ASIAN DEVELOPMENT BANK **RRP: SRI 34320**

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON

PROPOSED LOANS

TO

THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

FOR THE

RURAL FINANCE SECTOR DEVELOPMENT PROGRAM

November 2003

CURRENCY EQUIVALENTS

(as of 15 October 2003)

Currency Unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	$0.0106
$1.00	=	SLRs94.50

For the purpose of calculations in this report, the rate of $1.00 = SLRs97 has been used.

ABBREVIATIONS

ADB	–	Asian Development Bank
CBS	–	Center for Banking Studies
CBSL	–	Central Bank of Sri Lanka
CRB	–	cooperative rural bank
EA	–	Executing Agency
IA	–	implementing agency
IT	–	information technology
LIBOR	–	London interbank offer rate
MF-NGO	–	microfinance-nongovernment organization
MIS	–	management information system
MOC	–	Ministry of Co-operatives
MPDI	–	Ministry of Policy Development and Implementation
MRE	–	Ministry of Rural Economy
NDTF	–	National Development Trust Fund
NGO	–	nongovernment organization
NPL	–	nonperforming loan
OCR	–	ordinary capital resources
PIU	–	Program/project implementation unit
PMU	–	Program/project management unit
RDB	–	regional development bank
RERF	–	Rural Economy Resuscitation Fund
RF	–	rural finance
RFI	–	rural finance institution
RFSD Act	–	Rural Finance Sector Development Act
RFSDA	–	Rural Finance Sector Development Agency
RFSDP	–	Rural Finance Sector Development Program
SBS	–	Samurdhi banking society
SDB	–	SANASA Development Bank
TA	–	technical assistance
TCCS	–	thrift and credit cooperative society

NOTES

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

This report was prepared by A. Sharma (Team Leader) with assistance from A. Qadir. C. V. Vo, and M. Ozaki.

CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower	Democratic Socialist Republic of Sri Lanka
The Proposal	The proposed Rural Finance Sector Development Program (RFSDP) comprises three loans. Two loans are from the Asian Development Bank (ADB) Ordinary Capital Resources (OCR): (i) a program loan of $50,000,000 to support policy and institutional reforms in the rural finance sector; and (ii) a project loan of $10,000,000 for rural enterprise development. The third loan (also a project loan) of Special Drawing Rights7,005,000 from ADB's Special Funds resources is for institutional strengthening of rural finance institutions (RFIs).
Classification	Poverty Intervention Thematic: Good governance, gender and development
Environment Classification	Category B. An initial environmental examination was undertaken and the summary is a supplementary appendix.
Rationale	Notwithstanding average economic growth of nearly 5% over the past two decades, almost 40% of the population is poor or vulnerable to poverty. Poverty is overwhelmingly a rural phenomenon, as roughly 88% of the poor live in rural areas. Employment, either on-farm or nonfarm, is mainly in subsistence activities typical of poor and low-income households. Poverty reduction, therefore, is the central objective of the economic reform program of the Government of Sri Lanka. A vibrant rural economy requires a robust rural finance sector that can efficiently mobilize and allocate resources and facilitate exchange of goods and services. However, the rural finance sector in Sri Lanka is highly fragmented and the RFIs suffer from weak governance, poor repayment rates, high transaction costs, weak supervision, and recurring losses. Instead of mainstreaming good governance and sustainability as core values, successive governments have adopted ad hoc and short-term measures that exacerbated the weaknesses. As a result, the demand and supply gap for rural credit amounts to Sri Lanka rupees (SLRs) 10 billion ($103 million), of which half relates to rural poor households. The contribution of rural finance to rural growth through investments in agriculture and rural enterprises remains unfulfilled. Production and marketing bottlenecks, due to weak rural infrastructure and low skill levels, reduce the profitability of the rural sector, which remains trapped in low-risk and low-return investments. This will widen income gaps within rural areas and between rural and urban areas, and will have long-term negative effects on consumption and asset buildup, especially for rural poor households.

The Program Loan

Objectives RFSDP is designed to contribute to economic growth and poverty reduction. The goal is to enhance outreach of sustainable rural finance services. The objective is to establish a sustainable rural finance system through policy adjustments and improve the operations of RFIs. Institutionalizing policies that emphasize good governance will yield considerable benefits in terms of fostering a long-term sector-wide perspective for sustainability. Efficient delivery of rural finance services will reduce transaction costs and help ensure viability of RFIs as well as that of rural enterprises, thus contributing to employment generation, income expansion, and poverty reduction.

Components and Outputs Major issues in the rural finance sector that require policy interventions are covered by the program loan. Support for institutional strengthening and outreach are covered by the project loans. The program loan includes five components: (i) conducive policies, (ii) supportive legal and regulatory framework, (iii) institutional reforms for sustainability, (iv) strengthening the demand side, and (v) expansion of rural finance in conflict-affected areas. The reforms introduce fundamental changes in RFIs, namely cooperative rural banks (CRBs), regional development banks (RDBs), the National Development Trust Fund (NDTF), and Samurdhi Banking Societies (SBS). The legal and regulatory framework introduces effective supervision of RFIs and creates legal provision for enhancing the participation of microfinance-nongovernment organizations (MF-NGOs) and other private sector initiatives in rural finance. In addition, the reforms will redefine the Rural Economy Resuscitation Fund (RERF) for extending skills, technical, and marketing support to enable the rural poor to efficiently utilize rural finance services.

Financing Plan ADB will provide a loan of $50,000,000 from its OCR, with a 15-year term, including a grace period of 3 years, and an interest rate to be determined in accordance with ADB's London interbank offer rate (LIBOR)-based lending facility; a commitment charge of 0.75% per annum, and a front-end fee of 0.5% of the loan amount, and such other terms and conditions as set forth in the Program Loan Agreement.

Program Period and Tranching The program loan will be released over a 4-year period in four tranches to meet the expected occurrence of associated costs. The first tranche of $15,000,000 will be released on loan effectiveness, the second tranche of $20,000,000 within 12 months of the first tranche, the third tranche of $10,000,000 within 18 months of the second tranche, and the fourth tranche of $5,000,000 within 18 months of the third tranche, subject to compliance with release conditions.

Executing Agency and Implementation The Ministry of Policy Development and Implementation (MPDI) will be the Executing Agency. The Ministry of Rural

Arrangements	Economy will be the implementing agency (IA) for RERF, RDBs, and the Rural Finance Sector Development Agency; the Ministry of Co-operatives for CRBs; the Ministry of Samurdhi for SBS; and NDTF for NDTF restructuring.
Procurement	Loan proceeds will be utilized to finance the full foreign exchange cost of items produced and procured in ADB member countries, excluding ineligible items.
Counterpart Funds	Counterpart funds generated from the program loan will be used to meet the costs associated with the reform agenda.
The Project Loans	
Objective	There are two project loans. The OCR project loan supports rural enterprise development through a credit line. The project loan from ADB's Special Funds resources will support building sector capacity, developing financial infrastructure, RFI restructuring, and project implementation.
Financing Plan	ADB will provide a loan of $10,000,000 from its OCR, with a 25-year term, including a grace period of 5 years, and an interest rate to be determined in accordance with ADB's LIBOR-based lending facility; a commitment charge of 0.75% per annum, and a front-end fee of 0.5% of the loan amount; and such other terms and conditions as set forth in the Project Loan Agreement. ADB will provide a loan in various currencies equivalent to Special Drawing Rights7,005,000 from its Special Funds resources, with a 32-year term, including a grace period of 8 years; and with an interest rate charge of 1% per annum during the grace period and 1.5% per annum thereafter; and such other terms and conditions as set forth in the Project Loan Agreement.
Executing Agency and Implementation Arrangements	MPDI will oversee and coordinate project implementation. The Central Bank of Sri Lanka (CBSL) will be the IA for building sector capacity. Other IAs, indicated for the program loan, will deal with aspects relating to their respective institutions.
Procurement	Procurement of goods and services will be in accordance with ADB's *Guidelines for Procurement.* Expenditure procedures will be in accordance with ADB's *Loan Disbursement Handbook*. Consultants to be financed from the proceeds of the ADB loan will be recruited in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants. A total of 58 person-months of international and 628 person-months of domestic consulting inputs will be required for implementation. Where firms are to be engaged, the quality and cost-based selection method will be utilized for the selection of consultants. Where possible and appropriate, simplified technical procedures will be applied.

Benefits and Beneficiaries

RFSDP represents a shift to a financial system development approach where sustainable RFIs will meet income expansion, employment generation, and poverty reduction objectives through enhanced outreach and product diversity resulting in more clients served and their diverse needs met over time. Diminishing dependence of RFIs on subsidies will decrease politicization.

Legal and regulatory framework and institutional reforms have been anchored on good governance, transparency, and rigorous financial discipline. Cost-effective supervision ensures the safety of the savings of millions of rural households. While RFSDP will directly support about 10,000 small and micro rural enterprises and 850 community subprojects, the real benefit will accrue with the outreach expansion of RFIs using their own resources, estimated at 200,000 new clients during RFSDP duration.

Social and Environmental Issues

Rural poverty would be reduced more rapidly by sustainable RFIs than welfare-oriented arrangements with no prospects for sustainability. The strengthening of RFIs will ensure that the poverty reduction impact is felt beyond the life of RFSDP. RFIs have sound prospects to expand their services and meet the growing demand and supply gaps. Appropriately designed and priced services that take into consideration the asset and consumption buildup of households are expected to enhance household income above the poverty threshold after four or five micro loan cycles. For dealing with core poverty issues in conflict-affected areas, RFSDP provides a flexible approach for reactivating, strengthening, and establishing new RFIs.

Risks and Safeguards

The major risk relates to lack of sustained Government commitment to a market-driven rural finance sector. The Government's commitment to ongoing financial sector reforms mitigates this risk. Effective policy dialogue, stakeholder coordination, and capacity building are safeguards against the risk for delay in reforms. Public awareness to convey the benefit of reforms will further mitigate this risk. Realization of RFSDP objectives in the conflict-affected areas is related to improvement in operating conditions. In the meanwhile, RFSDP will facilitate the activities of enterprising RFIs in the area and invest in institutional strengthening for rapid expansion as the situation improves.

Resistance to RFI restructuring has been mitigated through upfront agreement with respective institutions on governance framework, support for recapitalization, and institutional strengthening. Safeguarding against delinquency risk is premised on tightening credit standards, more attention to credit risk, and rigorous credit appraisal. In addition, the Government's commitment not to interfere in lending and loan collections will improve the repayment culture.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on three proposed loans to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program (RFSDP).

II. THE SECTOR: PERFORMANCE, PROBLEMS, AND OPPORTUNITIES

A. Sector Description and Performance

2. Sri Lanka's human development index rank (89 out of 173)[1] and per capita gross domestic product ($870)[2] are by far the highest in South Asia. Sri Lanka's economic growth rate of nearly 5% over the past two decades is above the world average, suggesting resilience despite the civil conflict. Nevertheless, growth has been unevenly distributed and has not been fast enough to reduce poverty incidence. Poverty continues to be widespread, with estimates of 25% to 39%[3] of the population in poverty, depending on the level of the underlying poverty line.[4] The sizable difference between the estimates indicates that while the former may be classified as chronically poor, the latter are vulnerable to chronic poverty or to periods of chronic poverty caused by factors such as unemployment and poor harvests. Even those marginally above the poverty line are vulnerable, while the position in the conflict-affected areas[5] of the north and the east is presumed to be worse.[6] Even though there are wide regional disparities in poverty incidence, poverty is overwhelmingly a rural issue.

3. Accordingly, the economic reform program[7] of the Government of Sri Lanka aims to reduce poverty by building a supportive macroeconomic environment and by helping to establish lasting peace by relief, rehabilitation, and reconstruction to reduce conflict-related poverty. Creating opportunities for the poor to participate in economic growth, empowering the poor, and strengthening governance are other strategic foundations of the reforms. Broad-based rural development is the key strategy for poverty reduction including employment and income generation, and access to financial and business services.

4. **High Poverty Concentration in the Rural Sector.** The rural sector consists of about 15 million people, or nearly 80% of the total population of 18.7 million. Using the consumption-based upper poverty line, 88% of the poor live in rural areas, constituting 41% of the rural population. Income inequality between rural and urban areas is significant. Rural poverty is mostly associated with underemployment, as income from both farm and nonfarm sectors, that

---

[1] United Nations Development Programme. *Human Development Report,* various issues.
[2] Asian Development Bank (ADB). 2003. *Country Strategy and Program (*2004–2008)*: Sri Lanka.* Manila.
[3] Department of Census Statistics, *Household Finances and Expenditure Survey* 1990/91 and 1995/96; and Central Bank of Sri Lanka, *Consumer Finances and Socio Economic Survey*. These surveys differ in sample size and they define least-cost and nonfood bundles differently.
[4] Government of Sri Lanka. 2002. *Framework for Poverty Reduction.* Colombo. The consumption-based upper and lower poverty lines are SLRs1,032 and SLRs860 per person per month, respectively.
[5] Ampara, Anuradhapura, Batticaloa, Jaffna, Killinochchi, Mannar, Moneragala, Mullaitivu, Polonnaruwa, Puttalam, Triconmalee, and Vavuniya.
[6] ADB. 2003. *Country Strategy and Program (*2004–2008)*:Sri Lanka.* Manila. For the interim, the Government estimates that poverty in conflict-affected areas will be comparable to Uva province, the poorest province in the country. This represents 42% of the 1.9 million people estimated to be in the conflict-affected areas in 2001. Final results of the most recent official poverty head count undertaken in 2002 will provide definitive data.
[7] *Regaining Sri Lanka*, released in December 2002, outlines the vision and strategy of the Government for accelerated development. *Regaining Sri Lanka* includes the Government's Poverty Reduction Strategy. The International Monetary Fund approved 3-year arrangements (2003–2006) under the Poverty Reduction and Growth Facility and Extended Fund Facility amounting to $567 million for Sri Lanka, on 18 April 2003.

provide 75% of the rural employment, remains below consumption poverty levels. Most of the poor are farmers cultivating low-value crops on small plots of land; workers in the fisheries and livestock sectors; workers and the self-employed in remote areas lacking basic amenities; landless workers and craftspeople in low-wage, irregular operations; and squatter settlers and displaced persons. Slow growth in agricultural productivity and value addition, lack of integration with the mainstream economy, unclear land tenure, social exclusion, and limited access to basic social services, education, and infrastructure are some of the causes of poverty, along with inadequate economic growth and income distribution.[8] Only 40% of the rural areas have access to electricity, roads, and piped water. The Government owns roughly 80% of the land, two thirds of which is used by farmers under various tenure arrangements.

5. **Gender and Poverty.**[9] Despite favorable gender indicators compared to the rest of South Asia, female-headed households and women in conflict-affected areas have emerged as the new vulnerable groups. The most disadvantaged are the women who live in isolated communities without access to roads, electricity, services, and markets. Female unemployment rates are at least double those of men and the majority of women workers are trapped in low skill, low-income jobs, and with poor working conditions. Women are primarily unpaid family workers in agriculture. Self-employment and microcredit without access to skills, technology, and markets have perpetuated their poverty.

6. **Stratified Rural Finance Markets.** Rural finance (RF) includes savings, credit, insurance, and payment services. RF is broadly segregated into financial services provided to rural farm and nonfarm households, a large number of which are poor and low-income households. Microfinance, as a subset of RF, targets the poor. Considering the demographics of Sri Lanka, microfinance is primarily rural. On an aggregate level, rural loans for nonpoor households average SLRs250,000 ($2,577). Loans below SLRs100,000 ($1,030) to poor and low-income households are generally considered as micro loans, the average being SLRs19,500 ($200). Based on the consumption yardstick[10] of poverty, the RF market may be classified into three broad categories.

(i) **Lower Rural Poor or Lower Segment.** About 25% of the rural population comprising landless, subsistence farmers with an uneconomic holding size; poor fishing communities; coastal fisheries workers; farm and nonfarm laborers; plantation laborers; and those affected by conflict.

(ii) **Higher Rural Poor or Middle Segment.** About 25% of the rural population, mainly comprising petty traders and small and tenant farmers affected by limited marketing avenues, inadequate land tenure arrangements, and infrastructure constraints including road, electricity, and irrigation.

(iii) **Upper Segment.** Includes commercial farming, large plantations, medium-to-large rural enterprises, and agriculture produce wholesalers.

7. **Diverse Demand Pattern.** Corresponding to the stratified markets (para. 6), the demand for rural credit is diverse both in terms of activities for which credit is sought as well as the type

---

8 *Regaining Sri Lanka*, Annex 2, pp.123-129.

9 ADB. 2003. *Gender Assessment in Sri Lanka.* Manila.

10 Mission estimates based on upper and lower consumption-based poverty lines (footnote 4). The middle segment includes households marginally above the poverty line that are vulnerable to chronic or transient poverty. *Poverty Reduction in Sri Lanka: Issues, Findings, and Approaches* (ADB 2001), p.4, concludes that nearly half the population is vulnerable to the risk of consumption poverty.

and duration of credit. The upper market segment seeks high-end financial services such as letters of credit, export guarantees, and long-term investment capital. The middle segment requires working capital, cash credit, loans against pledge of produce, and medium- to long-term loans for crop cultivation, rural transport, and land development. The lower market segment requires credit for consumption, micro enterprises, crops, livestock, and minor irrigation. The rural poor demand relatively larger loans, compared to the average micro loan size of SLRs19,500, to diversify or increase the scale and scope of their activities.

8. The aggregate demand for rural credit is estimated at SLRs60 billion ($618 million).[11] Of this, the micro loan component is SLRs23 billion ($237 million) relating to 2.3 million borrowers.[12] In addition, the largely undocumented demand for rural credit by an estimated 20% female-headed households,[13] women in conflict-affected areas, poor women including returning migrant workers, and plantation workers could be significant. The major credit demand emanates from small rural enterprises,[14] agriculture and allied sectors including agriculture production and marketing, farm mechanization, land development, irrigation, livestock, and forestry. Sector distribution of rural credit demand[15] indicates 50% for the small rural enterprise sector, 30% for agriculture and allied sectors, and 20% for the rest.

9. As in the case of credit, the demand for savings is diverse with the lower segment primarily seeking rural finance institutions (RFIs) that provide security for their savings. Savings potential is immense, given the domestic savings to gross domestic product ratio of 16%. In addition, the need for risk mitigation is widely felt. With Sri Lanka receiving $1.1 billion in remittances during 2001, there is a significant opportunity for RFIs to tap into this market.

10. **Heterogeneous and Proliferating Supply Sources.** RF in Sri Lanka, while largely government-owned, has one of the most diversified supply sides in the region. A range of legislation governs the diverse range of RFIs[16] established for meeting the rural development and poverty reduction priorities through credit expansion. The Government's dominance in RF is exercised through ownership and control over pricing of services. The supply sources comprise:

(i) **Formal**, i.e., those supervised by the Central Bank of Sri Lanka (CBSL)—632 rural branches of commercial banks, 56 rural branches of National Savings Bank, 6 regional development banks (RDBs) with 191 branches, and SANASA Development Bank (SDB) with 8 branches.

(ii) **Semiformal**,[17] those established or registered under secondary rules of various legislation but not supervised by CBSL: National Development Trust Fund (NDTF); 311 cooperative rural banks (CRBs) with 1,196 outlets; 8,500 thrift and

---

[11] Aggregate demand estimates exclude the conflict-affected areas and informal arrangements.
[12] ADB. 2002. *Commercialization of Microfinance in Sri Lanka*. Manila.
[13] ADB.1999. County Briefing Paper. *Women in Sri Lanka.* Manila.
[14] Agriculture-related enterprises include small-scale processing of agriculture produce and byproducts into semifinished and finished goods, and production and supply of agricultural inputs. Nonfarm enterprises include basic transport, handicraft, and weaving.
[15] Published aggregate RF statistics are unavailable. This classification is based on Central Bank of Sri Lanka statistics and the disbursement pattern of ADB-funded and other external agency-funded projects.
[16] The wide range of RF providers have been given a broad classification for clarity. In this document, unless otherwise specified, RFIs collectively denote RDBs, SDB, and the entire range of semiformal RFIs including MF-NGOs. The term "RF" or "RFI" is thus inclusive of "microfinance" or "microfinance institution", respectively. The term "microfinance" or "microfinance institution" is used only for specific microfinance-related reference. Likewise, wherever relevant, commercial banks are specifically mentioned.
[17] In addition, there are other small-scale financing organizations such as the Tea Shakti Foundation and savings and credit societies organized under farmer organizations.

credit cooperative societies (TCCSs); 970 Samurdhi banking societies (SBSs); approximately 200 microfinance nongovernment organizations (MF-NGOs); numerous government rural credit programs; pawnshops; and 4,042 post offices that collect savings, often in collaboration with National Savings Bank.

(iii) **Informal or Noninstitutional**, such as rotating savings and credit associations, input suppliers, traders, moneylenders, landlords, friends, and relatives.

11. Commercial banks primarily serve the upper segment of the RF market and partially the middle segment. Commercial bank participation in the middle and lower segments of the RF market are generally through government programs. Semiformal RFIs focus on the middle and lower segments and the MF-NGOs target the most vulnerable sections within the lower segment. While the most numerous, the intermittent nature of credit from informal sources mainly caters to immediate consumption and contingencies. Interest charges in the informal sources are too high to leave any households surplus. Poor women are confined to subsistence activities with access only to informal sources of credit. Their weak bargaining power significantly raises the cost of credit to them.

12. Linked in a complex of relationships, the formal and semiformal sources meet nearly three fourths of the rural credit demand and provide saving facilities in most, if not all, parts of the country. Total rural loans outstanding with RFIs and commercial banks at end-2001 were SLRs50 billion. The total number of active micro loans, including those with MF-NGOs, is 1.65 million, with an outstanding amount of SLRs18.23 billion. In addition to micro loans, working capital, trade finance, investment credit, crop loans, and savings facilities are the most common services provided. Lending interest rates are in the range of 14–16% for state-owned commercial banks, 20–22% for private commercial banks, and 18–28% for others. Supply of risk mitigation and remittance services is affected by lack of explicit legal basis for extending such services by RFIs. (A sector and subsector analysis is in Appendix 1.)

B. Issues and Opportunities

13. A vibrant rural economy requires robust RF markets that can efficiently allocate resources and facilitate exchange of goods and services. Efficient RF markets contribute to poverty reduction through enabling rural households to respond to economic and technological opportunities that generate employment in farm and rural enterprises and establish forward and backward linkages in the rural economy. However, politicization has weakened both the commercial banks and RFIs. Bank of Ceylon and the People's Bank, the two largest state-owned commercial banks with half the banking sector assets and branches, have gone through successive institutional-strengthening processes for restoring capital adequacy, enhancing efficiency, and reducing nonperforming loans (NPLs). While Bank of Ceylon has shown improvements, the People's Bank has a capital adequacy of 11%. Its provision for loan losses covers only 60% of the NPLs and the repayment rate for rural credit is approximately 75%.[18] Both these banks are being restructured with World Bank and ADB[19] assistance. Some private domestic banks also reflect weak governance and financial status.

14. RFIs also have pervasive weaknesses and suffer from weak governance, high transaction costs, and recurring losses that add to the fiscal burden. Very few RFIs are

---

[18] Repayment rate in this document refers to collection as a percentage of loans due.

[19] ADB. 2000. *Report and Recommendation of the President to the Board of Directors on two Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the Private Sector Development Program. Manila*

financially self-sufficient and repayment rates go as low as 60%. RFIs are not even subject to basic prudential standards, and regulatory mechanisms for semiformal RFIs are inadequate, despite their mobilization of billions of SLRs as savings from millions of small depositors. The longer these problems remain neglected the more intractable they will become, as evident from the decade-long reforms of the commercial banks. Immediate and concerted efforts are required to address systemic issues in the RF sector.

1. Policies and Sector Plan

15. In the absence of a dedicated policy, the RF sector is heavily fragmented with RFIs that reflect weak governance and grossly inadequate institutional capacity. In particular, a history of ad hoc public sector interventions at the national and, increasingly, provincial levels has resulted in an uncontrolled proliferation of fundamentally weak RFIs. As a result, tolerance for loan defaults, waivers, and postponements has gradually increased.[20] Consequently, repayment rates remain low and sustainability of RFIs has suffered. Populist government programs promote financing of activities that generate insufficient as well as temporary economic and social benefits. Major issues in RF, such as regulation for deposit protection, receive inadequate attention and there is no institutionalized mechanism to coordinate RF interventions with rural and agriculture sector policies. In this environment, private sector investments in RF have remained marginal. A policy framework is required for redefining the Government's role in RF to facilitate the functioning of RF markets and to create the right incentives for greater private sector participation in RF.

2. Supervisory and Regulatory Framework

16. The absence of a policy and supervisory framework has allowed the proliferation of fundamentally unsustainable RFIs under various laws, which (i) enables government interventions in product and pricing decisions, weakens governance, and diminishes institutional autonomy; (ii) exacerbates the lack of enforcement of financial prudence; (iii) strengthens the tendency to operate on regulatory arbitrage; (iv) does not provide for transformation of MF-NGOs into depository institutions or regularize their savings activities; and (v) inhibits diversification of services that require a distinct legal mandate, such as remittances.

17. Accounting standards, management information system (MIS), and information technology (IT) platforms are rudimentary. As a result, institutional information is both inadequate and unreliable. Most semiformal RFIs are inadequately supervised, if at all, putting the savings of millions of rural households at risk. The proliferation of semiformal RFIs makes it difficult to institute an effective supervisory mechanism. Considering the banking sector weaknesses (para. 13), CBSL is rightly focusing on banks, which hold the bulk of banking sector assets. In addition, CBSL supervision for semiformal RFIs is not a cost-effective option. An effective response is to stem the proliferation of RFIs through a stricter entry threshold and operating standards, preferably through a cost-effective second-tier agency.

