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IDA/R2017-0072/1

March 17, 2017

Closing Date: Wednesday, April 5, 2017 at 6:00 p.m.

FROM: Vice President and Corporate Secretary

Sri Lanka - Financial Sector Modernization Project

Project Appraisal Document

Attached is the Project Appraisal Document regarding a proposed credit to Sri Lanka for a Sri Lanka Financial Sector Modernization Project (IDA/R2017-0072), which is being processed on an absence-of-objection basis.

Distribution:
- Executive Directors and Alternates
- President
- Bank Group Senior Management
- Vice Presidents, Bank, IFC and MIGA
- Directors and Department Heads, Bank, IFC and MIGA

Document of

The World Bank

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Report No: PAD2082

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF

SDR 55.4 MILLION
(US$75 MILLION EQUIVALENT)

TO THE

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

FOR A

SRI LANKA FINANCIAL SECTOR MODERNIZATION PROJECT

March 14, 2017

Finance and Markets Global Practice
South Asia Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective February 28, 2017)

Currency Unit =	Sri Lanka Rupee (LKR)
LKR 151.624964 =	US$1
US$ 1.353890 =	SDR 1

FISCAL YEAR
January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AGDSL	Auditor General's Department of Sri Lanka
BCP	Business Continuity Planning
CBSL	Central Bank of Sri Lanka
CCP	Central Counterparty
CDS	Central Depository System
CPCU	Central Project Coordination Unit
CPF	Country Partnership Framework
CSD	Central Securities Depository
CSE	Colombo Stock Exchange
DA	Designated Account
DLI	Disbursement-linked Indicator
DLR	Disbursement-linked Result
DMS	Debt Management Strategy
DvP	Delivery-versus-Payment
EEP	Eligible Expenditure Program
EPF	Employees' Provident Fund
ERD	Department of External Resources
FA	Financing Agreement
FCP	Financial Consumer Protection
FIRST	Financial Sector Reform and Strengthening Initiative
FM	Financial Management
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSOC	Financial Sector Oversight Committee
GDP	Gross Domestic Product
GFDR	Global Financial Development Report
GoSL	Government of Sri Lanka
GRM	Grievance Redress Mechanism
GRS	Grievance Redress Service
IBSL	Insurance Board of Sri Lanka
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
IPF	Investment Project Financing
IRR	Internal Rate of Return
IT	Information Technology
IUFR	Interim Unaudited Financial Report
M&E	Monitoring and Evaluation
MCR	Minimum Capital Requirement
MFI	Microfinance Institution
MIC	Middle-Income Country
MoF	Ministry of Finance

MoNP&EA	Ministry of National Policies and Economic Affairs
MoU	Memorandum of Understanding
MSME	Micro, Small, and Medium Enterprise
NBFI	Non-Bank Financial Institution
NCB	National Competitive Bidding
NCS	National Card Scheme
NITF	National Insurance Trust Fund
NPV	Net Present Value
OM	Operations Manual
PDO	Project Development Objective
PFMI	Principles of Financial Markets Infrastructure
PSC	Project Steering Committee
RBS	Risk-based Supervision
RTGS	Real-Time Gross Settlement
SEC	Securities and Exchange Commission of Sri Lanka
SOCB	State-owned Commercial Bank
SOE	State-owned Enterprise
SOFI	State-owned Financial Institution
SORT	Systematic Operations Risk-Rating Tool
SSS	Securities Settlement System
SSSS	Scripless Securities Settlement System
TA	Technical Assistance

Regional Vice President:	Annette Dixon
Country Director:	Idah Z. Pswarayi-Riddihough
Senior Global Practice Director:	Ceyla Pazarbasioglu-Dutz
Practice Manager:	Niraj Verma
Task Team Leader(s):	Anoma Kulathunga, Martin Melecky

BASIC INFORMATION

Is this a regionally tagged project?	Country(ies)	Lending Instrument
No		Investment Project Financing

[ ] Situations of Urgent Need of Assistance or Capacity Constraints

[ ] Financial Intermediaries

[ ] Series of Projects

Approval Date	Closing Date	Environmental Assessment Category
05-Apr-2017	31-Dec-2022	C - Not Required

Bank/IFC Collaboration
No

Proposed Development Objective(s)

The Project Development Objective (PDO) is “to contribute to increasing financial market efficiency and use of financial services among micro, small and medium enterprises (MSMEs) and individuals”.

The project will achieve the PDO through modernizing financial market infrastructure, upgrading the legal and regulatory framework for the financial system, and strengthening the institutional capacity of financial sector regulators (Central Bank of Sri Lanka, [CBSL]; Securities and Exchange Commission of Sri Lanka, [SEC]; and Insurance Board of Sri Lanka, [IBSL]).
On account of its comprehensive approach to creating an enabling environment for robust financial development, the project is also expected to advance financial inclusion through (a) increased financial efficiency and competition and (b) the greater reach and financial connectivity of MSMEs and individuals that the new and more inclusive financial market infrastructure shall enable.

Components

Component Name	Cost (US$, millions)
Supporting Selected Mid-Level Reforms through Results-Based Financing	15.00
Strengthening Regulators’ Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure	59.00

Project Implementation and Monitoring	0.81
Front-end Fee	0.19

Organizations

Borrower :	Democratic Socialist Republic of Sri Lanka
Implementing Agency :	Insurance Board of Sri Lanka Securities and Exchange Commission of Sri Lanka Central Bank of Sri Lanka

[ ] Counterpart Funding	[ ] IBRD	[✓] IDA Credit [ ] Crisis Response Window [ ] Regional Projects Window	[ ] IDA Grant [ ] Crisis Response Window [ ] Regional Projects Window	[ ] Trust Funds	[ ] Parallel Financing

Total Project Cost: 75.00	Total Financing: 75.00 Of Which Bank Financing (IBRD/IDA): 75.00	Financing Gap: 0.00

Financing (in US$, millions)

Financing Source	Amount
IDA-60060	75.00
Total	**75.00**

Expected Disbursements (in US$, millions)

