ADB

Progress Report on Tranche Release

Program Number: 36357
Loan Number: 2138
September 2010

Sri Lanka: Financial Markets Program for Private Sector Development

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 27 September 2010)

Currency Unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	$0.0089
$1.00	=	SLRs112.03

ABBREVIATIONS

ADB	–	Asian Development Bank
CBSL	–	Central Bank of Sri Lanka
CRIB	–	Credit Information Bureau of Sri Lanka
CSE	–	Colombo Stock Exchange
FIU	–	Financial Intelligence Unit
GDP	–	gross domestic product
IDP	–	internally displaced person
IMF	–	International Monetary Fund
MOFP	–	Ministry of Finance and Planning
NPL	–	nonperforming loan
PPMS	–	program performance management system
SBA	–	stand-by arrangement
SEMA	–	Strategic Enterprise Management Agency
SMEs	–	small and medium-sized enterprises
SPV	–	special purpose vehicle
TA	–	technical assistance

NOTES

(i) The fiscal year (FY) of the Government of Sri Lanka ends on 31 December.
(ii) In this report, "$" refers to US dollars.

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I. INTRODUCTION

1. The Board of Directors of the Asian Development Bank (ADB) approved the Financial Markets Program for Private Sector Development for the equivalent of $65 million on 15 December 2004.[1] The program comprises (i) a program loan of $60 million to support financial market policy reforms, and (ii) a technical assistance (TA) loan of $5 million for capacity building measures under the program. The program is based on the findings of a project preparatory TA.[2]

2. The objective of the program is to facilitate participation of the private sector, including small and medium-sized enterprises (SMEs), in the Sri Lankan economy by supporting government reforms to eliminate impediments to and develop opportunities for the private sector. The program aims to create a private sector that would take the lead in generating employment, boosting economic growth, and raising incomes, including in rural areas. In particular, the program seeks to facilitate private sector development by strengthening financial markets, including the restructuring and phased recapitalization of People's Bank. Accordingly, the program supports the government's medium-term development strategy, the Economic Policy Framework, published in July 2004. The framework focuses on key areas, including financial and capital market reform, improvements to private sector access to finance, enhancement of SME growth, and reduction of regional inequalities.

3. The reforms under the program were to be implemented over 3 years from December 2004 to December 2007, with the program loan divided into three equal tranches of $20 million. The first tranche was released upon loan effectiveness on 21 March 2005. The release of the second tranche, which requires the completion of 14 policy actions, was originally targeted for June 2006. However, program implementation was disrupted significantly by external and internal factors. External factors include (i) the impact of the December 2004 tsunami on the already overextended civil service, particularly the Ministry of Finance and Planning (MOFP), (ii) presidential elections in November 2005, and (iii) the subsequent change of government resulting in a substantial amount of time spent to rebuild ownership and find an appropriate way forward. This led to delays in the scheduled release of the second tranche. Internal factors included (i) difficulties in implementing the People's Bank restructuring plan due to resistance from People's Bank unions, and (ii) slippage in the preparation and passage of three pieces of legislation (the Secured Transactions Bill, the Securitization Bill, and the Securities and Exchange Commission Bill).

4. ADB has monitored loan implementation through regular inception and loan review missions during 2005–2010. Release of the second and third tranches is now justified based on progress with overall program implementation, the carrying out of second and third tranche release policy actions, and compliance with assurances. The status of second and third tranche and nontranche release policy actions is given in Appendixes 1 and 2. The status of compliance with program assurances is given in Appendix 3. The history of monitoring and review missions is given in Appendix 4.

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[1] ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Financial Markets Program for Private Sector Development.* Manila.

[2] ADB. 2003. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for Preparing the Private Sector Development Program (Subprogram II).* Manila (TA 3906-SRI, $1,000,000, approved on 12 December 2003).

II. RECENT MACROECONOMIC AND POLITICAL DEVELOPMENTS

A. Macroeconomic Developments

5. Sri Lanka's economy grew by 8.5% (year-on-year) in the second quarter of 2010 following annual gross domestic product (GDP) growth of 3.5% in 2009. Agriculture expanded by 5.1% with industrial production increasing by 9.2% and services by 8.8%. Growth was driven by strong performance in domestic trade and transport since the end of the civil war in May 2009. Other subsectors that contributed strongly to GDP growth during January–March 2010 include manufacturing (up by 5.8% year-on-year in real terms), construction (up by 8.5%), and financial services (up by 5.8%). The latest key economic indicators are given in Appendix 5.

6. Inflation decreased to 4.8% in June 2010 from 5.3% in May 2010 on a point-to-point basis. This was the fourth consecutive month in which the index registered a decline. Annual average inflation increased marginally to 3.9% in June 2010 from 3.6% in May 2010. The declining trend of inflation reflects a marked effort by the government to strengthen macroeconomic fundamentals—supported by an International Monetary Fund (IMF) stand-by arrangement (SBA) for $2.6 billion—and provides the foundations for sustainable inclusive growth.

7. In early June 2010, the government announced several reductions in import tariffs including abolishing the 15% surcharge on import duties. The duty on imported raw materials and machinery was cut from 11% to 8%, and a separate 2.5% duty, which was in place on most raw materials, plant, and machinery, was abolished. In addition, import taxes on cars, mobile phones, cameras, watches, and electronic equipment were slashed by 50%. A new four-band tariff structure is now in effect for import goods, with rates of 0%, 5%, 15%, or 30%. The reduction in import duties is likely to drive expansion of investment in the recovery phase.

8. The government has taken an additional step to simplify the duty regime by consolidating about 10 taxes levied on imports of essential commodities into a single "special commodity levy." The duty waivers granted to lessen the impact of high commodity prices in 2009 are also being phased out. The country's business sector welcomes these changes, which were partly facilitated by strong growth in fiscal revenue this year.

9. Fiscal revenue rose by 27% year-on-year during January–April 2010 to SLRs241.0 billion ($2.1 billion). The budget for 2010, which was scheduled to be presented to Parliament in November 2009, was postponed because of elections in the early part of 2010 and eventually presented in June 2010. Budgetary issues during the first 7 months of the year were managed with the use of a vote on accounts.

10. The fiscal deficit, which increased to 9.8% (including grants) in 2009, is budgeted to come down to 8% in 2010. In 2010, expenditure is expected to increase by 6.5% and revenue by 17%. While the projected deficit is higher than agreed under the IMF SBA, it is a realistic target for 2010. Total revenue for 2010 is estimated at SLRs817.8 billion ($7.2 billion). In 2010 the government estimates the revenue–GDP ratio to be 14.9% (up from 14.5% in 2009).[3] The expenditure–GDP ratio is budgeted to fall to 23.3% in 2010 (from 24.9% in 2009). This improvement in the fiscal balance is part of the government's commitment to strengthen fiscal

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[3] ADB is contributing to improve tax revenue mobilization through ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Fiscal Management Efficiency Project.* Manila.

discipline as per the objective under the Fiscal Management and Responsibility Act, 2003.[4] The peace dividend following the end of the conflict is likely to facilitate further fiscal consolidation and, through expenditure switching, support improved economic opportunities.

11. Improved global and domestic conditions resulted in a significant rise in exports and imports. Exports increased by 13.7% (led by higher earnings from the industry and agriculture sectors) and imports by 42.1% over the first 6 months of 2010 compared with the same period in 2009. The January–May trade deficit stood at $2,350.66 million. Remittances grew by 13.3% up to May 2010, reaching $1,498.2 million. The withdrawal of the Generalized System of Preference Plus concessions by the European Union on 15 August 2010 is likely to have a negative effect on export performance since the European Union is Sri Lanka’s largest trading partner, with trade worth $3.7 billion a year (about 20% of total trade). Under the Generalized System of Preference Plus concessions, lower European Union tariffs were applied to Sri Lanka’s exports.

12. In June, the IMF released two tranches of the SBA simultaneously. The funds, totaling around $408 million, bring overall disbursements under the SBA to $1.6 billion. The government has made good progress in achieving SBA performance indicators with the economy displaying improving fundamentals including reduced fiscal deficits, lower inflation, and gradual buildup of reserves. Sri Lanka’s gross official foreign exchange reserves are now a healthy $5.4 billion, equivalent to around 5.8 months of imports.

13. The Central Bank of Sri Lanka (CBSL) issued $278 million in Sri Lanka development bonds in June 2010. This exceeded the $275 million that CBSL had offered, after the issue drew bids of $289.1 million. In the same month, CBSL appointed a high-level committee to examine ways to raise Sri Lanka’s sovereign rating to investment grade, with a target of lifting the rating from B+ (with stable outlook) or B (with positive outlook), depending on the agency issuing the rating to at least BBB– by 2013. The committee will track public finances, inflation, and economic growth. In a show of increasing confidence in economic prospects, an international bond issue of $1 billion is planned for the fourth quarter of 2010 to be used partly to refinance higher cost debt and partly to support additional infrastructure investment.