3. Training Arrangements for Rural Finance

18. While RFIs have proliferated, there is a lack of affordable high-quality training for mainstreaming RF best practices. CBSL's Center for Banking Studies (CBS) and International

[20] Sustainability refers to the ability to provide high-quality financial services to existing and potential clients on a permanent basis without the need for government or donor support. This also implies a for-profit orientation in administration and operations to attract equity investments and mobilize savings and commercial borrowings.

Centre for Training of Rural Leaders offer limited training on RF. Sarvaodaya Economic Enterprise Development Services Management Training Institute and SANASA Training Institute are dedicated facilities. The Rural Development Training Institute provides some training on delivery of RF and social services. Universities do not offer courses specifically on RF or microfinance. None of these institutions currently offers a comprehensive curriculum that is consistent with RF best practices, which is a requirement of the majority of RFIs and even of commercial banks. Further, semiformal RFIs are unaware of their need for such training. Addressing the training needs of the RF sector, including those of policy makers and regulators, will have to be prioritized for effective institutional reform.

4. Institutional Sustainability

19. Irrespective of the type of RFI, the financial and operational results of the majority of RFIs fail to conform to internationally accepted standards for sustainability and the financial viability of RFIs in general is deteriorating. Supporting unviable entities is an increasing but avoidable strain on government resources. Outreach of RFIs has come at the cost of portfolio quality and continuity of RF services is not yet assured for many rural households.

20. **Regional Development Banks.** Established under the Regional Development Bank Act of 1985, RDBs are owned by the Government, CBSL, commercial banks, and CBSL Employee Provident Fund. The RDBs primarily focus on the middle and lower segments of the RF markets with nearly 80% of their loans below SLRs100,000 (Appendix 2). Aggregate deposits and outstanding loans at end-2001 were SLRs4.7 billion and SLRs5.5 billion, respectively. By volume, the RDBs provide approximately 18% of all micro loans. The orientation of RDB staff is inappropriate for banking with the poor. Overall portfolio quality remains weak. NPLs among the six RDBs range from 16% to 33%. Continued weaknesses in RDBs could affect the safety of deposits, and consequently diminish RDBs' image and business prospects. Nevertheless, RDBs represent a significant formal financial sector presence in rural areas and there is considerable potential for them to enhance their role in the RF sector. A holistic restructuring is required for improving governance, credit policies and products, and human resource management.

21. **Cooperative Rural Banks.** CRBs are member-based institutions (Appendix 3). Of the 311 CRBs, 306 are departments of multipurpose cooperative societies and five CRBs are stand-alone institutions. There are 1,196 CRB outlets. In addition, 14 apex district CRB unions pool CRB surpluses for investments. CRBs collectively mobilized SLRs16.6 billion at end-2001 in 5.8 million savings accounts. Their loans outstanding at end-2001 were SLRs5.9 billion at an average loan size of SLRs8,500. CRBs provide nearly one third of the total micro loans. While multipurpose cooperative societies come under the purview of the Cooperative Societies Act of 1972, the CRBs, as departments in these societies, are neither subject to any effective independent supervision nor do they file separate accounts. Governance is a key issue, as CRBs suffer from political capture by local interests. While between half and two thirds of the CRBs are reportedly viable, their performance varies.[21] The aggregate repayment rate is only 65%. The performance of the stand-alone CRBs is somewhat better. Because of the widespread nature of problems, any failure of CRBs will put the savings, of which two thirds are from nonmembers, at risk. About SLRs7 billion ($72 million) of CRB resources are considered at risk due to bad investments and poor portfolio quality.

22. The 8,500 registered TCCSs, with an estimated membership of 905,106, are federated into a nationwide network involving 33 district unions and a national federation of TCCSs

[21] In the absence of independent accounts, it is difficult to precisely indicate the financial status.

(Appendix 3). In total, 252,682 loans amounting to SLRs2.8 billion were outstanding as of end-2000. Women accounted for 55% of clients, with an average loan size of SLRs12,000. The TCCS federation has no central management and does not act as a regulator or supervisor, or even as an effective coordinator. The TCCSs suffer from weak accounting and MIS, and their systems and procedures are often incompatible across the primary, district, and national levels. The majority of TCCSs are considered to be dormant.

23. **Commercial Banks.** Beyond government programs, commercial banks also provide RF services in the normal course of business. In terms of volume, commercial banks constitute two thirds of aggregate rural credit and are the main providers of term credit for rural enterprises. While private commercial banks aggressively look for profitable RF business niches, they tend to concentrate on large loans. The state-owned commercial banks, on the other hand, will have to, on a priority basis, rationalize their RF operations to alter their target-driven approach, and shed accumulated overheads and inefficiencies. Expansion of RF operations is in the long-term interest of commercial banks, as urban banking centers are becoming overcrowded.

24. The restructuring of the state-owned commercial banks and greater participation of private commercial banks in rural areas are essential to enhance the supply of rural credit for rapid income expansion through rural enterprise financing. Systemic linkages with MF-NGOs could cost-effectively drive commercial bank expansion in microfinance. Currently, microfinance exposure of commercial banks is limited to government programs. Commercial bank participation in government sponsored subsidized credit programs crowds out the private sector banks. Despite this, some private commercial banks, especially Hatton National Bank, Seylan Bank, and Sampath Bank have made genuine attempts through innovative pilot schemes to enlarge their microfinance portfolio. People's Bank is also implementing a rural innovation project funded by Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ); this project needs to be mainstreamed and replicated by other commercial banks. Improvements in staff orientation, as well as skills for credit appraisal, delivery, and monitoring will serve to enlarge the scope of commercial bank participation in RF on a commercial basis.

25. **Apex Agencies.** In addition to savings and participation in government and external agency-funded programs, RFIs access refinance assistance for onlending. NDTF was established in 1992 under the Poverty Alleviation Program[22] as an apex agency for providing technical and refinance assistance for microfinance (Appendix 4). Most of NDTF's operations were wound up in 1998, though it continued its microfinance refinancing activities. It is the primary lender to MF-NGOs, but its lending is small compared with its resources (SLRs1.07 billion) and potential demand. At end-June 2002, NDTF had 160 partner RFIs, of which 81 were actively borrowing, and an outstanding loan portfolio of SLRs597.1 million ($6.2 million). NDTF's on-time loan repayment rate is about 88%. NDTF performance has been low due to (i) weaknesses in selection of target institutions, credit assessment, and portfolio management; (ii) difficulties in promoting viable micro enterprises in an environment of low economic growth, segmented markets, and serious infrastructure bottlenecks; (iii) institutional inadequacies of client RFIs and commercial banks; and (iv) weak capacity for RF institution building. Fundamental reforms are required to enhance NDTF's capacity, including changes in its incorporation, governance, client selection, and pricing practices. Only after this will NDTF be able to act as a focal point for development of the MF-NGOs.

26. As a specialized bank owned by the TCCSs, SDB (Appendix 3) mobilizes deposits through 10 branches for lending primarily through selected TCCSs (para. 22). As a result, SDB

[22] Funded by World Bank ($20 million), Kreditanstalt für Wiederaufbau ($10 million), and the Government ($5 million).

is filling the gap created by the weak TCCS federation. As of end-June 2001, SDB had 6,270 micro loans with a value of SLRs127.5 million ($1.3 million). SDB potential is largely dependent on the absorptive capacity of TCCSs, which is rapidly decreasing. SDB has to simultaneously gear for enhancing direct lending activities and concentrate only on viable TCCSs. At present, SDB's institutional capacities are similar to RDBs'.

5. Government Interventions

27. Government interventions include micro loans through commercial banks and several government-sponsored, often external agency-funded, rural credit programs especially for rural poor. CBSL and Samurdhi Authority are the executing agencies of nearly 30 such programs. CBSL supervises some external agency-funded and government rural credit programs that include interest subsidy schemes. While a developmental role of CBSL is justified to a degree, the nature of its current involvement perpetuate outmoded RF paradigm inconsistent with sustainable RF and is also a conflict of interest with its supervisory function. While government programs have averted severe poverty, political interference and weak design have encouraged dependence on below-cost credit and induced poor repayment behavior.[23]

28. The Samurdhi Program governed by the Samurdhi Authority of Sri Lanka Act No. 30 of 1995 is the main poverty reduction program, and has two main components (Appendix 5). The first set comprises welfare programs and subsidized lending programs through state-owned commercial banks. The second, SBS program that began in 1997, has 970 SBSs. With 1.7 million families as members, the SBS program reaches about 50% of all households. Women hold two thirds of the share in SBSs. Member and nonmember capital and savings amount to SLRs6.7 billion, and the total outstanding loans at end- 2001 were SLRs2.3 billion with 429,231 active loans. A credit guarantee scheme and two insurance schemes complement SBS. However, weak management and lack of effective supervision have weakened the system. Despite a repayment rate of 93.4% and a 3% per month interest rate on loans, three fourths of SBSs are nonviable due to administrative overheads that require recurring budgetary support. Governance and transparency are major and immediate concerns.

6. Legal Status and Institutional Capacity of Microfinance-Nongovernment Organizations

29. The poorest groups are reached only by way of group-guaranteed loans, which are mainly provided by MF-NGOs (Appendix 6). A high proportion of microfinance in conflict-affected areas is provided by MF-NGOs. However, the majority of MF-NGOs, which number around 200, are operationally and financially weak. Fewer than five have profitable operations.[24] The largest MF-NGO, Sarvodaya Economic Enterprise Development Services, commonly known as SEEDS, provides loans in the range $100–550, and at end-March 2001 had 177,974 active loan clients with an outstanding loan portfolio of SLRs667 million. Janashakthi has 67 societies comprising 28,168 women in 464 village societies that pool individual and group savings to extend small loans. Savings and loans outstanding amount to SLRs29 million and SLRs91 million, respectively. The Social Mobilization Fund, Arthachariya Foundation, and Agro mart are middle-sized MF-NGOs with 3,000–10,000 clients. The rest are small MF-NGOs with portfolio in the range of $10,000–40,000. MF-NGOs require substantial improvements in credit appraisal, supervision and monitoring, and loan-delinquency management.

[23] S. Jayaweera and M.S. Pal. *Women in Sri Lanka.* 1999. ADB; *Sri Lanka Poverty Assessment*. 2002. World Bank. 26 June; Datt and Gunewardena. 1997. Background paper for the World Bank *Sri Lanka Poverty Assessment*; and UNDP. 1998. *Sri Lanka National Development Report*.

[24] Lack of transparency and standardized financial reporting impede a detailed assessment.

30. Most of the small MF-NGOs are focused on broader social objectives, and give inadequate priority to improving their financial intermediation skills, especially in the areas of financial analysis, strategic planning, and governance. Substantial support under government and external agency-funded programs perpetuate this orientation leading to a widespread culture of dependence, a high-cost structure, and abrupt discontinuation after program closure. Despite not being legally permitted,[25] most MF-NGOs mobilize savings and would collapse if they did not do this. Therefore, there is a need to create an appropriate legal structure (para. 17) with adaptations to recognize and accommodate their distinctive operations. The MF-NGOs should be allowed opportunities for accessing loan funds and institutional strengthening support, provided that they demonstrate significant interest in sustainable microfinance.

7. Demand and Supply Gap for Rural Credit

31. While there is a wide RFI network, the estimated gap between demand and supply for rural credit is around SLRs10 billion ($103 million) at the current lending interest rates (para. 12). The credit supply could be higher by an estimated SLRs3 billion ($31 million), if the constraints imposed by limited access to medium- to long-term credit were removed. Within the overall gap, an estimated SLRs4.7 billion in 0.65 million accounts is for micro loans for the rural poor, at an average of SLRs20,000. However, this segment is restricted to borrowing amounts lower than that required for generating household surpluses to cross the subsistence and poverty thresholds. It is also difficult for this segment to obtain larger and longer-term loans in the range of SLRs50,000–100,000 for investing in fixed assets for expansion and diversification of their sources of income. Supply gaps are also marked for (i) loans of approximately SLRs200,000–1 million, but particularly in the range of SLRs250,000–300,000, the "missing middle",[26] that is neither a microfinance clientele nor adequately served by the commercial banks, and (ii) term loans of 2–5 years. The demand could be still higher with lower interest rates, which could be possible with decreased government presence in the debt market.

8. Rural Finance in Conflict-Affected Areas

32. Access to RF services is inadequate in the conflict-affected areas. To a great extent, formal sources of RF dried up during the conflict. The advent of the peace process provides an opportunity for customized response that incorporates best practices, innovations in RF delivery, and local adaptations to cater to the unique social and cultural conditions. The challenge is to support both the establishment of an institutional structure that will be able to provide quality financial services on a permanent basis as well as meeting the immediate financing needs of rural households. While the financing of household income-generating activities is important, it is equally important to support rural entrepreneurs who could generate local employment. Considering that institutions and infrastructure have been destroyed or badly neglected due to two decades of conflict, the need for simultaneous investments in the real sector and for capacity building of communities is critical for a sustainable RF sector. Sequencing the delivery of RF services with the ongoing and planned reconstruction efforts is important for maximizing the development impact.

---

[25] Under the Banking Act No. 30 of 1988 and the Finance Companies Act no. 78 of 1988, an institution must be licensed as a bank or a finance company to collect deposits from either members or nonmembers.

[26] ADB. 2000. *Rural Financial Markets in Asia: Policies, Paradigms and Performance.* Manila. This is volume 3 of *Study of Rural Asia*, ADB, 2000, published by Oxford University Press. The "missing middle" in the context of Sri Lanka broadly relates to activities such as repair shops, foundries, rural transport, trade, manufacture of small farm equipment, supply of high-yielding seeds and fertilizers, and irrigation facilities.

9. Demand-Side Development

33. Production and marketing bottlenecks due to weak rural infrastructure accentuate the risks in RF and reduce the profitability of the rural enterprises as well as RFIs. Low prices and poor productivity make it difficult for the rural sector to compete for investment capital against urban and industrial projects. In addition, the absence of forward and backward linkages to support value addition to rural produce impedes diversification of income sources. Low skill levels among clients in the lower segment of the RF market and the absence of risk mitigation mechanisms not only create risk aversion but also impair the ability of the rural poor to effectively utilize the availability of RF, equitably participate in the local economy, and reduce vulnerability to economic downturns and natural calamities. The impact of these has kept a large part of the rural economy at subsistence levels, resulting in a high poverty incidence.

34. Addressing these demand-side issues is costly, and its "public good" nature makes it difficult to attract private sector investments. The microfinance-plus[27] approach adopted by MF-NGOs and RFIs for addressing demand-side issues by factoring associated costs in the lending interest rate has the unintended impact of leaving little, if any, household surplus for the rural poor. The microfinance-plus approach through limited external agency-funding has also led to ambiguous social and financial intermediation goals, with little sustainable impact. Recognizing these, the Government recently set up a Rural Economy Resuscitation Fund (RERF) in the Ministry of Rural Economy (MRE) for supporting demand-side development with investments in small community-based infrastructure, skills, and marketing. Fiscal squeeze has, however, not allowed allocation of adequate resources, which impairs the potential benefits to the RF sector.

35. **Lessons Learned.** The weak sector performance confirms the lessons learned that (i) a supportive policy, legal, and regulatory framework is required for an orderly and systematic sector development; (ii) below-cost lending interest rates result in misallocation of resources and production inefficiencies; (iii) prolonged subsidy dependence undermines sustainability and integration with financial markets; and (iv) inadequate rural infrastructure and a low skills base depress rural incomes, which in turn adversely affect RF markets. Like other countries in the region, credit expansion is not accompanied by quality services, and inadequate availability of medium- to long-term rural credit persists. Where state-owned RFIs have failed, the private sector has not stepped in to fill the institutional and resource gaps.

36. Client perspectives in Sri Lanka suggest that (i) the lending interest rate is secondary to availability and accessibility;[28] (ii) the amount and term of credit available can only sustain present income levels, not enable the rural poor to cross successive income thresholds; and (iii) physical collateral requirements impede the ability to upscale rural enterprises. There is a growing consensus that rural poverty could be reduced rapidly by replacing welfare-orientation with market-based systems. The Government is also committed to the ongoing economic reform program that emphasizes private sector-led growth and structural reforms in the financial sector. RF reforms will be better accomplished as part of a broader economic reform agenda.

---

[27] Core financial intermediation functions relate to delivery of RF services. Rural including micro loans are delivered either through individuals or groups, the latter being formed with the intention to reduce delivery cost and build peer pressure. The microfinance-plus approach, on the other hand, covers skills and literacy training, enterprise training, leadership and empowerment training, provision of community infrastructure, procurement and marketing support, and risk mitigation. Extremely important and relevant as these are for social capital formation, they remain much beyond the capacity of MF-NGOs or RFIs to deliver and administer in a meaningful, sustainable, and cost-effective manner. In the process, neither social nor financial objectives are sustainably realized.

[28] For those used to below cost credit, the obvious expectation is a continuation of the current situation.

37. **Overall Rationale.** The rural sector supports the bulk of the population—the majority of the poor—and thus is the largest market for financial services in terms of number of clients. Impressive as the RF outreach is, it contrasts sharply with the deteriorating operational and financial status of RFIs. The demand and supply gap, still greater potential demand, and regional disparities in RF service delivery are largely unattended. Instead of mainstreaming governance and sustainability as core values, successive governments have adopted ad hoc measures that exacerbated the weaknesses. The contribution of RF in diversification into new farm and nonfarm opportunities and value addition in the rural sector remains unfulfilled. As a result, the rural sector is trapped in low-risk and low-return investments. This will widen income gaps both within rural areas and relative to urban areas, and will have long-term negative effects on consumption and asset buildup, especially among rural poor households.

38. A sustainable RF system is a critical element of successful rural economies. The creation of an effective and efficient RF system is conditional on the removal of systemic constraints and promotion of market-driven responses for providing appropriate products and services. This will only be possible if pursued with sustained commitment to establishing a facilitating policy, legal, and institutional framework. The financial drain in supporting weak RFIs and likely contingent liabilities has prompted the Government to seek viable RFIs. The ongoing reforms supported by the World Bank and ADB, which are aimed at restructuring commercial banks and introducing stricter prudential norms, provide a positive context for reforms in the RF sector. Success will still, though, depend on improvements in the macroeconomic climate and simultaneously addressing real sector issues. Access to RF at lower transaction cost is also important for successfully leveraging employment and enterprise opportunities in an environment in which World Trade Organization regulations are applied.

III. THE PROPOSED SECTOR DEVELOPMENT PROGRAM

39. The Government's aim is to reduce poverty incidence to from 25% to 20% and attain an economic growth rate of nearly 7% by 2005. The Government's economic reform program highlights the role of RF in empowering the poor, especially women, and emphasizes sustainability of RFIs, their integration with the financial sector, and the development of an integrated policy and legal framework for MF-NGOs. The poverty partnership agreement between the Government and ADB emphasizes on employment generation, pro-poor asset creation, promotion of RF intermediation, and a larger role of the private sector for sustainable growth. In addition, ADB's country strategy underlines the need for a suitable regulatory framework for RFIs and greater access to RF through RFIs, including MF-NGOs.

40. A systemic response to address the issues in RF is essential for reviving the rural economy through investments in agriculture and rural enterprises for promoting private sector-led economic growth to generate employment opportunities and reduce poverty. The Government is committed to introducing progressive policies for the development of the RF sector and protecting it from being used for short-term political gains. To accomplish this, an integrated package of policy, institutional development, and outreach expansion is needed along with strong commitment to pursue reforms. The sector development program modality has thus been chosen to facilitate the adoption of sector reforms to ensure that an adequate policy and legal framework is in place to optimize investments in institutional strengthening and outreach. RFSDP formulation was closely coordinated with various stakeholders, including CBSL, and representatives of the private sector, NGOs, and development partners. RFSDP is consistent with ADB's projects for strengthening nonbank financial services, small and medium enterprises, and the private sector. RFSDP develops synergies with ongoing ADB-funded social and agriculture sector interventions (Appendix 7). The agreements on RFSDP are reflected in

the Government's development policy letter and policy matrix (Appendix 8). The program framework is in Appendix 9 and a RF sector roadmap is in Supplementary Appendix 1.

A. Objectives and Scope

41. RFSDP is designed to contribute to economic growth and poverty reduction. The goal is to enhance outreach of sustainable RF services. The objective is to establish a sustainable RF system through policy adjustments to eliminate structural constraints to growth of the RF sector and to improve the operations of RFIs. Institutionalizing policies that emphasize good governance will yield considerable benefits in terms of fostering a long-term sector-wide perspective for sustainability. The investments in RF will be able to generate adequate returns in terms of rural growth and value addition. Further, efficient delivery of RF services adapted to the nature of demand will ensure the viability of RFIs as well as of the rural enterprises that they serve. A positive RF environment will encourage private sector involvement in RF, which could supplement and facilitate RF outreach in conflict-affected areas.

42. RFSDP consists of a program loan and two project loans. The policy reforms will establish an institutional framework for RF, with good governance and sustainability as core values. The project loans will assist in strengthening institutional capacity for enhancing outreach. The scope of the RF reforms will include policy, governance, institutions, and outreach. The range of interventions required in the RF sector is much beyond what could reasonably be covered within the span of RFSDP. Therefore, the scope of interventions has been determined based on RFI commitment to reforms, cost-effectiveness, significance of contribution to RF sector development, and replicability.

B. The Program Loan

1. Objectives

43. Major policy issues in the RF sector are covered by the program loan. The program loan goals are to ensure enhanced access by the rural households to RF services; good governance of RFIs; reduction in the role of the public sector; and increase in the role of the private sector, including MF-NGOs, in RF. The specific objective is to develop a sustainable RF system for providing efficient services, primarily to the middle and lower segments of the RF markets, for significant income expansion and poverty reduction impact.

2. Components and Outputs

44. The program loan has five components: (i) conducive policies, (ii) supportive legal and regulatory framework, (iii) institutional reforms for sustainability, (iv) strengthening the demand side, and (v) expansion of RF in conflict-affected areas.

a. Conducive Policies

45. Parallel to ongoing commercial bank reforms, the policy for the promotion of RF (Appendix 8) includes the following:

(i) establishing a high-level body for coordinating RF sector policies;

(ii) improving RF sector supervision and regulation;

(iii) expediting the recovery of dues;

(iv) phasing out CBSL's role in RF that raises conflict of interest;

(v) instituting fundamental RFI reforms in CRBs, RDBs, NDTF, and SBSs;

(vi) curtailing government actions to pardon and discourage debt recovery;

(vii) ensuring that RFIs have autonomy to price their services;

(viii) enhancing investments for demand-side development; and

(ix) promoting linkages between RFIs, NGOs, and community-based organizations.

b. Supportive Legal and Regulatory Framework

46. As part of RFSDP, the Rural Finance Sector Development Act (the RFSD Act) will be passed to consolidate the fragmented, ineffective, and dormant supervisory and regulatory mechanisms (paras. 16 and 17). The RFSD Act will be applicable to those RFIs, including MF-NGOs, which are not covered by the Banking Act of 1988 and are not under CBSL purview. The RFSD Act will: (i) provide for the establishment of a Rural Finance Sector Development Agency (RFSDA) for the supervision and regulation of RFIs not supervised by CBSL; (ii) prescribe the functions of and prohibitions on the various categories of RFIs; (iii) lay down licensing procedures and requirements; (iv) set out the regulatory and supervisory standards and systems; (v) list the prudential requirements, including disclosure and reporting requirements; and (vi) outline the process of establishing and winding up RFIs.

47. RFSDA will also serve as the nodal RF policy body for taking a holistic approach to RF sector issues, periodically reviewing sector developments, coordinating and guiding appropriate government interventions in RF, and maintaining a national database on RF. The RFSD Act progressively allows eligible RFIs, based on their institutional and financial capacity, to provide a wide range of services, including risk mitigation, remittances, and pledges. The RFSD Act makes RFIs liable for the security of deposits. Summary features, text of the RFSD Act, and implementation plan (Supplementary Appendix 2) were developed with extensive consultation with stakeholders, including the Government, CBSL, RFIs, and MF-NGOs.

48. The RFSD Act allows RFSDA to have only 10 staff. On-site and off-site supervision will be undertaken primarily through approved private sector auditors and audit firms[29] engaged at a fee to be paid by RFIs in a phased manner. This will eliminate the need for a large staff complement and ensure appropriate cost-effective supervision that allows operating flexibility to RFIs. Considering the disarray of the RF sector, due diligence of RFIs will precede the application of RFSDA provisions. Adequate transition time will be given to RFIs for full compliance. Considering the large number of eligible RFIs, RFSDA will initially set a threshold in terms of savings and loan size to limit its coverage to larger RFIs. Supervisory reach will gradually grow. While RFSDA will initially focus on CRBs, the immediate benefit will be the opportunity for eligible MF-NGOs to operate within a framework that recognizes the distinct nature of their operations, particularly savings mobilization and noncollateralized assets.

[29] Those qualified and registered as auditors, including those registered with the Institute of Chartered Accountants. RFI appraisal skills of auditors will be developed using the Project Loan proceeds (para. 79).