Fiscal Year	2017	2018	2019	2020	2021	2022	2023
Annual	0.29	4.15	6.41	10.62	19.17	24.52	9.84
Cumulative	0.29	4.45	10.85	21.47	40.64	65.16	75.00

INSTITUTIONAL DATA

Practice Area (Lead)

Finance & Markets

Contributing Practice Areas

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Gender Tag

Does the project plan to undertake any of the following?

a. Analysis to identify Project-relevant gaps between males and females, especially in light of country gaps identified through SCD and CPF

Yes

b. Specific action(s) to address the gender gaps identified in (a) and/or to improve women or men's empowerment

No

c. Include Indicators in results framework to monitor outcomes from actions identified in (b)

Yes

SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)

Risk Category	Rating
1. Political and Governance	● Substantial
2. Macroeconomic	● Substantial
3. Sector Strategies and Policies	● Substantial

4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and Social	Low
8. Stakeholders	Moderate
9. Other	
10. Overall	Substantial

COMPLIANCE

Policy

Does the project depart from the CPF in content or in other significant respects?

[ ] Yes [✓] No

Does the project require any waivers of Bank policies?

[ ] Yes [✓] No

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01		✓
Natural Habitats OP/BP 4.04		✓
Forests OP/BP 4.36		✓
Pest Management OP 4.09		✓
Physical Cultural Resources OP/BP 4.11		✓
Indigenous Peoples OP/BP 4.10		✓
Involuntary Resettlement OP/BP 4.12		✓
Safety of Dams OP/BP 4.37		✓
Projects on International Waterways OP/BP 7.50		✓
Projects in Disputed Areas OP/BP 7.60		✓

Legal Covenants

Sections and Description

Project Steering Committee :

The recipient shall ensure that the Project Steering Committee (PSC) will be established within two (2) months after the Effective Date. The recipient shall maintain the PSC through the period of implementation of the Project to (a) ensure effective coordination and communication among the implementing entities, the Ministry of Finance (MoF) and the Ministry of National Policies and Economic Affairs (MoNP&EA) – the Project executing agencies; (b) provide overall policy guidance and support to the Project implementing entities; and (c) mobilize and ensure coordination with other relevant stakeholders.

Sections and Description

Central Project Coordination Unit:

The recipient shall establish, within two (2) months after the Effective Date, and thereafter maintain, the Central Project Coordination Unit (CPCU) under the MoF, with adequate professional and administrative staff in numbers and with qualification and experience and under terms of reference satisfactory to the Association, and headed by a Project Director, as such unit shall be required to, among others, (a) carry out overall project coordination including overall financial management (FM) and reporting, (b) carry out quality control, as well as facilitate and coordinate procurement activities, (c) monitor and evaluate the Project's performance, and (d) manage the Project-level grievance and complaints procedures pursuant to the Operations Manual (OM).

Sections and Description

Operations Manual:

The recipient shall, through the CPCU, cause the Project Implementing Entities to (a) adopt the OM, in form and substance satisfactory to the Association, within two (2) months after the effective date, or the first date on which a VerificationReport shall be required under the project, whichever is earlier; (b) carry out the project in accordance with the OM; and (c) not amend, revise, or waive, nor allow to be amended, revised, or waived, the provisions of the OM or any part thereof without the prior written agreement of the Association.

In the event of any inconsistency between the OM and the Financing Agreement (FA), the provisions of the FA shall prevail.

Sections and Description

Annual work plan and budget :

The recipient shall, through the CPCU, cause each of the Implementing Entities, throughout Project implementation, to furnish to the Association for approval as soon as available, but in any case not later than November 30 of each year, an annual work plan and budget for the activities under Component 2 of the Project for each subsequent fiscal year, of such scope and detail as the Association shall have reasonably requested, except for the annual work plan and budget for the first fiscal year which shall be furnished before the commencement of the relevant activities under Component 2 of the Project.

Conditions

PROJECT TEAM

Bank Staff

Name	Role	Specialization	Unit
Anoma Kulathunga	Team Leader(ADM Responsible)		GFM06
Martin Melecky	Team Leader		SARCE
Asif Ali	Procurement Specialist(ADM Responsible)		GGO06
Bernadeen Enoka Wijegunawardene	Financial Management Specialist		GGO24
Abha Prasad	Peer Reviewer		GMF13
Anderson Caputo Silva	Team Member		GFM3A
Aza A. Rashid	Team Member		GFM06
Gynedi Srinivas	Team Member		GFM2B
Harish Natarajan	Team Member		GFM2B
Ilias Skamnelos	Peer Reviewer		GFM03
Junko Funahashi	Counsel		LEGES
Maria Teresa Chimienti	Team Member		GFM2B
Michael J. Goldberg	Peer Reviewer		GFMSO
Mohamed Ghani Razaak	Safeguards Specialist		GSU03
Mokshana Nerandika Wijeyeratne	Safeguards Specialist		GEN06
Nagavalli Annamalai	Team Member		GFM08
Nugegodage Dona Anne Shanuki Gunasekera	Team Member		GFM06
Satish Kumar Shivakumar	Team Member		WFALA
Sau Ngan Wong	Team Member		GFM08
Serap Gonulal	Team Member		GFM3A
Tisarani Rathnija Arandara	Team Member		GFM06

Varsha Marathe Dayal	Team Member		GFM06
William Joseph Price	Team Member		GFM3A

Extended Team

Name	Title	Organization	Location

SRI LANKA
SRI LANKA FINANCIAL SECTOR MODERNIZATION PROJECT

TABLE OF CONTENTS

I. STRATEGIC CONTEXT

A. Country Context

1. **Sri Lanka aspires to reach the upper middle-income country (MIC) status; yet, it faces the risk of declining growth potential.** During 2011–2015, Sri Lanka's economy was one of the fastest growing among South Asian peers with an average growth of 6.1 percent. The reduction in poverty and improvements in household welfare since 2002 are noteworthy[1] and place the country well on its way toward eradicating extreme poverty. Although poverty continued to decline between 2009/10 and 2012/13, inequality in both consumption and income has started to increase, as growth of per capita consumption and income of the bottom 50 percent are slower than the ones of the top 50 percent. Sri Lanka is the only country in South Asia that experienced an increase in consumption inequality in the last decade. In turn, rising inequality tempered the poverty-reducing impact of growth.