B. Political Developments

14. Sri Lanka's parliamentary elections, held in April 2010, returned the President's United People's Freedom Alliance to power with 144 seats, improving on its performance in the 2004 parliamentary election by 39 seats. The Sri Lanka Freedom Party of the President is the main constituent of the United People's Freedom Alliance.

15. In an election with low voter turnout (61% compared with about 75% for the presidential election earlier this year and the last parliamentary election in 2004), the United People's Freedom Alliance increased its share of votes in almost all districts, breaking the United National Party's traditional dominance in districts such as Colombo, Kandy, and Nuwara Eliya.

16. The defeated presidential candidate, General Sarath Fonseka, was elected to Parliament. The new cabinet comprises 44 ministries, including the President, smaller than the last cabinet of 56. The President has retained four key ministries—defense, finance, highways, and ports and aviation.

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[4] This was supported by ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Fiscal Management Reform Program.* Manila.

17. The United Nations appointment of a three-member commission to look into alleged human rights violation during the last stages of the war in Sri Lanka was met with protests led by a government minister. The government sees this as an unnecessary step given the ongoing work undertaken by the government-appointed committee to look into these allegations. The committee is deliberating and is expected to release its findings by February 2011 at the latest.

18. The humanitarian situation continues to improve with the return of internally displaced persons to their areas of origin or to host families. By September 2010, over 290,000 internally displaced persons had left the camps leaving less than 30,000 to be returned according to the latest update by the United Nations Office for the Coordination of Humanitarian Affairs. The government hopes to be able to resettle the bulk of those remaining by the end of the year and to finally close the relief centers, including the main Menik Farm center, by early 2011. Given the reduction in the number of internally displaced persons, the government has been reducing the number of zones and consolidating the remaining internally displaced person population within Menik Farm to ease the provision of services and remaining humanitarian support.

19. Arrangements are under way to bring about 40,000 hectares of cultivable areas in the northern and eastern districts to full-scale cultivation to improve livelihoods as well as to transform economic activities in those areas. In addition, the opening of the A-9 road, removal of fishing restrictions, opening of bank branches, and removing restrictions on transportation have expedited business development in the north.

III. STATUS OF PROGRAM IMPLEMENTATION

A. Program Implementation

20. The second tranche of the program comprises 14 policy actions; the third tranche comprises 9. The assessment of the combined 23 second tranche and third tranche release actions can be summarized as follows: (i) 18 policy actions have been carried out (ii) three policy actions have been partially carried out, and (iii) two waivers of policy actions have been requested. The explanations for the partially complied with actions and the request for two waivers are given in paras. 27, and 36–42. Appendixes 1–3 provide details on second and third tranche policy actions, nontranche policy actions, and assurances and their compliance status.

1. Focus Area 1: Development of Financial Markets

a. Policy Outcome 1: Increased Financial Products and Services Available to the Capital Market

21. **Cabinet approval of Secured Transactions Bill (second tranche) (carried out).** In its objective to promote secured lending in the economy, the government agreed to draft enabling legislation and establish a national system of registration for securing movable property. In a board resolution dated 19 December 2007, the Credit Information Bureau (CRIB) undertook to draft the legislation, to fund the registration system from its own resources, and to establish a registry (the cabinet approved the amendment to the Credit Information Bureau Act, 1990 on 14 February 2007). CRIB ensures availability of credit history for all SMEs. As a result, CRIB enables coverage of all SME borrowers and helps banks to shift from purely collateral-based lending to cash-flow-based lending that emphasizes greater reliance on character, better understanding of the business, and credit-rating information at the outset of the credit relationship with SMEs. Such credit information facilitates adoption of credit-scoring methods by lenders to reduce appraisal time and cost. After consulting with the legal profession and the

banking and finance industry, CRIB prepared a policy paper to consider the coverage of existing legacy registry systems. The paper outlines the proposed coverage of the registry under CRIB, the proposed phasing in of assets registration, and the eventual transfer of registration from other registries. It also sets out a time-bound action plan for implementation of the registry at CRIB (approved business plan, system requirements, and staff budgets). The preparation of the policy paper was delayed because of changes in CRIB top management. The policy paper to establish the registry was submitted to MOFP on 16 July 2009. The cabinet approved the Secured Transactions Bill; the gazetted notification is dated 13 March 2009.

22. **Introduction of the Secured Transactions Bill to Parliament (third tranche) (carried out).** The Secured Transactions Bill was submitted to Parliament on 3 June 2009. Parliament approved the bill in July 2009.

23. **Cabinet approval of amendment to the Finance Companies Act, 2000 (second tranche) (carried out).** On 8 August 2005, cabinet approval was obtained for an amendment to the Finance Companies Act, 2000 to permit leasing companies to transfer assets to a special purpose vehicle for securitization of assets.

24. **Introduction of an amendment to the Finance Companies Act, 2000 to Parliament (third tranche) (carried out).** The amendment to the Finance Companies Act, 2000 was submitted to Parliament in October 2005 and approved in November 2005.

25. **Cabinet approval of Securitization Bill (second tranche) (carried out).** Securitization is an important means to transfer risk backed by a steady revenue stream thereby allowing for financial sector deepening. The Securities and Exchange Commission led the drafting of the Securitization Bill and amendments to the existing legislation. Cabinet approved the amendments; the gazetted notification is dated 13 March 2009 (Appendix 1, Section II provides the amendments).

26. **Introduction of the Securitization Bill to Parliament (third tranche) (carried out).** The Securitization Bill was submitted to Parliament on 3 June 2009. However, Parliament has not yet approved the bill because of the ongoing policy debate in the context of the global financial crisis. The economy of Sri Lanka was adversely affected by the global crisis given the relatively open capital accounts. During the fourth quarter of 2008 and first quarter of 2009, almost $1.1 billion in debt and equity portfolio flows were repatriated, equivalent to a 35% decline in international reserves. The authorities acted decisively and did not prevent the repatriation. By late 2009, debt and equity portfolio flows had returned to precrisis levels. The authorities have reviewed the state of policies that led to the large impact of the global crisis on Sri Lanka and parliamentary approval of the Securitization Bill has been held up in this review. ADB and other international financial institutions continue to engage in policy dialogue to encourage approval of the Securitization Bill highlighting that securitization was not the proximate cause of the global crisis but rather underlying issues related to securitization such as the pricing and quality of the underlying assets involved in the transactions.

27. **Cabinet approval of a bill to establish the public debt office as an agency independent from CBSL and MOFP with responsibility for managing and issuing all public debt (third tranche) (waiver requested).** An active public debt management office that is professionally managed with a clear goal of efficiently mobilizing savings is critical for maintaining sound and stable public finances. Approval of a bill establishing the debt office is unlikely since the government, after careful deliberation on the merits of establishing a separate public debt office, decided that such an office is not a viable option. Instead it will focus on

CBSL's Department of Public Debt to provide the institutional framework to pursue operating independence of the debt office. The government's decision is based on its evaluation of two studies: (i) a 2005 CBSL study regarding the viability of a separate independent public debt management office, and (ii) a 2005 review of the feasibility of a separate independent public debt management office conducted under a TA cluster jointly financed by ADB and the Swedish International Development Cooperation Agency.[5] The government is committed to addressing conflict of interest between monetary policy and debt management functions by ensuring transparency of government debt pricing, and has strengthened debt management within CBSL. CBSL's Department of Public Debt is now entirely responsible for the primary market auction and the determination of cutoff rates The front and back office functions of the department have been segregated. The Department of Public Debt has been effective in ensuring that the government's financing needs are met at the lowest possible cost consistent with a prudent degree of risk, developing and strengthening the government securities market, while enhancing efficiency and maintaining stability. The Department of Public Debt falls under the competent guidance of CBSL which has received significant capacity strengthening, put in place professional management, and enhanced transparency and accountability including regular reporting.

28. **Reduction of the equity settlement cycle (third tranche) (carried out).** The Colombo Stock Exchange (CSE) effectively moved to a T+3 settlement cycle for buying and selling in the equities market on 10 December 2007. This followed the 3 September 2007 directive of Central Depository Systems, which is consistent with Securities and Exchange Commission and CSE instructions. Central Depository Systems is a fully owned subsidiary of the CSE and acts as the depository for all securities traded on the CSE. The CSE is mandated to use Central Depository Systems to buy or sell listed securities. The system introduced by Central Depository Systems at the CSE reduces the period between the time a buyer of shares listed on the CSE places an order with a registered dealer to buy shares (trade) and the transfer of payment for and delivery of such shares to the seller; from the date of trade plus 6 days (T+6) to the date of trade plus 3 days (T+3).

b. Policy Outcome 2: Enhanced Corporate Governance in the Financial Market

29. **Issuance of directive by the Securities and Exchange Commission making use of the Sri Lankan Corporate Governance Code mandatory (second tranche) (carried out).** To strengthen confidence in the equities market, on 19 February 2007 the Securities and Exchange Commission issued a directive for registered and listed companies to comply with the Corporate Governance Code effective 1 April 2007. During the first year, companies were allowed to explain noncompliance with the directive. Since 1 April 2008, the directive has been strictly enforced. The rules address issues such as the number of nonexecutive and independent directors in a company, the basis of determining "independence," disclosure and minimal requirements with respect to audit committees and remuneration committee, as well as improved transparency through enhanced reporting requirements. Overall, the corporate governance code has significantly contributed to renewed investor confidence in listed companies and to improved overall company performance and shareholder value.

