from key ministries that are involved in RF have actively participated in the process. Representatives from Central Bank of Sri Lanka (CBSL), Ministry of Agricultural Marketing Development (MOAMD),⁸ Ministry of Finance and Planning (MOFP), Ministry of Small and Rural Industries (MOSRI), and Ministry of *Samurdhi* and Poverty Alleviation (MOSPA), with the participation of private sector RFIs, convened a series of policy review workshops and developed recommendations, including establishing a credit information bureau for microfinance institutions and to review the existing debt recovery law to reduce delinquencies. The forum proposed an umbrella organization comprised of policy makers who will formulate policies for autonomous and sustainable RFI operations. The policy review process helped persuade policy makers to move away from state intervention to more autonomous and private sector-oriented RF development. Before the establishment of the policy forum, there was no systemic mechanism to discuss policy issues in a coordinated framework.

B. Supportive Legal and Regulatory Framework

14. The RFSDP proposed the Rural Finance Sector Development Act (RFSD Act) to provide the supervision and regulation of RFIs through prudential and non-prudential norms for good governance, transparency, and disclosure. The RFSD Act was intended to cover RFIs, including microfinance NGOs, which are not covered by the Banking Act of 1988 and hence not under CBSL purview. The RFSD Act was to facilitate the establishment of the independent Rural Finance Sector Development Agency (RFSDA) to supervise and regulate RFIs. As the first-

⁸ Formerly known as the Ministry of Agricultural Marketing Development, Hindu Affairs, and the Ministry Assisting Education and Vocational Training.

tranche release condition, the Government drafted the RFSD Act and implementation plan in consultation with CBSL, RFIs, and microfinance NGOs. The draft Act was approved by the cabinet of the then Government.

15. The RFSDP second-tranche conditions on the supportive legal and regulatory framework require: (i) enactment of the RFSD Act; (ii) establishment and notification of the board of directors of RFSDA; (iii) recruitment of RFSDA staff members; and (iv) development of the operating plan, guidelines and rules for the implementation of the RFSD Act.⁹ Implementation of these second-tranche conditions has been delayed by the change in the Government. The new Government fully recognizes the rationale for, and importance of, both the RFSD Act and the independent agency for supervision of RFIs. However, the Government is of the view that CBSL needs to be involved as a transitory measure in regulating and supervising these institutions and in establishing RFSDA. It justifies this position on four grounds. First, CBSL must ensure that RFSDA's regulation and supervisory practices are consistent with internationally accepted norms and practices for bank supervision. CBSL's initial involvement will substantially help in this. Second, CBSL's supervision role at the initial stage will ensure the presence of technical inputs to start RFI supervision and expedite the establishment of RFSDA. Third, CBSL's initial role will lead to a significant reduction in the cost of establishing RFSDA. Fourth, because of CBSL's initial work, RFSDA will inherit basic operational systems and procedures for smooth functioning.

16. Based on the discussion among MOFP, CBSL, and ADB, the Government has proposed to amend the above four second-tranche release conditions on the supportive legal and regulatory framework to allow CBSL to initially supervise and regulate RFIs. The amendments are proposed to convert the four conditions into the following two conditions: (i) CBSL shall establish a separate unit within itself to supervise and regulate RFIs, with the same functions and powers as envisaged for RFSDA;¹⁰ and (ii) CBSL shall conduct a legal review to facilitate CBSL assumption of the role envisaged for RFSDA while maintaining the scope, coverage, intent, and functions of the RFSD Act. It was agreed that CBSL should be able to transfer, after a period agreed with MOFP,¹¹ the related expertise and functions to an independent agency set up to ensure the cost-effectiveness of RFI supervision and regulation.

17. Amendments to the second-tranche release conditions are proposed because CBSL's involvement ensures technical inputs and consistency with international practices. It will also reduce costs of and speed up the establishment of RFSDA, and achieve the original objective of creating a sustainable RF system through good governance. The amendments allow CBSL to play an important role within the RFSDP during the transition. The final outcome of the amendments will be an independent agency that will supervise and regulate RFIs as originally envisaged. The amendments do not materially alter or fundamentally affect the RFSDP's purpose, components, costs, or benefits. With the revised arrangements, the third- and fourth-

⁹ ADB. 2003. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program*. Manila. Loan Agreement (Ordinary Operations), Attachment 2 to Schedule 3, Clause B. 2 - 5.