2. **The challenging global environment weakened macroeconomic stability, which can hinder growth.** During 2014–2015, Sri Lanka experienced significant capital outflows and reduced exports and remittances. These negative shocks resulted in the slowdown of economic growth to about 4.9 percent and contributed to heightened exchange rate pressures (Figure 1).[2] To support and stabilize the economy, the authorities implemented expansionary monetary and fiscal policies, which left the country with higher public debt and lower reserves. The accommodative monetary policy stance led to year-on-year expansion of credit to the private sector by 25 percent,[3] which supported growth but also increased financial sector vulnerabilities. Increased real interest costs of government borrowing further restricted the Government's ability to borrow at a sustainable level. Moreover, as the country nears the upper-MIC status, borrowing terms are becoming more commercial and could affect affordability. Finally, with low national savings compared to needed national investment, Sri Lanka must increase domestic savings mobilization and attract more foreign direct investment to sustain high growth.

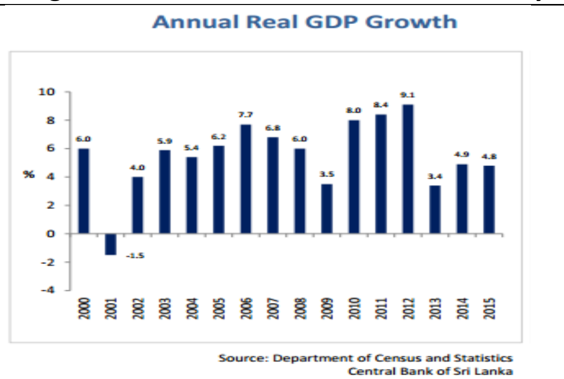
3. **Sri Lanka needs a new growth model that requires investment to shift from the public to the private sector.** The need to shift investment activity from the public to private sector becomes increasingly important for Sri Lanka due to constrained fiscal space and inefficiencies in public investment. Even infrastructure investment, in which the Government of Sri Lanka (GoSL) has always played a central role, will require enhanced private sector participation because of the scale of infrastructure financing needed over the next decade. To this end, domestic capital markets must evolve to be in a position to play a key role in the financing of large investments. In a report prepared for the Colombo Stock Exchange (CSE) in 2012, Mckinsey & Company estimated that to sustain the 8.0 percent target growth rate, the Government needs to mobilize at least US$300 billion targeting infrastructure over the next eight years.

[1] The headcount ratio of national poverty declined from 22.7 percent to 6.7 percent between 2002 and 2012.
[2] The executive board of the International Monetary Fund (IMF) has approved a three-year US$1.5 billion loan to support Sri Lanka's economic reform agenda. http://www.dailymirror.lk/110455/IMF-approves-bln-loan-to-back-SL-s-economic-reforms#sthash.M7d259nq.dpuf
[3] Despite the year-on-year expansion of credit to the private sector, the credit to gross domestic product (GDP) ratio remained at 30.8 percent

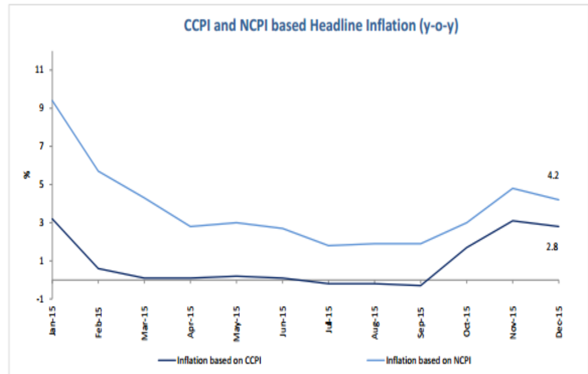
4. **The investment shift can help create the next 1 million jobs, and micro, small, and medium enterprises (MSMEs), in particular, could be the hinge for the new growth model to emerge.** Most private enterprises in Sri Lanka are small, which have profound implications for productivity. The 2014 Economic Census conducted by the Department of Census and Statistics, Sri Lanka found that 93 percent of private economic establishments had fewer than five employees. Around 99.5 percent of all enterprises in Sri Lanka are MSMEs. They contribute over 52 percent to the gross domestic product (GDP) and 69.5 percent of the total employment in the country.[4] These statistics reveal an immense potential to boost the MSMEs' level of contribution to the economy when compared with the GDP and employment contributions in other countries.

Figure 1. Selected Macroeconomic Indicators

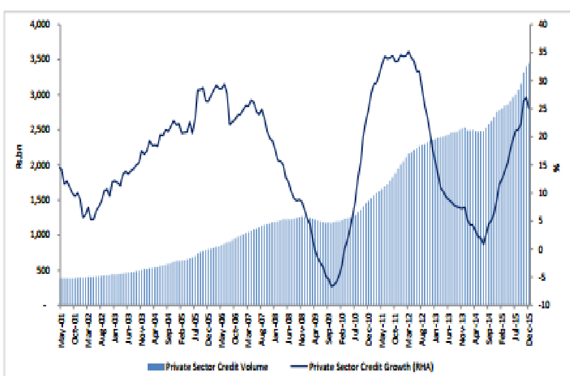
GDP growth slowed down but remains steady



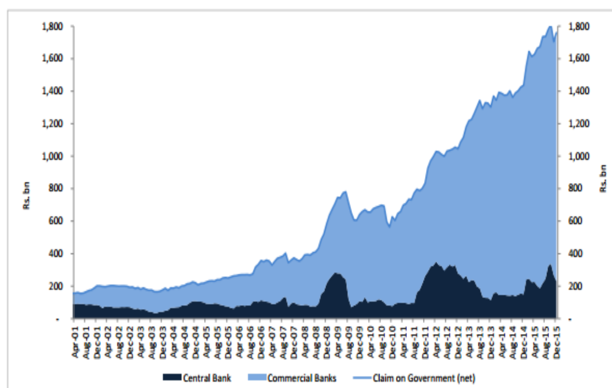
Inflation rebounded to still managable levels



Financial depth is low compared with peer countries and credit provision remains volatile



Net credit to the GoSL has been rising rapidly with posible crowding-out effects



Source: Central Bank of Sri Lanka (CBSL).