30. **Introduction to Parliament of a bill to amend the Securities and Exchange Commission Act, 1987 (second tranche) (carried out).** The Securities and Exchange Commission processed a bill amending the act, including urgent issues relating to the

[5] ADB. 2004. *Technical Assistance Cluster to the Democratic Socialist Republic of Sri Lanka for Implementing Products and Services for the Domestic Debt Market.* Manila.

appointment of commissioners. The amendment specifies a minimum number of private sector representatives and the need for diverse stakeholder interests in the commission to avoid conflict of interest. The cabinet approved the amendment; the gazetted notification is dated 13 March 2009. The amendment was submitted to Parliament on 3 June 2009; Parliament approved it in July 2009. (Appendix 1, Section III provides details of the amendments). The amendment ensures that the Securities and Exchange Commission is independent from the borrower by virtue of reflecting a balanced and diverse representation of public and private interests.

31. **Introduction to Parliament of a bill to amend the Banking Act, 1988 (second tranche) (carried out).** On 10 February 2005, the amendment to provide CBSL with the power and authority to take action against fraudulent financial schemes was submitted to Parliament. Parliament approved the bill to amend the act in October 2005.

32. **Cabinet approval of Anti-Money Laundering Bill (second tranche) (carried out).** The anti-money laundering framework includes three laws. The Convention on the Suppression of Terrorist Financing Act was enacted on 8 August 2005. It is consistent with the United Nations Convention of 10 January 2000 and provides for a financial intelligence unit (FIU) under CBSL to make investigations. The Prevention of Money Laundering Act and the Financial Transactions Reporting Act, both enacted on 6 March 2006, set out measures to combat money laundering and provide the FIU with the appropriate legal powers, and provide for the establishment of the FIU. The FIU receives reports of all cash and electronic transactions exceeding SLRs0.5 million, and requires financial institutions and fund managers to appoint compliance officers and undertake customer due diligence. The FIU was established on 23 March 2006 and submitted its first progress report in November 2006. Since then, the FIU has produced internal reports and submits these to the Asian Group on Money Laundering. The progress of the FIU is stated annually in CBSL's annual report.

33. **Introduction of the Anti-Money Laundering Bill to Parliament (third tranche) (carried out).** The Anti-Money Laundering Bill was submitted to Parliament in October 2005. Parliament approved the bill in November 2005. This is considered to be important in curbing fund transfers associated with undeclared income as well as funding the internal conflict.

c. Policy Outcome 3: Improved Regulation of the Insurance Industry

34. **Cabinet approval of an amendment to the Regulation of Insurance Industry Act, 2000 (second tranche) (carried out).** The Insurance Board of Sri Lanka prepared a draft amendment to the Regulation of Insurance Industry Act, 2000 which was approved by the cabinet on 10 December 2007. The amendment permits insurance companies registered under the Insurance Act to invest in securities including unit trusts, commercial paper, debt securities, and bonds issued against securitized assets. It is a critical step to extending the maturity spectrum of traded securities as well as improving fiscal system resources by better matching assets to liabilities of contractual savings.

35. **Introduction of an amendment to the Regulation of Insurance Industry Act, 2000 to Parliament (third tranche) (carried out).** The amendment to the Regulation of Insurance Industry Act, 2000 was submitted to Parliament on 3 June 2009. Parliament is expected to approve the amendment by the end of December 2010 at the latest.

2. Focus Area 2: Improved Operations of State-Owned Commercial Banks

36. **Introduction to Parliament of Strategic Enterprise Management Agency Act (second tranche) (partially carried out).** MOFP had sought to strengthen the corporate governance of a number of state-owned enterprises including People's Bank through parliamentary approval of a strategic enterprise management agency (SEMA) act. MOFP advises that passage of the SEMA act is not feasible because of lack of support from the employee unions of People's Bank and Bank of Ceylon[6] due to perceived risk in employment security arising from the commercial independence of People's Bank and Bank of Ceylon (Appendix 1, Section VII provides details on the proposed act). Under the circumstances, various alternative measures were adopted to strengthen corporate governance at People's Bank and Bank of Ceylon with the policy objective of commercial and political independence of these two institutions. MOFP established a banking steering committee, chaired by the governor of CBSL and cochaired by the secretary to the Treasury. SEMA is a member of the committee. The committee oversees the consistent application of banking governance reforms in line with the corporate governance codes issued by CBSL for all banks. In the case of state-owned banks, it also oversees compliance with MOFP guidelines on corporate governance for public enterprises issued in 2003.

37. CBSL issued a new code of corporate governance for banks in December 2007 consistent with pillar 2 of the Basel II framework and supported under the program (para. 29). The code is designed to strengthen board and management oversight and competence for risk management. Considering the fiduciary responsibility of boards to their stakeholders, and in the interest of wider financial system stability, CBSL issued a directive on corporate governance in December 2007 requiring banks to streamline their governance practices from 2008. Furthermore, on 23 April 2008, the boards of People's Bank and Bank of Ceylon adopted a corporate charter under which detailed guidelines are given to ensure that competent boards and corporate management teams are appointed that will function effectively by promoting value-added and independent decision-making processes in the best commercial interest of the two banks. The corporate charter emphasizes that the state's role in the two banks will be limited to strategic issues and policies. The state will not intervene in the day-to-day management of the two banks.

d. Policy Outcome 4: Improved Corporate Governance of State-Owned Commercial Banks

38. **Introduction to Parliament of a bill to amend the People's Bank Act, 1961 (second tranche) (partially carried out),** The amended People's Bank Act would provide commercial and political independence to the bank's board and management, as well as prevent the government from intervening in the bank's day-to-day affairs, including credit decisions and the interest rates set on loans to state-owned enterprises. MOFP advises that an amendment to the People's Bank Act is not feasible because of lack of support from People's Bank Employees Union due to perceived risk in employment security arising from the commercial independence of People's Bank. The government and People's Bank have committed to undertake alternative actions to meet the policy objectives in substance by issuing a People's Bank corporate charter consistent with (i) the Code of Best Practice in Corporate Governance in Public Enterprises issued by the Ministry of Finance in January 2003, (ii) the CBSL guidelines for corporate

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[6] The government respects the constitutional right of workers to establish unions. The unions have traditionally been strong in the state sector, especially rail and road transport, ports, government clerical service, and the finance sector. The share of public sector employees that are unionized in Sri Lanka remains very high and unions continue to have significant involvement in the operation of certain state enterprises and government agencies.

governance of banks effective January 2008, and (iii) responsibilities and duties of directors and officers under the Companies Act.

39. The People's Bank board adopted a corporate charter on 23 April 2008 after stakeholder consultation with the government, CBSL, the unions, and ADB. The corporate charter takes into account CBSL guidelines for corporate governance, which became mandatory on 1 January 2008. The People's Bank corporate charter improves and systematizes the bank's governance; makes governance more transparent; and demonstrates the bank's commitment to good corporate governance by enhancing responsible, accountable, and value-based performance management and effective oversight through stringent accountability procedures (para. 41).

40. **Introduction to Parliament of a bill to amend the Bank of Ceylon Act, 1939 (second tranche) (partially carried out).** The amended Bank of Ceylon Act, 1939 would provide commercial and political independence to the bank's board and management as well as prevent the government from intervening in the bank's day-to-day affairs, including credit decisions and interest rates set on loans to state-owned enterprises. MOFP advises that an amendment to the Bank of Ceylon Act is not possible because of lack of support from Ceylon Bank Employees Union due to perceived risk in employment security arising from the commercial independence of Bank of Ceylon (footnote 6). The government and Bank of Ceylon have committed to undertake alternative actions to meet the policy objectives in substance by issuing a Bank of Ceylon corporate charter consistent with (i) the code of best practice in corporate governance in public enterprises issued by the Ministry of Finance in January 2003, (ii) the CBSL guidelines for corporate governance of banks effective January 2008, and (iii) responsibilities and duties of directors and officers under the Companies Act. On 14 November 2007, the Bank of Ceylon board approved the Bank of Ceylon code of best practice on corporate governance after stakeholder consultation with the government, CBSL, and ADB. The Bank of Ceylon corporate charter improves and systematizes bank governance; makes its governance more transparent; and demonstrates the bank's commitment to good corporate governance by enhancing responsible, accountable, and value-based performance management as well as effective oversight through stringent accountability procedures (para. 41).