¹⁰ Even under the current Banking Act and the Finance Companies Act of 1988, institutions, including microfinance institutions, must be licensed by CBSL as banks or finance companies to collect deposits. However, the RFSD Act will facilitate the licensing of microfinance institutions as formal institutions without transforming them into banks or finance companies.

¹¹ The timing of transfer to the independent agency will be determined after MOFP, CBSL, and ADB review the progress of the specified actions for the agency in accordance with the RFSDP Act implementation plan (ADB. 2003. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program*. [Supplementary Appendix 2]. Manila.)

tranche release conditions, which require a review of operations in supervising and licensing RFIs, will be achievable within the specified time frame under the policy matrix.¹²

18. The progress made in the legal and regulatory framework is an important step toward enhanced RF sector governance and marks a fundamental policy change: transforming RF from a social program to a mainstream financial sector operation. CBSL has established a RFI supervision unit in the Bank Supervision Department, with two full-time staff members, and is organizing the legal review of the amendments to the RFSD Act for immediate enactment by the Parliament. The independent agency and supervisory and regulatory functions will be established according to the steps in the RFSD Act implementation plan¹³ as agreed with the Government.

C. Institutional Reforms for Sustainability

19. The RFSDP supports institutional strengthening and reform of CRBs, RDBs, NDTF, and SBSs; combined, they reach nearly 65% of the microfinance market. The institutional reforms are meant to (i) promote good governance, efficient operation, client-oriented products and services, and transparent and accountable resource management; (ii) allow institutions to fulfill their mandate; and (iii) facilitate seamless RF without sudden closure while strengthening institutions' governance and operations. Progress in institutional reforms confirms the Government's strong commitment to reforms in RF markets.

20. **Cooperative Rural Bank Reforms.** CRBs are member-owned institutions with a nationwide network. Most CRBs are not independent financial institutions but departments of multipurpose cooperatives (MPCs). CRBs collectively mobilize about SLRs17 billion in 5.8 million savings accounts and provide nearly one-third of the country's microcredit. While CRBs could lead in providing microcredit with strong social intermediation, their performance, especially of those with MPCs, suffered because of weak governance, limited financial intermediation skills, and politicization. Politically motivated investments and poor portfolio management by MPCs expose a significant portion of savings of members (mostly poor and low-income households) to the risk of capital losses.

21. The RFSDP envisages to separate CRBs from MPCs, eliminating the potential for political intervention and allowing sound management of deposits and efficient credit outreach. As part of the first-tranche release condition, MOAMD adopted a CRB restructuring policy, including a model CRB restructuring plan and CRB fund rules.¹⁴ Despite the political difficulty of separating CRBs from MPCs, 35 MPCs have adopted the general assembly resolutions to start CRB reforms, formed the restructuring task forces, and finalized the accounts audits of CRBs for FY2004 to develop restructuring plans for individual CRBs based on the model CRB restructuring plan.¹⁵ Given MPCs' initial resistance to such separation, the resolutions are an important step toward the autonomy and sound governance of CRBs and a major positive result of the RFSDP.

22. **Regional Development Bank Reforms.** With a market share in microcredit of nearly 18%, RDBs are an important player in RF. However, like most RFIs, they are beset with major institutional and operational problems. To address these issues, the RFSDP supports financial

¹² Footnote 11, Appendix 8.

¹³ Footnote 11, Supplementary Appendix 2.

¹⁴ The Government has adopted the CRB fund rules to provide capitalization support for CRBs. Capitalization support will be provided to CRBs that have completed the initial phases of the restructuring plan.

¹⁵ Footnote 11, Supplementary Appendix 2. MOAMD agreed to the model restructuring plan.

restructuring and institutional strengthening of RDBs. In April 2005, CBSL reduced its shareholding in each RDB to 20%. The RDB divestment complements the Government's financial sector reforms (para. 7) and helps reduce state involvement in RF. The divestment helped improve RDB operations as evidenced from improved financial performance, with nonperforming loan ratios falling from around 20% in 2003 to less than 10% in 2004.

23. **National Development Trust Fund Reforms.** NDTF was established in 1992 as an apex agency providing technical and refinance assistance for microfinance. It is the primary lender to microfinance NGOs, but its operation was smaller than that of other apex agencies in the region. At the end of June 2002, NDTF had 81 active borrowing microfinance NGOs with on-time repayment rate of about 88%.