49. Mechanisms for recovery of defaults will be strengthened through an in-depth review of the legal and institutional framework for recovery of debts from RFI defaulters and developing and implementing an action plan to facilitate expeditious recovery of debts from such defaulters, consistent with the principles of due process. This will encourage RFIs to expand their credit portfolio, thereby benefiting the rural economy.

c. Institutional Reforms for Sustainability

50. RFSDP will support reforms for CRB, RDBs, NDTF, and SBSs, whose combined outreach for micro loans is nearly 65% of the market. In view of the challenging responsibility, institutional reforms have been phased, among others, to correspond to RFSDP-supported capacity for managing the change process. To ensure effective utilization of resources, the overriding principles for RFSDP assistance for institutional reforms are: (i) demonstrated commitment of RFIs to sustainability and good governance; (ii) timely completion by the institutions of agreed actions; and (iii) adherence to restructuring/institutional strengthening benchmarks by the institutions. The intention is not to abruptly close or disrupt RFIs, but to assist their transformation into sustainable entities and provide adequate deposit protection.

51. **Cooperative Rural Bank Reforms.** The Ministry of Co-operatives (MOC), as part of RFSDP, has adopted a CRB Restructuring Policy including a model CRB Restructuring Plan and CRB Fund Rules (Supplementary Appendix 3). The first stage of CRB reforms will commence with the preparation of the restructuring plan for participating CRBs covering (i) due diligence process for demarcating assets and liabilities between the parent multipurpose cooperative society and the participating CRB, (ii) constitution of the CRB board of directors, and (iii) assessment of the amount required for capital adequacy of the CRB. Individual CRBs will then finalize and adopt the plan and enter into a formal agreement with MOC (CRB Restructuring Committee) for implementation. Capitalization support will then be provided from the CRB Fund. At the end of the first stage, a participating CRB will become a distinct financial entity with separate statement of accounts under the Cooperative Societies Act of 1972. Meeting the performance benchmarks in the CRB restructuring plans will be required for continued RFSDP assistance. The second stage comprises implementation of the restructuring plan with support for institutional strengthening from the project loan (para. 79).

52. **Regional Development Bank Reforms.** RFSDP will support reforms of RDBs where up to 80% of the CBSL stake has been divested and financial restructuring for ensuring capital adequacy undertaken. As part of RFSDP, the CBSL stake has been transferred to the Government for initiating divestment through the Public Enterprise Reform Commission. MRE, in consultation with CBSL, has prepared draft information memorandums for divestment including diagnostic studies and portfolio audits. Subsequent to divestment, MRE in consultation with CBSL and the concerned RDBs, will prepare RDB restructuring plans (phase one) covering (i) good governance, (ii) human resources, (iii) business processes, (iv) MIS, (v) auditing and accounting, and (vi) performance benchmarks. The plans will be implemented with support from the project loan (para. 79).

53. **National Development Trust Fund Reforms.** As part of RFSDP, NDTF has been incorporated as a company limited by guarantee for enhanced governance and operational flexibility, and for establishing a distinct borrower and lender relationship with participating RFIs. In consultation with ADB, NDTF will develop and adopt an NDTF Corporate Plan covering (i) strategy, (ii) organization and human resources development, (iii) operational policies and guidelines for finance activities, (iv) policies and procedures for nonfinance activities, and (v) partnership arrangements with RFIs. The plan will include performance benchmarks and will

be implemented with support from the project loan (para. 79). The aim is to transform NDTF into an effective microfinance apex agency for enhancing the capacity and outreach of MF-NGOs, especially in conflict-affected areas.

54. **Samurdhi Banking Society Reforms.** As part of RFSDP, SBSs has completed a diagnostic study and portfolio audit as a basis for determining institutional strengthening options in consultation with ADB. Based on the agreed option, the Ministry of Samurdhi will prepare an SBS Institutional Strengthening Plan covering (i) governance, (ii) organization and human resources, (iii) operational policies and guidelines, (iv) MIS, (v) accounting and auditing, (vi) business and viability projections, and (vii) implementation schedule. The objective of the plan is to ensure good governance and sustainability of SBSs, which is critical for a significant poverty reduction impact with a gender emphasis. The plan will include performance benchmarks and will be implemented with support from the project loan (para. 79).

d. Strengthening the Demand Side

55. RFIs mirror the conditions of the activities they finance, and the quality of their portfolios depends on the condition of the enterprises to which they lend. In order to address the real sector issues for enhancing rural productivity, as part of RFSDP the Government has redrawn the scope of the RERF for investments in skills development; marketing networks; infrastructure for enhancing better price realization of rural produce; community infrastructure such as storage, small-scale irrigation; and farmer information centers (Appendix 10). RERF will support such activities mainly through community-led development initiatives in collaboration with NGOs and with full beneficiary participation, including cost sharing and control of investments.[30] RERF activities will be coordinated with ongoing and planned ADB-funded projects. Guidelines on sanction, usage, and monitoring of RERF formulated in consultation with ADB, NGOs, women's groups, and RFIs have been adopted by MRE (Supplementary Appendix 4). The location of RERF in MRE ensures coordination with RFIs, as MRE is also the nodal ministry for RFSDA and RDBs.

56. The involvement of rural communities in identifying, planning, executing, and monitoring subprojects will help expand the RF market and maintain peer pressure as a substitute for physical collateral, which the poor do not possess. RERF will help realize the inherent synergy between the social and financial intermediation provided by specialized agencies. An added advantage is the elimination of duplication of investments in social intermediation by a multitude of agencies, often done inefficiently. In the process, the RFIs, especially MF-NGOs, will be able to concentrate on acquiring much needed financial skills.[31]

e. Expansion of Rural Finance in Conflict-Affected Areas

57. As part of RFSDP, measures for the expansion of RF services in the conflict-affected areas (para. 32) will be continually assessed and identified in consultation with ADB to help ensure a systematic institutionalized response including (i) supporting institutional strengthening

---

[30] ADB. 2000. *Finance For the Poor: Microfinance Development Strategy.* Manila. This identifies social intermediation as a core strategic element. ADB-funded PAK: Microfinance Sector Development Program created an arrangement similar to RERF for demand-side development that has led to positive externalities for the microfinance sector. ADB-funded MON: Rural Finance Project also supports the establishment of Information Resource Centers for enhancing the capacity of rural borrowers through a participatory process involving NGOs and community organizations for effectively utilizing access to RF services.

[31] To be provided under the Project Loan component for Building Sector Capacity (para. 77).

of new RFIs,[32] (ii) prioritizing reform of CRBs in the region, (iii) activating and concentrating RERF interventions in the region, and (iv) ensuring coordination with other initiatives.[33] The Government, as part of RFSDP, has allocated 10% each of the RERF and the rural enterprise development credit (para. 80) for the expansion of RF in the conflict-affected areas. In addition, RFSDP will provide institutional strengthening support to MF-NGOs and commercial banks that seek to expand their operations in the conflict-affected areas.

3. Important Features

58. RFSDP integrates the key elements of ADB's strategies for poverty reduction, the private sector, and microfinance development, as well as ADB's RF market analysis.[34] RFSDP provides a lead role for ADB in RF, which is critically linked to a range of rural sector interventions. Further, RFSDP design directly contributes to the goals of the Government's economic reform program (para. 3).

59. **Linkages**. RFSDP is anchored with the reforms in the banking sector and is consistent with ADB-funded projects and sector development programs relating to small and medium enterprises, rural development, and plantation development (Appendix 7). RFSDP will also benefit from ADB-funded infrastructure projects that will facilitate greater exchange of goods and services and linkages between rural and urban sectors. In addition, the ongoing structural adjustment process (para. 3) creates better conditions for a market-based RF sector.

60. **Realistic Agenda.** The scope of reforms and corresponding agencies are based on commitment to reforms and significance of impact. RFSDP has been developed by absorbing successful international and local practices and RFSDP-supported reforms are sequenced for generating increasing acceptance among stakeholders during implementation. Besides potential sustainability, an important criterion for the selection of RFIs[35] for reform is their presence in conflict-affected areas for enabling an effective response with the onset of peace.

61. **Good Governance.** RFSDP emphasizes a comprehensive range of restructuring measures, as incremental changes are insufficient for good governance. Accordingly, RFSDP fundamentally alters the norms for governance of selected RFIs, particularly the CRBs. Extensive use of IT and MIS upgrading will facilitate transparency.

62. **Strengthening the Private Sector and Civil Society.** RFSDP supports RFIs that either have private sector interest or are in the process of increasing their private sector stake. CRBs and SBS are member-based entities, while CBSL's stake in RDBs is to be divested. In addition, the RFSD Act provides legal status for MF-NGOs, which are mostly private, for mobilizing savings. Assured funding from RERF for social intermediation through NGOs and community-based organizations will contribute to gender equality.

---

[32] Budgeted under the Project Loan (para.79).

[33] ADB. 2003. *Assessment of Needs in the Conflict Affected Areas* (2 volumes). Manila.

[34] R179-99: *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*, 19 October 2000; R78-00: *Promoting the Private Sector to Support Growth and Reduce Poverty: Private Sector Development Strategy*, 9 March 2000; R106-00: *Finance For the Poor: Microfinance Development Strategy,* 16 May 2000; and ADB. 2000. *Rural Financial Markets in Asia: Policies, Paradigms and Performance*. Manila. This is part (volume 3) of ADB. 2000. *Study of Rural Asia*, published by Oxford University Press.

[35] SBS, CRBs, and NDTF (through participating RFIs) have presence in conflict-affected areas. The Government intends to revisit its plans to establish RDBs in conflict-affected areas when the security situation improves.

4. Financing Plan

63. It is proposed that ADB provide a loan of $50 million from its ordinary capital resources (OCR) for RFSDP, with a 15-year term, including a grace period of 3 years, and an interest rate to be determined in accordance with ADB's London interbank offer rate (LIBOR)-based lending facility; a commitment charge of 0.75% per annum, and a front-end fee of 0.5%[36] of the loan amount; and such other terms and conditions as set forth in the Program Loan Agreement.

64. The use of ADB funds is in support of policy reforms that address politically sensitive long-standing issues and socially significant measures to enhance outreach to the rural sector. The fundamental shift in the RF paradigm is reflected in (i) emphasis on depoliticization, autonomy, good governance, and sustainability; (ii) encouraging private sector participation in RF for enhancing employment and income generating opportunities for the poor; and (iii) recognizing and supporting the role of MF-NGOs.

65. The reforms ensure support for social sectors where continued and direct government involvement is warranted. Phasing out misdirected and nontargeted subsidies through institutional reforms will enhance the fiscal space of the Government. This will enable release of funds, among others, for social sectors as well as for relief and reconstruction in conflict-affected areas. RFSDP reforms also significantly reduce the risks to the savings of the poor households held with weak RFIs, thus enabling the Government to avoid the increased social and financial costs of delayed reforms. Most significantly, the enhanced access to a range of RF services will enable rural households to take advantage of economic opportunities that new technology in manufacturing and agriculture provides.

66. The estimated direct cost of implementing RFSDP reforms at $70 million[37] include: (i) operationalizing RFSDA ($10 million), comprising office and administrative costs ($5 million) and cost of due diligence of RFIs ($5 million);[38] (ii) CRB reforms ($35 million), comprising capitalization costs, at approximately SLRs5 million per CRB ($15 million)[39] and erosion of value in loans and investments ($20 million);[40] (iii) RDB restructuring, $5 million;[41] (iv) RERF, $10 million;[42] (v) NDTF reforms, $5 million; and (vi) SBS reforms, $5 million.[43] RFSDP has been designed in view of the prevailing fiscal stress on the Government. Accordingly, the RFSDP program loan meets 70% of the estimated costs. With improving sustainability, the RFIs are expected to generate surpluses, thus potentially obviating the need for further government investment in the RF sector.

5. Implementation Arrangements

a. Program Management

67. The Ministry of Policy Development and Implementation (MPDI) will be the Executing Agency (EA) and will coordinate with CBSL, MOC, MRE, Ministry of Samurdhi, and Ministry of

---

[36] The 0.5% front-end fee is only for loans approved during 2003.
[37] These estimates exclude institutional strengthening costs covered by the project loan.
[38] Starting in year 4, the licensing fee paid by RFIs will meet part of RFSDA expenses.
[39] CRBs in their existing form do not have equity.
[40] This is at best conservative, as CRB loans to multipurpose cooperative societies are inadequately recorded and many multipurpose cooperative societies are insolvent. Experience from commercial bank reforms indicate that the erosion in assets turns out to be more than estimates.
[41] The valuation of CBSL stake in RDBs is expected to be lower than the paid up amount.
[42] This refers to social intermediation in coordination with RFIs.
[43] The audits indicate unrealized losses in NDTF and SBS.

Finance on policy reforms. MPDI will establish a program management unit (PMU), headed by a program director, who will be the Additional Secretary of MPDI, for monitoring implementation. The program director will be assisted by two directors and four full-time staff, recruited with RFSDP support, with qualifications and experience acceptable to ADB. MRE (for RERF, RDBs, and RFSDA), MOC (for CRBs), NDTF (for NDTF), and the Ministry of Samurdhi (for SBSs) will be implementing agencies (IAs) and will set up program implementation units (PIUs). Each PIU will have a program director supported by one specialist staff with qualifications and experience acceptable to ADB. MPDI will constitute a program steering committee, for interagency coordination, comprising the heads of the PIUs and a representative each from the Ministry of Finance and MPDI. The steering committee will select a chairperson from amongst its members and meet every quarter. A program organization chart is in Appendix 11.

b. Period of Implementation

68. The 4-year implementation period will be completed by December 2007 (Appendix 12).

c. Procurement and Disbursement

69. The loan proceeds will be used to finance the foreign exchange costs of items produced and procured in ADB member countries, excluding ineligible items (Appendix 13). The Government will certify that (i) if the loan proceeds will finance goods already imported, the value of eligible imports in the period concerned will exceed the amount of the requested withdrawal or (ii) if the loan proceeds will finance items to be imported, the value of eligible imports in the immediately preceding 1-year period will be equal to or greater than the amount of the requested withdrawal plus all other amounts expected to be withdrawn during the period.

d. Accounting, Auditing, and Reporting

70. An audit of the use of the loan proceeds will be undertaken if requested by ADB and ADB retains the right to (i) audit any account and (ii) verify the validity of the certification issued by the Government for each withdrawal application. Prior to withdrawal, the Government will open a deposit account at CBSL to receive all loan proceeds. The account will be established, managed, operated, and liquidated in accordance with terms satisfactory to ADB. The PMU will send quarterly progress reports to ADB on policy and institutional reforms.

e. Counterpart Funds

71. As part of RFSDP, the Government will contribute the counterpart funds for RFSDA ($10 million), CRB ($10 million), and RERF ($10 million) from the first and second tranches (para. 72). Balance counterpart funds from first and second tranches as well as counterpart funds from subsequent tranches will be allocated in consultation with ADB. Precise and monitorable dedication of counterpart funds through explicit commitments directly supports RFSDP reforms and contributes to the Government's and ADB's poverty reduction goals.

f. Tranching and Monitoring

72. The program loan will be released over a 4-year period after loan effectiveness in four tranches to meet the expected occurrence of associated costs. The first tranche of $15 million will be released on loan effectiveness, the second tranche of $20 million within 12 months of the first tranche, the third tranche of $10 million within 18 months of the second tranche, and the

fourth tranche of $5 million within 18 months of the third tranche, subject to compliance with the conditions for their release.

73. Monitorable and time-bound actions are reflected in the policy matrix attached to the development policy letter (Appendix 8). Both the Government and ADB will regularly and closely monitor RFSDP implementation. Special audits and reviews will be conducted periodically.

g. Program Performance Management System

74. The PMU will establish and maintain a program performance management system that will include a database on the status of policy measures and program indicators based on the policy matrix. This will be linked with the project performance management system (para. 99).

h. Program Review

75. The Government and ADB will conduct a comprehensive midterm review at the end of year 2 to evaluate the progress of the reform measures and their impact on the RF sector. In addition, ADB will also monitor implementation through periodic reviews and progress reports. ADB will conduct annual reviews throughout the implementation period. These will help in identifying further actions for the continued development of the RF markets.

C. The Project Loans

1. Objectives

76. The project loans' objective is to strengthen key sector institutions for providing training in RF, efficient service delivery, sector supervision, and outreach expansion. Strengthening key sector institutions will increase the access of rural households to RF services.

2. Components and Outputs

77. **Building Sector Capacity**. RFSDP will support the CBS as a center for excellence in RF. CBS capacity (para. 18) will be enhanced to (i) create awareness of the possibilities, prospects, and risks in RF; (ii) improve governance of RF operations; (iii) undertake demand assessment for developing products and services in line with nature of demand with due recognition of gender dimensions; (iv) institute enhanced portfolio management capability; (v) design systems and procedures for reducing the cost of delivery of RF services; (vi) enhance environmental awareness and social safeguard screening steps in credit appraisal; (vii) disseminate RF best practices; and (viii) strengthen linkages between commercial banks, RFIs, and MF-NGOs. Using its facilities, CBS will provide extensive training for RFI staff including training for trainers. Support, through CBS, will be provided to the Rural Development Training Institute to enhance the effectiveness of social intermediation with an emphasis on gender aspects that could be mainstreamed through RERF interventions. RFSDP will coordinate with funding agencies that have RF interventions.[44] RFSDP will support capacity building of commercial banks, through the CBS, to upgrade their RF operations as well as strengthen their RF operations in conflict-affected areas. All materials and reports developed with RFSDP support will be placed on the CBS web site. After the midterm review, RFSDP will (i) support the consolidation of the outputs into a distance learning diploma course through the

[44] Work undertaken by GTZ of Germany with the People's Bank will be considered for replication.

Open University[45] and (ii) consider the transfer of the facilities and skills developed at CBS with RFSDP support to the proposed new RF training center that CBSL is envisaging.

78. **Developing Financial Infrastructure.** Institutional development support for RFSDA (paras. 46–49) will include (i) organizational design; (ii) operating procedures including off-site and on-site supervision; (iii) prudential standards for RFIs including reporting, audit, accounting, and MIS; and (iv) MIS and IT design and equipment for RFSDA. Assistance will also cover training and skills development of RFSDA staff. In addition, RFSDP will, through RFSDA or any appropriate agency, support private sector audit and credit-rating firms for developing their RFI appraisal skills with emphasis on governance, accounts, and MIS.

79. **Rural Finance Institution Restructuring.** Following the adoption of policy reforms (paras. 50–54), the second stage of institutional reforms will constitute the implementation of the CRB Restructuring Plan, RDB Restructuring Plan, NDTF Corporate Plan, and SBS Institutional Strengthening Plan. The scope will cover governance, organization, human resources, business processes, and products and services. The reorienting, redesigning, and repackaging of products and services as well as of systems and procedures will be undertaken to ensure minimal transaction cost. IT and MIS architecture will be upgraded in line with international best practices in business processes. In addition, institutional strengthening of those MF-NGOs that meet the RFSDA licensing criteria will be available through NDTF, especially for expanding their operations in the conflict-affected areas.

80. **Rural Enterprise Development.** RFSDP will provide onlending support to RFIs that meet predetermined eligibility criteria. The onlending support ($10 million equivalent) will be only for subloans not exceeding SLRs100,000 targeted at micro enterprises and small rural enterprises. To start with, 10% of the credit line will be for conflict-affected areas. Three fourths of the credit line by amount will be for women entrepreneurs (paras. 8 and 11). As regards mitigating demand and supply gaps for rural credit for larger loans (para. 31), RFSDP, through prioritizing institutional reforms, provides the basis for RFIs to enhance outreach by mobilizing as well as prudently deploying client savings. This approach will provide much greater prospects for sustained outreach than a finite credit line.

81. **Project Implementation Support**. RFSDP will support the establishment and capacity building of the PMU and PIUs for the following: (i) MPDI for overall coordination; (ii) MRE for RERF and RFSDA implementation, and RDB reform coordination; (iii) MOC for coordinating CRB reforms and effective use of the CRB Fund; and (iv) NDTF and SBS for effective project implementation. RFSDP will provide partial operating support cost to the EA and IAs.

3. Important Features

82. Sector capacity building and application of IT provides the basis for upgrading, managing, and sustaining RF sector improvements. Capacity building will enhance the ability of RFIs to develop new client-centered products and the credit line will facilitate immediate delivery of credit products including in resource poor and conflict-affected areas. Further, institutional strengthening is expected to produce a stream of benefits that includes efficiency and greater outreach within a transparent supervisory environment. Commercially viable orientation of RFIs will facilitate their linkages with the financial sector.

[45] The Open University is the IA for Loan No. 1999-SRI (SF): Distance Education Modernizing Project, for $45 million.

83. Women who own very few assets and little land will especially benefit, as they are often disadvantaged due to collateral constraints. In addition to the allocation of 75% of the rural enterprise development credit, RFSDP design mainstreams gender concerns through (i) gender awareness training to promote gender balanced client outreach and (ii) encouraging RFIs to formulate business plans, which include quantifiable targets for gender outreach, especially in conflict-affected areas. Further, the community investment planning process under RERF will include needs assessment of female community members.

4. Financing Plan

84. The estimated cost of $27.79 million equivalent (Table 1), comprises $3.64 million (13%) in foreign exchange and $24.15 million equivalent (87%) in local currency costs (Appendix 14, and Supplementary Appendix 5). The financing plan is in Table 2.

Table 1: Project Loan Cost Estimates ($ million)

Item	Foreign Exchange	Local Currency	Total
A. Base Cost			
1. Building Sector Capacity	0.28	0.59	0.87
2. Rural Finance Institution Restructuring	0.87	5.00	5.87
3. Developing Financial Infrastructure	0.22	1.04	1.26
4. Rural Enterprise Development	0.00	15.00	15.00
5. Project Implementation Support	0.81	1.56	2.37
Subtotal (A)	**2.18**	**23.19**	**25.37**
B. Contingencies			
1. Physical Contingencies	0.11	0.41	0.52
2. Price Contingencies	0.11	0.55	0.66
Subtotal (B)	**0.22**	**0.96**	**1.18**
C. Service Charges			
1. Interest During Implementation	0.57	0.00	0.57
2. Commitment Charges	0.17	0.00	0.17
3. Front-end Fee	0.50	0.00	0.50
Subtotal (C)	**1.24**	0.00	**1.24**
Total	**3.64**	**24.15**	**27.79**
	13%	87%	100%

Source: Asian Development Bank estimates.

85. It is proposed that ADB provide a loan of $10 million from its OCR for the rural enterprise development credit. The Borrower will be the Democratic Socialist Republic of Sri Lanka. The OCR loan will have a 25-year term, including a grace period of 5 years, and an interest rate to be determined in accordance with ADB's LIBOR-based lending facility; a commitment charge of 0.75% per annum, and a front-end fee of 0.5% of the loan amount; and such other terms and conditions set forth in the Project Loan Agreement.

86. A loan of $10 million equivalent from ADB's Special Funds resources will support building sector capacity, RFI restructuring, developing financial infrastructure, and project implementation. The Borrower will be the Democratic Socialist Republic of Sri Lanka. The loan will have 32-year term, including a grace period of 8 years; and with an interest rate charge of 1% per annum during the grace period and 1.5% per annum thereafter, and such other terms and conditions as set forth in the Project Loan Agreement.

87. The provision of local currency costs is considered warranted for ensuring that sufficient and timely funding is available for outreach expansion and institutional strengthening, thereby minimizing the risk of implementation delay. Country considerations justify higher local currency financing, especially when the Government has shown willingness to borrow OCR funds for a core poverty intervention. The Government has made concerted efforts to maintain domestic investment levels to sustain growth, but the country faces persistent budget pressures, arising from, among others, the civil conflict. Moreover, the program loan only partially meets the cost of implementing the reforms (para. 66).

Table 2: Project Loan Financing Plan ($ million)

Source	Foreign Exchange	Local Currency	Total Cost	%
Asian Development Bank	3.64	16.36	20.00	72
Rural Finance Institutions	0.00	3.00	3.00	11
Subborrowers	0.00	3.00	3.00	11
Government	0.00	1.79	1.79	6
Total	**3.64**	**24.15**	**27.79**	**100**

Source: Asian Development Bank estimates.

5. Implementation Arrangements

a. Project Management

88. As the EA, MPDI will coordinate project implementation support. CBSL will be the IA for building sector capacity. Other IAs will deal with their respective institutions (para. 67). PIUs will submit information and analysis to the PMU and coordinate the fielding and work of consultants. The PMU will ensure submission of periodic reports. Sound accounting and internal control systems will be adopted by the PMU.

89. **Flow of Funds.** The following terms and conditions will apply for disbursements:

(i) **Building sector capacity:** grant from the Government to CBSL.

(ii) **Developing financial infrastructure:** grant from the Government to RFSDA.

(iii) **RFI restructuring:** grants for RFIs except for RDBs. For the divested RDBs, support will be available as soft loans through NDTF under terms and conditions laid down in a separate subsidiary loan agreement satisfactory to ADB.

(iv) **Rural enterprise development:** Ministry of Finance will relend to NDTF at average weighted deposit rates under the terms and conditions laid down in a separate subsidiary loan agreement satisfactory to ADB (Supplementary Appendix 6). A service charge will be admissible to NDTF.

(v) **Project implementation support:** grant from the Government to EAs and IAs.

90. **Management of Cooperative Rural Bank Fund and Rural Economy Resuscitation Fund.** Each fund is governed by specific rules, to ensure that the specified objectives are

achieved. Independent auditors will annually audit both funds and their usage and the reports will be made public.

(i) The CRB Restructuring Committee at MOC will manage the CRB Fund. CRB Fund Rules (Supplementary Appendix 3) include (i) fund description and definitions, (ii) objectives and purposes, (iii) contributions and investments, governance and administration, (iv) annual reports and audits, and (v) eligible institutions. To be eligible, CRBs will adopt and abide by the restructuring plan performance benchmarks. Capitalization support from the CRB Fund will be long-term loans at a cost to be determined by MOC. These loans will be converted to subordinated debt (Tier II capital) after 3 years at mutually agreed terms, including dividends, provided that the CRBs demonstrate positive performance.

