



Technical Assistance Report

Project Number: 50349-003
Transaction Technical Assistance (TRTA)
January 2022

Democratic Socialist Republic of Sri Lanka: Enhancing Small and Medium-Sized Enterprises Financial Services Outreach

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 2 December 2021)

Currency unit	–	Sri Lanka rupee (SLRe/SLRs)
SLRs1.00	=	\$0.00495
\$1.00	=	SLRs201.95

ABBREVIATIONS

ADB	–	Asian Development Bank
CBSL	–	Central Bank of Sri Lanka
COVID-19	–	coronavirus disease
ERC	–	Emergency Response Component
PFI	–	participating financial institutions
SMEs	–	small and medium-sized enterprises
SMECGI	–	SME credit guarantee institution
TA	–	technical assistance
WSMEs	–	women-owned small and medium-sized enterprises

NOTE

In this report, "\$" refers to United States dollars.

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CONTENTS

	Page
TRANSACTION TECHNICAL ASSISTANCE AT A GLANCE	
I. THE ENSUING PROJECT	1
II. THE TECHNICAL ASSISTANCE	3
A. Justification	3
B. Outputs and Activities	3
C. Cost and Financing	4
D. Implementation Arrangements	4
III. THE PRESIDENT'S DECISION	5
APPENDIXES	
1. Cost Estimates and Financing Plan	6
2. List of Linked Documents	7

TRANSACTION TECHNICAL ASSISTANCE AT A GLANCE

1. Basic Data		Project Number: 50349-003	
Project Name	Enhancing Small and Medium-Sized Enterprises Financial Services Outreach	Department/Division	SARD/SAPF
Nature of Activity	Capacity Development	Executing Agency	Department of Development Finance
Modality	Regular		
Country	Sri Lanka		
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		0.80
		Total	0.80
3. Operational Priorities		Climate Change Information	
✓ Addressing remaining poverty and reducing inequalities		GHG Reductions (tons per annum)	0.000
✓ Accelerating progress in gender equality		Climate Change impact on the Project	Low
✓ Tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability		ADB Financing	
✓ Strengthening governance and institutional capacity		Adaptation (\$ million)	0.10
		Mitigation (\$ million)	0.00
		Cofinancing	
		Adaptation (\$ million)	0.00
		Mitigation (\$ million)	0.00
Sustainable Development Goals		Gender Equity and Mainstreaming	
SDG 1.1, 1.5		Effective gender mainstreaming (EGM)	✓
SDG 5.a			
SDG 8.10, 8.3		Poverty Targeting	
SDG 9.3		General Intervention on Poverty	✓
SDG 10.1			
SDG 13.a			
4. Risk Categorization Complex			
5. Safeguard Categorization Safeguard Policy Statement does not apply			
6. Financing			
Modality and Sources		Amount (\$ million)	
ADB		0.80	
Transaction technical assistance: Financial Sector Development Partnership Special Fund		0.30	
Transaction technical assistance: Technical Assistance Special Fund		0.50	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		0.80	
Currency of ADB Financing: US Dollar			

I. THE ENSUING PROJECT

1. **Development challenge.** Small and medium-sized enterprises (SMEs) are critical for Sri Lanka's sustainable economic growth. They are responsible for 52% of the country's gross domestic product. SMEs are arguably even more important for poverty reduction as they provide 45% of employment and considered as a source of innovation.¹ Despite their importance, SMEs struggle to access financing for business growth.² Key constraints include banks' insufficient lending capacity, SMEs' limited business development capacity, networking, and insufficient policy and institutional framework. These issues are more severe for women-owned SMEs (WSMEs), which is represented only around 8% among formal enterprises.³

2. The Asian Development Bank (ADB) has supported the Government of Sri Lanka to address the issues with strong focus on women empowerment through a series of loans, grants and technical assistance (TAs) (Appendix 2). In particular, Small and Medium-Sized Enterprise Line of Credit Project has brought positive impacts in changing the behaviors of banks and SMEs.⁴ During 2016–2020, \$175 million worth of ADB loans have reached out to 3,539 SMEs, of which 1,339 (37.8%) are WSMEs, with semi-annual lending targets for participating banks and cofinancing grant for WSMEs. However, banks still rely heavily on collateral-based-lending—resulting to further financial exclusions of many SMEs, in particular WSMEs, who do not have collateral.