24. As part of the first-tranche condition, NDTF has been incorporated as a company limited by guarantee for improved governance. The articles of association of NDTF, which were adopted for incorporation, ensures that the board of directors, comprising public and private sector representatives, exercises independent management decisions for NDTF's sound and autonomous operation. With the incorporation and installment of the independent board, NDTF's operations have improved. NDTF currently has 148 active microfinance NGO borrowers, and their average on-time repayment rates are 98% or above. With the credit line support for rural enterprise development under the RFSDP (project loan 2041), NDTF has significantly expanded its outreach.

25. NDTF developed a corporate plan in August 2005 to further improve its operations. The plan emphasizes the need to improve internal controls for greater accountability and enhance the capacity of its partner microfinance institutions. The plan will be implemented with the support provided under the project loan 2042(SF) of the RFSDP, and specific performance benchmarks are proposed to measure implementation progress.

26. **Samurdhi Banking Society Reforms.** The *samurdhi* program 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. With over 1.7 million members, 3.5 million savings accounts, and half a million active loans, the SBS Program is the largest microfinance program in Sri Lanka and covers nearly 50% of all households. However, SBSs suffer from weak management, poor governance, and lack of effective supervision. The impact of these is reflected in high operating costs, low productivity, and poor portfolio quality. The program's politicization also impaired SBSs' ability to operate efficiently. However, consolidation or closure of SBSs was considered highly unrealistic because of the political implications.

27. Under the RFSDP, MOSPA initiated a diagnostic study and portfolio audit and developed an institutional strengthening plan to transform SBSs into sustainable financial intermediaries. The plan intends to enhance SBSs' operational efficiency without consolidating or merging SBSs and is being implemented under the project loan 2042(SF) of the RFSDP. The reform facilitated the change in policy focus of the *samurdhi* program management. MOSPA now considers the SBS Program not as a social welfare program but as a financial service for poor and low-income people.

D. Strengthening the Demand Side

28. To better improve rural productivity under the RFSDP, the Government has widened the scope of RERF for investments in skill development, marketing networks, and infrastructure to

realize better prices for rural produce. RERF supports community development in collaboration with NGOs and potential beneficiaries. The RERF secretariat, which was established at the Ministry of Small and Rural Industries (MOSRI), is fully functional and staffed with experts on rural infrastructure, social development, and community mobilization. Four community development projects, including construction of a community well, a food-processing training center, a fish product sales center and agricultural plant nursery, have been initiated, and another 53 project proposals have been identified. Community investment projects supported by RERF will complement credit outreach expansion for better use of community resources and improved rural output.

E. Expansion of Rural Finance in Conflict-Affected Areas¹⁶

29. In view of institutional RF constraints economic reconstruction in conflict-affected areas, the RFSDP provides systemic responses in those areas, including (i) supporting institutional strengthening of new RFIs¹⁷ operating in the areas, (ii) prioritizing reform of CRBs in the areas, (iii) activating and concentrating RERF interventions in the region, and (iv) ensuring coordination with other initiatives. The Centre for Banking Studies of CBSL, which is supported under the project loan 2042(SF) to be a center for excellence for training and capacity development of RFIs, is developing RFI training curricula and modules for RFIs in conflict-affected areas. MOAMD is raising MPCs' awareness of restructuring of CRBs operating in those areas. The first-tranche condition required the Government to develop a policy framework for RF in conflict-affected areas to improve Government and donor coordination, support for institutional strengthening, and credit outreach. This condition has been complied with. MOSRI has reported that 11 community-based development projects have been identified to develop small-scale local infrastructure in the affected areas. As of October 2005, NDTF has disbursed about SLRs135 million worth of credit to 3,906 conflict-affected households through 21 partner microfinance NGOs to support rural enterprise development and income-generating activities.

30. In the wake of the tsunami, the Government announced a scheme for restoring livelihoods through concessional credit to small- and medium-sized enterprises and microenterprises. To provide expeditious financial support to affected households, a part of the credit line for rural enterprise development under the project loan 2041 of the RFSDP was reallocated for emergency credit.¹⁸ As of October 2005, NDTF, through its 44 partner microfinance NGOs, had lent to 8,114 affected households in nine affected districts.¹⁹

V. CONCLUSION

31. As envisaged, the RFSDP has laid a solid foundation for fundamental reforms in RF. The reform program is substantially on track, with some components reporting more encouraging progress than the others. The Government recognizes the importance of a more conducive policy environment and has taken measures to improve the legal and regulatory framework for supervision of RFIs. It has also brought CBSL to play a more dynamic role at the

¹⁶ Ampara, Anuradhapura, Batticaloa, Jaffna, Killinochchi, Mannar, Moneragala, Mullaitivu, Polonnaruwa, Puttalam, Triconmalee, and Vavuniya.