(ii) RERF will be invested in long-term treasury bills and the revenue generated will be transferred quarterly to a designated bank account of MRE for ensuring a realistic disbursement schedule.[46] An RERF Secretariat, established in terms of the Guidelines for RERF Investment and Operations (Supplementary Appendix 4), will undertake administration of the RERF, select service providers, enter into partnership agreements, appraise proposals, and make payments based on invoices to the account of service providers after documentary evidence. While RERF investments will be grants for rural poor communities, RERF may seek capital repayments in the event that any investment generates a cash flow. All such cash inflows, however, will have to be reinvested in RERF.

b. Period of Implementation

91. The 4-year implementation period will be completed by December 2007 (Appendix 12).

c. Procurement

92. Procurement of goods and services will be subject to the provisions of ADB's *Guidelines for Procurement*. Vehicles and office equipment will be procured through international competitive bidding procedures for packages exceeding $500,000 equivalent, and through international shopping procedures for packages between $100,000 and $500,000 equivalent. For packages below $100,000 equivalent direct purchase may be used. Indicative contract packages and mode of procurement are in Appendix 15.

d. Consulting Services

93. A total of 58 person-months of international and 628 person-months of domestic consulting services will be financed by the project loan from ADB’s Special Funds resources (Supplementary Appendix 7). Consulting services will support building sector capacity (82 person-months); RFI restructuring (307 person-months); developing financial infrastructure (120 person-months); and project implementation support (177 person-months). The consulting inputs reflect the need to ensure that adequate technical skills are continuously available throughout RFSDP in view of sector capacity constraints, the range of RFIs being reformed, and the strengthening of the PMU and PIUs. Consulting inputs mitigate the risk of frequent changes

[46] This mechanism provides a long-term assured source of funding and ensures adequate controls for selection of subprojects that provide greater social and economic returns. An assured funding source will encourage NGO service providers to specialize and work toward improving their efficiency in social service delivery.

(para. 115) of personnel associated with RFSDP implementation. They also ensure appropriate technical inputs that would otherwise not be possible in view of the budget constraints facing the EA and IAs. The consultants will be placed in the IAs, and within the IAs to respective specialized agencies, such as for RFSDA and RERF within MRE.

94. All consultants to be financed from the proceeds of the ADB loans will be recruited in accordance with ADB's *Guidelines on the Use of Consultants* and arrangements for the engagement of domestic consultants satisfactory to ADB. Where firms are to be engaged, the quality and cost-based selection method and simplified procedures will be used for consultant selection. Consultants will be recruited by MPDI on behalf of all IAs. To facilitate consultant recruitment, position-based terms of reference and indicative consulting packages are provided in Supplementary Appendix 7.

e. Disbursement Arrangements

95. MPDI, on behalf of the Government, will open at CBSL, within 1 month of loan effectiveness, an impress account denominated in US dollars. The imprest account will be established, managed, replenished, and liquidated in accordance with ADB's *Handbook on Loan Disbursements* dated January 2001 and ADB's *Interim Guidelines for Disbursement Operations—LIBOR-Based Loan Products* dated July 2002. ADB will advance 6 months of estimated expenditures or 10% of the total whichever is lower into the imprest account for each of the OCR and Special Funds resource loans. Foreign exchange payments or letters of credit, as well as local currency expenditures, may be paid out of the imprest account. The ADB statement of expenditure procedure will be used to liquidate and replenish the imprest account for individual payments not exceeding $50,000.

96. The EA and IAs will maintain separate records and accounts, adequate to identify goods and services financed out of the loan proceeds and to disclose the use of such goods and services following sound accounting principles. Auditors acceptable to ADB will audit such records and accounts annually. Within 9 months of the close of the financial year, certified copies of the audit report together with the auditor's opinion will be submitted to the Government and ADB. The audit reports will include a separate opinion on the use of the imprest account and statement of expenditure procedures.

f. Accounts, Audits, and Reports

97. The PMU will submit reports to ADB concerning the use of loan proceeds, project administration, and financial management. The reports will include (i) quarterly and annual project implementation reports, (ii) a midterm review report, and (iii) a project completion report to be submitted not later than 6 months after project completion. The reports, consolidating inputs from IAs, will cover (i) expenditures, (ii) activities financed, (iii) highlights of audit reports, (iv) training activities and their impact, (v) institutional strengthening, (vi) rural enterprise development, and (vii) progress on RF expansion in conflict-affected areas. These aspects will be discussed in greater detail in the annual reports.

98. The Government will maintain separate records and accounts for the imprest account and project expenditure in accordance with sound accounting principles and will have such accounts and records audited annually by auditors acceptable to ADB. The Government will ensure that the submission of project reports, audited accounts, and financial statements is in compliance with ADB's guidelines. Independent auditors acceptable to ADB, will audit RFSDA, RERF, participating RDBs, and consolidated accounts for NDTF and SBS. The audit reports will

be submitted to ADB within 9 months of the reporting period. MOC will provide the key findings of CRB reforms and summarize audit findings of participating CRBs. The auditors will also carry out inspection of physical activities.

g. Project Performance Management System

99. MPDI, drawing on data from IAs, will establish and maintain a project performance management system that will generate semiannual and annual reports. The information system will comprise (i) financial and efficiency indicators of RFIs;[47] (ii) number of borrowers by gender and poverty classification, type of services, and the size of transactions; and (iii) social intermediation outreach. The IAs will periodically monitor the socioeconomic indicators of borrowers such as income, asset holding, and employment status to measure poverty outreach and poverty reduction impacts of RFSDP. RFI restructuring and institutional strengthening will provide financial benchmarks

h. Project Reviews

100. ADB and the Government will periodically review project implementation. The reviews will include evaluation of the project scope, implementation arrangements, consultation with IAs and participating RFIs, implementation of RFI restructuring, progress with the policy reform agenda, and capacity-building measures. ADB will also field regular review missions, including a midterm review mission, and project completion review missions. A comprehensive midterm review at the end of year 2 will be undertaken to evaluate actual physical and financial progress. Based on this review, modifications and improvements will be considered.

IV. PROGRAM BENEFITS, IMPACTS, AND RISKS

A. Benefits and Impacts

1. Policy

101. RFSDP represents a shift toward a financial system development approach where sustainable RFIs, over a time, are expected to attain greater outreach, including to the poor, and product diversity, resulting in more clients served and their diverse needs met. Sustainability will diminish political interference by reducing the dependence on government resources and subsidies, which in turn will enable the Government to increase development investment. Increased access to RF services will facilitate growth and diversification of private sector rural enterprises, for both farm and nonfarm sectors, which will generate local employment opportunities and contribute to poverty reduction. Policy, legal, regulatory, and institutional reforms are anchored on good governance, transparency, and rigorous financial discipline. RFSDP supported reforms will strengthen the sector through the following:

(i) RFIs can better respond to growth opportunities when they operate in a conducive policy environment and are appropriately governed. RFSDP provides the framework and incentives for sustainable RF markets to develop.

[47] RFI restructuring and institutional strengthening plans will provide financial benchmarks. The model CRB Restructuring Plan includes key performance benchmarks to serve as monitoring indicators. Similar performance benchmarks will be developed for effective monitoring in consultation with other RFIs.

(ii) RFSDP encourages private sector entry in RF by demonstrating the profit potential of the RF sector. The Government's gradual exit as an RF provider will enable competition to emerge, which will improve quality and efficiency.

(iii) The development of a supervisory and regulatory framework will contribute to financial soundness, good governance, transparency, and encourage integration of the hitherto segmented RF markets with the mainstream financial sector.

(iv) Checks on the proliferation of unsustainable and ineffectively supervised RFIs will reduce regulatory arbitrage and forbearance, and enhance the security of rural savings.

(v) RFSDP will eventually force all RFIs to reform or risk being marginalized. The need for budgetary support to unviable RFIs will diminish when the reformed RFIs are able to sustainably fill outreach gaps.

(vi) Sector analysis undertaken in consultation with ADB will make certain that the needs of the conflict-affected areas are being appropriately addressed. This will strengthen ADB's lead role in RF sector development.

2. Institutional

102. RFSDA will provide cost-effective supervision appropriate for small RFIs that need flexibility and improvisations. While ensuring prudent lending and investment decisions,[48] RFSDA will also facilitate coordination of RF policies to maximize the impact of rural sector investments. In the process, commercial banks will overcome their apprehension of increasing their RF portfolio. Prior RFI commitment to reforms will facilitate and expedite the institutional transformation. The resulting efficiency and cost savings will enable early recovery of RFI restructuring costs. The RFIs can turn themselves around within 3–5 years with recapitalization and reduction in NPLs, cost reductions due to rationalization of systems and procedures, and MIS and IT upgrading. In addition, improved repayment rates due to depoliticization of debt recovery will improve portfolio quality.

3. Economic and Financial

103. Outreach expansion will have a significant employment generation and income enhancement impact. Direct employment will be generated by the high labor content of the small rural and micro enterprise subprojects, whether financed by the rural enterprise development credit (para. 80) or by own funds of RFIs. The estimated 10,000 micro enterprises to be financed by the rural enterprise development credit are expected to generate about 10,000 full-time jobs, primarily for rural women. In addition, the RERF could support 850 subprojects each requiring some 200 person-days equivalent of community labor with significant social development content, especially gender empowerment. Such benefits include improved rural household incomes that will result from an increase in the cropping intensity and cultivated area with better irrigation, regular availability of inputs, application of improved technology, lower transaction and financial costs, and timely access to markets. Resource flows in conflict-affected areas will be assured through specific allocations under RERF and the rural enterprise development credit line.

[48] The RFSD Act restricts investments to only government-approved investments, sets capital-adequacy requirements for obtaining and maintaining a license, and requires RFIs to create provisions for deposit protection.

104. Enhanced financial and institutional capacity of RFIs with RFSDP support will enable RFIs to deploy their funds (savings and borrowings) in credit, thus reversing the flow of resources from rural areas. Conservatively, a one percentage point increase in the credit-to-deposit ratio translates into nearly 20,000 new borrowers at the average micro loan size of SLRs20,500. It is expected that the aggregate credit-to-deposit ratio of RFIs will increase by 10 percentage points, translating into 200,000 additional borrowers during RFSDP duration. More significantly, RFI reforms and deposit protection measures through the RFSD Act will significantly enhance the security of the savings of rural households. Considering that there are about 7 million savings accounts with RFIs, their protection and proper deployment in rural areas constitutes the most significant benefit of RFSDP.

4. Environmental

105. A summary initial environmental examination of farm and nonfarm activities was made and the results were grouped into two broad classes, representing loans for small rural enterprises and for micro enterprises to determine their impact on the environment. As concluded in the initial environmental examination, none of the representative farm and nonfarm enterprises is likely to result in a significant environmental impact. There are no negative environmental impacts that cannot be mitigated. Subborrowers will be required to follow relevant environmental standards and regulations. As part of building sector capacity, CBS will enhance the environmental management system (para. 77) of the participating RFIs. The summary initial environment examination is in Supplementary Appendix 8.

5. Social and Poverty

106. Reducing poverty is best served by reducing the incidence and impact of the causes of poverty for the largest number of people. To achieve this, in line with the Government's program,[49] RFSDP aims to support pro-poor RFIs; capacity building of RFIs and their clients; access of the poor to social services and infrastructure through RERF; rural livelihoods; and investments in conflict-affected areas. With the participation of major RFIs, the poverty reduction impact of RFSDP reforms will be widespread. Enhanced legal provisions for improved governance and sustainability of RFIs increase the prospects to expand RF outreach to meet the growing demand and supply gaps even beyond the life of RFSDP. Increased supply of RF will help rural households intensify and expand their operations through application of improved technology. Linkages within the rural economy and between the rural and urban economies will also be stimulated through increased financial intermediation.

107. Increased and preferential support for rural women entrepreneurs explicitly supports gender equity. In addition, RERF will ensure that rural women have access to supporting mechanisms for access to skills, technology, and markets (paras. 55-56) along with credit. Community-based projects will also be developed with poor women as a target group. Specific allocations for conflict-affected areas for RERF and rural enterprise development credit will support programs, such as access to basic services and livelihood opportunities for women affected by armed conflict, including war widows. For ensuring these, gender awareness training and collation of gender-disaggregated data have been integrated into RFSDP design.

108. RFSDP will not have any adverse impact on indigenous peoples and, thus, will not trigger ADB's *Policy on Indigenous Peoples* and the *Policy on Involuntary Resettlement.*

[49] Government of Sri Lanka. 2002. *Regaining Sri Lanka.* Colombo.

However, a social-safeguard screening step has been added to ensure that there will be no adverse impacts. A Summary Poverty Reduction and Social Strategy is in Appendix 16.

B. Risks

109. The RFSDP design is based on lessons learned from successful practices. Success and impact will, though, depend on a number of assumptions that are subject to varying degrees of risk. Mitigating measures have been put in place as appropriate and possible.

1. Program Loan

110. **Commitment to Reform.** The lack of sustained government commitment to a market-driven RF sector is a major risk. The Government has already committed to reform measures relating to good governance, effective supervision, and sustainability. It is also expected that improved economic performance as a result of the ongoing structural reforms will reduce the pressure on the Government to intervene in the RF markets, especially for lowering lending interest rates. The Government's commitment to commercial bank reforms, despite strong opposition from staff unions, suggests that RF reforms will also be similarly pursued.

111. **Delay in Policy Reforms.** Effective policy dialogue, stakeholder coordination, and capacity-building support are safeguards for smooth implementation of policy reforms. Public awareness to convey the real benefits of the reforms will further mitigate the possible risks of delay in policy reforms. For expediting reforms, RFSDP supports recapitalization and institutional strengthening, including technological upgrading for the reforming RFIs.

112. **Coverage of Conflict-affected Areas.** The realization of RFSDP objectives depends upon the ability of RFIs to operate effectively in the conflict-affected areas. Some enterprising MF-NGOs, CRBs, SBSs, and commercial banks have already started small RF operations in these areas. RFSDP will encourage and facilitate this process, and simultaneously invest in institutional strengthening for rapid expansion as the situation improves.

2. Project Loans

113. **Institutional Reforms.** Decades of politicization have created norms and values in RFIs that are not easily amenable to change. Such norms could affect restructuring, erode autonomy, and prevent the expected improvements in repayments from materializing. Factors that diminish the risks include financial support for restructuring and upfront agreement on governance framework and autonomy. RFSDP support is contingent on performance. Restructuring plans with performance benchmarks will be introduced to track institutional performance. RFIs appreciate that better performance will enable them to expand their operations and provide a greater range of services.[50]

114. **High Delinquency.** RFIs are most vulnerable to increases in loan losses and reductions in loan revenues. The following constitute an effective safeguard against delinquency: (i) stricter application of legal measures for minimizing willful defaults; (ii) tightening of credit standards, more attention to credit risk, and rigorous credit appraisal through application of IT for improving portfolio quality; (iii) significant investment in capacity building for adoption of successful RF practices; and (iv) in the case of microfinance, peer pressure, to ensure repayments. In addition, government commitment not to interfere in lending and loan collections will improve repayment

[50] The RFSD Act links the scale and range of operations to financial performance.

rates. RFIs will also be adequately capitalized to meet transient risks. Tighter prudential norms could drive up costs in the short term and could even require higher provisioning. However, in the medium to long run these will strengthen viability.

115. **Implementation Delays**. Capacity constraints and frequent changes in personnel (para. 93) at the EA and the IAs might delay implementation. Project implementation support and close performance monitoring will help reduce the adverse affects of this. Adequate technical assistance and capacity-building support have also been provided.

V. ASSURANCES

116. The Government has given the following assurances, in addition to the standard assurances, which have been incorporated in the legal documents:

Program Loan

(i) The Government will ensure: (a) that the objectives achieved, policies adopted and actions taken as set forth in the policy letter and the policy matrix will continue to be in full force and effect for the duration of the RFSDP period and subsequently; and (b) proper and timely achievement, adoption, compliance, and implementation of the objectives, policies and actions to be achieved, adopted, complied with, and implemented as set forth in the policy letter and the policy matrix and will ensure that once achieved, adopted, complied with and implemented, such objectives, policies and actions will continue to be in full force and effect during and subsequent to the RFSDP period.

(ii) The Government will support RFSDA in the licensing, supervision, and regulation of the RFIs and will ensure that adequate funds are provided to RFSDA in a timely and efficient manner to ensure its successful functioning.

(iii) The Government will promptly inform ADB of any changes in the board of directors or senior management of RFSDA and will ensure that any such changes will be made in accordance with the provisions of the RFSD Act.

(iv) The Government will ensure that the RERF and CRB Fund operations are conducted, to the satisfaction of ADB, in an efficient and transparent manner. Any amendment to the RERF trust deed and/or CRB Fund rules shall be subject to ADB's prior approval. The Government shall promptly inform ADB of any changes in the management of RERF and/or CRB Fund.

(v) The Government will acquire and instill forensic accounting capability to ensure tracking and minimizing corruption in RFSDP implementation.

(vi) The Government will carry out RFSDP in accordance with its environmental laws and regulations and ADB's Environment Policy.

Project Loans

(i) In case of natural calamities and unforeseen circumstances that affect the equity and liquidity of RFIs, ADB will be consulted immediately and a remedial action

plan acceptable to ADB will be prepared within 1 month thereafter, and subsequently implemented to the satisfaction of ADB.

(ii) The Government will ensure that no persons will be negatively affected in terms of ADB's Policy on Involuntary Resettlement and ADB's Policy on Indigenous People.

(iii) The Government will ensure that lending operations of RFIs availing project support will be carried out in accordance with all environmental laws and regulations of the Government and with ADB's Environment Policy.

(iv) The Government will allocate and make available in a timely manner sufficient funds for the implementation of the Project.

VI. RECOMMENDATION

117. I am satisfied that the proposed loans would comply with the Articles of Agreement of ADB and recommend that the Board approve:

(i) the loan of $50,000,000 to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program from ADB's ordinary capital resources with interest to be determined in accordance with ADB's LIBOR-based lending facility; a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Program Agreements presented to the Board;

(ii) the loan of $10,000,000 to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Project from ADB's ordinary capital resources with interest to be determined in accordance with ADB's LIBOR-based lending facility; a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Project Agreements presented to the Board; and

(iii) the loan in various currencies equivalent to Special Drawing Rights7,005,000 to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Project from ADB's Special Funds resources with an interest charge at the rate of 1% per annum during the grace period and 1.5% per annum thereafter; a term of 32 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Project Agreements presented to the Board.

Tadao Chino
President

14 November 2003

SECTOR AND SUBSECTOR ANALYSIS

1. The rural finance (RF)[1] sector in Sri Lanka has a history of ad hoc public sector interventions, resulting in a proliferation of financially and institutionally weak RF institutions (RFIs). Many RFIs have been created by funding agencies, ministries, and departments to channel rural credit under numerous government-sponsored programs to special interest groups. Practices that sharply deviate from prudent financial intermediation, including subsidized interest rates, politicization of benefits, and debt cancellation, have resulted in weak credit discipline and crowding out of the private sector.

2. **Rural Economy.** Sri Lanka's population was 18.7 million in 2001. Its per capita gross domestic product of $870 is the highest in South Asia. Sri Lanka has had relatively healthy economic growth, with an average growth rate of nearly 5% per annum during the last two decades. In terms of human development indicators, Sri Lanka has achieved a level consistent with those of high-income countries. However, economic growth has been skewed in favor of the urban sector. Concentration of industry close to the main ports has led to an uneven regional distribution of the benefits of economic growth. Poverty continues to be widespread, with estimates ranging from 25% to 39% of the population.[2]

3. Sri Lanka is primarily a rural economy with almost 80% of the population living in rural areas. Poverty is predominantly a rural phenomenon with rural poverty incidence in some regions being as high as 50%. Rural economy is adversely affected by stagnant agriculture growth, poorly targeted agriculture subsidies, and a weak land tenure and registration system. As in the rest of the region, production and marketing bottlenecks due to weak rural infrastructure and the resulting low profitability and productivity make it difficult for the rural sector in Sri Lanka to compete for investment capital. On the other hand, policies relating to agriculture repress farm income potential. Absence of forward and backward linkages to support value addition to rural produce impedes diversification of income sources.

4. As a result, predominantly agricultural areas such as the North-Western and Uva provinces remain less developed, and the Southern province is the poorest in terms of per capita income and has the highest unemployment rate, outside the conflict-affected areas. Rural labor cannot be absorbed by the nonfarm sector due to difficulties in promoting viable rural enterprises including micro enterprises in an environment of sluggish macroeconomic growth, segmented markets, and infrastructure bottlenecks. The rural economy is largely subsistence based, offering very few opportunities for upward mobility. Low skill levels among the rural poor also inhibit their participation in the local economy.

5. **RF Structure.** The RF sector in Sri Lanka consists of (i) the formal sector:[3] state-owned and private commercial banks, National Savings Bank (NSB), regional development banks (RDBs) and SANASA Development Bank (SDB); (ii) the semiformal sector: cooperative rural banks (CRBs), thrift and credit cooperative societies (TCCSs), Samurdhi Banking Societies (SBSs), National Development Trust Fund (NDTF), about 200 microfinance-nongovernment

---

[1] In this appendix, the term 'RF' or 'RFI' (RF institution) is inclusive of 'MF' (microfinance) or 'MFI' (MF institution)', respectively. The term 'MF' or 'MFI' is used only for specific MF related reference.

[2] Depending on the underlying poverty line. The official consumption-based poverty line for the chronically poor is SLRs860 per adult per month, excluding the north and the east (Government of Sri Lanka. 2002. *Framework for Poverty Reduction.* Colombo.).

[3] Formal sector RFIs include those supervised by the Central Bank of Sri Lanka (CBSL) and semiformal RFIs are those established or registered under secondary rules of various laws but not supervised by CBSL.

organizations (MF-NGOs), private sector pawnshops, and numerous programs of the Government of Sri Lanka with rural credit components; and (iii) informal sources including rotating savings and credit associations, input suppliers, traders, moneylenders, landlords, friends, and relatives.

6. NSB and its predecessors have been mobilizing savings since 1832. Savings and credit cooperatives have functioned for nearly a century and now have five million members. Many MF-NGOs and community-based organizations started rural savings and group-based lending programs in the 1980s for poverty reduction and social development. Subsequent government policies of providing RF as a tool for poverty reduction required state-owned commercial banks to provide financial services to the rural poor. In 1986, the Government established regional rural development banks to provide normal and subsidized rural credit, which were later converted into six RDBs. The government-operated SBS program, started in 1997, has grown rapidly in terms of number of societies and total loan portfolio. As a result, RF outreach in Sri Lanka is relatively high compared to other countries in the region.

7. RFIs in Sri Lanka have traditionally emphasized savings (Table A1.1). NSB has SLRs134 billion in 13.5 million deposit accounts, many held by rural savers who access accounts through 4,042 postal agencies. RDBs also collect significant amounts of savings. Savings by semiformal RFIs totaled almost SLRs24 billion in 2000. Cooperatives are the largest semiformal mobilizers of savings, accepting almost SLRs20 billion through the CRB and TCCS networks. SBSs also collect a significant amount of savings. MF-NGOs, though not legally allowed, accept deposits either as compulsory, voluntary, or equity contributions. Commercial banks do not classify their accounts as urban or rural, and are, therefore, not included in Table A1.1, but also mobilize savings from rural areas.

Table A1.1: Deposits at Major Rural Financial Institutions[a]
(SLRs million)

Rural Finance Institutions	Savings	Special Savings	Fixed Deposits	Shares	Total
CRBs	10,870	—	3,937	—	**14,807**
TCCSs	1,757	902	739	841	**4,239**
SANASA Development Bank	194	12	810	161	**1,177**
SBSs	2,033	—	—	983	**3,016**
RDBs	2,731	305	899	1,060	**4,995**
SEEDS (MF-NGO)	488	138	—	—	**626**
Janashakthi (MF-NGO)	21	7	1	17	**46**
Total	**18,094**	**1,364**	**6,386**	**3,062**	**28,906**

CRBs = cooperative rural banks, TCCSs = thrift and credit cooperative societies, SBSs = Samurdhi Banking Societies, RDBs = regional development banks, SEEDS = Sarvodaya Economic Enterprise Development Services, MF-NGO = microfinance-nongovernment organization.
[a] As of December 2000.
Source: ADB. 2002. *Commercialization of Microfinance: Sri Lanka*. Manila.

8. At end-2000, there was approximately SLRs50 billion of rural credit supply for both micro loans, up to SLRs100,000, and non-micro loans provided by the formal and semiformal sectors (Table A1.2). At the prevailing lending interest rate,[4] the demand for rural credit is estimated at SLRs60 billion. The present supply of SLRs50 billion leaves a gap of SLRs10 billion. Of this, half relates to micro loans. The demand could be significantly higher if the constraints imposed by limited access of medium- to long-term credit were removed.

[4] 14–16% for state-owned commercial banks, 20–22% for private commercial banks, and 18–28% for others.

9. Cooperatives are the main suppliers of micro loans but CRBs, the major arm of the cooperative sector, have a very low credit to deposit ratio, indicating weak credit delivery capacity. RFIs have a strong gender focus, with nearly 70% of their clientele being women.