3. **Impact of the coronavirus disease pandemic.** The coronavirus disease (COVID-19) pandemic has severely impacted the SME sector in the country. Decline of global demand, supply chain disruption, and slowdown of local economic activities due to the social distancing and containment measures have caused many SMEs to face liquidity shortage which severely hampered business continuation. The government has provided economic relief measures targeting the vulnerable SMEs: (i) the Central Bank of Sri Lanka (CBSL) relaxed monetary policy, launched an LKR150 billion concessionary refinancing program to provide liquidity to SMEs; (ii) financial institutions were allowed to reschedule nonperforming loans without downgrading asset classification; and (iii) the government announced a debt repayment moratorium on bank loans for SMEs until December 2021.⁵ In spite of these measures and although banks are well-capitalized, there is a risk that the lending capacity of the banks will decline as asset quality worsens and profitability declines due to prolonged impact of the pandemic.

4. In November 2020, ADB approved the third additional financing to the Small and Medium-Sized Enterprise Line of Credit Project to provide affordable working capital financing through 10 local banks to SMEs under its Emergency Response Component (ERC).⁶ As of 30 September 2021, around \$37.5 million equivalent of the ERC were lent to 1,260 SMEs, and 526 (42%) were without collateral against real estates or financial assets, which exceeds an original target of 20%. However,

¹ Ministry of Industry and Commerce, Government of Sri Lanka. 2015. [National Policy Framework for Small Medium Enterprise \(SME\) Development](#). Colombo. The national definition of SMEs in this policy framework includes informal (i.e., unregistered), micro, small and medium-sized enterprises. SMEs in this TA report follows this national definition.

² An International Finance Corporation (IFC) study revealed that the credit supply to formal SMEs is \$2.1 billion, while \$13.7 billion of demand is unmet. Some 35% of formal SMEs indicated that they were fully constrained by finance and 31% indicated that they were partly constrained (Source: IFC. 2017. [IFC Enterprise Finance Gap Survey](#)).

³ It was estimated that 27% of informal enterprises are controlled by women (Source: Department of Census and Statistics. [Non-Agricultural Economic Activities in Sri Lanka Economic Census 2013/2014](#). 2014 Colombo).

⁴ ADB. [Small and Medium-Sized Line of Credit Project](#).

⁵ World Bank. 2021. [Sri Lanka Development Update 2021: Economic and Poverty Impact of COVID-19](#). Washington DC.

⁶ ADB. 2020. [Report and Recommendation of the President: Proposed Loan and Administration of Grant and Technical Assistance Grant for Third Additional Financing for Small and Medium-Sized Enterprises Line of Credit Project](#). Manila. The third additional financing of \$165 million loan has three components: (i) Emergency Response Component to provide affordable working capital loans for SMEs affected by COVID-19, (ii) SME Component to provide long-term loans for underserved SMEs, mainly WSMEs, to undertake capital investments, and (iii) Pilot Component to provide affordable long-term loans for tea smallholders to promote capital investments, including replanting.

its outreach remains constrained. State-owned banks tend to provide non-collateralized subloans to rural micro enterprises but require personal guarantee, and private sector banks have less reliance on personal guarantee while merely meeting the minimum non-collateralized subloan target of 20% by focusing on medium-sized enterprises.⁷ To mobilize liquidity to a wider range of SMEs, a well-functioning credit guarantee scheme is critical for mitigating banks' risks especially under the current market environment (para. 3). The credit guarantee scheme can also catalyze banks' lending to long-term capital investments to accelerate post-pandemic economic recovery and transformation. Notwithstanding, the COVID-19 pandemic has also created opportunities for economic diversification and innovation, including the rise of e-commerce and other knowledge-based services, which currently do not have much asset for collateral thus face difficulty in financial access.