¹⁷ Supported under project loan 2042(SF).

¹⁸ A major change in implementation arrangements for project loan 2041 was approved by the Vice President (Operations 1) on 25 February 2005, reallocating \$7 million out of \$10 million for credit line support for rural enterprise development to provide emergency microcredit to tsunami-affected people. The emergency microcredit scheme ensures support to poor and low-income affected households by keeping the credit ceiling at SLRs100,000.

¹⁹ Ampara, Batticaloa, Colombo, Galle, Hambantota, Jaffna, Kalutara, Matara, and Trincomalee.

initial stages of this process and to ensure that the independent agency envisaged under the RFSDP will be established with proper systems and procedures and guidance from CBSL. The proposed amendments to the four second-tranche release conditions on the supportive legal and regulatory framework (paras. 15–17) are necessary to facilitate those processes and ensure expeditious transition to an independent and autonomous RFI supervision and regulation system. The financial, operational, and organizational restructuring of major RFIs initiated under the RFSDP is ongoing and on track. The capacity development support to RFIs is continuing and helps those institutions improve their outreach and sustainability. Measures have also been taken to strengthen the demand side of RF, though their impact will be felt only after some time. The Government has shown a strong commitment to continue the reforms. Expeditious deployment of credit support through the apex organization under the RFSDP framework ensured immediate financial support for tsunami-affected households without undermining sound operational practice of microfinance institutions. The RFSDP's progress confirms that the policy and institutional reforms are unfolding in line with the program framework (Appendix 2). The reform is most likely to build its own momentum and produce the results envisaged in the RFSDP. Continued support for the program will ensure that poor and low-income people who are underserved and unserved by the RF markets to be able to harness the benefits of the reforms. Hence, the release of the second tranche is important to sustain the momentum of the reforms. Including the proposed amendments to the four conditions on the supportive legal and regulatory framework, the Government has complied with all the second-tranche release conditions (one substantially complied and the rest fully complied). The \$20 million second tranche will assist a supportive legal and regulatory framework (\$7 million), CRB restructuring (\$5 million), and RERF investment (\$5 million). The Government will determine the use of the remaining counterpart funds of the second tranche (\$3 million) in consultation with ADB.

VI. THE PRESIDENT'S RECOMMENDATION

32. In view of the substantial progress made in the implementation of the overall Rural Finance Sector Development Program and (i) an amendment to the four conditions on the supportive legal and regulatory framework to replace them with the two new conditions, as stated in paragraphs 15–17; (ii) the full satisfaction of 13 conditions (including the two amended conditions); and (iii) substantial satisfaction of one condition, the President recommends that the Board approve, on a no-objection basis, (i) an amendment to the four conditions for the release of the second tranche on the supportive legal and regulatory framework,²⁰ and (ii) the release of the second tranche in the amount of \$20 million for the Rural Finance Sector Development Program Loan. In accordance with established procedures, the release of the second tranche will be effected not less than 10 working days after the date of circulation of this progress report.

²⁰ ADB. 2003. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program*. Manila. Loan Agreement (Ordinary Operations), Attachment 2 to Schedule 3, Clause B.2 – 5.

STATUS OF SECOND-TRANCHE POLICY ACTIONS
Rural Finance Sector Development Program (Loan 2040-SRI)