Table A1.2: Supply of Rural Credit

Rural Finance Institutions	Outstanding Loans[a] (SLRs millions) Micro Loans	Non-micro Loans[b]	Total Rural Loans	Members /borrowers
Cooperatives				
CRBs	5,569	1,382	6,951	3,900,000
TCCSs	2,845	—	2,845	810,250
Government Owned				
SBSs	2,070	—	2,070	1,703,366[c]
Bank of Ceylon	1,831	9,669	11,500	100,241[d]
People's Bank	1,840	10,560	12,400	194,000[d]
Quasi-government				
RDBs	3,234	360	3,594	422,376
MF-NGOs	2,000	—	2,000	—
Private Commercial/Development Banks	606	13,280	13,886	—
Estimated loan losses	(3,014)	(1,763)	(4,777)	—
Net Outstanding	**16,981**	**33,488**	**50,469**	**—**

— = not available, CRBs = cooperative rural banks, TCCSs = thrift and credit cooperative societies, SBSs = Samurdhi Banking Societies, RDBs = regional development banks, MF-NGOs = microfinance-nongovernment organizations.
[a] As of December 2000.
[b] Total loan portfolio of rural branches and 20% of portfolio on other branches outside the Western province.
[c] As of December 2001.
[d] Active microcredit borrowers, as of June 2001.
Sources: ADB. 2001. *Technical Assistance to Sri Lanka for Preparing Rural Finance Sector Development Project*. Manila; Australian Agency for International Development and Gesellschaft f?r Technische Zusammenarbeit. 2002. *National Microfinance Study of Sri Lanka: Survey of Practices and Policies*. Colombo; and mission estimates.

10. **Major Issues in RF.** In the absence of a conducive RF policy, government participation and control of RF were perpetuated on the understanding that (i) access to cheap institutional credit could induce investment; (ii) government intervention in the sector was required to ensure sufficient flow of rural credit; and (iii) banks, both commercial and specialized, had a social responsibility to serve the rural clientele even if it meant incurring losses. The Government pursued this approach through directed credit, state-owned RFIs, concessional refinance, and loans at below-cost interest rates. In this repressive environment RFIs and CBs had little, if any, incentive to adopt sound practices and enhance portfolio quality through strict credit appraisal and delinquency management. As a result, RF suffers from weak governance, poor repayment rates,[5] high transaction costs, weak supervision, and recurring losses that add to the fiscal burden. Despite some success in credit expansion, availability of medium- to long-term credit in rural areas has remained limited.

11. The absence of RF policy has led to proliferation of legislation that allows establishment of fundamentally unsustainable RFIs. More significantly, in the majority of RFIs accountancy standards, transparency, management information systems, and information technology platforms are rudimentary. In most cases the real financial status of RFIs is hidden. CRBs do not have independent accounting and reporting from their parent multipurpose cooperatives. The government-sponsored programs such as SBSs do not include in their accounts administrative costs borne by the Government. Many RFIs are unsupervised or operate without proper prudential regulations. Conflicts prevail in terms of ownership and regulation, as CBSL is

[5] Repayment rate refers to collection as a percentage of loans due.

both part owner and regulator of RDBs. Weak supervisory infrastructure in the cooperative sector results in inadequate supervision of CRBs, despite the fact that they hold substantial deposits from nearly 5 million members and nonmembers. The legal status of MF-NGOs remains ambiguous in terms of their right to mobilize deposits.

12. The performance of the majority of RFIs do not conform to sustainability norms when assessed against internationally accepted industry standards. Many RFIs are heavily dependent on government subsidies and external agency funds and the majority of RFIs are far from financial self-sufficiency (Table A1.3). Low sustainability of RFIs stems from absence of performance management systems based on tangible financial indicators; lack of sufficient managerial expertise; and deviation from best practice standards. In a situation of recurring losses, investment in institutional capacity is neither a priority nor are there sufficient training institutions and arrangements for meeting capacity-building needs of the RF sector.

Table A1.3: Viability Ratios of Major Rural Financial Institutions[a] (%)

Rural Finance Institutions	Operational Self-Sufficiency[b]	Financial Self-Sufficiency[c]
CRBs[d]	83	83
SBSs[e]	43	38
RDBs[f]	117	103[g]
SEEDS (MF-NGO)	72	55
Janashakthi (MF-NGO)	130	82

CRBs = cooperative rural banks, SBSs = Samurdhi Banking Societies, RDBs = regional development banks, SEEDS = Sarvodaya Economic Enterprise Development Services, MF-NGO = microfinance-nongovernment organization.
[a] As of December 2001.
[b] Operational self-sufficiency = total operational income/(total operational costs + financing costs + loan loss provisions).
[c] Financial self-sufficiency = total financial revenue/total operational cost - less donations and all subsidies including subsidized interest and inflation adjustments.
[d] Average of five sample well performing and poorly performing CRBs.
[e] Average of three sample average performing SBSs.
[f] Average of six RDBs.
[g] Data for indirect subsidies for RDBs are not available, thus the figure excludes adjustment for subsidies.
Source: Annual reports of RFIs; and ADB. 2001. *Technical Assistance to Sri Lanka for Preparing Rural Finance Sector Development Project*. Manila.

13. More than a third of RF supply is through government programs. The weak credit discipline that accompanies such interventions is reflected, for instance, in nonperforming loans of about 20–30% among RFIs and the RF portfolio of commercial banks. Only about two thirds of CRBs are reported to be financially viable. However, due to lack of transparency, it is not clear how many are actually profitable after adjustments for loan loss provisions, write-offs, and subsidies. SBSs and other government programs also entail large recurrent costs. While a few large MF-NGOs are moving toward self-sustainability, the vast majority of smaller and less well-established MF-NGOs are not operating on a very sound basis. The lack of transparency and standardized financial reporting impedes a detailed assessment of their financial condition.

14. Besides a general deficiency in service quality, there is growing gap between supply and demand for rural credit from formal and semiformal sectors. The lowest end of the market comprising the poor, marginal, and subsistence farmers is restricted to borrowing amounts that are much below these people's needs. For example, most RFIs require collateral such as land or personal guarantors for loans above SLRs50,000. Due to this, rural small and micro enterprises have great difficulty in borrowing the amounts necessary for upscaling and diversifying, which are also hindered by the low levels of skills in rural areas. Private commercial banks, while keen to expand their rural outreach, are better equipped to provide larger loans. Systemic linkages between MF-NGOs and commercial banks have yet to emerge.

15. **Lessons Learned.** The evolution of RF markets in Sri Lanka has been considerably distorted, resulting in fragmented markets that vary in development and density by region. Highly inefficient supply-driven application of capital and weak nonmarket-driven management are generally regarded as the basic reasons for failure. Specific causes of failure revolve around high operating costs, losses, and decapitalization. The cumulative effect of financial repression and dependence on government has affected institutional norms that remain averse to change and accountability. The RF sector as a whole requires a complete reorientation before it can move forward on a continuum toward self-sufficiency. A systemic response to address the issues in RF is essential for reviving the rural economy through investments in agriculture and in rural enterprises.

16. **Strengthening RF Markets.** The Government's ongoing economic reform program aims to reduce poverty and help establish lasting peace through relief, rehabilitation, and reconstruction to reduce conflict-related poverty. Broad-based rural development is the key strategy for poverty reduction including employment, income generation, and access to financial and business services.

17. The most critical element in the RF reform process is a policy paradigm to shape the norms and incentives in which RFIs operate and enable sustainable RF markets to develop. The paradigm will emphasize a financial system development approach where RF market development is placed in the broader perspective of financial sector development. Direct interventions by the Government will be limited to situations where identifiable market failures exist and cost-effective, transparent means to address them are available. A supervisory and regulatory framework to stem proliferation of RFIs through a stricter entry threshold and financial and operating standards will follow the policy framework. Considering the large number of small RFIs, a second tier agency would provide flexible supervisory options compared to CBSL. The policy and regulatory framework will provide the basis for institutional reforms anchored on good governance, transparency, and rigorous financial discipline. The private sector stake must be gradually enhanced in the reformed RFIs to level the playing field for competition and commercialization. Sector capacity constraints must also be simultaneously addressed.

18. Considering the infrastructure and skills deficit context in which most RFIs operate, it is important that RF reforms are accompanied by significant investments in demand-side development that enable the rural poor, for instance through better skills and access to markets, to effectively utilize RF services. For dealing with core poverty issues in conflict-affected areas, a flexible approach for reactivating, strengthening, or establishing new institutions is required. While reforms will eventually enable an adequate response to demand and supply gaps, investments directed for specific underserved market niches will be required in the short to medium term.

19. The strategic components represent a shift to a demand-driven approach where sustainable RFIs, over a period of time, are expected to achieve greater outreach, including the poor, and product diversity resulting in more clients served and their diverse needs better met. This will diminish political interference and willful defaults. The resulting sustainable system will be able to support income expansion and poverty reduction and reduce fiscal pressure, enabling increased investment in development. This reform agenda will significantly contribute to the Government's aim to reduce poverty to 20% and increase economic growth to 7% a year by 2005.

REGIONAL DEVELOPMENT BANKS

A. Legal Framework and Ownership

1. District-based regional rural development banks (RRDBs) established in 1986 were consolidated into six regional development banks (RDBs) in 1997. This process involved financial consolidation, a broader ownership base, and shareholder-appointed board members. The paid up capital of each RDB is SLRs150 million. As of September 2002, the majority shareholder was Central Bank of Sri Lanka (CBSL) with participation of Bank of Ceylon, People's Bank, National Savings Bank, and CBSL Employee Provident Fund (Table A2.1). Due to its shareholding structure, RDBs are categorized as quasi-government financial institutions and are considered susceptible to political influence. RDBs are under CBSL supervision. There is a proposal to establish three RDBs in the conflict-affected areas of the north and the east. However, no time frame has yet been announced.

Table A2.1: Ownership Structure and Network of Regional Development Banks[a]

RDB	Wayamba	Kandurata	Sabara-gamuwa	Ruhuna	Rajarata	Uva
Ownership (% share)						
Central Bank of Sri Lanka	68	68	68	68	52	52
Bank of Ceylon	8	8	8	8	12	12
National Savings Bank	8	8	8	8	12	12
People's Bank	8	8	8	8	12	12
CBSL Employee Provident Fund	8	8	8	8	12	12
Number of branches	34	32	41	37	21	26
Number of staff	316	256	324	347	152	220

[a] As of September 2002.
Source: Central Bank of Sri Lanka.

B. Operations

2. RDBs provide normal and subsidized credit to individuals and businesses in rural areas. The deposit and loan outstanding amounts at end-2001 were SLRs4.7 billion and SLRs5.5 billion, respectively. About 80% of loans are microcredit loans under SLRs100,000. Personal guarantees from customers or immovable property are used as collateral. Lending interest rates vary between 12% and 27%. The lending portfolio is diversified (Table A2.2), with pawnbroking constituting nearly half of the portfolio. Lending exposure to farming is low.

Table A2.2: Purpose-wise Classification of Aggregate Loan Portfolio[a]

Type	Volume (SLRs million)	Percentage of Total Portfolio (%)
Agriculture	408	10.1
Livestock and Fisheries	72	1.7
Small Industry	294	7.3
Construction/Electrification	165	4.1
Commerce	446	11.0
Pawnbroking/others	2,658	65.8
Total	**4,043**	**100.0**

[a] As of December 2000.
Source: Central Bank of Sri Lanka.

3. The organizational and operating cost structures of RDBs mirror those of commercial banks and are inappropriate for their roles as microcredit providers. In some cases, they have shown a tendency to move away from their traditional client base of rural poor and low-income households and provide larger loans. While the average loan size of RDBs is small, this does not necessarily indicate that they are effectively satisfying the credit needs of the rural poor.

C. Profitability and Portfolio Performance

4. RDBs inherited many portfolio problems from the RRDBs. Portfolio quality remains problematic for all six RDBs. Nonperforming loans as a percentage of the total portfolio range from 16% to 33% (Table A2.3). Each RDB has established a special debt recovery program to reduce nonperforming loans. Kandurata, Sabaragamuwa, and Wayamba RDBs show low levels of nonperforming loans compared to the other three RDBs. Sabaragamuwa in particular has improved its portfolio quality. Ruhuna, Rajarata, and Uva RDBs have comparatively high levels of nonperforming loans, with Rajarata's loan portfolio having deteriorated over the past 3 years. The aggregate repayment rate (as percentage of amount due) for the RDBs was 88% at end-2001. Loans are classified as nonperforming after 90 days and are subject to aging analysis.

Table A2. 3: Financial Performance of Regional Development Banks[a]

Performance Indicator	Wayamba	Kandurata	Sabara-gamuwa	Ruhuna	Rajarata	Uva
Return on Average Assets (%)	1.44	1.44	0.96	1.24	-1.48	0.84
Nonperforming portfolio (%)	17	16	16	21	25	33
Total assets (SLRs million)	1,742	1,036	1,558	2,031	675	824
Total deposits (SLRs million)	929	596	1,073	1,160	441	546
Loans and advances (SLRs million)	1,365	728	1,091	1,320	436	578
Paid-up capital (SLRs million)	150	150	150	150	100	100
Total shareholder funds (SLRs million)	250	176	185	316	126	121
Profit Before Tax (SLRs million)	53	24	15	48	-10	7
Profit After Tax (SLRs million)	25	15	15	25	-10	7

[a] As of December 2001.
Source: Regional Development Banks.

5. While five out of the six RDBs have shown nominal profits, it is not clear whether these profits were adjusted for indirect subsidies. CBSL is of the opinion that these reflect a true picture and that the profitability of RDBs is improving despite the high level of nonperforming loans. CBSL-prescribed prudential guidelines apply to RDBs.

D. Issues

6. RDBs have fared better than their predecessors, the RRDBs. However, there is significant room for improvement in governance, transparency, human resources, and systems and procedures. There is no private sector representation on the board of directors to provide commercial expertise or orientation. RDBs need to urgently focus on enhancing portfolio quality by reducing the nonperforming loans and acquiring modern technology for credit appraisal and delinquency management. Without reducing subsidy dependence RDBs will neither become autonomous nor sustainable. RDBs have to realize that the lower end of the rural finance market provides sufficient avenues for profitable operations and should refrain from diversifying into market segments and products for which they are ill equipped. The Government has decided to divest 80% of the CBSL stake in RDBs and facilitate their restructuring under the Rural Finance Sector Development Program.

COOPERATIVE FINANCIAL INSTITUTIONS

1. Sri Lanka has one of the oldest cooperative movements in the world, dating back to 1906. Cooperative societies are governed by the Cooperative Societies Act of 1972. The 10,518 primary cooperatives have a membership of about 5 million and represent a significant political constituency. Over 8,000 cooperatives are engaged in savings and credit activities. Their nationwide network provides half of the total annual number of micro loans.[1] Cooperative rural banks (CRBs) and thrift and credit cooperative societies (TCCSs)[2] are the two major cooperative systems providing financial services.

A. Cooperative Rural Banks

2. **Organization and Governance.** The CRBs are the most prominent member-owned and managed financial cooperatives, covering urban as well as rural areas. At the end of 2001, 311 CRBs had 1,196 branches and 3.9 million members. CRBs demonstrate many strong features, including low-cost operations, community orientation, rural culture, low-risk loan products, savings-led financial services, and rural bank-characterized business operations. CRBs are not supervised by the Central Bank of Sri Lanka (CBSL). Originally, the People's Bank, a state-owned commercial bank, exercised supervision, provided liquidity support, and managed the surplus (savings over loans) of the CRBs. After the discontinuation of this arrangement in 1992, the CRBs were placed under the management and supervision of the Ministry of Co-operatives, which does not have adequate capacity to supervise financial institutions.

3. Most CRBs are not independent legal entities but are departments of multipurpose cooperative societies (MPCSs). Such “captive” CRBs therefore have no capital of their own and come under the complete control of their MPCS. Separate financial accounts to reflect a true and fair picture of financial status are not prepared for captive CRBs. Poor accounting and lack of separate CRB balance sheets increase depositors' risk. In addition to captive CRBs, there are five “free-standing” CRBs (CRBs that are not departments of MPCSs). There are also 14 district CRB unions, formed to provide the services formerly provided by the People’s Bank, that pool CRB surpluses and invest them in a variety of vehicles including loans to larger nonmember entities and MPCSs.[3] The withdrawal of CRB surpluses from the People’s Bank has accelerated in recent years due to the weak financial position of the People’s Bank. There have been reports of district CRB unions lending to MPCSs, using the CRB deposit funds.

4. In addition to savings and credit through the captive CRBs, MPCSs engage in a wide variety of commercial activities including consumer stores, supermarkets, transport, petrol filling stations, bakeries, and rice mills. Many MPCSs have experienced recurring losses in these commercial activities, which have eroded the value of their equity. The surpluses of captive CRBs, which in some cases are the sole profitable activity of MPCSs, are incorporated into the total MPCS surplus, leaving the CRB with inadequate capital adequacy. Captive CRBs come under the control of their MPCS Board of Directors, and the General Manager of the MPCS serves as the chief executive officer of the CRB. Generally, neither the MPCS Board nor the MPCS General Manager has adequate experience and skills to operate a financial institution. This arrangement compromises good governance and may influence the lending decisions of the captive CRBs, which are often the primary financier of clients of the commercial units of MPCSs.

---

[1] Loans below SLRs100,000. The aggregate microloan supply in Sri Lanka is estimated at SLRs18.23 billion in 1.65 million accounts.
[2] Savings and credit societies organized under farmer organizations are also in the nature of cooperatives.
[3] Over and above what the attached CRB can provide.

5. **Operations.** CRBs can mobilize savings from members and nonmembers, and savings from nonmembers now constitute about 70% of total CRB deposits (Table A3.1). At end-December 2001, CRBs deposits amounted to SLRs16.6 billion in 5.8 million savings accounts, mainly from rural areas. The average savings size was SLRs2,860 per account. Savings continue to grow, by 15% during 2001. CRBs can lend only to members. CRB loans are mainly for housing and productive activities but pawning is an increasingly important activity. CRBs also provide services such as collection of utility bills and payment of pensions to farmers. Collectively, the CRBs disbursed SLRs2.3 billion during 2000. The aggregate outstanding loan at end-2001 was SLRs5.9 billion with an average loan size of about SLRs8,500. Loan funds are provided entirely from deposits.

Table A3.1: Cooperative Rural Bank Portfolio Performance
(SLRs millions)

Year	1997	1998	1999	2000	2001
Total deposits mobilized	9,871	11,234	12,914	14,807	16,576
Total loans and pawning	5,166	5,555	7,232	6,951	5,906
Total investments	9,553	10,494	10,996	9,461	10,520
Total loans and investments	14,719	16,049	18,228	15,648	16,426

Source: Department of Cooperative Development.

6. **Portfolio Quality and Profitability.** The Department of Cooperative Development (DCD) reports that 1,174 of the total of 1,507 CRB outlets are profitable. However, this is highly unlikely when the overall repayment rate is only 65%. Provisioning that is not based on portfolio quality and failure to charge CRB-related MPCS overheads to CRB profitability have inflated the "profits" of CRBs. In the absence of separate financial statements, CRB profitability is not clear. Study of a sample of captive and free-standing CRBs shows that operational and financial self-sufficiency vary depending on their status (Table A3.2). The two free-standing CRBs achieve over 100% financial self-sufficiency and have adequate yield on the loan portfolio.

Table A3. 2: Summary Financial Performance of Sample Cooperative Rural Banks, 2001[a]

	Free-Standing CRBs		Captive CRBs		
Sample Cooperative Rural Bank	Polgahawela	Menikhinna	Rambewa	Anuradapura	Shara-wasthipura
Total financial revenue (SLRs '000)	25,275	20,624	560	922	1,070
Adjusted administrative costs (SLRs '000)	7,734	5,784	477	826	396
Loan-loss provision (SLRs '000)	69	199	1,198	89	186
Adjusted cost of funds (SLRs '000)	14,434	10,804	330	598	608
Net financial income (SLRs '000)	3,038	3,837	(1,445)	(591)	(120)
Operational self-sufficiency (%)	114	123	28	61	90
Financial self-sufficiency (%)	113	111	27	67	95
Actual average gross loan portfolio yield	15.62	16.94	4.54	8.81	9.82

CRBs = cooperative rural banks.
[a] As of December.
Source: Department of Cooperative Development.

7. It is estimated that a CRB with a poorly performing loan portfolio may lose as much as SLRs13 for every SLRs100 it lends. Lending interest rates do not factor in risks, and the poor quality of existing loans depresses the portfolio yield. CRBs' loan classification system is

significantly different from the banking sector and CRBs do not have a policy of loan-loss provisioning or writing off, although sometimes the external auditor from DCD recommends some provisions. CRBs maintain that their unique system for collecting overdues justifies this. Loans without any principal or interest repayments are treated as past due 6 months from the first default, during which time five repayment notices are issued. The Commissioner, Co-operative Development, then refers the loan for arbitration. Failure to settle at this stage gives the CRB the right to refer the matter to the magistrates court, which is required to act on the award made at arbitration stage and order it to be collected as a fine due to the state. This gives the order to pay great weight: failure to comply can lead to imprisonment but even this does not extinguish the CRB claim. The system appears to work but the administrative machinery is very slow, sometimes taking years, and subject to corruption.

8. **Issues.** CRBs are probably the only unsubsidized RF network in Sri Lanka. CRBs have been in existence for a long time and have survived without external support, in some cases sustaining the parent MPCSs, for at least a decade. The CRB model has several strong characteristics that are essential to becoming a viable and sustainable rural finance institution. Unfortunately, these strengths are almost nullified by a poor regulatory system, political capture, poor administration, very poor accounting standards, and a poor auditing system. Surpluses of captive CRBs have been inappropriately deployed by parent MPCSs. Significant amounts of small depositors' funds are at risk. CRBs need to operate as distinct financial entities with autonomy to pursue viable business operations. This is only possible through fundamental changes in legal, governance, supervisory, financial, and institutional arrangements.

B. Thrift and Credit Cooperative Societies

9. The primary thrift and credit cooperative societies (TCCSs) were the first cooperatives to be established after the enactment of the Cooperative Act of 1911. By 1965, there were reportedly some 4,500 TCCSs. At end-December 2000, the numbers had grown to some 8,500 TCCSs with a membership of 905,106, although many are reported to be dormant. TCCSs are widely spread throughout the country in both rural and urban areas. TCCSs specialize in microfinance, providing about 15% of total micro loans. District unions were formed to support the TCCSs and an apex organization, the Federation of Thrift and Credit Cooperatives (FTCC) of Sri Lanka was established. However, the FTCC is just a loose network of TCCSs. It has no central management and does not act either as a supervisor or an effective coordinator. As a result, the TCCSs suffer from weak accounting and information management, low efficiency, and nonviability. In addition, the systems and procedures are not compatible among TCCSs at the primary and district levels.

10. SANASA Development Bank (SDB) was established as a licensed specialized bank in 1997 and is owned by the TCCSs, district unions, and the FTCC. SDB's role is "to mobilize deposits at competitive rates of interest and invest such deposits in community-based lending programs with particular focus on TCCS, their members, and micro enterprises."[4] SDB is taking over some of the lending to TCCS from the FTCC. As of June 2001, SDB had total loans outstanding of SLRs127.5 million. While SDB mainly lends to the district and primary societies, it also lends to microfinance-nongovernment organizations, community-based organizations, self-help groups, and individuals who are not society members.

[4] ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Southern Province Rural Economic Advancement Project*. Manila.

NATIONAL DEVELOPMENT TRUST FUND

A. Background

118. The National Development Trust Fund (NDTF) was established in 1992 to manage a Poverty Alleviation Project, including a credit fund for lending to partner rural finance institutions (RFIs) to onlend to the poor, a human resources development fund, a rural works fund, and a nutrition fund. The Poverty Alleviation Project was funded by the World Bank, Kreditanstalt f?r Wiederaufbau, and the Government of Sri Lanka. While NDTF's noncredit operations were wound up in 1998, it continues as a wholesale lender to RFIs. At end-2001, NDTF had a loan portfolio of SLRs373.9 million net of provisions of SLRs135.8 million. In addition, SLRs700.8 million are invested in government securities and fixed deposits. NDTF is governed by a 15-member Board of Trustees, selected by the Government and comprising nine public sector and six private sector representatives.

B. National Development Trust Fund Performance

119. NDTF's performance, outreach, and impact on the microfinance (MF) sector have been limited compared with its resources and market potential. Concerns center on its scale of operations, loan portfolio management, selection and support of partner RFIs, and weak institutional capacity. NDTF disbursed SLRs337.6 million in loans in 2001 to partner RFIs including microfinance nongovernment organizations (MF-NGOs), cooperative rural banks, thrift and credit cooperative societies, regional development banks, and other banks. As of June 2002, NDTF had 160 partner RFIs, of which 81 were active borrowers with outstanding loans totaling SLRs597.1 million. Of this, SLRs127.9 million (21.4%) was considered doubtful, mostly made up of long-standing overdues with thrift and credit cooperative societies, cooperative rural banks, and MF-NGOs. Most of these are probably unrecoverable. The financial viability of NDTF is weak. Partner RFIs often repay loans from new NDTF borrowings because of the low cost of NDTF funds. The interest spread is estimated to cover only 30% of NDTF's operating costs excluding overhead charges.

120. The present legal status of NDTF as a trust does not permit a legally binding lender-borrower relationship with its partner RFIs. While NDTF remains the main wholesale lender to MF-NGOs, providing loans to 60 of them in 2001, lending to MF-NGOs constituted only 26% of total lending in that year. Partner RFIs include commercial banks that have access to other sources of funds. Further, NDTF has not provided any significant capacity-building support to MF-NGOs or encouraged their adoption of best practices, either through direct assistance or by using its position as a lender to exert influence. NDTF does not have sufficient staff with technical and managerial skills for effectively implementing its program.