[4] Asia SME Finance Monitor-2014, Asian Development Bank (ADB).

B. Sectoral and Institutional Context

Financial Sector Background

5. **The financial system in Sri Lanka is dominated by banks and state ownership.** In 2015, the banking sector comprised 25 licensed commercial banks and 7 licensed specialized banks that accounted for 59 percent of the total financial system assets,[5] of which the state-owned banks[6] contributed more than 44 percent. Further, the non-bank financial institution (NBFI) sector is made up of 46 financial companies and 7 specialized leasing companies that account for only 7 percent of total financial system assets. A large number of microfinance institutions (MFIs), which contribute to expanding financial inclusion, is still outside the perimeter of the regulated financial system.[7] The insurance and capital markets sector accounts for a relatively small share of the sector's total assets. The 28 insurance companies represent 3.3 percent of the financial sector, while the capital markets sector, comprising 294 companies, accounts for only 0.9 percent. Sri Lanka has a sectoral supervisory structure with the Central Bank of Sri Lanka (CBSL) covering banking, finance companies, leasing, and microfinance; the Securities and Exchange Commission of Sri Lanka (SEC) covering capital markets; and the Insurance Board of Sri Lanka (IBSL) covering insurance. For the purpose of coordinating the supervisory functions of the financial sector, the Inter-Regulatory Institutions Council was formed in 2007, consisting all financial sector primary regulators with the objective of ensuring appropriate policy directions for the orderly development of the financial sector and strengthening financial system stability. It was reconstituted in 2015 as the Financial Sector Oversight Committee (FSOC) to emphasize its financial system oversight role. However, this committee is yet to reach its full potential.

6. **The development of the financial sector has not been commensurate with the development of the real economy as reflected in its low depth relative to peers.** Despite having a per capita income 2.5 times and 3 times higher than that of India and Bangladesh, respectively, Sri Lanka's credit to GDP ratio at 40.73 percent is lower than that of India (52.6 percent) and Bangladesh (43.9 percent) and is a fraction of that of China, Vietnam, and Thailand (Figure 2). It is also below the South Asia regional average (47.59) and the MIC average (97.03). Relative to regional peers, Sri Lanka's financial sector has room to grow in terms of the size of total assets, credit intermediation (Table 1), in depth and diversification.

Table 1. Indicators of Banking Activities for Selected Countries (2015)

Country	Broad Money (M2)[8]/GDP	Bank Domestic Credit/GDP
China	205.7	153.3
Vietnam	137.6	111.9
Thailand	129.7	151.3
India	79.2	52.6
Bangladesh	64.5	43.9

[5] http://www.cbsl.gov.lk/pics_n_docs/10_pub/_docs/efr/annual_report/AR2015/English/12_Chapter_08.pdf.
[6] The state sector banks consist of two commercial banks and six specialized banks.
[7] Since May 2016, new legislation providing for the regulation of the microfinance sector has been introduced; CBSL is yet to issue any licenses.
[8] Broad money (M2) is sum of currency outside banks; demand deposits other than those of the Central Government; the time, savings, and foreign currency deposits of resident sectors other than the Central Government; bank and travelers checks; and other securities such as certificates of deposit and commercial paper (World Bank, World Development Indicator Database)

Country	Broad Money (M2)[8]/GDP	Bank Domestic Credit/GDP
Pakistan	53.5	15.4
Sri Lanka	**40.8**	**40.73**

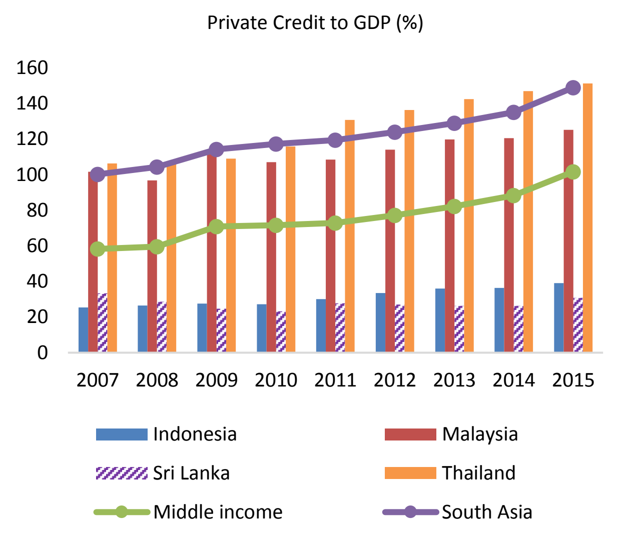
Source: World Development Indicators.

7. **The absence of a competitive, diversified, and well-regulated financial market limits the access to investment finance for MSMEs and economic opportunities for the financially underserved.** MSMEs continue to get crowded out (figure 2) from the banking sector by larger corporate clients, state-owned enterprises (SOEs), and government debt financing as banks and other financial institutions consider them to be high credit risks.[9] Capital markets—which could have provided an avenue for funding, especially for larger corporates including SOEs—are underdeveloped leading to their overreliance on the banking system for funding, which happens at the expense of smaller firms. But, credit institutions have also not developed adequate internal capacity for serving MSMEs mainly due to insufficient competition, resulting in low incentives to modernize and innovate to serve this segment. While the depth of the credit market, as measured by the credit-to-GDP ratio, has been stagnating around 30 percent, lending to the Government and SOEs has been increasing without any major improvement in bank efficiency (Figure 2). As a result, MSMEs[10] perceive access to finance as a major constraint to investment and growth, more so than in peer countries (Figure 2), and, for example, over 50 percent of the enterprises have reported that their working capital came from their own resources.