Conditions for Release	Status of Compliance
A. Conducive Policies <p>1. CBSL, MOC, MOF, MOSRI, and MOSPA shall, in consultation with ADB, undertake policy review of rural finance sector development to address other emerging rural finance sector issues within the scope of the Program and shall recommend appropriate actions, if any, as required.</p>	<p>A series of RF policy reviews was conducted, including a review of the legal and institutional framework for recovery of debts. The recommendations include (i) establishing a credit information bureau for microcredit to reduce cases of loan default, (ii) initiating a legal review of the existing legal framework for debt recovery, and (iii) developing an umbrella organization for policy makers to formulate RF policies.</p>
B. Supportive Legal and Regulatory Framework <p>2. The Borrower shall enact and bring into force the RFSD Act.</p> <p>3. MOFP shall notify the establishment of the Board of Directors of RFSDA.</p> <p>4. MOFP shall ensure recruitment of 10 staff members of RFSDA and provide ADB with a list of such members.</p> <p>5. MOFP shall adopt and notify, if necessary, the operating plan, guidelines, and the rules as required under the RFSD Act and present to ADB a progress report thereon.</p> <p>6. CBSL, MOAMD, MOF, MOSRI, and MOSPA shall, in consultation with ADB, review the legal and institutional framework for recovery of debts from RFI defaulters and prepare and finalize an 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.</p>	<p>To ensure expeditious establishment of the RF supervisory and regulatory functions and sound technical inputs to be placed at RFSDA, the Government has proposed to involve CBSL during the initial process of establishing RFSDA and amend the RFSD Act to allow CBSL to assume the role of a RF supervisory authority as a transitional measure until such time that an independent agency is established for RF supervision and regulation. To facilitate those, MOFP, CBSL, and ADB proposed the amendments to the four second-tranche release conditions on the supportive legal and regulatory framework (B. 2 – 5) to convert them into the following two conditions: (i) CBSL shall establish a separate unit within itself to supervise and regulate RFIs, with the same functions and powers as envisaged for RFSDA; and (ii) CBSL shall conduct a legal review to facilitate CBSL assumption of the role envisaged for RFSDA while maintaining the scope, coverage, intent, and functions of the RFSD Act.</p> <p>CBSL has established a unit to supervise RFIs under the Bank Supervision Department as a transitory arrangement and initiated the legal review of the RFSD Act. The unit at CBSL has two full-time CBSL staff members, and upon the Act's passage, will start developing regulatory guidelines. CBSL, at a time agreed by MOFP and ADB, will transfer the expertise and functions to an independent agency to be established specifically for RF supervision and regulation purpose.</p> <p>The legal and institutional framework for recovery of debts was reviewed as part of the policy review.</p>
C. Institutional Reforms for Sustainability <p>(i) Cooperative Rural Banks</p> <p>7. MOAMD shall, to the satisfaction of ADB, implement the first phase of the restructuring of twenty-five (25)</p>	<p>A total of 35 MPCs has agreed for CRB restructuring through the general assembly resolutions, formed the restructuring task forces and finalized the account audits</p>

Conditions for Release	Status of Compliance
<p>CRBs by (i) establishing the restructuring task forces at MPCs; (ii) assessing the assets and liabilities of such CRBs, preparing balance sheets and income statements of such CRBs, and determining their capital requirements; (iii) developing the Second Tranche CRB Restructuring Plan; (iv) reaching an agreement on the Second Tranche CRB Restructuring Plan with such CRBs; and (v) providing support for capitalization; and provide ADB with a progress report thereon.</p> <p>(ii) Regional Development Banks</p> <p>8. RDBs shall register the transfer of CBSL's equity to MOFP and shall provide ADB with relevant documents evidencing the same.</p> <p>9. MOFP shall transfer the equity in RDBs acquired from CBSL to the Public Enterprises Reforms Commission.</p> <p>(iii) National Development Trust Fund</p> <p>10. NDTF shall, in consultation with ADB, develop and adopt NDTF Corporate Plan covering (i) strategy, (ii) organization and human resource development, (iii) operational policies and guidelines for financial activities, (iv) policies and procedures for non-financial activities, (v) partnership arrangements, and (vi) performance benchmarks and implementation schedule and provide ADB with NDTF Corporate Plan and a resolution of the Board of NDTF confirming adoption and ratification thereof.</p> <p>(iv) Samrudhi Banking Societies</p> <p>11. MOSPA shall, in consultation with ADB, review options available for the strengthening of SBSs and inform ADB of the outcome of the review.</p> <p>12. MOSPA shall develop and adopt the <i>samurdhi</i> institutional strengthening plan covering (i) governance, (ii) organization and human resources, (iii) operational policies and guidelines, (iv) MIS, (v) accounting and auditing, (vi) business and viability projections, and (vii) implementation schedules and provide ADB with a copy of the <i>samurdhi</i> institutional strengthening plan.</p>	<p>for FY2004. The preparation of the second-tranche CRB restructuring plans, including the assessment of the capital requirements for the CRBs, are under way with the assistance of external auditors.</p> <p>CBSL's equity of RDB was transferred to MOFP in April 2005 for divestment. The official notification was submitted to ADB. As the Public Enterprises Reforms Commission facilitates state-owned enterprise divestment, MOFP's share will be transferred to it at the time of divestment.</p> <p>NDTF has developed a corporate plan and presented it to its Board of Directors on 11 August 2005. The Board resolution was obtained on 11 November 2005. The plan will be implemented under the project loan 2042(SF) with the assistance of consultant experts.</p> <p>MOSPA developed a <i>samurdhi</i> institutional strengthening plan, with a detailed implementation plan in October 2005. MOSPA adopted the plan on 23 November 2005 and submitted the final plan to ADB on 30 November 2005. The plan will improve the sustainability of SBSs through product diversification, operational efficiency improvement, and savings mobilization, among other things.</p>
<p>D. Strengthening the Demand Side</p> <p>13. MOSRI shall submit to ADB a progress report demonstrating operations of RERF in accordance with the guidelines.</p> <p>14. MOSRI shall audit and review the operations of RERF and provide ADB with an audit/review report thereon.</p>	<p>MOSRI has submitted the progress report on RERF. The RERF secretariat was established and five full-time staff were recruited. RERF community development projects commenced in four districts, and the RERF grants were handed over in October 2005. Additional 53 projects were identified.</p>
<p>E. Expansion of Rural Finance in Conflict-Affected Areas</p> <p>15. MOSRI shall review the progress of the RERF investments in the north and the east and provide ADB with a progress report thereon.</p> <p>16. MOSRI shall provide ADB with a progress report</p>	<p>The RERF secretariat has identified 11 community-based projects in conflict-affected areas. The outreach expansion is progressing rapidly. According to the progress report submitted by MOSRI, as of October 2005, approximately 3,900 conflict-affected people in the</p>