C. Institutional Reform

121. As part of the Rural Finance Sector Development Program, NDTF has been incorporated under the Companies Act No.17 of 1982 to provide it with a proper legal basis to act as a lending institution. Institutional strengthening support will be provided to transform NDTF into a viable MF apex organization capable of acting as a focal point for development of the MF sector with the goal of rapidly expanding outreach, particularly in the conflict-affected areas, and guiding MF-NGOs towards financial sustainability.

SAMURDHI PROGRAM AND SAMURDHI BANKING SOCIETIES

A. Background

1. The Samurdhi Program, the main poverty reduction scheme of the Government of Sri Lanka has operated since 1995. The program includes income transfer (welfare grant) and community-based rural infrastructure development components. The Samurdhi Banking Society (SBS) Program was introduced in March 1997 as part of the Samurdhi Program to promote savings and investment in rural areas. The SBS Program is operated by the Samurdhi Authority of Sri Lanka under the purview of the Ministry of Samurdhi, Agriculture and Livestock.

2. The SBS Program is based on the concept of group collateral and collective savings of five-member groups, the great majority of whom receive Samurdhi welfare grants. Successful groups join together to form autonomous village-level societies—SBSs—which are managed by Samurdhi managers and supervised by divisional secretaries of the Government. Each SBS member purchases SLRs500 worth of shares to become eligible to borrow. With over 1.7 million members in 2002, the SBS Program is the largest microfinance institution (MFI) in Sri Lanka and one of the largest in the world. Over 60% of shareholders are female.

B. Samurdhi Banking Society Performance

3. The SBS Program has achieved tremendous growth in terms of membership, savings mobilization, and credit disbursement, with high repayment rates. As of June 2002, there were 989 SBSs operating in 286 divisional secretariats and a further 8 SBSs will be opened soon. There were 3.5 million savings accounts, including compulsory deposits of Samurdhi beneficiaries. Total deposits at mid-year 2002 amounted to SLRs6.7 billion, an increase of over 300% since 2000. The value of paid-up capital amounted to SLRs1.5 billion, an increase of SLRs120 million relative to the previous year. The total value of loans issued from inception by SBSs totals SLRs5.5 billion and of this, half was issued in 2001 alone, making the SBS Program the fastest growing loan program in Sri Lanka. Outstanding loans of SBS at end-2001 amounted to SLRs2.3 billion with 429,231 active loans. The on-time loan recovery rate as of June 2002 was reported as 93.4%, which is the best recovery ratio among MFIs in Sri Lanka. The high repayment rate is mainly due to the large number of Samurdhi development officers employed in the field as well as the system that pays welfare grants through SBSs, putting SBS managers in a good position to ensure repayment.

4. However, the SBS operation is very expensive. The operational cost,[1] excluding the cost of funds, of an average performing SBS in 2001 was approximately 73% of its average gross loans outstanding, significantly higher than typical successful MFIs in the region.[2] No SBS attained 100% financial self-sufficiency.[3] The financial self-sufficiency of the best performing SBS was estimated at 78.7%, while that of the average performing SBSs was 38.5% (Table A5). As the majority of SBS costs are borne by the Government, and with the current staff and operational cost level, most SBSs are expected to be unsustainable over the long run. It is

---

[1] Including allocation of 75% of the salary and allowances of government staff assigned to the SBS. The Samurdhi Authority of Sri Lanka argues that the government staff working for SBSs also contribute to other components of the Samurdhi Program (welfare grants, insurance, community infrastructure) and therefore only a small part of the cost of such personnel should be allocated to SBSs. However, even after allocation of a lower proportion of government staff costs, the SBSs remain very high cost MFIs.

[2] The ratio in other MFIs of similar size in Bangladesh is 5% for the Association for Social Advancement, 8% for the Bangladesh Rural Advancement Committee, and 9% for the Grameen Bank.

[3] According to the definition by the Consultative Group to Assist the Poorest, financial self-sufficiency = total financial revenue/total operational cost - donations and all subsidies including subsidized interest and inflation adjustments.

estimated that SBSs as a whole have at least 60% excess staff and about 99% of SBSs are currently unprofitable. Restructuring measures such as further cost reductions, expanded loan and saving activities, and efficiency and productivity improvements are necessary for the majority of SBSs to achieve financial sustainability.

Table A5: Summary Operational Efficiency Performance of a Selected Representative Sample of Samurdhi Banking Societies[a]

Item	Best Performing	Top 20%	Average Performing	Poorly Performing
Samurdhi Banking Society	Rakwana	Dambulla	Polgahawela	Wariyapola
Financial Revenue from Loan Portfolio (SLRs)	20.48	24.26	26.21	24.96
Adjusted Administrative Costs (SLRs)	37.29	57.72	72.88	81.09
Loan Loss (provision) (SLRs)	0.78	6.13	0.77	7.56
Estimated Cost of Funds (SLRs)	9.35	9.35	9.35	9.35
Net Financial Income (SLRs)	(26.94)	(48.94)	(56.79)	(73.04)
Operational Self-sufficiency (%)	94.56	73.37	42.70	32.93
Financial Self-sufficiency (%)	78.73	65.59	38.45	30.69

[a] Per 100 units of gross loan portfolio outstanding.
Sources: ADB. 2001. *Technical Assistance to Sri Lanka for Preparing Rural Finance Sector Development Project*. Manila.

122. The Samurdhi Authority of Sri Lanka does not produce separate audited accounts for its banking and financial activities and the SBS accounts are not consolidated. SBSs depend on the Divisional Secretary Office to prepare their final accounts and conduct the annual audit. A large number of SBS accounts are not audited. The allocation of government-subsidized costs is not included in individual SBS accounts. SBS operating surpluses appear to be appropriated for various cost centers within the Government, which would impair the ability of an SBS to build a sound equity base for its independent operation. Further, SBSs are not under the supervision of any independent supervisor.

C. Proposed Institutional Reform

123. Broad-based institutional reforms are needed to transform SBSs into autonomous and viable financial institutions to play a significant role in rural poverty reduction in Sri Lanka. SBSs need to move toward operational self-sufficiency by fundamentally restructuring their operations. Within the scope of the Rural Finance Sector Development Program, portfolio analysis and diagnostic reviews were undertaken with the objective of developing an SBS Institutional Strengthening Plan to strengthen SBSs' institutional capabilities as viable rural finance institutions and poverty reduction instruments to achieve greater cost-effectiveness and operational sufficiency. The portfolio analysis covers the performance analysis of loan, equity, and liquid asset portfolios of selected SBSs and the impact of portfolio quality on overall financial condition and performance. The diagnostic review analyzes SBSs’ organization, management, operations, credit policies, and related processes. The SBS Institutional Strengthening Plan incorporating the outputs of portfolio analysis and diagnostic reviews will cover improvement of governance, operational standards including accounting and auditing, financial viability, and outreach.

MICROFINANCE-NONGOVERNMENT ORGANIZATIONS

1. There are about 200 microfinance-nongovernment organizations (MF-NGOs) in Sri Lanka, of which four are large entities and the rest are small multisector NGOs. Many of the MF-NGOs apply an "MF-plus" approach whereby borrowers are supported by other services, primarily training and business development services. As a result, MF-NGOs are not focused on sustainable provision of financial services and their financial intermediation skills are weak, especially in accounting and loan analysis. A brief description of the large MF-NGOs follows.

2. **Sarvodaya Economic Enterprise Development Service (SEEDS).** SEEDS is a registered company limited by guarantee, established in 1986 by Sarvodaya Shramadana Sangamaya Movement (Sarvodaya), an NGO started in 1958 to empower villages through strengthening their capacity to develop enterprises. Through its head office in Colombo and 11 district offices, SEEDS serves as a wholesale lender to Sarvodaya village societies and Sarvodaya village banks that onlend to their members. As part of its "MF-plus" approach, SEEDS also provides training, monitoring, supervision, and enterprise development support to Sarvodaya societies and banks. As of March 2001, the SEEDS network had 177,974 loan clients with an outstanding portfolio of SLRs667 million, and SLRs358 million in savings in 662,272 savings accounts. Women constitute 60% of clients.

3. The operational and financial self-sufficiency[1] of SEEDS at end-2001 was 72% and 55%, respectively. While the repayment rate is 94%, 18.5% of loans to Sarvodaya societies and banks are delinquent, of which about 76% are over 12 months in arrears. The overall portfolio quality of the network could be weaker still, as Sarvodaya societies and banks have weak financial management, supervision, and control systems. Their financial viability is also in doubt. The SEEDS network requires substantial improvements in supervision, credit appraisal, and delinquency management.

4. **Janashakthi**. As an offshoot of the Government of Sri Lanka's poverty reduction program, Janashakthi began operations as a member-based MF-NGO in 1989. Janashakthi societies organized themselves into Janashakthi bank societies (JBSs) to pool individual and group savings and extend small loans. There are 67 JBSs with a total membership of 28,168 with about 5,300 groups of five women each. The target market is families earning less than SLRs1,500 per month. At village level, the groups meet weekly with individuals contributing SLRs25 each time. In addition, each group member must subscribe SLRs500 in the capital of JBS. Savings and loans outstanding at end-December 2001 were SLRs29 million and SLRs91 million, respectively. Loan repayment rates average around 97%. The consolidated surplus of all JBSs was SLRs0.8 million at end-December 2001 or an average of SLRs11,370 per JBS. While most JBSs are profitable, expansion is affected by lack of funds for supporting its multidimensional approach to poverty reduction covering health, nutrition, environment, and banking.

5. **Social Mobilization Foundation** is the banking arm of the Government's Integrated Rural Development Project. It has around 10,000 clients with a revolving fund of SLRs20 million.

6. **Arthachariya Foundation.** Founded in 1992, the Arthachariya Foundation has a strong poverty focus, working only with the poorest in the villages. It has a revolving fund of approximately SLRs20 million and a client base of around 3,000.

---

[1] The Consultative Group to Assist the Poorest defines financial self-sufficiency as total financial revenue/total operational cost - donations and all subsidies including subsidized interest and inflation adjustments.

EXTERNAL AGENCY COORDINATION MATRIX[a]

Rural Development	Agriculture	Microfinance	Financial Sector	Small and Medium Enterprises
Asian Development Bank Infrastructure, community development, social capital, and some rural finance (RF). • Southern Province Rural Economic Advancement Project ($25 million) • North East Community Restoration and Development Project ($25 million) • North Central Province Rural Development Project ($20 million) • Southern Province Rural Development Project ($38 million) **World Bank** Improvement, better operation, and maintenance of irrigation facilities. • Mahaweli Restructuring and Rehabilitation Project **Others** International Fund for Agricultural Development (IFAD); Japan Bank for International Cooperation (JBIC); Swiss Agency for Development Cooperation; United Nations Development Programme (UNDP); and World Food Programme	**Asian Development Bank** Investments in tea, rubber, coconuts and other perennial crops, factory consolidation, marketing, research support, and integrated farming system. • Second Agriculture Program ($60 million) • Plantation Development ($20 million) • Plantation Reform Program ($60 million) • Second Perennial Crops Development Project ($20 million) • Tea Development Project ($35 million) **World Bank** • Improved agricultural production in conflict-affected areas. • North-East Irrigated Agriculture Project • Others • IFAD, JBIC, and UNDP	**Others** Microfinance services for small farmers and landless poor, and review of existing financial institutions. • Rural Banking Innovations Project (Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ)) • Small Farmers and Landless Credit Project (IFAD) • Poverty Alleviation Microfinance Project (JBIC)	**Asian Development Bank** Developing financial institutions • Fourth Development Finance Project ($75 million) **World Bank** Institutional Strengthening of the Central Bank of Sri Lanka, fiscal stabilization, improvement of the state-owned financial institutions, and diversifying savings instruments. • Central Bank of Sri Lanka Strengthening Project • Financial Sector Reforms Program	**Asian Development Bank** Regulatory reform and strengthening of small and medium enterprise capacities. • Small and Medium Enterprise Sector Development Program ($26 million)
International Monetary Fund: Accelerate economic growth and poverty reduction through: (i) strengthening public finances; (ii) reforming the financial sector, public enterprises, labor market, and trade regime; and (iii) strengthening macroeconomic policy instruments and institutions. • 2003–2006 - Poverty Reduction and Growth Facility and Extended Fund Facility, amounting to $567 million.				
Rural Finance Sector Development Program				
Enhanced access to credit will complement improved infrastructure and greater accessibility to markets. The Rural Economy Resuscitation Fund can be utilized for rural community infrastructure development.	Efficient rural finance intermediation will enable maximization of household benefits from higher farm productivity and commodity prices through better access to agricultural inputs.	Establishment of new microfinance institutions will extend outreach to the lowest segment of the RF markets	Reforms in RF markets will enhance the flow of resources in the rural sector. Development of a legal framework will not only improve the governance of RF institutions, but also protect depositors.	RF services for rural enterprises will help rural households diversify income sources and promote small and medium enterprise activities in rural areas.

[a] Only major and ongoing interventions.

DEVELOPMENT POLICY LETTER AND POLICY MATRIX

මුදල් අමාත්‍යාංශය

நிதி அமைச்சு

MINISTRY OF FINANCE

මහ ලේකම් කාර්යාලය කොළඹ 01. செயலகம், கொழும்பு 01. **The Secretariat, Colombo 01.**

කාර්යාලය / அலுவலகம் / Office: 484500, 484600, 484700
ෆැක්ස් / பெக்ஸ் / Fax: (941) 449823
ටෙලෙක්ස් / டெலெக்ஸ் / Telex: (941) 21409 CE

මගේ අංකය / எனது இல. / My No.: ERD/AB/FN: 25/D
ඔබේ අංකය / உமது இல. / Your No.:
දිනය / திகதி / Date: 13th October 2003

Mr. Tadao Chino
President
Asian Development Bank
Metro Manila
Philippines

Dear Mr. President,

SRI LANKA: RURAL FINANCE SECTOR DEVELOPMENT PROGRAM

1. At the outset, on behalf of the Government of Sri Lanka we would like to thank the Asian Development Bank (ADB) for the substantial assistance, which it has continued to provide to Sri Lanka over the years. Mr. President, it is a critical year in Sri Lanka's history. A major opportunity is within reach to restore peace and bring an end to two decades of conflict that has held back economic advancement and perpetuated poverty. Capitalizing on this opportunity, the Government aims to work towards reducing poverty incidence to 20% and attaining a GDP growth rate of 7% by 2005. Nearly 2 million additional jobs are envisaged.

2. The 'Regaining Sri Lanka' and the Government's economic reform program prioritizes poverty reduction by creating opportunities for the poor to participate in economic growth including empowering the poor and strengthening governance. Farm and nonfarm, including micro, small, and medium enterprises are expected to provide the bulk of employment. This will critically depend on the availability of adequate and affordable rural finance services.

3. Important as rural finance is to our development strategy, the rural finance sector in Sri Lanka varies in development and density by region. Loan collection problems are pervasive and transaction costs remain high. Most of the Rural Finance Institutions (RFIs) are not sustainable and are prone to interference. Inadequate supervision of RFIs could endanger the savings of millions of rural households. Recognizing these deep-seated issues, the Government has decided to introduce a comprehensive rural finance reform agenda. We thank ADB for assisting in the formulation of the Rural Finance Sector Development Program (RFSDP). I summarize the policy directions, the details of which are in the attached policy matrix.

4. **Conducive Policies.** The Government will complement, facilitate, and improve the functioning of the RF markets and gradually exit from direct service delivery except in case of demonstrated market failures. Divestment of Central Bank and Government equity in RFIs and promotion of the private sector will accompany institutional reforms. Supervision and regulation of rural finance will be significantly enhanced for ensuring adequate protection of small rural depositors. In addition, RFIs will have the autonomy to price their services. Correspondingly, the Government will not intervene in setting interest rates, pardoning outstanding loan repayments, and discouraging debt recovery.

5. **Supportive Legal and Regulatory Framework.** Mr. President, the supervision and regulation of RFIs, those outside Central Bank purview, are inadequate considering that RFIs hold the savings of nearly 6–7 million depositors. Control of assets is also weak, resulting in doubtful investments. Therefore, a crucial element of the reform agenda is the establishment of a regulatory agency for ensuring good governance and transparency. The regulatory agency will also serve as a coordinating body for the fragmented rural finance sector. The enactment of the Rural Finance Sector Development Act is being actively pursued for realizing these objectives. Simultaneously, the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 is being reviewed for facilitating recovery of dues.

6. **Institutional Reforms for Sustainability.** The Government is fully cognizant that despite weaknesses the RFIs do meet the financial services need of a significant number of rural households. Government will support fundamental reforms in Cooperative Rural Banks, Regional Development Banks, National Development Trust Fund, and Samurdhi Banking Societies for significantly enhancing their contribution to economic growth and poverty reduction. While there are other RFIs as well, the Government at this stage will prioritise the reforms of these four RFIs. In consultation with ADB, institution specific reform agenda will be pursued for enhancing sustainability and efficiency through good governance, human resources development, improved systems and procedures, audit and accounting, and risk management. These RFIs will also be required to adopt a viable business plan. I am glad that ADB will provide capitalization and institutional strengthening support.

7. **Strengthening the Demand Side.** Recognizing that poverty is multidimensional, we have established a Rural Economy Resuscitation Fund (RERF) for enhancing community-based investments in the rural sector. The RERF will be utilized for skills development, marketing networks, infrastructure for enhancing better price realization of rural produce, and community infrastructure such as storage, and small-scale irrigation. RERF will adopt such activities for support through community led development initiatives in collaboration with NGOs with full beneficiary participation including cost sharing and control of investments. Mr. President, the synergy of these investments with rural finance will be realized in a number of ways such as through creation of new economic opportunities and activities, generating additional employment and income, and facilitating improved delivery of rural services with linkages between RFIs, communities, and NGOs.

8. **Expansion of Rural Finance in Conflict Affected Areas.** A range of measures for developing the RF sector in the North and the East has been adopted in consultation with ADB for meeting the development challenge in the conflict-affected areas that require institutional building as well as meeting the immediate rural finance need. This starts with (i) active coordination with donor efforts for synergy, (ii) resource and institutional support for RFIs especially NGOs in the North and East, and (iii) resource allocations under RERF as well as credit line to support expansion of RF services. These will be pursued with the latest innovations for financial services in post-conflict situations.

9. Mr. President, the Government is committed to enhancing economic opportunities in the rural sector. RFSDP emphasis on good governance and sustainability will strengthen the rural finance system, thus opening up the possibility of arresting the reverse flow of resources from the rural sector, expanding income, and reducing poverty. By supporting RFSDP, ADB has once again demonstrated the consistency of its interventions with key national priorities.

Yours sincerely,

K. N. Choksy

K. N. CHOKSY, P.C., M.P
MINISTER OF FINANCE

POLICY MATRIX

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

Objectives	Rationale	First Tranche/Actions Complied December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
(ii) Supportive Legal and Regulatory Framework					
(a) Rural Finance Sector Development Act (RFSD Act)					
Develop the RF sector for efficient service delivery through a supporting supervisory mechanism.	Need for a legal framework for the supervision of RFIs through prudential and nonprudential norms for good governance, transparency, and disclosure is widely felt. Lack of enforcement of financial prudence in RF sector has endangered depositors' interest and encouraged proliferation of weakly governed unsustainable RFIs.	The RFSD Act will provide for the establishment of a Rural Finance Sector Development Agency (RFSDA) for the supervision and regulation of RFIs that are not supervised by CBSL. **(Cabinet approved law)**	The RFSD Act **(Enacted law).** Establishment of the Board of Directors of RFSDA **(MRE notification).** Recruitment of RFSDA staff. **(List of Staff)** Adoption, and if, necessary, notification of operating plan, guidelines, and rules as required under the RFSD Act. **(RFSDA progress report)**	Formulation of guidelines for RFI supervision, regulation, accounting, prudential and nonprudential standards, and framework for outsourcing. **(RFSDA progress report).** Prepare a list and engage a panel of auditors for supervision and regulation of RFIs. **(RFSDA progress report)** Commence supervision and licensing of RFIs. **(RFSDA progress report)** Review of RFSDA operations. **(MRE, MOF, and ADB)**	Licensing of at least 200 RFIs provided such RFIs are eligible under the RFSD Act. **(RFSDA progress report)** Continuing due diligence and supervision and regulation of RFIs. **(RFSDA progress report)** Review of RFSDA operations. **(MRE, MOF, and ADB)**
(b) Enhancing Legal Basis for Repayments					
Facilitate the efforts of RFIs for collection of dues.	Access to competitive financing for small-scale borrowers, including those in the rural economy, became restricted due to reluctance of banks to extend their outreach in view of the risk of defaults and lack of expeditious means for dealing with defaulters.		CBSL, MOC, MOF, MRE, MPDI, and MOS shall, in consultation with ADB, review the legal and institutional framework for recovery of debts from RFI defaulters and shall prepare and finalize an action plan (Action Plan) to facilitate expeditious recovery of debts from such defaulters,	***CBSL shall implement the Action Plan and provide ADB with a progress report thereon.*** *(CBSL Progress Report)*	***CBSL, MOC, MOF, MRE, MPDI, and MOS shall, in consultation with ADB, review the effectiveness of the Action Plan implemented to expedite recovery of debts from RFI defaulters, and shall recommend any further remedial***

Objectives	Rationale	First Tranche/Actions Complied December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
			consistent with the principles of due process and the need to protect poor defaulters who are unable (as opposed to unwilling) to pay, and provide ADB with a copy of the Action Plan. **(Action Plan)**		***actions necessary to improve recovery or remove any difficulties that may have arisen, which recommendations shall be implemented by the CBSL.*** *(CBSL Progress Report)*
(iii) Institutional Reforms for Sustainability					
(a) Cooperative Rural Banks (CRBs)					
Upgrade CRBs into model RFIs with sustainability and good governance as core principles.	As a group, the CRBs are the largest RFI in terms of outreach and volume of business. However, weak governance and politicization have affected their performance and sustainability. Fundamental changes are required for upgrading governance, organization, human resources, business process, products, and services.	Adoption of CRB Restructuring Policy including Model Restructuring Plan. **(CRB Restructuring Policy and Plan)** Establish a CRB Restructuring Committee at MOC. **(MOC will notify to MPDI)** Finalization of operating guidelines of CRB Fund. **(MOC will notify to MPDI)** Establishment of CRB Fund at MOF. **(MOC will notify to MPDI)**	Implement the first phase of restructuring of 25 CRBs by (i) establishing the restructuring task forces at multipurpose cooperative societies (MPCSs); (ii) assessing assets and liabilities of such CRBs, preparing the balance sheets and income statements of such CRBs, and determining their capital requirements; (iii) developing the Second Tranche CRB Restructuring Plan based on Model Restructuring Plan; (iv) reaching an agreement on the Second Tranche CRB Restructuring Plan with such CRBs; and (v) providing capitalization support for such CRBs (the Procedure) **(MOC Progress Report).**	Review of Second Tranche CRB Restructuring Plan implementation. **(MOC Progress Report)** Implement the second phase of restructuring of additional 75 CRBs by following the procedure outlined in second tranche. **(MOC progress report)**	Implement the third phase of restructuring, where number of CRBs will be decided in consultation with ADB, by following the procedure outlined in second tranche. **(MOC progress report)** Monitoring of Restructuring Plan implementation. **(MOC progress report)** Assessment of the need to continue the CRB Fund. **(MOC progress report)**

Objectives	Rationale	First Tranche/Actions Complied December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
(b) Regional Development Banks (RDBs)					
Transform RDBs into sustainable and efficient RFIs.	The RDBs represent a significant formal financial sector presence in the rural areas and there is considerable potential for them to contribute to rural economic growth. Comprehensive reform starting with divestment is required to enhance outreach and long-term sustainability.	Transfer of CBSL equity in RDBs to MOF for initiating divestment. **(CBSL letter)** Information memorandum for divestment for all the 6 RDBs. **(Information memorandum, CBSL)** Assigning 2 CBSL officers to assist MRE, the nodal ministry for RDBs. **(MRE letter)**	RDBs shall register the transfer of CSBL's equity to MOF and provide relevant documents evidencing the same. **(MRE letter)** MOF transfers equity in RDBs acquired from CBSL to the Public Enterprise Reforms Commission. **(MOF letter)**	Release of the information memorandum and divestment of 2 RDBs. **(MRE report)** Preparation and adoption of Third Tranche Restructuring Plan for 2 RDBs covering: (i) governance; (ii) human resources; (iii) business processes; (iv) management information system; (v) auditing and accounting; and (vi) performance benchmarks. **(Restructuring Plan)** Implementation of the Third Tranche Restructuring Plan. **(MRE progress report)**	Release of information memorandum and undertake divestment of 2 RDBs. **(MRE report)** Preparation and adoption of Fourth Tranche Restructuring Plan for these 2 RDBs following the procedure outlined in Third Tranche. **(Restructuring Plan)** Implementation of Fourth Tranche Restructuring Plan. **(MRE progress report)**
(c) National Development Trust Fund (NDTF)					
Enhance the legal, financial, and operational scope of NDTF.	NDTF provides technical and refinance assistance to RFIs. NDTF's potential contribution to RF sector is constrained by limitations inherent in its legal structure, institutional capacity constraints, and weak capacity of its partner organizations. Changes in the constitution,	Incorporation under the Companies Act No. 17 of 1982. **(Memorandum and articles of association)** Constitution of Board, appointment of Chairperson, and Managing Director in accordance with provisions of the Company Act. No. 17 of 1982. **(NDTF notification)**	Development and adoption, in consultation with ADB, of the NDTF Corporate Plan covering: (i) strategy; (ii) organization and human resources development; (iii) operating policies and guidelines for financial activities; (iv) policies and procedures for	Implementation of the NDTF Corporate Plan. **(NDTF progress report)** Achievement of performance targets outlined in the NDTF Corporate Plan. (**NDTF progress report)**	Complete implementation of the NDTF Corporate Plan and achievement of performance targets. **(NDTF progress report)**