41. **Commercial and political independence through the corporate charters of People's Bank and Bank of Ceylon.** The corporate charters of People's Bank and Bank of Ceylon will catalyze improved operating efficiency of both banks by enhancing responsible, accountable, and value-based performance management as well as furthering effective oversight through stringent accountability procedures (such as an effective internal audit system and the appointment of specialized board subcommittees for compliance, audit, governance, and risk management). In line with international best practice, the charters provide detailed guidelines to ensure that competent boards and corporate management teams are appointed that will function effectively by promoting value-added and independent decision-making processes in the best commercial interest of the two banks. The corporate charters emphasize that the state's role in the two banks will be limited to strategic issues and policies. The state will not intervene in day-to-day management of the two banks.

e. Policy Outcome 5: People's Bank Restructured and Recapitalized

42. **Establishment of a collective agreement by People's Bank (second tranche) (waiver requested).** Under the program, People's Bank was required to enter into a collective agreement with the trade union representing more than 85% of the permanent employees of the bank. In the collective agreement, the parties agree to implement the People's Bank restructuring plan and meet the plan's performance targets. People's Bank signed collective

agreements with People's Bank Employees Union and People's Bank Officers Association on 29 June 2006. The collective agreements did not explicitly support the restructuring plan. During the midterm review in March 2007, the government asked that this policy action be waived. The People's Bank board and management have demonstrated their resolve and ability to carry out restructuring without formal union support. Accordingly, while the unions deviated from the course of actions initially intended and committed to, the policy outcome of restructuring People's Bank has been achieved (para. 43).

43. **Implementation of the People's Bank restructuring plan (second and third tranche) (carried out).** The People's Bank development plan 2004–2008 forms the basis for benchmarking the bank's reforms under the program. It entails quantitative and qualitative targets which, overall, have been satisfactorily met. The People's Bank strategic plan 2009–2014, approved by the bank's board on 28 November 2008, covers such important areas as strategy, human resources (adoption of effective incentives and meritocracy), and cost-effectiveness (including a branch consolidation plan). The fact that People's Bank has continued restructuring and committed itself to performance indicators to improve bank operations in the medium term over and beyond what was agreed to under the program, underscores the success and sustainability of the initial ADB support. The success and sustainability of the initial ADB support is evident from the Fitch Ratings Lanka upgrade of the long-term credit rating of People's Bank from "A-" to "A" in July 2009. Appendix 6 highlights key performance indicators under the People's Bank development plan 2004–2008 and strategic plan 2009–2014. Implementation of the restructuring plan includes the following six elements.[7]

(i) **Satisfactory capital adequacy (second and third tranche) (carried out).** By the end of December 2009, the capital adequacy ratio had increased to a satisfactory 13.4%, which is Basel II compliant (the capital adequacy ratio as of December 2008 was also Basel II compliant at 10.5%). This was achieved even after provisioning in 2009 for the bank's crude oil derivative contracts estimated at $26 million. Satisfactory capital adequacy was achieved by MOFP providing SLRs1.5 billion of recapitalization funds in December 2008 following three previous capital provisions totaling SLRs4.5 billion: SLRs2.0 billion in December 2005, SLRs1.0 billion in December 2006, and SLRs1.5 billion in December 2007. The capital provisions were augmented in 2008 with a tier 2 debenture issue of SLRs2.5 billion and retained earnings of SLRs1.5 billion that were reinvested in the bank as well as a second debenture issue of SLRs2.5 billion and retained earnings of SLRs1.9 billion in 2009. As a result of meeting the regulatory capital adequacy requirements, the letter of comfort extended by the government was withdrawn in 2009 and with it interest payments to People's Bank for restructuring bonds, which were placed by the government to recapitalize the bank in 1993 and 1996. The government had extended the letter of comfort since 1999, undertaking to support the bank with equity to the extent required to meet minimum capital requirements. As documented in the People's Bank credit update by Fitch Ratings Lanka (13 July 2009), People's Bank management has indicated to credit rating agencies that it will manage the capital position to ensure satisfactory capital adequacy is maintained. This is also evidenced and reflected in the bank's financial statements at the end of June 2010, which indicate a satisfactory capital adequacy ratio of 13.3%. Based on significant

[7] Corroborated by 6 independent reviews of People's Bank operations conducted by PricewaterhouseCoopers from July 2005 to June 2008 (financed by the TA loan), independent reviews by Fitch Ratings Lanka, and People's Bank audited financial statements.

improvement in the bank's financial performance, some analysts expect an upgrade of the credit rating for People's Bank.

(ii) **Satisfactory loan portfolio quality.** As a result of consistent efforts, nonperforming loans (NPLs) of People's Bank have remained well within the restructuring plan targets since 2003. The NPL ratio improved significantly from 19.5% in 2003 to 6.7% at the end of December 2008 (well in line with the 9.7% target in the development plan). Despite a CBSL directive with more stringent NPL classification issued in May 2008, the People's Bank NPL ratio has steadily fallen during this period mostly because of the decline in absolute NPLs as recoveries have improved. The bank's NPL ratio remained at 6.7% as of the end of December 2009 despite a difficult year for Sri Lanka's banking industry with an average NPL ratio of 9%. The bank's NPL ratio increased slightly to 6.9% at the end of June 2010.

(iii) **Satisfactory efficiency.** People's Bank steadily improved its efficiency from 2004 to 2009. The cost–income ratio was brought down to 60.6% in 2009 (well in line with the 71% target in the 2009–2014 strategic plan), compared with 65.4% in 2008. The cost–income ratio was more than 70% during 2004–2006. The improved efficiency can be attributed to increases in net interest income and nonfunded income, as well as to controlled management of expenses, including personnel cost. People's Bank restricted personnel costs in 2007 (6% increase from the previous year), 2008 (5.2% increase from the previous year), and 2009 (3.2% increase from the previous year). The bank's management has emphasized controlling personnel costs by rationalizing the deployment of staff, and expects an appreciable reduction in headcount in the medium term through natural attrition, given the age profile of employees. As of 30 June 2010, the bank's cost–income ratio was reduced to 57% resulting from growth in net interest income and overhead reduction (including contraction in staff-related expenses). The average cost–income ratio for the Sri Lankan banking industry in June 2010 is 48%, well below that of People's Bank. To compete effectively with competitors in the private sector and compete with the more efficient state banks in terms of productivity, People's Bank needs to continue to reduce its cost–income ratio to be on par with these institutions.

(iv) **Strong loan portfolio growth and loan portfolio diversification.** The loan portfolio has grown strongly, exceeding projected targets in 2006, 2007, 2008, and 2009 (as per the restructuring plans). Total loans reached SLRs299.10 billion at December 2009, which is well above the target of SLRs293.50 billion in the 2009–2014 strategic plan. The pawn business has grown consistently and constituted about 33% of the loan portfolio at the end of December 2009, with pawn advances reaching SLRs97.50 billion. In terms of diversification of its business portfolio, People's Bank reports that 23% of its total loan portfolio at the end of December 2009 was lending to state-owned enterprises.

(v) **Enhanced profitability.** The profitability of People's Bank increased in 2008 and 2009. This can be attributed to higher average yields on loans and advances, together with higher returns on Treasury bills and bonds as well as better management of overhead costs. Net profit after tax grew by 23% from SLRs2.71 billion in 2008 to SLRs3.32 billion at the end of December 2009. The net profit after tax of SLRs3.32 billion is the highest ever profitability recorded by People's

Bank and was achieved even after fully provisioning in 2009 for the bank's crude oil derivative contracts estimated at $26 million.

(vi) **Increased return on assets.** At the end of December 2009, return on assets declined marginally to 1.4% (from 1.5% at the end of December 2008) due to growth in fee-based income not keeping up with the growth in assets. However, the return on assets of 1.4% meets the 2009–2014 strategic plan target of 1.3%. Furthermore, the return on assets increased to 1.7% as of the end of June 2010 because of an increase in the proportion of higher-yielding loans and advances.

B. Program Management and Institutional Arrangements

44. MOFP is the executing agency for the program. CBSL, the Insurance Board of Sri Lanka, People's Bank, the Land Commissioner's Department, and SEMA are the implementing agencies. A project director was appointed in June 2005. However, due to significant time spent rebuilding ownership and finding an appropriate way forward for the new government that came into power at the end of 2005, MOFP established a steering committee 2 years later on 20 July 2007, chaired by the secretary, MOFP, to coordinate policy decisions that needed to be taken to pursue reforms under the program. The committee, which meets regularly and as needed, is made up of key officials from concerned ministries and agencies. The steering committee also calls upon affected sectors for consultations on important issues that have a bearing on the program, such as labor unions, employer federations, nongovernment organizations, academics, People's Bank, and the Colombo Stock Exchange. The first tranche was released upon loan effectiveness on 21 March 2005. The first tranche conditions continue to be satisfied.