Conditions for Release	Status of Compliance
pertaining to outreach expansion.	north and east have directly benefited from the microcredit support under the outreach expansion.

ADB = Asian Development Bank, CBSL = Central Bank of Sri Lanka, CRB = cooperative rural bank, MIS = management information system, MOAMD = Ministry of Agricultural and Marketing Development, MOFP = Ministry of Finance and Planning, MOSPA = Ministry of *Samurdhi* and Poverty Alleviation, MOSRI = Ministry of Small and Rural Industries, MPC = multipurpose cooperative, MRE = Ministry of Rural Economy, NDTF = National Development Trust Fund, RDB = regional development bank, RERF = Rural Economy Resuscitation Fund, RF = rural finance, RFI = rural finance institutions, RFSD Act = Rural Finance Sector Development Act, RFSDA = Rural Finance Sector Development Agency, SBS = *samurdhi* banking society.

PROGRESS UNDER PROGRAM FRAMEWORK
Rural Finance Sector Development Program (Loan 2040-SRI)

Design Summary	Measurable Indicators	Progress as of January 2006
Goal Reduce poverty and facilitate economic growth in rural Sri Lanka	Reduce poverty incidence to 20% from 25% by 2005 Attain economic growth of 7% by 2005 Enhance outreach and sustainability of RF sector	There is a declining trend of absolute poverty in Sri Lanka, as measured by the percentage of people living below \$1 a day. Economic growth has been strong for the last few years, at 6.0% in 2003 and 5.4% in 2004.
Purpose Establish a sustainable RF system through policy, legal, regulatory, and institutional reforms	Develop a policy framework for RF sector to decrease Government's ad hoc interventions and direct involvement in RF provision 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 sector to use RF through support for skills development and access to community infrastructure	Policy review development has started and it will continue. Ongoing. The process for enactment of an Act for RF supervision and regulation is ongoing. CBSL has established a unit to supervise RFIs. The functions of the unit will eventually be transferred to an independent agency. The outreach expansion of onlending support is continuing. RF outreach has improved, especially in the conflict-affected areas with the lending support by the apex organization to microfinance NGOs. Skills training for community development is ongoing (under RERF).
Output (i) Conducive policies for RF development	Policy letter and policy matrix implemented Independent and autonomous RFIs operating in a competitive environment	13 conditions for the second-tranche release in the policy matrix were fully complied and one is substantially complied. The Government intervention in RFI operations is diminishing. RDBs enjoy a greater autonomy than before.