5. **Sustainable SME credit guarantee.** Recognizing the timely need for enhancing SME financing, the government requested ADB's support for developing an SME credit guarantee facility. The government has historically launched various SME credit guarantee schemes, but none has flourished. Market participants cite operational deficiencies and issues such as slow claims processing, limited guarantee coverage, and high premiums. In May 2021, the government has obtained its cabinet approval for establishing a financially sustainable SME credit guarantee institution (SMECGI) based on ADB's original proposal in 2017, which reflected lessons learned from previous local experiences and international best practices, including World Bank's principles for public credit guarantee schemes for SMEs.⁸

6. **The ensuing project.** ADB will support the government's vision to create a sustainable mechanism for credit guarantee operations, rather than launching a short-term measure for easing credit to SMEs. For this reason, the ensuing project, Small and Medium-Sized Enterprises Credit Guarantee Institution Project, is being designed towards a sustainable operation of SMECGI. It should be well-funded, profitable, efficiently managed, removed from political influence, and operated with the highest level of corporate governance and risk management practices with support from the central bank. Those principles will ensure SMECGI retains a strong credit rating to attract participating financial institutions (PFIs). SMECGI will be incorporated under the Companies Act and jointly owned by the government and the PFIs that will access SMECGI's credit guarantee services.⁹ The joint ownership structure will mitigate the risks of adverse selection and moral hazard by PFIs in originating and monitoring guaranteed loans. PFIs will nominate board directors to reflect their relevant views as guarantee service users and equity investors in SMECGI operations.

7. The project's outcome is SME access to finance enhanced, and the project outputs are (i) corporate and regulatory framework for SMECGI established (project output 1), (ii) financially sustainable guarantee institution operationalized (project output 2), and (iii) SME financial outreach enhanced (project output 3). ADB's \$100-million loan will be used for the government to subscribe SMECGI's capital for its initiation and expansion of credit guarantee services to SMEs.

⁷ The analysis was carried out for 858 subloans that were approved by the executing agency, Ministry of Finance, during January–July 2021.

⁸ ADB. 2016. [Technical Assistance Consultant's Report: Credit Guarantee Scheme Draft Final Report](#). Manila; Refer to linked document 4 (Lessons Learned from Previous Credit Guarantee Schemes in Sri Lanka) and linked document 5 (International Precedent of SME Credit Guarantee Schemes), accessible in Appendix 2.

⁹ The initial ownership structure of SMECGI is targeted at 80–90% by the government and 10–20% by initial PFIs subject to the ongoing negotiation between the government and initial PFIs. Later, the equity subscription by private sector entities may increase, in concurrence with ADB, by new equity issuances to new PFIs and strategic investors.

II. THE TECHNICAL ASSISTANCE

A. Justification

8. The proposed TA will support the implementation of the ensuing project. Beyond formulating the plan for establishing the SMECGI, the TA will support SMECGI's operationalization in a prompt manner as response measure to the pandemic and in line with best practices (para. 5). Through the TA, ADB will proactively contribute to building the SMECGI's credibility in the market. The financial soundness that ADB will require will improve the SMECGI's credit rating, which will in turn increase capital efficiency of the financial sector and reduce the borrowing rates for SMEs.¹⁰ The TA will strengthen the capacity of SMECGI in achieving priority development mandates, such as financial inclusion of WSMEs and climate change adaptation, in a sequential manner. Furthermore, the TA will support developing an enabling regulatory environment and market infrastructure to promote innovative financing modalities for SMEs that are constrained by collateral requirements.¹¹ As such, the proposed TA (i) is highly relevant in addressing the fundamental issue of SMEs' limited financial access to accelerate post-pandemic economic recovery (para. 4), (ii) is innovative given it is the first attempt for Sri Lanka to establish SMECGI (para. 5), and (iii) will mobilize highly technical knowledge and capacity building support in a holistic manner to overcome past failures (paras. 5–9). The TA is included in the country operations business plan for Sri Lanka, 2021–2023.¹²

B. Outputs and Activities

9. The proposed TA will support project outputs 2 and 3 (para. 7) through the following three TA outputs.¹³ TA outputs 1 and 2 will support SMECGI meet conditions for disbursement and utilization of ensuing loan disbursements and its initiation of guarantee operations while TA output 3 will strengthen enabling environment for SME finance.