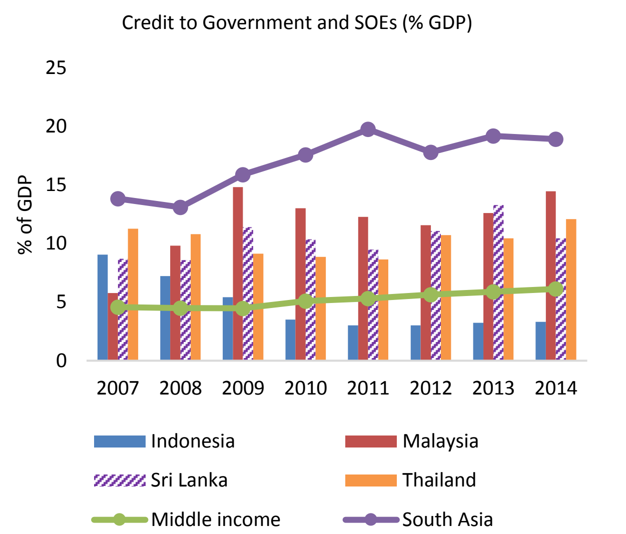
[9] Since lending to SOEs is backed by treasury guarantees, thus carrying zero risk for regulatory purposes, banks continue to lend substantial amounts to SOEs. For example, the two state-owned commercial banks (SOCBs), which account for about 40 percent of the banking system, concentrate their credit to supporting the national budget and SOEs. The two SOCBs dedicate an estimated 70 percent and 40 percent, respectively, of their lending to SOEs and the GoSL, leaving little space for lending to MSMEs to support a broad-based development of the economy.
[10] While the figure depicts MSMEs, the situation is similar or worse for the micro sector.

Figure 2. Role of the State in the Financial System

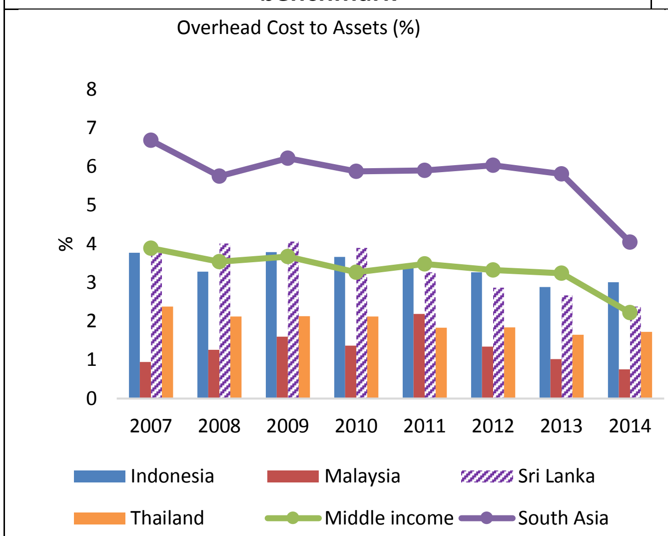
Credit deepening is stagnant and lags behind peers



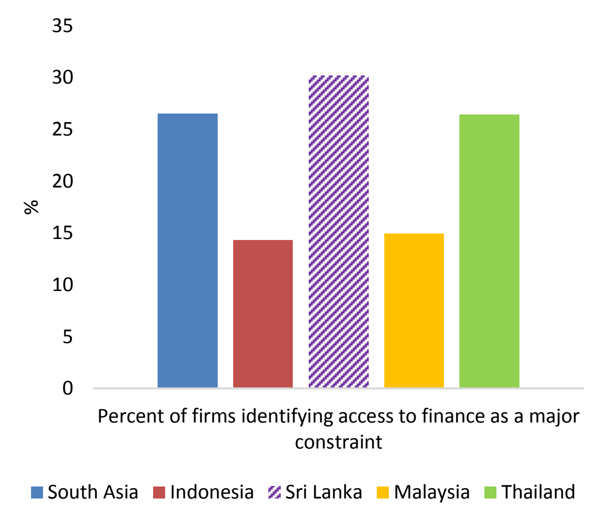
The GoSL and SOEs absorb a large part of the credit market



Bank efficiency is worsening compared to MICs benchmark



Firms and small and medium enterprises see finance as a major hurdle for business



Source: World Development Indicators, Finstats 2016 and Doing Business Databases, World Bank

The Challenge - Importance of Developing the Enabling Environment

8. **To remain on its path to upper-MIC status, Sri Lanka must address financial sector challenges to build a more efficient, inclusive, and stable financial system that can support shared prosperity.** Robust financial sector development can help Sri Lanka sustain its developmental returns. More efficient finance

can boost the competitiveness of Sri Lankan firms and overall job creation. The deepening of capital, pension, and insurance markets can help manage some fiscal challenges such as deficit financing and contingent liabilities due to aging population, natural hazards, and the economic vulnerability of the poor. Greater financial inclusion can help increase spatial integration and access to opportunities and contain costs of informality. Improved governance and transparency in the financial market can spill over to the rest of the economy. However, to make this happen, Sri Lankan authorities must effectively address several challenges in the financial sector. Among other actions, addressing gaps in financial sector infrastructure, legal framework, and supervisory capacity are needed as key starting points (evidenced by the Financial Sector Assessment Program [FSAP], 2015, and the requests for technical assistance (TA) from financial sector supervisors).

9. **The low and decreasing efficiency of the banking and NBFI sectors must be tackled head-on to boost overall competitiveness in the economy.** The persistently high cost-to-income ratio in Sri Lanka's banks signals cost inefficiencies.[11] Banks need to improve management of operational costs to catch up with peer countries. NBFIs may need to overhaul their operations, as analysis has revealed major inefficiencies in this subsector. Improving market entry and exit for banks and NBFIs can enhance overall market contestability. Low market transparency can be improved by promoting clearer and more comprehensive disclosure of prices by banks and NBFIs and by scaling up the extent and quality of information released by the CBSL.