Design Summary	Measurable Indicators	Progress as of January 2006
(ii) Legal framework for supervising RFIs	Supervisory and regulatory system for RFIs instituted through passage of the RFSD Act and RFSDA 500 RFIs audited and 200 licensed by the end of 2007	The process for enactment of an Act for RF supervision and regulation is underway. The Act will allow CBSL to initially involve RF supervision and regulation functions until an independent agency for this purpose is established. Preparatory work is ongoing. The unit for RFI supervision was established in the Bank Supervision Department of CBSL.
(iii) Facilitating the recovery of dues from RFI defaulters	Effective debt recovery and write-off policies adopted by RFIs Legal power to collect dues from willful defaulters exercised by RFIs	A legal and policy review of debt recovery is ongoing.
(iv) CRB reforms	Financial viability of CRBs improved, with at least 30% of CRBs meeting and maintaining full financial self-sufficiency by the end of 2007 At least 100 CRBs restructured	CRB reform is ongoing as stipulated in the model CRB reform plan. 35 MPCs have taken initial actions to restructure their CRBs.
(v) RDB reforms	Financial viability of RDBs improved, with at least four RDBs fully financially self-sufficient by the end of 2007	Financial performance of RDBs has improved. CBSL divested its shares in RDBs.
(vi) NDTF reform	Capacity and outreach of NDTF improved to transform it into an effective microfinance apex agency with 150 active microfinance NGO partner organizations by the end of 2007	NDTF has been transformed into an effective microfinance apex agency, and it has 148 active microfinance NGO borrowers.
(vii) SBS reforms	Governance and sustainability strengthened to make SBS an effective poverty reduction instrument, with 50% reduction in subsidy dependence by the end of 2007	SBS reform is ongoing. MOSPA has adopted the <i>Samurdhi</i> institutional strengthening plan, including measures for improving financial self-sufficiency.
(viii) Redefining of RERF	Social and physical infrastructure in rural communities improved to maximize the effects of RF services by financing 850 community subprojects	RERF investment for rural community development is ongoing and commenced four projects. A further 53 projects have been identified for funding.

Design Summary	Measurable Indicators	Progress as of January 2006
(ix) Expansion of RF services in the conflict-affected areas	Sustainable RF system, including commercial banks and microfinance NGOs, established and providing efficient and viable RF services in conflict-affected areas.	RF service outreach expansion is ongoing. Approximately, SLRs135 million of credit was disbursed through NDTF in conflict-affected areas. Commercial bank operations are limited.
(x) Development of RF related training capacity of CBS	10% of RERF and 10% of rural enterprise development credit line implemented in conflict-affected areas	RERF investment in conflict-affected areas is ongoing. The RERF secretariat identified 11 projects in those areas.
	Best RF operations practices disseminated to RFIs—100 CRBs, 200 SBS, 4 RDBs, 100 microfinance NGOs, and 3 commercial banks	The training program development at CBS is ongoing, including the extended training program in conflict-affected areas.
	Effective microfinance modalities adopted by RFIs in conflict-affected areas	
(xi) Rural enterprise development	10,000 rural small and microenterprises enlarged or established by 2007	About 9,000 rural small and microenterprises received credit support through NDTF.
(xii) Institutional development support for CBSL, MOAMD, MOSRI, NDTF, RFSDA, and RFIs	Better accounting and information standards implemented among RFIs	CBS has conducted training programs for key RFIs and NDTF.
	Efficient RFI supervision and regulation functions established	CBSL has established a unit for RFI supervision and regulation in the Bank Supervision Department.
	Proper administration of community-based public-private investments established	RERF investment is facilitating community-based public-private investment initiatives.
(xiii) Program/project implementation support	Effective project management exercised	All program management units and project implementation units are functioning satisfactorily.