Objectives	Rationale	First Tranche/Actions Complied December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
	organization, and operating procedures of NDTF will be required for it to play an enhanced and active sector development role.	Approval of MOF to transfer the Government contribution of $5 million made in 1991 to the Credit Risk Fund of NDTF (trust) along with the interest thereon aggregating SLRs800 million equivalent to the new company. **(MOF letter)**	nonfinancial activities; (v) partnership arrangements; and (vi) performance benchmarks and implementation schedule. **(NDTF Corporate Plan and board resolution indicating its adoption).**		
(d) Samurdhi Banking Societies (SBS)					
Initiate institutional reforms for sustainability.	Within the overall ambit of the Samurdhi Program, the SBS provide a critical link to poverty reduction through household income generating activities. Significant as their achievements are, SBS have yet to become sustainable. Broad-based institutional reforms are necessary for ensuring the sustainability of SBS.	Completion of portfolio analysis and diagnostic reviews. **(Portfolio analysis and diagnostic review)**	Review of institutional strengthening options in consultation with ADB. **(Review outcome)** Development and adoption of a Samurdhi Institutional Strengthening Plan covering: (i) governance, (ii) organization and human resources; (iii) operational policies and guidelines; (iv) management information system, accounting, and auditing; (v) business and viability projections; and (vi) implementation schedules.**(Samurdhi Institutional Strengthening Plan)**	Implementation of Samurdhi Institutional Strengthening Plan and achievement of indicated milestones. **(SBS progress report)**	Completion of Samurdhi Institutional Strengthening Plan and attainment of agreed performance indicators. (**SBS progress report)**
(iv) Strengthening the Demand Side					
Enhance effectiveness and outreach of RF through community based rural sector investments.	Sustained social preparation including skill development and access to basic infrastructure is necessary to benefit from access to RF for the rural	A Rural Economy Resuscitation Fund (RERF) has been established for accelerating rural economic growth. RERF will support community led development	RERF operates in terms of Guidelines for Investment and Operations (Guidelines). **(RERF progress report—MRE)**	RERF operates in terms of the Guidelines. **(RERF progress report—MRE)** RERF operations	RERF operates in terms of the Guidelines. **(RERF progress report—MRE)** RERF audited and

Objectives	Rationale	First Tranche/Actions Complied December 2002 to November 2003	Second Tranche: Within 12 months of First Tranche	Third Tranche: Within 18 months of Second Tranche	Fourth Tranche: Within 18 months of Third Tranche
	poor, especially women. Although returns from increased social and rural infrastructure are high, investments are limited due to externalities and high costs.	initiatives for skills development, rural marketing networks, and community infrastructure in collaboration with NGOs and other service providers. RERF usage will be coordinated with RFI operations. **(RERF trust deed—MRE)** Guidelines on eligible purposes, appraisal, partnership arrangements with service providers, and monitoring. This includes 10% of RERF investments in conflict-affected areas. **(RERF Guidelines—MRE)**	RERF operations audited and outcome submitted to ADB. **(RERF audit report—MRE)** Review of RERF in operations. **(RERF audit/review report—MRE)**	audited and outcome submitted to ADB. **(RERF audit report - MRE)** Review of RERF operations. **(RERF review report—MRE)**	outcome submitted to ADB. **(RERF audit report—MRE)** Review of RERF operations. **(RERF review report—MRE)**
(v) Expansion of RF in Conflict-Affected Areas					
Enhancing the access of sustainable RF in the conflict-affected areas of north and the east.	The challenge in the conflict-affected areas is to support the establishment of an institutional structure that will be able to provide quality financial services on permanent basis as well as meeting the immediate financing needs of rural households. The need for simultaneous investments for the development of the rural economy is also critical for a sustainable RF sector.	A policy framework for the development of sustainable RF in the conflict-affected areas including: (i) coordination with overall Government and donor plans; (ii) institutional strengthening support for expansion of RF services; and (iii) allocations in RERF and RFSDP credit line. **(Policy letter)**	Review of RERF investments in the conflict-affected areas. **(RERF progress report—MRE)** Outreach expansion. **(Project progress report)**	Review the impact of RFSDP in the conflict-affected areas. **(Project progress report—MPDI)** Continued RERF investments and outreach expansion. **(Project progress report—MPDI)** Institutional strengthening of RFIs and commercial banks in the conflict-affected areas. **(Project Progress Report—MPDI)**	Review the impact of RFSDP in the conflict-affected areas. **(Project progress report—MPDI)** Continued RERF investments and outreach expansion. **(Project progress report—MPDI)** Institutional strengthening of RFIs and commercial banks in conflict-affected areas. **(Project Progress Report—MPDI)**

PROGRAM FRAMEWORK

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
Goal Reduce poverty level and facilitate economic growth in rural Sri Lanka	Reduce poverty incidence from 25% to 20% by 2005 Attain economic growth rate of 7% by 2005 Enhance outreach and sustainability of rural finance (RF) sector	• Economic reform program assessment • Program reports • Program reviews (semiannual, annual and midterm) • Impact monitoring report • Project completion report (PCR) • Asian Development Bank (ADB) review missions	Peace and absence of civil strife
Purpose Establish a sustainable RF system through policy, legal, regulatory, and institutional reforms	Develop policy framework for RF sector to decrease Government of Sri Lanka's ad hoc interventions and direct involvement in provision of RF services Develop enabling legal and regulatory framework for RF sector Enhance RF outreach and sustainability through governance reforms, mainstreaming of RF industry best practice, and diversification of products and services Increase ability of rural households to utilize RF through support for skill development and access to marketing networks	• Program reports • Project reviews • Audit reports • ADB review missions • PCR • Project performance audit report (PPAR)	Government's commitment to pursue economic policy reforms that enable RF institutions (RFIs) Is to operate autonomously within a liberalized financial policy regime Active participation of nongovernment organizations (NGOs) as social service providers
Outputs (i) Conducive policies for RF development	Policy letter and policy matrix implemented Independent and autonomous RFIs operating in a competitive environment	• Program reports • Audit reports • ADB review missions	Government maintains its commitment to facilitate the operations of RF markets
(ii) Legal framework for supervising RFIs	Supervisory and regulatory system for RFIs instituted through enactment of Rural Finance Sector Development Act (RFSD Act) and establishment of Rural Finance Sector Development Agency (RFSDA) 500 RFIs audited and 200 licensed by end-2007, provided they are eligible	• Program reports • Project reviews • ADB review missions	Government's commitment to enforce the legal framework

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
(iii) Facilitating the recovery of dues from RFI defaulters	Effective debt recovery policies adopted by RFIs Effective use of debt recovery instruments by RFIs for collecting dues from willful defaulters	• Program reports • Program reviews • Audit reports	Government's commitment to enforce strict repayment culture.
(iv) Cooperative Rural Bank (CRB) reforms	Financial viability of CRBs improved with at least 30% of CRBs meeting and maintaining full financial self-sufficiency by end-2007 At least 100 CRBs restructured	• Program reports • Program reviews • Audit reports • ADB review missions	Ministry of Co-operatives (MOC) commitment for CRB restructuring
(v) Regional Development Banks (RDB) Reforms	Financial viability of RDBs improved with at least 4 RDBs meeting full financial self-sufficiency by end-2007	• Program reports • Program reviews • Audit reports • ADB review missions	RDBs' consent and commitment for restructuring
(vi) National Development Trust Fund (NDTF) Reform	Capacity and outreach of NDTF improved to transform it into an effective microfinance (MF) apex agency with 150 active MF-NGO partner organizations by end-2007	• Program reports • Program reviews • Audit reports • ADB review missions	Sustained willingness by NDTF to reform
(vii) Samurdhi Banking Societies (SBS) Reforms	Governance and sustainability strengthened to make SBS an effective poverty reduction instrument with 50% reduction in subsidy dependence by end-2007	• Program reports • Program reviews • Audit reports • ADB review missions	Willingness of Ministry of Samurdhi (MOS) to act on the results of the diagnostic study and portfolio audit
(viii) Redefining Rural Economy Resuscitation Fund (RERF)	Social and physical infrastructure environment in rural communities improved to maximize the effects of RF services by financing 850 community subprojects	• Project reports • Impact monitoring reports • Audit reports • ADB review missions	No politicization of RERF operations
(ix) Expansion of RF services in the conflict-affected areas	Sustainable RF system including commercial banks and MF-NGOs established and providing efficient and viable RF services in the conflict-affected areas 10% of RERF and 10% of rural enterprise development credit line implemented in the conflict-affected areas	• Project reports • Project reviews • Impact monitoring reports • Audit reports • ADB review missions • PCR • PPAR	Secure environment and effective credit demand in the conflict-affected areas
(x) Development of RF related training capacity of Center for Banking Studies (CBS)	Best RF operational practices disseminated to RFIs—100 CRBs, 200 SBS, 4 RDBs, 100 MF-NGOs, and 3 commercial banks Effective microfinance modalities adopted by RFIs in the conflict-affected areas	• Project reports • Project reviews • ADB review missions	Government's commitment to ensure enabling environment for RFIs

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
(xi) Rural enterprise development	10,000 rural small and micro enterprises enlarged or established by 2007	• Project reports • Project review • ADB review missions • Impact monitoring report • PCR • PPAR	Favorable rural economic environment without civil strife
(xii) Institutional development support for Central Bank of Sri Lanka (CBSL), MOC, Ministry of Policy Development and Implementation (MPDI), Ministry for Rural Economy (MRE), NDTF, RFSDA, MOS, and RFIs	Better accounting and information standards implemented among RFIs Efficient RFI supervision and regulation functions established Proper administration of community based public-private investments established	• Project reports • Project review • Audit reports • ADB review missions	Commitment and cooperation of the organizations are maintained
(xiii) Program/Project implementation support	Effective project management exercised	• Project reports • Project review • ADB review missions	Capable and adequate Program/Project staff are appointed
Activities			
(i) Establishing conducive policies which include phased reform plans for RFIs; redefined role of the Government; decreasing ownership of RFIs by CBSL; effective supervision and regulation for deposit protection; and promoting larger private sector role in RF	Conducive policies adopted High-level coordinating body for the RF sector policies established RFI reforms initiated RF sector supervision and regulation improved	• Government-provided policy framework • Project reports • Project reviews • ADB review missions	No political interference in policy formulation
(ii) Adopting the Act for RFI supervision, establishing RFSDA which functions as a supervisory body for RFIs, and providing institutional supports for RFSDA	The RFSD Act enacted RFSDA established and regulatory guidelines and standards finalized, and panel of auditors appointed Licensing and supervision of 200 RFIs carried out by RFSDA by end-2007 Audit and inspection of 500 RFIs conducted by end-2007	• Program report • Project review • ADB review missions	The Government's commitment to enforce RFSD Act
(iii) Implementing Action Plan for facilitating repayment from RFI defaulters.	Acton Plan implemented	• Program report • Project review • ADB review missions	No political interference in implementing the Action Plan

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
(iv) Developing a framework for CRB reforms covering governance, organization, human resources, business process, and products and services	MOC adopts CRB Restructuring Policy, Model Restructuring Plan, and CRB Fund Rules At least 100 participating CRBs capitalized and become distinct financial entities under the Cooperative Societies Act of 1972 by end-2007	• Project reports • Project reviews • ADB review missions	MOC and CRBs' commitment to fully implement the restructuring plans
(v) Developing a comprehensive institutional strengthening plan for RDBs	Divestment of 80% of CBSL equity in at least 4 RDBs by end-2007 MRE, with CBSL assistance, develop RDB restructuring plans and capitalize RDBs, as required	• Project reports • Project reviews • ADB review missions • Program reports • Program reviews	Early divestment of CBSL stake in RDBs
(vi) Developing NDTF corporate plan covering strategy, operational policies, and financing guidelines	NDTF incorporated as a company limited by guarantee NDTF Corporate plan developed by June 2004	• Project reports • Project reviews • ADB review missions • Program reports • Program reviews	No political interference in the process Commitment and capability of new management
(vii) Developing SBS institutional strengthening plan	Diagnostic study and portfolio audit completed Institutional strengthening plan developed covering governance, and operational policies, and guidelines by June 2004 Adequate capitalization and loan loss provisions made	• Project reports • Project reviews • ADB review missions • Program reports • Program reviews	MOS's sustained commitment to reforms
(viii) Expanding the scope of RERF trust and institutionalizing its operations	Trust deed amended and enhanced RERF Secretariat established and fully operative by June 2004 RERF finances 850 community projects implemented by approved service providers by end-2007	• ADB review missions • Impact monitoring reports	No politicization of RERF Clear and transparent RERF disbursement policies
(ix) Strengthening CBS to emerge as a center for disseminating RF best practices and designing innovative approaches to RF in post-conflict areas	CBS staff and management adopt the vision and mission and qualified staff placed	• Project reports • Project reviews • ADB review missions	CBSL's commitment to provide adequate human resources

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
(x) Capacity building for enabling RFIs to enhance outreach in conflict-affected areas	Capacity development needs are identified and training is provided	• Project reports • Project reviews • ADB review missions	Government's sustained commitment to develop a liberalized and competitive financial sector
(xi) Institutional strengthening of RFIs and RFSDA	CRB Restructuring Plans, RDB Restructuring Plans, NDTF Corporate Plan, RFSDA Implementation Plan, and SBS Institutional Strengthening Plan fully implemented by end-2007	• Project reports • Project reviews • ADB review missions	Government's sustained commitment to develop a liberalized and competitive financial sector
(xii) Capacity development programs for RFIs, CBSL, RFSDA, MOC, MPDI, MRE, and MOS	Capacity development needs are identified and training is provided	• Project reports • Project reviews • ADB review missions	Trained staff retained within the organizations
(xiii) Establishing a project management unit and project implementation units	Project management unit established within MPDI and project implementation units established at CBSL. MRE (RERF, RFSDA, RDB) MOC, MOS, and NDTF	• Project reports • Project reviews • ADB review missions	Capable and adequate staff are appointed Coordination is complete and effective
(xiv) Onlending support to RFIs for providing credit for rural small enterprises and micro enterprises	10,000 rural small and micro enterprises received loans by end-2007	• Project reports • Project reviews • Audit reports • PCR • PPAR	Government pursues financial sector reform that support RFI operations in rural areas
Inputs			
Program Loan Legal framework for RFI supervision and regulation (Activities i, ii, iii)	$10 million—ordinary capital resources	• Project reports • Audit reports • ADB review missions	
RFI Restructuring (Activities iv, v, vi, and vii)	$30 million—ordinary capital resources		
Demand Side Development (Activity viii)	$10 million—ordinary capital resources		
Total	**$50 million**		
Project Loan Institutional Strengthening (Activities ix, x, xi, xii, and xiii)	$10 million—special funds resources		
Rural Enterprise Development (Activity xiv)	$10 million—ordinary capital resources		
Counterpart Contribution	$7.79 million		
Total	**$27.79 million**		

RURAL ECONOMY RESUSCITATION FUND

A. Background and Rationale

1. Financing alone is insufficient to enable the poor to escape poverty. To utilize financial services effectively, productive activities must allow microentrepreneurs to generate sufficient returns to remain viable in the medium to long term. This requires an environment that permits and encourages microentrepreneurs to take benefit from market opportunities, and facilitates their continuous access to critical support services. Microenterprises in rural areas face serious constraints, including inadequate physical infrastructure such as electricity and roads, lack of business support including research and development and business advisory services, and a low skill base. Private sector microenterprise development can be better realized by removing these constraints while providing effective linkages to rural finance (RF) services.

B. Objective

2. The Government's Rural Economy Resuscitation Fund (RERF), established to address rural social and economic constraints through small community-based investments, cannot realize its potential due to inadequate resources. The Rural Finance Sector Development Program (RFSDP) will support refocusing and enhancement of RERF for financing rural community-based investment projects with linkages to RF services. Strategic investments in skills development, marketing networks, infrastructure for improved distribution, and marketing of rural products to achieve better prices and community infrastructure such as storage facilities, small-scale irrigation, and farmer information centers will catalyze social preparation and entrepreneurial activity. Links to RF services will enhance the ability of rural communities to benefit from market opportunities.

3. The RERF aims to support demand side development for the growth of the RF sector. The objective of the RERF is, by providing support for community development, to develop the capability of the poor to make efficient use of RF services for their income generating activities. RERF projects will be initiated, identified, designed, and implemented by rural communities in collaboration with service providers including nongovernment organizations (NGOs).

C. Management and Finance

4. The RERF will be administered by the RERF Trust. The RERF Trust is chaired by the Director General of the Ministry of Rural Economy (MRE) and administered by the trustees, consisting of representatives from the Ministry of Finance and the private sector including NGOs. The trustees are appointed by the Minister of Rural Economy. The trustees are responsible, among others, for ensuring that the RERF is utilized for the purpose of poverty reduction and economic enhancement of rural communities, and approving investment and operational decisions arranged or recommended by the RERF Secretariat (the Secretariat).

5. The administration and management of the RERF will be supported by the Secretariat, which consists of a chief executive officer, an engineer as a rural community infrastructure specialist, and a gender and social development specialist. The Secretariat, with delegated authority of the trustees, will process rural community investment proposals for RERF funding and other investment tasks for the approval by the trustees. The overall functions of the Secretariat will be (i) managing the RERF capital and facilitating its appropriate investment, (ii) processing the RERF for community investment projects, and (iii) providing administrative support for the trustees and other stakeholders for smooth operation of the RERF. All the

Secretariat staff will be recruited in the open market for a fixed term that can be extended for a further fixed term. The total annual expenditure for management and administration of the RERF will not exceed 5% of the amounts credited to the RERF account.

6. The capital of the RERF will be provided by the Government. The Government will contribute proceeds of the RFSDP program loan equivalent to $10 million to enhance the RERF capital. RFSDP contribution to RERF will be invested by the Government in approved government securities to avoid any speculative investments and to ensure due and careful consideration of project applications. The interest revenue generated will be transferred into a designated income account with the Trust to be expensed out to meet the objectives of the RERF. The Secretariat will manage the income accounts. All payments will be based on invoices and credited to the account of service providers after documentary evidence that the investment has been completed to the satisfaction of the community. RERF investments for communities will be grants for community development and social intermediation. However, recipient communities are required to contribute at least 10% of the total investment amount, primarily in kind such as material or labor contribution, or in cash whenever appropriate, especially when projects require relatively high capital inputs.

D. Operations

7. Given the need for investment in rural communities and the relatively limited resources available, investments funded by the RERF must be carefully selected to ensure they have greater potential to benefit a large proportion of the households in the community. The proposed community investment projects should meet the objectives of (i) increasing the access of poor communities of disadvantaged areas to basic infrastructure facilities; (ii) enhancing efficiency and productivity of the local resource pool; (iii) creating income-earning opportunities for the poor households; and (iv) empowering the poor, especially women.

8. RERF grant funding for rural community investment projects using RFSDP resources will be limited to $3,000 equivalent, to ensure that resources are channeled to small and medium-scale projects for meeting the immediate needs of the rural poor. Requests for funding exceeding $3,000 can be approved by the trustees on review of justification up to a maximum of $5,000 per project. For projects above this ceiling, resources from other sources can supplement RERF funding and community contribution.

9. For investments funded by RERF, communities will be the primary entities to identify their needs, priorities, and required interventions. Communities will develop their projects with assistance from service providers and enter into partnership agreement with the RERF Trust specifying detailed project design, budget, financing plan including community contribution, and operation and maintenance arrangements. RERF funding will be based on project proposals prepared by communities including a feasibility report, village profile, and initial environmental assessment. Upon review and approval by the trustees, the communities will open a bank account to be operated by the community representatives including one woman, to receive the RERF grant installments and to expense out the project-related expenses.

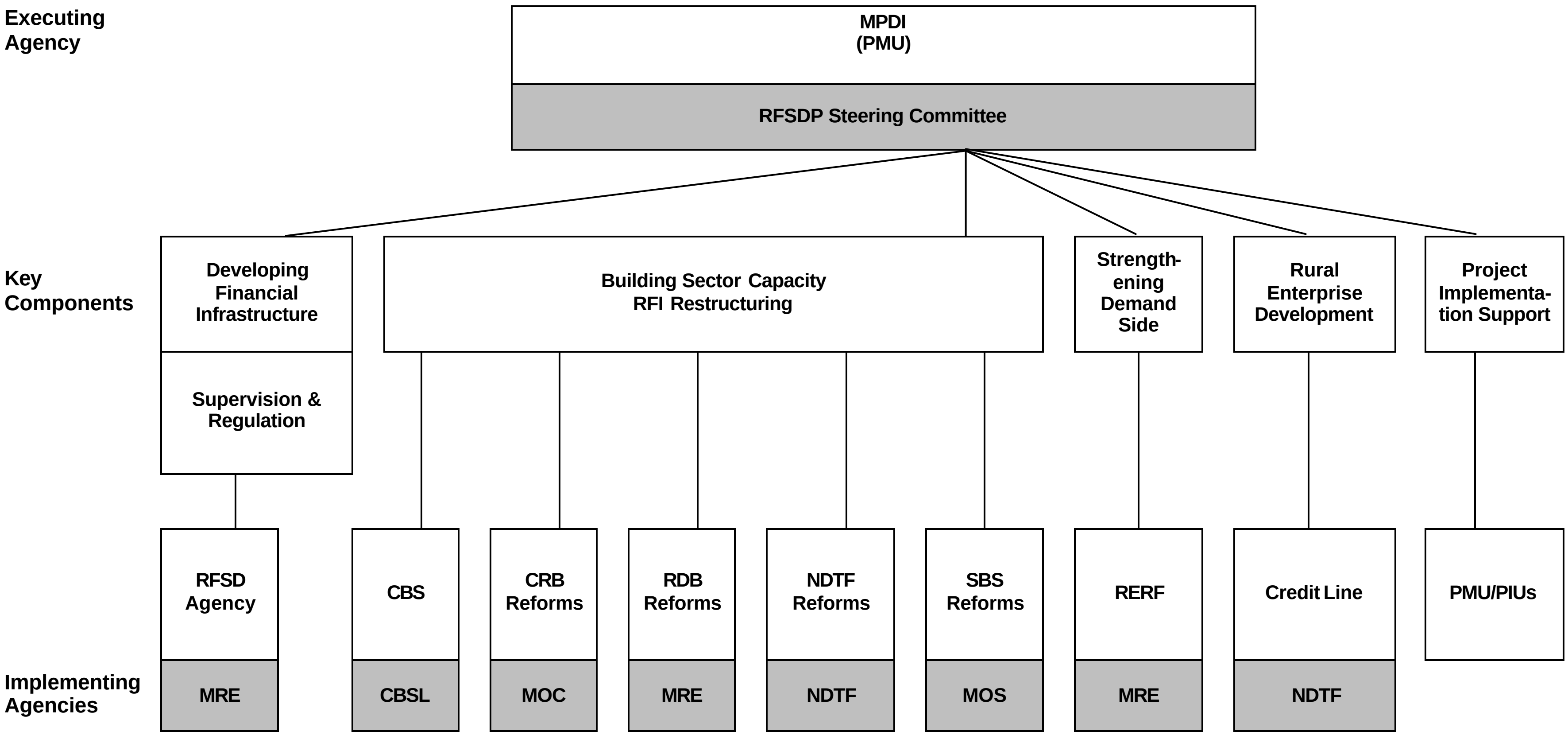
10. It is expected that RERF resources will fund 850 community projects by end-2007, and thereafter 275 per year. The investment arrangements of RERF enable it to finance community investment projects amounting to SLR800 million by 2015. The funding projection with indicative projects is attached (Table A10).