10. **Inadequate diversification of Sri Lanka's financial system hinders possible gains in financial efficiency, development of alternative channels for credit intermediation, and economic resilience.** Underdeveloped capital, pension, and insurance markets (where, for instance, insurance premium to GDP at around 1 percent is much lower than comparators), undermine the ability of Sri Lanka to meet the long-term financing needs of the economy. With a concessional interest rate regime and limited exposure to external capital flows and weak financial infrastructure for bond markets, debt markets are underdeveloped. Developed capital markets offer businesses better access to low-cost, long-term financing, which is vital for expansion and growth of businesses. Gaps in governance in comparison with international best practice, the lack of adequate pricing benchmarks, and low use of technology hamper the development of Sri Lanka's nascent capital market. Long-term funding needs of larger firms and infrastructure projects need a well-functioning capital market to allow for advances in economic efficiency and risk management. Moreover, developed capital markets provide diversification opportunities for pension funds and other investors. The 2015 FSAP pointed to a number of gaps in financial sector infrastructure (such as the risk in settlement of corporate securities) as well as the legal framework and supervisory capacity (such as the SEC Act and enforcement powers of SEC and IBSL) to boost competition and efficiency in non-bank financial markets.

11. **The move toward risk-based and consolidated supervision across all financial subsectors remains work in progress, even though it is well accepted by the country authorities.** While the financial system is relatively stable, business inefficiencies and the inadequate culture of risk management can create vulnerabilities in an environment when interest rates and business margins continue in a downward trend. Some small and midsize banks, licensed specialized banks, and NBFIs already show elevated levels of nonperforming loans despite an environment of regulatory forbearance. Such risks must be addressed in a consolidated and forward-looking manner. Furthermore, regulatory and supervisory

[11] Cost-to-income ratios are constantly higher than peers and the South Asia regional average and MICs (2015 FSAP)

loopholes that the market has been exploiting and the strong emergence of financial sector groups[12] makes functional consolidated supervision a necessity. This also creates a level-playing field for institutions that do not belong to any financial groups and operate across banking, insurance, capital markets, or leasing industries. Risk-based supervision (RBS) and consolidated supervision not only are important for assessing the financial soundness of institutions, but also can stimulate greater market competition that is currently missing in the Sri Lankan market. However, inadequate capacity and resources (with regard to staff, expertise, and tools) to meet their expanding responsibilities have led to effectiveness challenges for the three main regulators. Further, regulatory and supervisory frameworks for MFIs, financial consumer protection (FCP), and pensions have not yet been developed. The absence of well-defined standards and a framework for FCP has led to considerable consumer detriment that spans across different financial services—from insurance, to banking, to NBFI and to the prudentially unregulated microfinance.[13]

The Change Process and Government Ownership

12. **The need for financial sector reform is fully articulated in the GoSL's development directions as outlined in recent policy statements and endorsed through the 2016 and 2017 budgets.** The 2015 FSAP identified priority reforms in the financial sector.[14] In line with its general pledge to stronger governance and reform, the GoSL too has expressed commitment to create the enabling business environment in which the financial sector can operate effectively and efficiently. The GoSL recognizes the need to reform the banking industry and stimulate competition within the sector, increase outreach to underserved areas and sectors, and improve the supervisory capacity of CBSL to address systemic risks in the banking sector as well as regulate and oversee the NBFI and microfinance sectors. While acknowledging the innovations and expansions of the banking sector that have extended banking to the door step of the customer, the GoSL identifies the restrictive practices of collateral-based lending that have become an impediment to the development of the MSME sector and the business startup culture in Sri Lanka. The GoSL also perceives capital markets to be an untapped resource and recognizes the weaknesses discussed above. Strengthening of insurance business, in particular the agri-insurance, and provision of pension annuities are other areas of key importance highlighted in the budget.[15] The GoSL and CBSL, in particular, recognize the area of financial stability and effective implementation of macroprudential policy as important. They work with the International Monetary Fund (IMF) on this area under the TA that follows up on the 2012 FSAP Stability Module.[16] The Asian Development Bank (ADB) is assisting in the areas of capital market development following the 2015 FSAP recommendations that complements the work of the World Bank.

[12] Companies that have a common holding and business interests in diversified financial sector assets like insurance, banking, leasing, and so on.

[13] Under the 2017 government budget proposals, it is proposed to establish the Financial Consumer Protection Authority in Sri Lanka.

[14] Dominance of the commercial banking system and absence of a vibrant capital market were also identified as constraints in a number of previous reports; by ADB (2005), IMF/World Bank's FSAP (2007) World Bank study on 'South Asian Bond Markets – Developing Long Term Financing For Growth' in 2008, the Financial Policy Note of the World Bank in 2012, and World bank study on 'Unlocking Sri Lanka's Financial Resources: Role of Capital Markets in providing Long Term Financing' in 2015.

[15] Sri Lanka Government 2016 Budget presented in November 2015.

[16] The IMF conducted a follow-up TA on the 2012 FSAP Stability Module in April 2015. The mission recommended the strengthening of the organizational framework for financial stability, financial regulation and supervision, macroprudential surveillance, and crisis preparedness and management. This World Bank project has incorporated the relevant recommendations into the project design and will coordinate with IMF in the implementation stage.

Financial Sector Modernization Project

13. **The project addresses some of the main constraints in the financial sector and is also key in generating a demonstration effect for deeper engagement on high-level financial sector reforms.** The project is designed to address several of the key challenges confronting the development of the financial sector in Sri Lanka. In component 2, this project aims to improve the financial market infrastructure (FMI), legal and regulatory framework for the financial system, and the institutional capacity of financial sector regulators, all of which are essential actions for a stronger financial sector.

14. **The project focuses on addressing select technical and mid-level recommendations identified through the 2015 FSAP and aligns with the ongoing policy dialogue on sector reform priorities (see Box 1).** While the project does not focus on high-level policy recommendations, the results based financing component of the project (component 1) addresses several mid-level policy recommendations, thus, facilitating a platform of engagement that enables downstream progress on high-level reforms. This component targets developing more competitive markets by requiring a holistic supervisory approach; switching to a forward-looking supervisory perspective; and leveling of the playing field within and across financial subsectors. It also aims to improve the investment performance of the pension provident funds to secure adequate replacement income for retirees.