Design Summary	Measurable Indicators	Progress as of January 2006
<p>Activities</p> <p>(i) 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</p> <p>(ii) Adopting the Act for RFI supervision, establishing RFSDA, which functions as a supervisory body for RFIs, and providing institutional supports for RFSDA</p> <p>(iii) Implementing Action Plan for facilitating repayment from RFI defaulters</p> <p>(iv) Developing a framework for CRB reforms covering governance, organization, human resources, business process, and products and services</p> <p>(v) Developing a comprehensive institutional strengthening plan for RDBs</p>	<p>Conducive policies adopted</p> <p>High-level coordinating body for the RF sector policies established</p> <p>RFI reforms initiated</p> <p>RF sector supervision and regulation improved</p> <p>The RFSD Act enacted</p> <p>RFSDA established and regulatory guidelines and standards finalized, and panel of auditors appointed</p> <p>Licensing and supervision of 200 RFIs carried out by RFSDA by the end of 2007</p> <p>Audit and inspection of 500 RFIs conducted by the end of 2007</p> <p>Action Plan implemented</p> <p>MOAMD adopts the CRB restructuring policy, model restructuring plan, and CRB fund rules</p> <p>At least 100 participating CRBs capitalized and become distinct financial entities under the Cooperative Societies Act of 1972 by the end of 2007</p> <p>Divestment of 80% of CBSL equity by the end of 2007 in at least four RDBs</p> <p>MOFP, with CBSL assistance, develop RDB restructuring plans and capitalize RDBs, as required</p>	<p>The policy framework is being developed.</p> <p>Established.</p> <p>Initiated.</p> <p>CBSL has established a unit for RFI supervision and regulation.</p> <p>CBSL is pursuing the passage of an Act which contains the same principles and functions of the RFSD Act but incorporates CBSL's assumption of the RF supervision and regulation role as a transitory arrangement.</p> <p>Initially, the unit established at CBSL will develop regulatory guidelines in line with international best practice. Upon completion of the guidelines, the unit will start auditing selected RFIs. Those functions will be transferred to an independent agency at the time agreed by the Government and ADB.</p> <p>The policy recommendation for Action Plan was made.</p> <p>Adopted.</p> <p>CRBs are being separated from MPCs, and the capitalization support for the initial 25 CRBs is being assessed.</p> <p>Divestment of 80% of CBSL equity is completed.</p> <p>RDB restructuring plans are being developed.</p>

Design Summary	Measurable Indicators	Progress as of January 2006
(vi) Developing NDTF corporate plan covering strategy, operational policies, and financing guidelines	<p>NDTF incorporated as a limited company</p> <p>Assets and liabilities transferred to the new company</p> <p>NDTF corporate plan developed by June 2004</p>	<p>Incorporated.</p> <p>Completed.</p> <p>Completed.</p>
(vii) Developing SBS institutional strengthening plan	<p>Diagnostic study and portfolio audit completed</p> <p>Institutional strengthening plan developed covering governance, and operational policies, and guidelines by June 2004</p> <p>Adequate capitalization and loan loss provisioning made</p>	<p>Completed.</p> <p>Completed.</p> <p>Ongoing.</p>
(viii) Expanding the scope of RERF trust and institutionalizing its operations	<p>Trust deed amended and enhanced</p> <p>RERF secretariat established and fully operative by June 2004</p> <p>RERF finances 850 community projects implemented by NGO service providers by the end of 2007</p>	<p>Completed.</p> <p>Completed.</p> <p>RERF investment has started in four districts. Additional 53 projects have been identified.</p>
(ix) Strengthening CBS so that it becomes a hub 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	CBS has developed and conducted new training programs.
(x) Capacity building to enable RFIs to enhance outreach in conflict-affected areas	Capacity development needs are identified and training is provided	The capacity development need assessment is ongoing.
(xi) 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	Institutional strengthening continued at NDTF, CRBs, and RDB.
(xii) Capacity development programs for RFIs, CBSL, RFSDA, MOAMD, and MOSRI	Capacity development needs are identified and training is provided	The capacity development need assessment is ongoing.

Design Summary	Measurable Indicators	Progress as of January 2006
(xiii) Establishing a project management unit and project implementation units	Project management unit established within MOFP and project implementation units established at CBSL, MOSRI (RERF), MOAMD, and MOSPA	The units have been established and operating satisfactorily.
(xiv) Onlending to RFIs to provide credit for rural small enterprises and microenterprise development	10,000 rural small and microenterprises received loans by the end of 2007	About 9,000 rural small and microenterprises received loans.

CBS = Center for Banking Studies, CBSL = Central Bank of Sri Lanka, CRB = cooperative rural bank, MOAMD = Ministry of Agricultural Marketing Development, MOFP = Ministry of Finance and Planning, MOSPA = Ministry of *Samurdhi* and Poverty Alleviation, MOSRI = Ministry for Small and Rural Industries, MPCs = multipurpose cooperatives, NDTF = National Development Trust Fund, NGO = nongovernment organization, SBS = *samurdhi* banking societies, RDB = regional development bank, RERF = Rural Economy Resuscitation Fund, RF = rural finance, RFI = rural finance institutions, RFSDA = Rural Finance Sector Development Agency, RFSD Act = Rural Finance Sector Development Act.