C. The Technical Assistance Loan

45. The government has benefited from the TA loan, which was funded by the equivalent of $5 million from ADB's Special Funds resources for capacity building measures. The TA loan has (i) strengthened the insurance industry by building capacity of the Insurance Board of Sri Lanka through the appointment of an actuary for 1 year to be responsible for life and general insurance; (ii) strengthened banking expertise at SEMA to improve its management of the four state-owned banks in its portfolio through the appointment of a banking advisor for 2 years; and (iii) developed domestic and international skills to draft appropriate regulations and legislation for the program. The TA loan also financed semiannual independent reviews of operations of People's Bank by PricewaterhouseCoopers. As part of the assurances in the loan agreement, an independent review of People's Bank operations is to be conducted every 6 months. Given the government's reluctance to hire consultants on borrowed funds, only $456,340 was committed and $453,120 was disbursed.

IV. CONCLUSION

46. Despite developments that have disrupted program implementation—including the tsunami, change of government, escalation of hostilities, financial market stress from the global economic crisis, and a rapid turnover of MOFP senior management—the program has made very important achievements in strengthening financial markets and contributing to private sector development in Sri Lanka. It is improving the efficiency of the financial markets, increasing availability of alternative financial sources of funding to the private sector, improving corporate governance, and strengthening fiscal stability. It supports private sector development that assists the government in meeting its development objectives. It helps facilitate access by the private sector, including SMEs, to domestic sources of financing and capital. It supports the

development of a sound, more competitive banking system through the restructuring and recapitalization of People's Bank. Mortgage financing is more readily available; this will improve the quality and cost of housing throughout the country. People's Bank now provides better financial products and services that specifically address the SME market, especially in rural areas. An expanding SME sector will stimulate demand for labor and lead to the shifting of workers from agriculture and nonwage employment to jobs of higher productivity and higher wages in industry and services. The development of financial markets will reduce vulnerability of the banking system to external shocks and provide increasing opportunities for SME entrepreneurs to access financing and thereby improve employment generation prospects in the economy. Since women traditionally account for nearly half of the workforce in the SME sector, the program has a favorable impact on the employment and income of women.

47. The government has made significant progress in implementing the program. Slippage in the preparation and passage of legislation, impediments in implementing the People's Bank restructuring plan, as well as the change of government at the end of 2005 resulting in a substantial amount of time spent to rebuild ownership and find an appropriate way forward led to delays in program implementation. However, with these primarily resolved, the momentum and commitment to effective reforms has increased. This increased momentum is due in part to numerous factors, including (i) greater understanding across stakeholders of the objectives of the reforms; (ii) improved trust among ADB staff, program management, and government officials; and (iii) a stronger sense of purpose and appreciation of the program benefits across the departments involved in the program.

V. RECOMMENDATION

48. In view of the substantial progress made in the implementation of the Financial Markets Program for Private Sector Development, as evidenced by (i) 18 tranche release policy actions that have been carried out; and (ii) three tranche release policy actions that have been partially carried out, the President recommends that the Board approve, on a no-objection basis:

(i) the waiver of full compliance with three tranche release policy actions that have been only partially carried out;

(ii) the waiver of two tranche release policy actions because of lack of union support to finalize a collective agreement with People's Bank and lack of government support to establish a public debt office as a separate authority; and

(iii) the release of the second and third tranches in the aggregate amount of $40,000,000 for the Financial Markets Program for Private Sector Development Loan in Sri Lanka.

POLICY MATRIX—
STATUS OF SECOND AND THIRD TRANCHE RELEASE ACTIONS

Focus of Reform	Policy Actions to Be Taken Before Second Tranche (T2) and Third Tranche (T3)	Comments
I. Secured Transaction Financing		
(1) Cabinet approval of Secured Transactions Bill **(T2)**	(a) Establishment of a national system of registration for securing moveable property, including machinery and equipment (the "Moveable Property Registry"); (b) Establishment or appointment of an agency responsible for the Moveable Property Registry; and (c) Any necessary consequential amendments to the Registration of Documents Ordinance No. 23 of 1927, and the Companies Act (a bill reflecting the measures in paragraphs 2(a) – (c), the "Secured Transactions Bill.	**Carried out.** The cabinet approved the Secured Transactions Bill. The gazetted notification is dated 13 March 2009. The policy paper to establish a registry was submitted to the Ministry of Finance and Planning (MOFP) on 16 July 2009.
(2) Introduce Secured Transactions Bill in Parliament **(T3)**		**Carried out.** The Secured Transactions Bill was submitted to Parliament on 3 June 2009.
(3) Cabinet approval and publication of an amendment to Finance Companies Act **(T2)**	Permitting leasing company to transfer assets to special purpose vehicle (SPV).	**Carried out.** On 8 August 2005, the Finance Leasing Amendment Act No. 24 (2005) amended para. 24 of the Finance Leasing Act No. 56 (2000) to permit leasing companies to transfer assets to an SPV for securitization of assets.
(4) Introduce amendment to the Finance Companies Act in Parliament **(T3)**		**Carried out.** The amendment to the Finance Companies Act was submitted to Parliament in October 2005.
II. Public Trading of Securitized Bonds / Public Debt Office		
(1) Cabinet approval of Securitization Bill **(T2)**	(a) SPVs may be established as separate legal entities to own and pool assets ("Securitized Assets") against which securities may be issued; (b) The Securities Exchange Commission will (i) regulate and supervise SPVs, and (ii) be afforded the authority to issue regulations relating to SPVs including (a) procedures and requirements for establishment and registration of SPVs,	**Carried out.** The cabinet approved the Securitization Bill. The gazetted notification is dated 13 March 2009.

Focus of Reform	Policy Actions to Be Taken Before Second Tranche (T2) and Third Tranche (T3)	Comments
	and (b) reporting, disclosure and any other requirements to facilitate the ability of SPVs to own and transfer related securities; (c) SPVs must be registered with the Securities and Exchange Commission; and (d) Parate Rights will be revised or amended to permit the transfer of ownership rights to assets held by SPVs.	
(2) Introduce Securitization Bill in Parliament **(T3)**		**Carried out.** The Securitization Bill was submitted to Parliament on 3 June 2009.
(3) Cabinet approval of a bill to establish public debt office **(T3)**	Establish public debt office as an agency independent from the Central Bank of Sri Lanka (CBSL) and the Ministry of Finance and Planning (MOFP) and responsible for management, administration, and issuance of all of the Borrower's sovereign debt.	**Waiver requested.** Approval of a bill establishing the debt office is unlikely since the government has decided to focus on CBSL's Department of Public Debt instead of establishing a separate public debt office. The government is committed to addressing conflict of interest between monetary policy and debt management functions as well as strengthening debt management within CBSL. The primary market auction and cutoff rates are now determined entirely by CBSL's Department of Public Debt. The front and back office functions of the department are now segregated.
(4) System to reduce time of equity settlement cycle to T+3 is fully operational at the Colombo Stock Exchange (CSE) **(T3)**	Introduce system at CSE for reducing the period between the time a buyer of shares listed on the CSE places an order with a registered dealer to buy shares ("Trade") and the transfer of payment for and delivery of such shares to the seller; from the date of Trade plus 6 days (T+6) to the date of Trade plus 3 days (T+3)	**Carried out.** On 10 December 2007, CSE effectively moved to a T+3 settlement cycle for buying and selling in the equities market.
III. Corporate Governance in the Financial Market		
(1) Directive regulation issued by the Securities and Exchange Commission requiring companies registered under the Companies Act, and publicly listed on the Colombo Stock Exchange to comply with the Sri Lankan Corporate Governance Code. **(T2)**		**Carried out.** On 19 February 2007, the Securities and Exchange Commission issued a directive for registered and listed companies to comply with the Corporate Governance Code effective 1 April 2007. Within 1 year, companies are allowed to explain noncompliance with the directive. The directive has been strictly enforced since 1 April 2008.