Box 1. 2015 FSAP Summary Recommendations

The 2015 Development FSAP made recommendations at three levels to improve financial sector efficiency and financial inclusion in Sri Lanka and boost inclusive growth and job creation as given below:

- **High-level policy recommendations**—such as strengthening state-owned financial institutions (SOFIs) governance, integrating the supervisory structure and improving supervisory governance, and rationalizing and consolidating state financial support programs (credit lines and partial credit guarantee schemes)
- **Mid-level policy recommendations—**such as establishing an institutional and legal framework for financial consumer protection, improving investment management of pension provident funds, and removing the monopoly of state-owned insurance companies[17] in the insurance business with the Government
- **Technical-level recommendations**—such as improving the financial sector infrastructure, upgrading the legal and regulatory framework, introducing risk-based and consolidated supervision, and increasing the supervisory capacity to assess and monitor risks and enforce regulations across all financial subsectors

[17] Sri Lanka Insurance Corporation and the National Insurance Trust Fund (NITF).

C. Higher Level Objectives to which the Project Contributes

15. **The operation is fully aligned with the Country Partnership Framework (CPF) for Sri Lanka for FY17–FY20.**[18] The project will contribute to the achievement of the first CPF pillar on improving macro-fiscal stability and competitiveness by enabling the country's transition to become a more outward-oriented, competitive, globally integrated economy. It will also help promote more and better-paying private sector jobs for the bottom 40 percent of the population. Specifically, the planned activities will directly facilitate the achievement of Objective 1.4: Enhancing Financial Inclusion and Financial Sector Efficiency. Further, it is envisaged that the proposed work on capital market development and pension investment will also complement the activities on public finance management (Objective 1.1) and social protection (pension) systems (Objective 2.2). The CPF identified that the future World Bank Group initiatives will focus on activities including (a) strengthening and enhancing regulatory, supervisory, and governance structures in line with international standards; (b) expanding access to finance for MSMEs and underserved segments through working with banks and NBFIs by supporting the development of strategy, capacity, and financing; (c) deepening the capital market through necessary legal, regulatory, and market infrastructure while introducing new products, instruments, and markets; and (d) developing the credit and financial infrastructure. The proposed project expects to invest in these areas.

16. **The project is also in line with the GoSL's development directions.** These were outlined in recent policy statements and endorsed through the 2016 and 2017 budgets, as well as the Government's plan for MSME development for sustainable growth and job creation. The current project builds on the achievements and the development activities carried out by an earlier project (the IDA-funded 2000–05 CBSL modernization project, the outcome of which was rated 'Highly Satisfactory' by the Internal Evaluation Group's project completion review, having achieved its objective under each component).

17. **Overall, the project aims to level the playing field and align the incentives of the financial sector for greater support of inclusive growth in Sri Lanka.** The leveling of the playing field and aligning of incentives could be achieved through modernized financial infrastructure, a legal and regulatory framework in line with good international standards, and greater capacity of regulators to conduct holistic and forward-looking supervision across all financial subsectors. The resulting greater market competition, financial sector efficiency, and inclusion of firms and people in the use of needed financial tools are expected to follow. In turn, MSMEs will be able to exploit greater economic opportunities by investing, growing, and creating new and better jobs. To sustain the expected gains in poverty reduction and shared prosperity, the project will also help enhance the financial soundness of financial firms and thus contribute to overall financial and macroeconomic stability.

[18] CPF Report 104606-LK discussed by the Board on May 31, 2016.

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

18. **The Project Development Objective (PDO) is "to contribute to increasing financial market efficiency and use of financial services among micro, small, and medium enterprises (MSMEs) and individuals".**

19. **The project will achieve the PDO through modernizing financial market infrastructure, upgrading the legal and regulatory framework for the financial system, and strengthening the institutional capacity of financial sector regulators (Central Bank of Sri Lanka, CBSL; Securities and Exchange Commission of Sri Lanka, SEC; and Insurance Board of Sri Lanka, IBSL).** On account of its comprehensive approach to creating an enabling environment for robust financial development, the project is also expected to advance financial inclusion through (a) increased financial efficiency and competition and (b) the greater reach and financial connectivity of MSMEs and individuals that the new and more inclusive financial market infrastructure shall enable.

B. Project Beneficiaries

20. **The project beneficiaries are the financial sector regulators (CBSL, SEC, and IBSL).** The interventions planned with the regulators will also permeate to financial firms, MSMEs, and individuals. While the financial sector regulators and several providers of core financial sector infrastructure[19] will benefit from the project directly, it is likely that MSMEs and individuals, including women, and beneficiaries under the Employees' Provident Fund (EPF)[20] will also be positively impacted.

C. PDO-Level Results Indicators

21. **The contribution to increasing financial market efficiency will be measured by**

(a) increased transactions of retail electronic payments on the modernized infrastructure (measured by the growth of cards issued under National Card Scheme [NCS] in relation to total debit cards issued);

[19] For example, LankaClear (the national retail payments infrastructure company owned by the CBSL and the commercial banks in Sri Lanka), the CSE, LankaSettle (real-time gross settlement [RTGS] system), LankaSecure — the Central Securities Depository (CSD), the Scripless Securities Settlement System (SSSS) for government securities, Central Depository System (CDS)—the central securities depository, and Securities Settlement System (SSS) for corporate securities (which is a fully owned subsidiary of the CSE).

[20] EPF was established under Act No. 15 of 1958 and is currently the largest social security scheme in Sri Lanka. This is a defined contribution scheme.

(b) increased trading in the secondary government bond market (measured by the growth of secondary market trades of central government debt in value terms);

(c) increased share of private insurance companies in newly issued insurance policies (measured by the growth in insurance premiums to GDP); and

(d) increased financial soundness of MFIs (measured by establishing and complying with the regulatory minimum capital requirement [MCR] for the MFIs).