A10.1. Projected Utilization of Rural Economy Resuscitation Fund
($'000)

Item	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
						Year						
Rural Economy Resuscitation Fund (RERF)	5000.0	10000.0	10000.0	10000.0	10000.0	10000.0	10000.0	10000.0	10000.0	10000.0	10000.0	10000.0
RERF Income Account												
Opening Balance	0.0	**97.4**	**154.8**	**214.3**	**276.0**	**269.5**	**262.7**	**255.6**	**248.3**	**240.7**	**232.9**	**224.7**
Interest Revenues (8.0%)[a]	400.0	803.9	806.2	808.6	811.0	810.8	810.5	810.2	809.9	809.6	809.3	809.0
Administrative Expenses												
Administration Cost (5%)[b]	20.0	40.2	40.3	40.4	40.6	40.5	40.5	40.5	40.5	40.5	40.5	40.4
Service Provider Fees (5%)[c]	13.5	33.6	33.6	33.6	37.0	37.0	37.0	37.0	37.0	37.0	37.0	37.0
Subtotal Administrative Expenses	**33.5**	**73.8**	**73.9**	**74.1**	**77.6**	**77.5**	**77.5**	**77.5**	**77.5**	**77.5**	**77.5**	**77.5**
Rural Community Investment Project												
Infrastructure Project												
Village Markets (20%)	100.0	250.0	250.0	250.0	275.0	275.0	275.0	275.0	275.0	275.0	275.0	275.0
Market Information/Computer Centers (10%)	20.0	50.0	50.0	50.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0
Rural Access Roads (10%)	50.0	125.0	125.0	125.0	137.5	137.5	137.5	137.5	137.5	137.5	137.5	137.5
Small Irrigation (10%)	30.0	75.0	75.0	75.0	82.5	82.5	82.5	82.5	82.5	82.5	82.5	82.5
Water Harvesting/Domestic Water Supply (10%	30.0	75.0	75.0	75.0	82.5	82.5	82.5	82.5	82.5	82.5	82.5	82.5
Drainage and Sewerage (10%)	20.0	50.0	50.0	50.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0
Mini-hydro Electric (5%)	25.0	62.5	62.5	62.5	68.8	68.8	68.8	68.8	68.8	68.8	68.8	68.8
Social Project												
Skills Training (10%)	10.0	25.0	25.0	25.0	27.5	27.5	27.5	27.5	27.5	27.5	27.5	27.5
Agriculture/Livestock Extension and Support (5%	5.0	12.5	12.5	12.5	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8
Leadership/Social Awareness Training (5%)	4.0	10.0	10.0	10.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0
Computer Literacy Training (5%)	5.0	12.5	12.5	12.5	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8
Subtotal	299.0	747.5	747.5	747.5	822.3	822.3	822.3	822.3	822.3	822.3	822.3	822.3
Less Subborrower Contribution[d]	29.9	74.8	74.8	74.8	82.2	82.2	82.2	82.2	82.2	82.2	82.2	82.2
Total RERF Disbursement	**269.1**	**672.8**	**672.8**	**672.8**	**740.0**	**740.0**	**740.0**	**740.0**	**740.0**	**740.0**	**740.0**	**740.0**
Closing Balance	**97.4**	**154.8**	**214.3**	**276.0**	**269.5**	**262.7**	**255.6**	**248.3**	**240.7**	**232.9**	**224.7**	**216.2**
Projected Rural Community Project Numbers												
Infrastructure Projects	75	190	190	190	206	206	206	206	206	206	206	206
Social Projects	25	60	60	60	69	69	69	69	69	69	69	69
Total	**100**	**250**	**250**	**250**	**275**	**275**	**275**	**275**	**275**	**275**	**275**	**275**

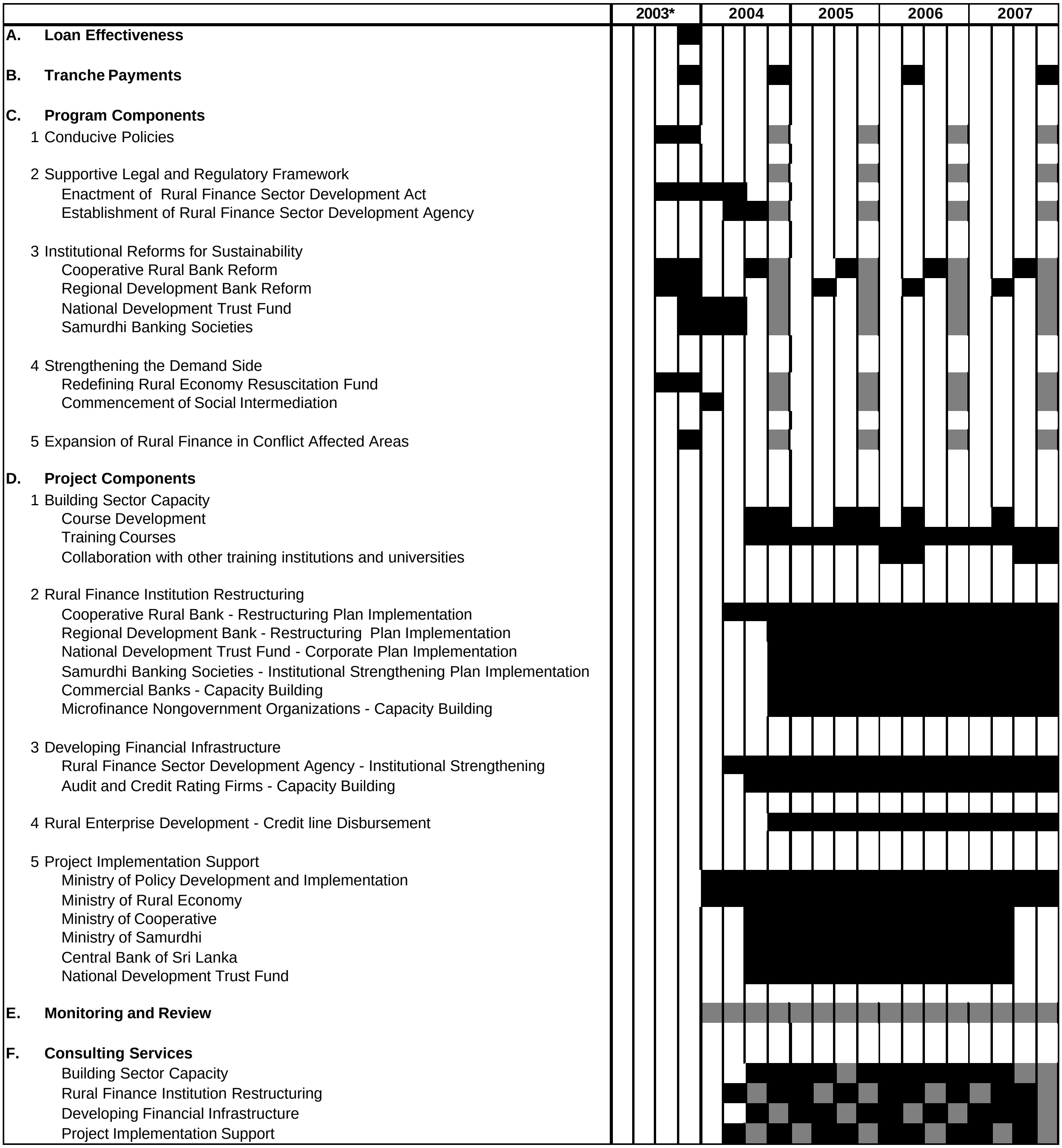
[a] Based on the current Government treasury bill yield
[b] Percentage of the total interest earned.
[c] Percentage of the total RERF Disbursement
[d] 10% of subproject cost
Source: Asian Development Bank Estimates

PROGRAM ORGANIZATION CHART



CBS = Center for Banking Studies, CBSL = Central Bank of Sri Lanka, CRB = cooperative rural bank, MOC = Ministry of Co-operatives, MOS = Ministry of Samurdhi, MPDI = Ministry of Policy Development and Implementation, MRE = Ministry of Rural Economy, NDTF = National Development Trust Fund, PIUs = project implementation units, PMU = project management unit, RDB = regional development bank, RERF = Rural Economy Resuscitation Fund, RFI = Rural Finance Institution, RFSD Agency = Rural Finance Sector Development Agency, RFSDP = Rural Finance Sector Development Program, SBS = Samurdhi Banking Society.

PROJECT IMPLEMENTATION SCHEDULE



* Project preparation

Continuous

Review / Intermittent

INELIGIBLE ITEMS

The following list provides ineligible items for goods to be procured. No withdrawals will be made in respect of:

(i) expenditures for goods included under the following Harmonized System[1] chapters or headings:

Chapter	Heading	Description of Items
22	22.03 – 22.08	Alcoholic beverages
24	24.01	Tobacco, unmanufactured; tobacco refuse
24	24.02	Tobacco, manufactured (whether or not containing tobacco substitutes)
28	28.50 – 28.52	Radioactive and associated materials
71	71.01 – 71.04	Pearls; precious and semiprecious stones, unworked or worked
71	71.05 – 71.06 71.09 – 71.15	Jewelry of gold, silver or platinum group metals (except watches and watch cases); and goldsmiths or silversmiths wares (including set gems)
71	71.07 – 71.08	Gold, nonmonetary (excluding gold ores and concentrates)
84	84.59	Nuclear reactors and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors.

(ii) expenditures for goods intended for a military or para-military purpose or for luxury consumption;

(iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a and 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification;

(iv) expenditures for goods supplied or to be supplied under any contract that a national or international financing institution or any other financial agency has financed or agreed to finance, including any contract financed or to be financed under any loan from the Asian Development Bank; and

(v) expenditures incurred more than 180 days prior to loan effectiveness.

[1] Harmonized system means the Harmonized Community Description and Coding System of the Government of Sri Lanka, which is based on Customs Co-operation Council Nomenclature established by the Convention for the Classification of Goods in Customs Tariffs, concluded at Brussels in June 1983.

COST ESTIMATES AND FINANCING PLAN
Table A14.1: Expenditure Accounts Project Summary
($ '000)

Expenditure Accounts	Building Sector Capacity	Rural Finance Institution Restructuring	Developing Financial Infrastructure	Rural Enterprise Development	Project Implementation Support	Total
I. Investment Costs						
A. Rural Enterprise Credit						
1 Credit Line	-	-	-	15,000.0	-	15,000.0
B. Equipment & Vehicles						
1. Office Equipment	158.7	2,025.6	82.7	-	121.3	2,388.3
2. Vehicles	28.2	84.6	56.4	-	84.5	253.7
Subtotal Equipment & Vehicles	**186.9**	**2,110.2**	**139.1**	**-**	**205.8**	**2,642.0**
C. Training						
1. Institution Staff	235.6	960.2	-	-	-	1,195.8
2. Intermediaries	-	1,322.8	-	-	-	1,322.8
Subtotal Training	**235.6**	**2,283.0**	-	-	-	**2,518.6**
D. Specialist Support						
1. Project Implementation	-	-	137.7	-	1,324.3	1,462.0
2. Consultant Services (International)	212.6	425.3	202.5	-	801.9	1,642.3
3. Consultant Services (Domestic)	236.9	868.6	328.4	-	36.4	1,470.3
4. Direct Contracts	-	182.3	455.6	-	-	637.9
Subtotal Specialist Support	**449.5**	**1,476.2**	**1,124.2**	-	**2,162.6**	**5,212.5**
Total Baseline Costs	**872.0**	**5,869.4**	**1,263.3**	**15,000.0**	**2,368.4**	**25,373.1**
Physical Contingencies	43.6	293.5	63.1	-	118.4	518.6
Price Contingencies	40.3	395.2	73.5	-	150.0	659.1
Total Project Costs	**955.9**	**6,558.1**	**1,399.9**	**15,000.0**	**2,636.8**	**26,550.8**
Service Charges	-	-	-	-	-	1,236.7
Total Cost to be Financed	**955.9**	**6,558.1**	**1,399.9**	**15,000.0**	**2,636.8**	**27,787.5**

Source: Staff estimates.
Note: Figures may not add up to total due to rounding.

Table A14.2: Expenditure Accounts by Financiers
($ '000)

	Asian Development Bank		Rural Finance Institutions		Sub-borrowers		Government of Sri Lanka		Total		Foreign Exchange	Local[a] Currency	Duties & Taxes
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	Amount	Amount
A. Rural Enterprise Credit													
Credit Line	9,000.0	66.7	3,000.0	13.3	3,000.0	20.0	-	-	15,000.0	54.0	-	15,000.0	-
Subtotal Rural Enterprise Credit	**9,000.0**	**66.7**	**3,000.0**	**13.3**	**3,000.0**	**20.0**	**-**	**-**	**15,000.0**	**54.0**	**-**	**15,000.0**	**-**
B. Equipment & Vehicles													
Office Equipment	2,310.3	87.0	-	-	-	-	346.5	13.0	2,656.8	9.6	577.6	1,732.7	346.5
Vehicles	234.5	87.0	-	-	-	-	35.2	13.0	269.7	1.0	70.3	164.2	35.2
Subtotal Equipment & Vehicles	**2,544.8**	**87.0**	-	-	-	-	**381.7**	**13.0**	**2,926.5**	**10.5**	**647.9**	**1,896.9**	**381.7**
C. Training													
Institution Staff	1,224.7	90.9	-	-	-	-	122.5	9.1	1,347.2	4.8	-	1,224.6	122.5
Intermediaries	1,342.7	90.9	-	-	-	-	134.3	9.1	1,477.0	5.3	-	1,342.7	134.2
Subtotal Training	**2,567.4**	**90.9**	-	-	-	-	**256.8**	**9.1**	**2,824.2**	**10.2**	-	**2,567.3**	**256.7**
D. Specialist Support													
Project Management	494.5	30.1	-	-	-	-	1,149.0	69.9	1,643.5	5.9	-	1,594.1	49.5
Consultant Services	4,156.6	100.0	-	-	-	-	-	-	4,156.6	15.0	1,753.5	2,403.2	-
Subtotal Specialist Support	**4,651.1**	**80.2**	-	-	-	-	**1,149.0**	**19.8**	**5,800.1**	**20.9**	**1,753.5**	**3,997.3**	**49.5**
Subtotal	**18,763.3**	**73.8**	**3,000.0**	**7.8**	**3,000.0**	**11.8**	**1,787.5**	**6.6**	**26,550.8**	**95.5**	**2,401.4**	**23,461.5**	**687.9**
Service Charges	1,236.7	100.0	-	-	-	-	-	-	1,236.7	4.5	1,236.7	-	-
Total Disbursement	**20,000.0**	**72.0**	**3,000.0**	**10.8**	**3,000.0**	**10.8**	**1,787.5**	**6.4**	**27,787.5**	**100.0**	**3,638.1**	**23,461.5**	**687.9**

[a] Excluding Taxes and Duty.
Source: Staff estimates.
Note: Figures may not add up to total due to rounding.

INDICATIVE PROCUREMENT PACKAGES

	Package	Units	Total Cost ($'000)	Procurement Mode
1.	Package 1 - Center for Banking Studies			
	Server and Network[a]	1	14.7	
	Computers[b]	10	27.6	
	Total		42.3	DP
2.	Package 2 - Cooperative Rural Banks			
	Specialist Software	300	827.3	
	Computers	300	349.3	
	Total		1176.6	ICB
3.	Package 3 - Regional Development Banks			
	Server and Network	6	88.2	
	Computers	60	165.5	
	Specialist Software	6	7.0	
	Total		260.7	IS
4.	Package 4 - National Development Trust Fund			
	Server and Network	1	14.7	
	Computers	30	82.7	
	Specialist Software	30	34.8	
	Total		132.2	IS
5.	Package 5 - Samurdhi Banking Societies			
	Server and Network	1	14.7	
	Computers	160	441.2	
	Total		455.9	IS
6.	Package 6 - Rural Finance Sector Development Agency			
	Server and Network	1	14.7	
	Computers	10	27.6	
	Specialist Software	1	1.2	
	Office equipm ent	1	20.8	
	Total		64.3	DP
7.	Package 7 - Project Management Unit			
	Server and Network	1	14.7	
	Computers	5	13.9	
	Specialist Software	1	1.2	
	Office equipment	1	20.8	
	Total		50.6	DP
8.	Package 8 – Ministry of Rural Economy			
	Server and Network	1	14.7	
	Computers	10	27.8	
	Specialist Software	1	1.2	
	Office equipment	1	20.8	
	Total		64.5	DP
9.	Package 9 - Vehicles[c]			
	4 Wheel Drive	8	225.6	IS

DP = direct purchase, ICB = international competitive bidding, IS = international shopping.
[a] Server, networking, standard software, printers, documentation, and manuals. [b] Desktop personal computers, printers, and manuals. [c] For project management unit and project implementation units excluding Ministry of Rural Economy.
Source: Asian Development Bank estimates.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

A. Linkage to the Country Poverty Analysis

Sector identified as a national priority in Country Poverty Analysis? YES	**Sector identified as a national priority in Country Poverty Partnership Agreement? YES**
In its *Framework for Poverty Reduction*, the Government of Sri Lanka (Government) addressed its policy to reduce poverty through: (i) funding strategic infrastructure development and developing a sustainable financial and ancillary service environment for the private sector to expand opportunities for the poor to participate in economic growth; and (ii) fostering pro-poor transformation in agriculture by using intensified policy dialogue to advocate adoption of more market-oriented policies.	Asian Development Bank (ADB) medium-term development goals for Sri Lanka stipulate that a high priority is accorded to broad-based rural development through increasing productivity of the poor, developing infrastructure especially in rural and remote areas, increasing access to financial and business services, and providing a stable and sustainable macroeconomic environment. Further, the medium-term goals address conflict-related poverty by providing rehabilitation and reconstruction assistance to the conflict-affected areas targeting employment generation.

Contribution of the sector/sub sector to reduce poverty in Sri Lanka:

In Sri Lanka, almost 40% of the population is estimated to be either poor or vulnerable to poverty, and roughly 88% of the poor live in rural areas. Farmers with few nonfarm sources of income, cultivating small plots of land, and casual workers account for a large share of the poor. Rural poverty is also due to inequitable access to economic infrastructure, poorly targeted agriculture subsidies, weak land tenure and registration system, and inadequate support for rural enterprise development. The development of a sustainable rural finance (RF) sector and efficient RF institutions (RFIs) will help promote rural economic growth and poverty reduction, through (i) increased productivity and profitability of rural economic activities through high value crops and improved manufacturing technology; (ii) higher employment generation; and (iii) private sector development, especially micro and small enterprises.

B. Poverty Analysis Improved Governance/Gender & Development

What type of poverty analysis is needed?

Despite a nationwide network of a wide range of RFIs, the supply gap in rural credit is estimated at SLRs10 billion. Half of this relates to rural poor. The Rural Finance Sector Development Program (RFSDP) will aim to effectively meet the demand for RF services emanating from the rural poor and the vulnerable. Thus, the key focus of the poverty analysis is (i) poverty assessment and mapping of the poor and vulnerable who are unable to access RF services, (ii) stocktaking of tangible and intangible productive assets of the poor and vulnerable for making effective use of access to RF for income generating activities, and (iii) identifying constraints to enhancing RF outreach.

Poverty in Sri Lanka. The benefits of the economic growth of about 5% over the past 2 decades are not evenly distributed. While the level of consumption poverty in all the provinces exceeds 20%, it is 40% and above in all but the Western Province. In the north and the east, economic activity has been disrupted due to the civil conflict, causing a decline in the contribution of this region to national gross domestic product from 15% in the 1980s to 4% in 1997.

Poverty and the Civil Conflict. The civil conflict that has lasted for over a decade has resulted in at least 60,000 deaths, injured, and internally displaced people. Physical assets, including homes, schools, shops, vehicles, and machinery have been abandoned and public infrastructure has virtually collapsed. Social services function with great difficulty, and there is limited access to shelter, health, education, water, and sanitation. The conflict caused widespread prevalence of underweight among children, as high as 50%; and physical injury and psychological stress. It is estimated that the conflict has reduced Sri Lanka's economic growth by about 2–3% a year.[1]

Poverty and the Agriculture Sector. The stagnant agriculture sector and low productivity per capita also lead to persistence rural poverty. Agriculture accounts for roughly 40% of the workforce and produces only 18% of GDP. The single most important impediment to agricultural prosperity is a policy regime that substitutes consultation and participation in decision making with administrative control. State ownership of some 80% of the land, restriction on land allocation, pervasive input and credit subsidies, and frequent changes in agricultural trade policies result in inefficient use of resources and restrict access to improved agro-technology, especially seeds and planting materials.

[1] Central Bank of Sri Lanka. 1999. *Annual Report*. Colombo.

Paddy farmers and landless laborers employed in the paddy sector comprise a large share of the rural poor. There is considerable evidence to show that returns to labor, land, and management in paddy cultivation have been decreasing in real terms since the mid-1980s. Parallel development of the rural nonfarm sector is necessary for absorbing the surplus labor from agriculture, thereby relieving pressure on agricultural holdings.

Rural Poverty and the Policy. The Government initiated various welfare programs such as the Samurdhi Program, which combines income transfers, small-scale capital projects, and development of savings and credit societies. The government welfare programs, however, ineffectively targeted relief payments and various kinds of subsidies, and allowed the farmers only a limited title to the government land. The current welfare programs of the Government are unsustainable, subject to political interference, and encourage dependence. Poor payment records among most RFIs are the result of ill-conceived development programs and political interventions. There is a growing consensus that rural poverty would be reduced more rapidly by replacing welfare-oriented policies with policies conducive to structural changes and the encouragement of market forces.

Rural Poverty and the Nonfarm Subsector. Many rural households among the lower poor are unable to benefit from RF because they cannot bear the risk of failure of their micro enterprises. People at this income level will derive the greatest benefit from the rural sector growth that increases farm and nonfarm employment opportunities. In Sri Lanka rural people with land do not have secure title, and most landholdings are nontradable. This places the poor at a disadvantage in accessing rural credit for expansion and diversification of their livelihoods. There is a clear need for an accelerated land reform, and for alternatives to collateral-based lending. Commercial banks are seen as inaccessible or unresponsive to the needs of small and micro rural enterprises, especially for small agriculture-based enterprises, when compared to RFIs, nongovernment organizations (NGOs), government-sponsored rural credit programs, or community-based organizations or informal sources such as moneylenders and pawnbrokers.

C. Participation Process

Stakeholder analysis prepared YES	Participation Strategy YES

Stakeholder Analysis. RFSDP will involve participation of stakeholders at different levels and from different sectors. Being the direct focus, marginal and subsistence farmers, women and the rural poor will be active participants. Rural farm and nonfarm households currently being served by RFIs will continue to have access to RF services and hence remain active participants. The restructuring of RFIs (Cooperative Rural Banks, Regional Development Banks, Samurdhi Banking Societies, and National Development Trust Fund) will further extend their outreach covering additional rural poor in remote areas as well as the poorest who have been unable to access RF from commercial banks and other institutional sources. The proposed Rural Finance Sector Development Act for regulation of RFIs will ensure secured financial services and deposit protection. At the Government level, Ministry of Policy Development and Implementation, Ministry of Rural Economy, Ministry of Co-operatives, Ministry of Samurdhi and the Central Bank of Sri Lanka will be involved in RFSDP implementation. In addition, the proposed policy and investment options include a special support package for extension of RF services in the north and the east, hence requiring participation by various Ministries, funding-agencies, NGOs, and civil society. Through RFI restructuring and outreach expansion through rural enterprise development, significant private sector participation and development are expected. Also, extension of the formal credit services to rural areas will curb usury practices. NGOs and civil society will be active participants in planning and implementation of the Rural Economy Resuscitation Fund (RERF). Social intermediation through RERF will enhance the capacity of the poor to effectively utilize the increased access to RF services.

Participation Strategy. During implementation, the proposed policy and investment interventions will follow an integrated participatory approach. Involvement of stakeholders from various levels and sectors will ensure that the approach is adhered to through methods such as participatory stakeholder interviews, focus group discussions, and rapid appraisal. The social assessment will emphasize participatory process of direct beneficiaries and lower-end RF service providers to assess their needs and formulate effective outreach mechanisms and identify monitoring and evaluation indicators. The assessments will also involve consultations with (i) women groups to identify gender related issues, (ii) the poorest and vulnerable such as female-headed households to assess their special needs, and (iii) households in geographically remote areas where rural poverty is most acute. Monitoring and evaluation will be carried out in a participatory manner with a set of indicators measurable by beneficiaries and stakeholders.

D. Gender and Development

Strategy to maximize impacts on women: The social analysis includes gender analysis to identify issues and constraints for women to take and utilize RF services. A strategy of social intermediation will be prepared to assess training and skill development needs for women.

Gender plan prepared? Yes. (Refer section F. Components and Targets for Gender Strategy)

E. Social Safeguards and other Social Risks

Issues	Significant/ Non Significant/ Uncertain/ None	Strategy to Address Issues	Output Prepared
Resettlement	None	There will be no resettlement issues resulting from the implementation of RFSDP. There will be positive impacts on resettlement due to improved productivity in agricultural sector as well as greater employment and more diversified employment opportunities in the rural economy.	RFSDP includes a social safeguard-screening step to ensure that this is the case.
Affordability	None	There will be no affordability-related issues. In contrast, reduced dependence on very expensive informal sources of credit will not only reduce the price of inputs, cost of production, but will also ensure that rural households are able to get better price for their produce. The reduced cost of production along with productivity improvements will result in a competitive rural sector that will not be dependent on Government subsidies and welfare programs.	No
Labor	None	Enhanced outreach as a result of RFI restructuring will increase rural economic activities leading to greater employment opportunities. Community support and expansion of RF services in the conflict-affected areas will rebuild social and economic infrastructure, revive economic sectors, and generate significant employment opportunities. Further, the rural enterprise development credit line support for rural small and micro enterprises will increase employment opportunities in both agriculture and agriculture-related sectors.	No
Indigenous People	None	No adverse issues related to the indigenous people are anticipated.	No
Other Risks/ Vulnerabilities	None	No other adverse issues are anticipated.	No

F. Components and Targets for Gender Strategy

Component/ Activity	Strategy and Target
Building Sector Capacity	• Gender awareness training for promoting gender balanced client outreach. • Encourage RFIs to formulate business plans with quantifiable gender outreach targets.
RERF	• Community investment planning process will include need assessment of female community members. • Female community members will participate in design and construction planning of community-based infrastructure.
Expansion of RF in the conflict-affected areas	• Gender awareness training for RFIs to expand outreach to female clients. • Encourage RFIs to formulate business plans with quantifiable gender outreach targets. • Encourage microfinance-NGOs to hire female staff. • RERF will provide social intermediation, specifically aimed at potential female clients.
Rural enterprise development	• 75% of the credit line for rural enterprise development is targeted at female clients of RFIs.
Project implementation support	• The baseline survey to be undertaken at the start of RFSDP, repeated at midterm and at project completion will be gender-disaggregated and include gender impact indicators. • Staff at the project management unit and project implementation units will be provided gender awareness training for project monitoring and evaluation.