Focus of Reform	Policy Actions to Be Taken Before Second Tranche (T2) and Third Tranche (T3)	Comments
(2) Introduction to Parliament of a bill to amend the Securities and Exchange Commission Act **(T2)**	Incorporating an obligation of the MOFP to appoint Securities and Exchange Commission commissioners that collectively facilitate a Securities and Exchange Commission that is independent from the Borrower by virtue of reflecting a balanced and diverse representation of public and private interests.	**Carried out.** The cabinet approved the Securities and Exchange Commission Act amendment; the gazetted notification is dated 13 March 2009. The Securities and Exchange Commission Act amendment was submitted to Parliament on 3 June 2009.
(3) Introduction to Parliament of a bill to amend the Banking Act **(T2)**	To provide the Central Bank the power and authority to take action against Fraudulent Financial Schemes.	**Carried out.** On 10 February 2005, the Banking Amendment Act No. 2 inserted Article 83C in the Banking Act, stipulating the powers of CBSL to take action against fraudulent financial schemes.
IV. Money Laundering		
(1) Cabinet approval of Anti-Money Laundering Bill **(T2)**		**Carried out.** The anti-money laundering framework includes three laws. On 8 August 2005, the Convention on the Suppression of Terrorist Financing Act was enacted. This is consistent with the United Nations convention of 10 January 2000. It provides for a financial intelligence unit (FIU) under CBSL with the responsibility to make investigations. The Prevention of Money Laundering Act and the Financial Transactions Reporting Act, both enacted on 6 March 2006, set out measures to combat money laundering and provide the FIU with the appropriate legal powers, and provide for the establishment of the FIU. The FIU receives reports of all cash and electronic transactions exceeding SLRs0.5 million and requires financial institutions and fund managers to appoint compliance officers and undertake customer due diligence. The FIU was established on 23 March 2006 and submitted its first progress report in November 2006.
(2) Introduce Anti-Money Laundering Bill in Parliament **(T3)**		**Carried out.** The Anti-Money Laundering Bill was submitted to Parliament in October 2005.
V. Insurance Industry Regulation		
(1) Cabinet approval of amendment to the Insurance Industry Act. **(T2)**	Permitting insurance companies registered under the Insurance Act to invest in securities including unit trusts, commercial paper, debt securities, and bonds issued against Securitized Assets (the "Amendments to the Insurance Act")	**Carried out.** The Insurance Board of Sri Lanka prepared a draft amendment to the Regulation of Insurance Industry Act. The cabinet approved the amendment on 10 December 2007.
(2) Introduce amendment to the Insurance Industry Act in		**Carried out.** The amendment to the Insurance Industry Act was submitted to Parliament on 3 June 2009.

Focus of Reform	Policy Actions to Be Taken Before Second Tranche (T2) and Third Tranche (T3)	Comments
Parliament **(T3)**		
VI. Corporate Governance of State-Owned Commercial Banks		
(1) Introduction to Parliament of a bill to amend the People's Bank Act incorporating measures to ensure the commercial and political independence of the People's Bank board of directors and management. **(T2)**		**Partially carried out.** An amendment to the People's Bank Act is not feasible due to lack of support from People's Bank Employees Union. The government and People's Bank have committed to undertake an alternative action to meet the policy objectives by issuing a People's Bank corporate charter consistent with (i) the code of best practice in corporate governance in public enterprises issued by MOF in January 2003, (ii) the CBSL guidelines for corporate governance of banks effective January 2008, and (iii) responsibilities and duties of directors and officers under the Companies Act. The People's Bank board adopted the corporate charter on 25 January 2008 after stakeholder consultation with the government, CBSL, and ADB. The corporate charters of People's Bank and Bank of Ceylon will catalyze improved operating efficiency of both banks by enhancing responsible, accountable, and value-based performance management, as well as furthering effective oversight through stringent accountability procedures (such as an effective internal audit system and the appointment of specialized board subcommittees for compliance, audit, governance, and risk management). In line with international best practices, detailed guidelines are given under the charters to ensure that competent boards and corporate management teams are appointed that will function effectively by promoting value added and independent decision making processes in the best interest of the two banks. The corporate charters emphasize that the state's role in the two banks will be limited to strategic issues and policies. The state will not intervene in day-to-day management of the banks.
(2) Introduction to Parliament of a bill to amend the Bank of Ceylon Act incorporating measures to ensure the commercial and political independence of the Bank of Ceylon board of directors and management. **(T2)**		**Partially carried out.** The amendment to the Bank of Ceylon Act is unlikely due to lack of support from Ceylon Bank Employees Union. The government and Bank of Ceylon have committed to undertake an alternative action to meet the policy objectives by issuing a Bank of Ceylon corporate charter consistent with (i) the Code of Best Practice in Corporate Governance in Public Enterprises issued by MOF in January 2003, (ii) the CBSL guidelines for corporate governance of banks effective January 2008, and (iii) responsibilities and duties of directors and officers under the Companies Act. On 14 November 2007, the Bank of Ceylon board approved the Bank of Ceylon Code of Best Practice on Corporate Governance after stakeholder consultation with the government, CBSL, and ADB.

Focus of Reform	Policy Actions to Be Taken Before Second Tranche (T2) and Third Tranche (T3)	Comments
		The corporate charters of People's Bank and Bank of Ceylon will catalyze improved operating efficiency of both banks by enhancing responsible, accountable, and value-based performance management as well as furthering effective oversight through stringent accountability procedures (such as an effective internal audit system and the appointment of specialized board subcommittees for compliance, audit, governance, and risk management). In line with international best practice, detailed guidelines are given under the charters to ensure that competent boards and corporate management teams are appointed that will function effectively by promoting value-added and independent decision-making processes in the best interest of the two banks. The corporate charters emphasize that the state's role in the two banks will be limited to strategic issues and policies. The state will not intervene in their day-to-day management.
VII. Strategic Enterprise Management Agency		
Introduction of Strategic Enterprise Management Agency (SEMA) Act to Parliament **(T2)**	Incorporating at least: (a) the essential principles contained in the Presidential Decree, dated 4 June 2004, establishing SEMA; (b) measures to ensure the commercial and political independence of the People's Bank (i) board of directors; and (ii) management; (c) measures to ensure the commercial and political independence of the Bank of Ceylon's (i) board of directors; and (ii) management; and (d) any necessary consequential amendments to the People's Bank Act, and the Bank of Ceylon Act.	**Partially carried out.** MOFP advised that the passage of the Strategic Enterprise Management Agency Act is not feasible due to lack of support from People's Bank Employees Union and Ceylon Bank Employees Union. The following alternative actions were agreed to meet the policy objective of commercial and political independence of People's Bank and Bank of Ceylon. MOFP has established a steering committee for the banking system, chaired by the governor of CBSL and cochaired by the treasury secretary. SEMA is a member of the committee. The committee oversees the consistent application of governance reforms for banking in line with the corporate governance codes issued by CBSL for all banks. In the case of state-owned banks, it also oversees compliance with MOFP guidelines on corporate governance for public enterprises issued in 2003. CBSL issued a new code of corporate governance for banks in December 2007 consistent with pillar 2 of the Basel II framework. The code is designed to strengthen board and management oversight and competence for risk management. Considering the fiduciary responsibility of boards to their stakeholders, and in the interest of wider financial system stability, CBSL issued a directive on corporate governance in December 2007 requiring the banks to streamline their governance practices from 2008. Furthermore, on 23 April 2008, the boards of People's Bank and Bank of Ceylon adopted a corporate charter under which detailed guidelines are given to ensure that competent boards and corporate management teams are appointed that will function effectively by promoting value-added and independent

Focus of Reform	Policy Actions to Be Taken Before Second Tranche (T2) and Third Tranche (T3)	Comments
		decision-making processes in the best commercial interest of the two banks. The corporate charter emphasizes that the state's role in the two banks will be limited to strategic issues and policies. The state will not intervene in their day-to-day management.
VIII. People's Bank Unions		
Establishment of a collective agreement by the People's Bank **(T2)**		**Waiver requested.** People's Bank signed collective agreements with the Ceylon Bank Employees Union and People's Bank Officers Association on 29 June 2006. The collective agreements do not explicitly support the restructuring plan. During the midterm review, the government asked that this policy action be waived. The People's Bank board and management have demonstrated their resolve and ability to carry out restructuring of People's Bank without formal union support.
IX. Restructuring and Recapitalization of People's Bank		
(1) The People's Bank shall have continued to implement (a) the Restructuring Plan; and (b) the Performance Indicators, (i) in accordance with the agreed time-schedule stated in the Restructuring Plan, or such other time-schedule as shall have been agreed by the People's Bank, SEMA, and ADB in a separate writing, and (ii) to the satisfaction of each of SEMA and ADB. **(T2+T3)**		**Carried out.** The People's Bank development plan 2004–2008 forms the basis for benchmarking the bank's reforms under the program. People's Bank submitted its final strategic plan for 2009–2014 in March 2009, and is now implementing it.
(2) The Borrower shall have provided the People's Bank with funds in the amounts and at the times required in accordance with the Phased Recapitalization Plan. **(T2+T3)**		**Carried out.** To date, the government has provided People's Bank with recapitalization funds on four occasions: SLRs2.0 billion in December 2005, SLRs1.0 billion in December 2006, SLRs1.5 billion in December 2007, and SLRs1.5 billion in December 2008.

Source: Asian Development Bank.