10. **Output 1: Operational frameworks of Small and Medium-Sized Enterprises Credit Guarantee Institution developed.** The TA will support developing corporate management and business operations for launching guarantee operations and strengthen SMECGI's capacity through the following key activities:

- (i) **Guarantee operations.** The TA will provide hands-on support for SMECGI staff to finalize and implement policies, in accordance with the agreements to be captured in participation agreement and gender-responsive banking practices, on (a) guarantee origination and approvals including risk-based pricing of guarantee fee, (b) guarantee management including efficient and transparent claim procedures, (c) treasury operations, (d) risk management, and (e) guarantee recovery operations with PFIs.
- (ii) **Safeguards.** The TA will support SMECGI staff to establish and implement an environmental and social management system in compliance with ADB's safeguard policy.¹⁴
- (iii) **Financial management, monitoring, and other corporate management.** The TA will develop SMECGI's human resource strategy, monitoring and evaluation through a sex-disaggregated management information system, and financial management system to ensure proper project financial accounting and reporting by PFIs.

¹⁰ Because the guarantee institution is expected to have a high domestic credit rating, financial institutions will have to hold less capital against its guarantees than it would for the corresponding SME loans.

¹¹ Sri Lanka has key market infrastructure for SME finance, such as secured lending legislation, a credit information bureau, and a property registry, but those infrastructure could be further upgraded to promote cashflow-based lending.

¹² ADB. 2020. *Country Operations Business Plan: Sri Lanka, 2021–2023*. Manila.

¹³ Project output 1 is being supported by the existing TA for Small and Medium-Sized Enterprise Cluster Development and Financial Innovation (TA 9080).

¹⁴ The safeguards categorization for the ensuing project are (i) Environment: FI-B/C, (ii) Involuntary Resettlement: FI-C, and (iii) Indigenous Peoples: FI-C.

11. **Output 2: Small and Medium-Sized Enterprises Credit Guarantee Institution's guarantee business expanded.** The TA will support expanding SMECGI's guarantee business to be financially sustainable and inclusive through the following key activities:

- (i) **Long-term strategy.** The TA will prepare a SMECGI's long-term strategy that targets, among other objectives, attracting external equity investments possibly through an initial public offering that meets the expectations of socially responsible investors.
- (ii) **Women entrepreneurship finance.** Based on the needs assessment of WSMEs, the TA will develop the SMECGI's capacity of supporting WSMEs and launch a new guarantee product and marketing campaign that specifically target WSMEs.¹⁵
- (iii) **Climate change finance.** Based on a gap assessment of the enabling environment, SMECGI's corporate strategy, risk management, and monitoring and evaluation systems will be strengthened to incorporate climate change elements in a feasible manner, in line with relevant country systems.¹⁶

12. **Output 3: Enabling environment for small and medium-sized enterprises finance enhanced.** The TA will support developing country's institutional systems that enable financial institutions to undertake cashflow-based lending to SMEs through the following key activities:

- (i) **Promotion of financial literacy.** The TA will support expanding the ongoing government's initiative to provide business development support to women entrepreneurs through online platform in the area of financial literacy.
- (ii) **Credit risk database.** The TA will develop a strategy to introduce a national credit risk database that will house statistical data on the credit attributes of SMEs. The SMECGI and other financial institutions will have access to this data to refine their risk calculations, which can reduce transaction costs for SME loan and guarantee.

C. Cost and Financing

13. The TA is estimated to cost \$800,000, of which (i) \$500,000 will be financed on a grant basis from ADB's Technical Assistance Special Fund (TASF-other sources), and (ii) \$300,000 will be financed on a grant basis from the Financial Sector Development Partnership Special Fund. The key expenditure items are listed in Appendix 1. The government will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, and other in-kind contributions.¹⁷ The government has been informed that approval of the TA does not commit ADB to finance any ensuing project.

D. Implementation Arrangements

14. ADB will administer the TA. The Department of Development Finance, Ministry of Finance will be the executing agency. The SMECGI and Ministry of Finance will be the implementing agencies. The TA will be implemented over 5 years from January 2022 to December 2026. ADB will select,

¹⁵ The TA will take advantage of ADB's ongoing support for developing an ecosystem for women entrepreneurship development through the ongoing TA financed by Women Entrepreneurs Finance Initiative (TA 9080-SRI, Appendix 3). This ongoing TA will support gender gap assessments for PFIs and SMECGI.