POLICY MATRIX
STATUS OF NONTRANCHE RELEASE ACTIONS

Focus of Reform	Status and Comments
Other Covenants	
Schedule 5 para. 7 Within one month of the Effective Date, a Steering Committee, shall be formed chaired by the Secretary, MOFP and comprised of key officials from concerned ministries and agencies, including the Central Bank, Insurance Board of Sri Lanka, Strategic Enterprise Management Agency (SEMA), the Securities and Exchange Commission, the Land Commissioner's Department, and the People's Bank.	A steering committee was formed in July 2007, more than 2 years after the effective date. This was due to significant time spent by the new government (which came into power at the end of 2005) to rebuild ownership and find an appropriate way forward.
Schedule 5 para. 10 The Borrower shall ensure that the Borrower's phased recapitalization of the People's Bank shall be suspended if the People's Bank does not achieve the Performance Indicators in accordance with the agreed time-schedule contained in the Recapitalization Plan.	ADB agreed to the borrower's phased recapitalization of People's Bank even though People's Bank did not achieve its performance indicators in accordance with the agreed time schedule in the recapitalization plan.
Schedule 5 para. 11 The Borrower shall ensure that (a) SEMA and the People's Bank inform ADB of any change to the People's Bank Board of Directors, or the People's Bank senior management team as soon as reasonably practicable, following such change, and (b) any such change is made in consultation with SEMA.	Carried out.
Schedule 5 para. 12 The Borrower shall cause SEMA to, and SEMA shall, coordinate the conduct of an independent third-party review of the implementation of the Restructuring Plan of People's Bank at least every six months basis, and shall provide ADB with a report of each such review within 45 days of the end of every six months.	Carried out.
Schedule 5 para. 13 No later than 30 January 2005, the People's Bank shall commence a formal process of consultation and dialogue with the Joint Council on the Restructuring Plan, to consult and discuss the implementation of the Restructuring Plan and to obtain their input and consider their views in the context of the Restructuring Plan; and shall inform employees and obtain	The consultation process was conducted and proved to be unsuccessful.

Focus of Reform	Status and Comments
feedback through the Team Briefing Process on the Restructuring Plan.	
Schedule 5 para. 14 No later than 30 September 2005, the Borrower and SEMA will ensure that the People's Bank enters into an agreement with the Ceylon Bank Employees Union and any trade union of the Joint Council the People's Bank deems relevant following the consultation process on the Restructuring Plan, that requires the parties to implement the Restructuring Plan (the "Collective Agreement").	Compliance is not possible since unions refuse to support the restructuring plan in writing. This was an unrealistic objective once the change of government was undertaken at the end of 2005.
Schedule 5 para. 15 Within 6 months of the Effective Date, the Borrower shall cause the Securities and Exchange Commission to commence preparation of a Sri Lankan Corporate Governance Code for companies registered under the Companies Act and publicly listed on the CSE taking into account the *Code of Corporate Governance for Banks and other Financial Institutions (2002)* issued by the Central Bank of Sri Lanka in 2002 and international best practice.	Carried out. On 19 February 2007, the Securities and Exchange Commission issued a directive for registered and listed companies to comply with the Corporate Governance Code effective 1 April 2007. During the first year, companies were allowed to explain noncompliance with the directive; however, since 1 April 2008, the directive has been strictly enforced.
Schedule 5 para. 16 The Borrower shall ensure that public and private sector entities covered under the Program comply with all applicable environmental regulations, and in particular with provisions of the National Environment Act of 1980, as amended, and ADB's Environment Policy.	Carried out. No applicable environmental regulations relate to policy actions to be carried out by private and public sector entities under the program.
Schedule 5 para. 17 The Borrower shall ensure that that Counterpart Funds are used to finance the local currency costs relating to the implementation of the programs and other activities consistent with the objectives of the Program and the Policy Letter.	Carried out. A significant portion of the counterpart funds was used to finance the recapitalization of People's Bank consistent with the objectives of the program and policy letter.
Schedule 5 para. 18 Within three months of the Effective Date, the MOFP shall establish and maintain a Program Performance Management System for the monitoring and evaluation of the Program during and after implementation, acceptable to ADB (the "PPMS"). The PPMS shall include a database on the status of policy measures. Quarterly reports of the PPMS shall be submitted to the	Carried out.

Focus of Reform	Status and Comments
Steering Committee and ADB within 30 days of the end of each quarter.	
Schedule 5 para. 19 The MOFP 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.	Carried out.
Schedule 5 para. 22 The Borrower shall have used its best efforts to introduce into Cabinet a bill to amend the Securities and Exchange Commission Act to permit trading of derivative and futures instruments no later than the release of the Second Tranche.	Carried out.
Schedule 5 para. 23 The Borrower shall encourage the Central Bank to issue a directive requiring interest rate swap transactions to comply with the Protocols of the International Swaps and Derivatives Association, Inc. no later than the release of the Second Tranche.	Carried out. On 31 December 2005, CBSL issued a directive on derivatives trading permitting interest rate swaps, interest rate options, forward rate agreements, cross-currency swaps, and currency commodity options for up to 10 years based on the underlying asset.

Source: Asian Development Bank.

PROGRAM ASSURANCES

The government has given program and project loan assurances that must be complied with during implementation of the Financial Markets Program for Private Sector Development. These assurances are not related to the second and third tranche release requirements.

Achievements Action	Implementation Status
Program Loan	
1. The policies adopted and actions taken before the date of the Loan Agreement as described in the development policy letter and the policy matrix will continue to be in effect for at least the duration of the Program Agreement.	Ongoing.
2. The Government will adopt the other policies and actions included in Program and specified in the development policy letter and the policy matrix in a timely manner, and will ensure that the policies and actions continue to be in effect for at least the duration of the Program.	Ongoing.
3. The Government will ensure that public and private entities covered under the Program comply with all applicable environmental regulations, and in particular with the provisions of the National Environment Act of 1980, as amended and ADB's Environment Policy.	Carried out. No applicable environmental regulations relate to policy actions for the private and public sector entities under the program.
4. Except as ADB may otherwise agree, the Government will ensure that the Government's phased recapitalization of the People's Bank under the Restructuring Plan will be suspended if the People's Bank does not achieve the performance targets according to the agreed schedule contained in the Restructuring Plan. In such an event, ADB will conduct a special review mission of the financial performance and operations of the People's Bank, after which ADB, the People's Bank, Strategic Enterprise Management Agency (SEMA), and the Government shall agree on a remedial plan to achieve the performance targets or such other recommendations made by the mission.	Carried out. ADB has agreed that despite People's Bank not achieving all the performance targets according to the agreed schedule contained in the restructuring plan, the government's phased recapitalization of People's Bank can continue.
5. No later than 30 September 2005, the Government and SEMA will ensure that the People's Bank enters into a Collective Agreement with the trade union representing more than 85% of full time employees, and other parties, as the People's Bank considers necessary, and among other things, agree to implement the restructuring plan.	Compliance is not possible since unions refuse to support the restructuring plan in writing.
6. SEMA will conduct an independent third party review of operations of the People's Bank on a semi-annual basis.	Carried out.
7. Within 6 months from the effective date, SEMA will commence preparation of (i) the SEMA Act, (ii) amendments to the People's Bank Act, and (iii)	Compliance is not possible since passage of the Strategic Enterprise Management Agency Act, and amendments to the People's Bank Act and Bank of Ceylon Act is not

Achievements Action	Implementation Status
amendments to the Bank of Ceylon Act.	feasible due to lack of support from People's Bank Employees Union and Ceylon Bank Employees Union.
8. The Government will ensure that SEMA and the People's Bank inform ADB of any change to the board of directors or management of the People's Bank as soon as reasonably practicable.	Carried out.
9. Within 6 months of the effective date of the loans, the Government shall cause the Securities and Exchange Commission to commence preparation of a Sri Lankan Corporate Governance Code for companies listed on the CSE.	Carried out.
10. The Government shall have used its best efforts to introduce into Cabinet a bill to amend the Securities and Exchange Commission Act to permit trading of derivative and futures instruments no later than the release of the second tranche.	Carried out.
11. The Government shall encourage the Central Bank to issue a directive requiring interest rate swap transactions to comply with the protocols of the International Swaps and Derivatives Association, Inc. no later than the release of the second tranche.	Carried out. On 31 December 2005, CBSL issued a directive on derivative trading permitting interest rate swaps, interest rate options, forward rate agreements, cross-currency swaps, and currency commodity options up to 10 years based on the underlying asset.
12. The Borrower shall use its best efforts to introduce a bill to amend the Revenue Act and the Companies Act into Parliament (if needed), to eliminate taxation on the dividend paid on fixed income mutual funds so preventing double taxation, no later than the release of the second tranche.	Ongoing.
TA Loan	
1. Within one month of Parliament’s enactment of the SEMA Act, the Government shall cause SEMA to become a party to the TA Project Agreement and assume all rights powers, duties, and obligations of the Implementing Agencies under the TA Project Agreement.	Not carried out. since Parliament has not enacted the Strategic Enterprise Management Agency Act.
2. The Government shall ensure that for the capacity building provided to the Implementing Agencies, selection criteria satisfactory to ADB is adopted in connection with identifying staff members for training; that training is provided in accordance with arrangements satisfactory to ADB; and that the recipients of such training continue their services for no less than two years upon completion of the training.	Carried out.
3. People’s Bank shall review market research provided under the TA Project, and based on such market research, consider revisions to its business plan.	No market research was provided under the TA project.

ADB = Asian Development Bank, CBSL = Central Bank of Sri Lanka, MOFP = Ministry of Finance and Planning, TA = technical assistance.
Source: Asian Development Bank.

CHRONOLOGY OF FINANCIAL MARKETS PROGRAM FOR PRIVATE SECTOR DEVELOPMENT

Type of Mission	Dates	Mission Duration (days)	No. of Travelers	Total Field Days	Person-Months
Inception	23–26 Feb 2005	4	4	16	0.53
Review	21–22 Jul 2005	2	1	2	0.07
Review	24–30 Aug 2005	7	2	14	0.47
Review	29–30 Aug 2005	2	1	2	0.07
Review	24–26 Nov 2005	3	1	3	0.10
Subtotal 2005				**37**	**1.24**
Review	25–28 Jan 2006	4	2	8	0.27
Review	24–26 Apr 2006	3	1	3	0.10
Review	1–3 Aug 2006	3	2	6	0.20
Review	31 Oct–3 Nov 2006	4	2	8	0.27
Review	5–14 Dec 2006	10	2	20	0.67
Subtotal 2006				**45**	**1.51**
Midterm Review	14–28 Mar 2007	15	3	45	1.50
Midterm Review	20–29 Mar 2007	10	1	10	0.33
Review	15-23 Aug 2007	9	1	9	0.30
Review	23 Aug 2007	1	1	1	0.03
Review	4–12 Dec 2007	3	2	6	0.20
Subtotal 2007				**71**	**2.36**
Review	22–24 Jan 2008	2	2	4	0.13
Review	12–14 May 2008	1	2	2	0.07
Review	15–17 Dec 2008	3	1	3	0.10
Subtotal 2008				**9**	**0.30**
Review	20–22 Mar 2009	3	1	3	0.10
Subtotal 2009				**3**	**0.10**
Review	2–4 Aug 2010	3	1	3	0.10
Subtotal 2010				**3**	**0.10**
Total				**168**	**5.61**

Source: Asian Development Bank.

KEY ECONOMIC INDICATORS

Item	Fiscal Year 2006	2007	2008	2009	2010 Latest
A. Income and Growth					
1. GDP per capita ($, current)	1,421.0	1,634.0	2,014.0	2,053.0	
2. GDP growth (%, in constant prices)	7.7	6.8	6.0	3.5	8.5 (Q2); 7.8 (Half-yearly)
a. Agriculture	6.3	3.4	7.5	3.2	5.1 (Q2); 7.2 (Half-yearly)
b. Industry	8.1	7.6	5.9	4.2	9.2 (Q2); 8.0 (Half-yearly)
c. Services	7.7	7.1	5.6	3.3	8.8 (Q2); 7.8 (Half-yearly)
B. Saving and Investment (current and market prices, % of GDP)					
1. Gross domestic investment	28.0	28.0	27.6	24.5	
2. Gross national saving	22.3	23.3	17.8	23.9	
C. Money and Inflation (annual % change)					
1. Consumer price index	10.0	15.8	22.6	3.4	4.5 (Jan-Aug)
2. Total liquidity (M2)	17.8	16.6	8.5	18.6	6.1 (Jan-July)
D. Government Finance (% of GDP)					
1. Revenue and grants	17.3	16.6	15.6	15.1	4.4 (Jan-April)
2. Expenditure and onlending	24.3	23.5	22.6	24.8	7.5 (Jan-April)
3. Overall fiscal surplus (deficit)	(7.0)	(6.9)	(7.0)	(9.8)	(3.1) (Jan-April)
E. Balance of Payments					
1. Merchandise trade balance (% of GDP)	(11.9)	(11.0)	(14.0)	(7.4)	
2. Current account balance (% of GDP)	(5.3)	(4.3)	(9.5)	(0.5)	
3. Merchandise export ($) growth (annual % change)	8.4	12.5	6.5	(12.7)	13.7 (Half yearly)
4. Merchandise import ($) growth (annual % change)	15.7	10.2	24.0	(29.5)	42.1 (Half yearly)
F. External Payments Indicators					
1. Gross official reserves (including gold, $ million in weeks of current year's imports of goods)	13.2	14.8	6.0	24.8	20.4 (End of May)
2. Gross Official Reserves ($ million)	2,515.0	3,063.0	1,753.0	5,097.0	5,428.4 (End June)
3. External debt service (% of exports of goods and services)	12.7	13.1	15.0	16.9	
4. Total external debt (% of GDP)	49.4	51.0	43.7	49.8	
G. Memorandum Items					
1. GDP (current prices, SLRs billion)	2,939.0	3,578.0	4,411.0	4,825.0	2,705.0 (Half yearly)
2. Exchange rate (SLRs/$, average)	104.0	110.6	108.3	114.9	113.73 (Till 31 Aug)
3. Population (million)	19.9	20.0	20.2	20.5	

( ) = negative, GDP = gross domestic product, SLRs = Sri Lankan Rupees.

Sources: Central Bank Annual Report 2009, Central Bank Website – Selected Economic Indicators 31 August 2010, and Department of Census and Statistics National Accounts 2010.

KEY PERFORMANCE INDICATORS

Table A6.1: People's Bank Development Plan, 2004–2008

	2004		2005		2006		2007		2008	
Item	**Actual**	**Strategic Plan Targets**	**Actual**	**Strategic Plan Targets**	**Actual**	**Strategic Plan Targets**	**Actual**	**Strategic Plan Targets**	**Actual**	**Strategic Plan Targets**
Cost–Income Ratio (%)	73.1	73.5	72.7	72.8	73.8	71.9	68.7	69.0	65.4	66.0
Nonfunded Income–Net Income Ratio (%)	22.9	21.3	21.6	23.4	19.0	25.0	22.9	27.6	22.5	28.3
Head Count - Permanent	9,592	10,060	9,531	9,700	9,645	9,400	8,416	9,100	8,587	8,800
Profit per Employee (SLRs '000)	217	180	291	210	327	240	282	320	315	400
Return on Asset (Pre-tax) (%)	1.2	0.8	1.6	0.8	1.3	0.9	1.4	1.1	1.5	1.2
Return on Equity (%)	(289.0)	20.2	139.2	22.1	44.2	23.8	20.5	29.8	18.8	34.5
Capital Adequacy (%)	(2.3)	0.7	1.9	4.3	5.6	9.1	6.9	12.9	10.5	16.4
Advances–Deposits Ratio (%)	66.0	70.8	63.2	70.4	76.7	73.6	84.0	73.3	81	74.5
Net Interest Margin (%)	4.5	4.2	4.3	4.0	4.5	4.0	4.6	3.8	4.9	3.7
Nonperforming Advances– Total Advances Ratio (%)	14.1	17.00	11.0	15.2	7.1	13.0	5.9	11.2	6.7	9.7
Total Loans and Advances	140,209	120,672	157,738	125,664	223,391	138,825	253,370	151,529	263,462	168,212
Total Nonperforming Loans	19,715	20,572	17,418	19,142	15,951	17,987	14,865	17,027	17,857	16,237

( ) = negative.
Source: People's Bank.

Table A6.2: People's Bank Strategic Plan, 2009–2014

	2009		Dec 2010	Dec 2011	Dec 2012	Dec 2013	Dec 2014
Item	**Actual**	**Strategic Plan Targets**	**Strategic Plan Targets**	**Strategic Plan Targets**	**Strategic Plan Targets**	**Strategic Plan Targets**	**Strategic Plan Targets**
Cost–Income Ratio (%)	60.6	71.0	57.6	54.9	56.4	52.7	50.0
Nonfunded Income–Net Income Ratio (%)	21.9	22.6	17.4	16.9	17.0	16.8	16.1
Head Count – Permanent	8,863	8,600	8,750	8,790	8,780	8,710	8,650
Profit per Employee (SLRs '000)	375	302	497	601	644	808	885
Return on Assets (Pre-tax) (%)	1.4	1.3	1.4	1.7	1.6	1.8	1.9
Return on Equity (%)	19.7	14.6	23.0	24.0	23.0	25.0	24.0
Capital Adequacy (%)	12.6	12.0	12.1	12.2	12.1	12.4	12.3
Advances–Deposits Ratio (%)	75.0	82.0	79.0	80.0	80.0	81.0	81.0
Net Interest Margin (%)	5.2	4.6	5.2	5.0	4.9	4.8	4.8
Nonperforming Advances / Total Advances (%)	6.7	6.3	6.7	6.3	5.8	5.3	4.8
Total Loans and Advances	299,077	293,545	353,631	398,669	508,373	508,373	574,363
Total Nonperforming Loans	20,040	18,600	23,800	24,990	27,027	27,027	27,837

Source: People's Bank.