¹⁶ The gap assessment will assess the progress of CBSL's [Roadmap for Sustainable Finance in Sri Lanka](#), the readiness of financial institutions to report climate change related information of SME borrowers, and the need of additional fiscal incentives for SMEs to undertake new investments for climate change adaptation using guaranteed loans.

¹⁷ The value of the government contribution is estimated to account for 5.9% of the total TA cost. In addition, SMECGI, as funded by the government and PFIs, will bear the cost for the entire capacity building of SMECGI based on the initial knowledge support from the TA. During the TA implementation, ADB will collaborate with successful public credit guarantee institutions in other Asian countries, such as Malaysia and the Republic of Korea for advising SMECGI.

supervise, and evaluate consultants. The implementation arrangements are summarized in the following table.

Implementation Arrangements

Aspects	Arrangements			
Implementation period	January 2022–December 2026			
Executing agency	Department of Development Finance, MOF			
Implementing agencies	MOF, SMECGI			
Consultants	To be selected and engaged by ADB			
	Firm 1 (QCBS, 90:10)	TA output 3	international (3 person-months) and national (6 person-months)	\$114,000
	Firm 2 (QCBS, 90:10)	TA outputs 1, 2 and 3	national (78 person-months)	\$423,000
	Individual 1	TA outputs 1 and 2	international (3 person-months)	\$82,500
	Individual 2	TA outputs 1 and 2	international (3 person-months)	\$67,500
	Individual 3	TA outputs 1 and 2	national (1 person-month)	\$20,000
Disbursement	Disbursement of TA resources will follow ADB's <i>Technical Assistance Disbursement Handbook</i> (2020, as amended from time to time).			

ADB = Asian Development Bank, MOF = Ministry of Finance, QCBS = quality- and cost-based selection, SMECGI = Small and Medium-Sized Enterprises Credit Guarantee Institution, TA = technical assistance.

Source: Asian Development Bank estimates.

15. **Consulting services.** ADB will engage the consultants following the ADB Procurement Policy (2017, as amended from time to time) and its associated project administration instructions and/or staff instructions.¹⁸ All the disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2020, as amended from time to time).

III. THE PRESIDENT'S DECISION

16. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$800,000 on a grant basis to the Democratic Socialist Republic of Sri Lanka for Enhancing Small and Medium-Sized Enterprises Financial Services Outreach, and hereby reports this action to the Board.

¹⁸ Terms of Reference for Consultants (accessible from the list of linked documents in Appendix 2).

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Amount
A. Asian Development Bank ^a	
1. Consultants	
a. Remuneration and per diem	
i. National consultants (79 person-months)	443.0
b. Local travel	18.0
c. Reports and communications	4.0
2. Seminars and conferences ^b	10.0
3. Contingencies	25.0
Subtotal (A)	500.0
B. Financial Sector Development Partnership Special Fund ^c	
1. Consultants	
a. Remuneration and per diem	
i. International consultants (9 person-months)	225.0
ii. National consultants (6 person-months)	39.0
b. International and local travel	15.0
c. Reports and communications	2.0
2. Contingencies	19.0
Subtotal (B)	300.0
Total	800.0

Note: The TA is estimated to cost \$800,000, of which contributions of \$800,000 from the Asian Development Bank and the Financial Sector Development Partnership Special Fund are presented in the table. The government will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, and other in-kind contributions. The value of the government contribution is estimated to account for 5.9% of the total TA cost.

^a Financed by the Asian Development Bank's Technical Assistance Special Fund (TASF-other sources). Administered by the Asian Development Bank.

^b At least one seminar will be conducted to disseminate the role of credit guarantee for financial inclusion.

^c Administered by the Asian Development Bank.

Source: Asian Development Bank estimates.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/LinkedDocs/?id=50349-001-TARreport>

1. Terms of Reference for Consultants
2. Approved Project Concept Paper
3. Previous and Ongoing ADB Projects for the Development of Small and Medium-Sized Enterprises
4. Lessons Learned from Previous Credit Guarantee Schemes in Sri Lanka
5. International Precedent of Small and Medium-Sized Enterprises Credit Guarantee Schemes