22. **The project will also track a set of additional intermediate monitoring and evaluation (M&E) indicators as part of its M&E framework outlined at the end.** Among others, these include gender disaggregated measures for the use of financial services (for example, MFI and MSME lending) and citizen engagement indicator (that is, percentage of project beneficiaries who agree that the project activities/results reflected their needs).

III. PROJECT DESCRIPTION

A. Project Components

Project Design and Rationale

23. **To help increase financial efficiency and, thereby, financial inclusion, the project will modernize financial infrastructure, upgrade the relevant legal framework, and strengthen financial sector regulators' supervisory capacity.** Through supporting financial market infrastructure and the legal and regulatory framework and strengthening the institutional capacity of regulators, the project aims to contribute to addressing some of the key financial sector constraints discussed above. Importantly, the project's results-based financing component supports the project design through a set of mid-level reforms that are critical to achieving the project objectives. As discussed above, efficiency and inclusion in financial services are critical for boosting inclusive growth, in particular by enabling investment, growth, and job creation by MSMEs. The Government's policy statements and 2016 and 2017 budgets echo this potential. The project thus focuses on assisting the GoSL with its priority financial sector reforms. Moreover, it builds a platform for possible high-level reforms of financial policy and institutions in the near future. The project aims to boost financial access for MSMEs through a market-enabling approach rather than supporting direct interventions by the GoSL such as credit lines of partial credit guarantee schemes. As reported by the 2015 FSAP, such direct interventions have been ineffective, have been weakly governed, and are introducing distortions to the proper functioning of the financial system. The project design emphasizes the need for effective coordination across implementing entities (CBSL, SEC, and IBSL) by establishing a high-level Project Steering Committee (PSC) and a ministry-level Central Project Coordination Unit (CPCU). The ongoing/planned complementary TA activities supported by the World Bank including the Financial Sector Reform and Strengthening Initiative (FIRST) trust funds are expected to further bolster the implementation arrangements and probability of achieving the project objectives (refer to the Lessons Learned and reflected in the Project Design section below for details of these TA activities).

24. **The proposed support will include the following three components:**[21]

- Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing
- Component 2: Strengthening Regulators' Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure
- Component 3: Project Implementation and Monitoring

25. Annex 2 describes the project details and identifies the links between activities, implementation entities, and the project outputs. The front-end fee will also be paid out of the project proceeds.

Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing (IDA financing US$15 million)

26. **The implementation of selected mid-level reforms through disbursement-linked indicators (DLIs) enables successful implementation of component 2 and thus, reinforces the overall positive impact of the project.** The Project components are based on the 2015 FSAP recommendations. Concrete parts of the component 2 that each DLI enables are described in annex 2, Table 2.2 under the heading 'Enabling Results'. The funds will be disbursed to the government and financial sector regulators responsible for disbursement-linked results (DLRs)—(see Annex 2, table 2.2 column 'Responsible Institutions'). Annex 1, Table 1 provides the annual disbursement targets and the expected impact of each DLI.

27. **Disbursement of funds under the component will be subject to the achievement of the following DLIs:**

(a) DLI 1: Adoption of a consolidated risk-based approach to supervision of financial institutions

(b) DLI 2: Establishment of the Financial Consumer Protection Authority across all financial services under an independent authority or an authority under CBSL

(c) DLI 3: Establish an information system for holistic management of the EPF's assets (investment) and liabilities (collections) and adopt a diversified investment strategy

(d) DLI 4: Establishment of Delivery-versus-Payment (DvP) mode of settlement for corporate securities to minimize possible risks to financial stability

(e) DLI 5: Restructuring of the National Insurance Trust Fund (NITF) by separating the underwriting and reinsurance businesses

[21] As mentioned in paragraph 15 above, the project addresses select mid-level (Component 1) and technical-level (Component 2) recommendations of the 2015 FSAP.

Component 2: Strengthening Regulators' Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure (IDA financing US$59 million)

28. **The component aims to strengthen the institutional capacity of the financial sector regulators.** This component is expected to enhance proactive enforcement of market discipline, financial soundness, business conduct, and market competition due to increased supervisory powers, a legal and regulatory framework aligned with good international practice, market data access, and data management and analytical skills of the supervisors. This component will include the implementation of several key information and communication technology systems with related cybersecurity components. It will finance goods and equipment, non-consulting as well as consulting services, and trainings and workshops. A strong regulatory and supervisory capacity is essential for maintaining the stability and efficiency of the financial system, especially relevant in the context of the progressively complex evolution of the financial sector. The component, through strengthening the regulators, also contributes to enabling them to facilitate better financial intermediation and outreach in the banking sector, capital markets, and the insurance sector.

- **Subcomponent 2a: Strengthening the capacity of CBSL for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US$31 million).** This subcomponent includes activities focused around supporting core central banking functions and developing market infrastructure. The subcomponent will support strengthening of the regulators' capacity to meet the growing complexity and evolution of financial markets. It will facilitate strengthening of the legal and regulatory framework and supervisory capacity that are in line with international best practice in the areas of microfinance, financial consumer protection, non-bank financial institutions, and bank supervision and establishing a comprehensive consolidated risk-based supervision framework. The project will further support modernizing key financial infrastructure through technology investments in hardware and software for the national payment system, the EPF information technology (IT) platform/database, settlement and clearing infrastructure for the government securities market, the foreign exchange market monitoring mechanism, treasury management system, and strengthen/replace CBSL IT system – FinNet to facilitate risk-based supervision of banks, NBFIs, and MFIs, and for Financial Intelligence Unit. Training and capacity building will be provided under most activities. The expected result is a strengthened legal, regulatory, and supervisory framework as well as supervisory expertise and powers of the CBSL including in the areas of microfinance and financial consumer protection; and modernized financial infrastructure, with a focus on payment systems, EPF investment management, and central government bond market development.

- **Subcomponent 2b: Strengthening the capacity of SEC for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US$19 million).** This subcomponent lays the foundation needed to stimulate capital market development through addressing the existing regulatory, infrastructure, and capacity gaps identified. The upgrading of the regulatory and supervisory capacities of SEC will enable it to fully meet its current and future regulatory and market development function, in line with international standards, while streamlined market infrastructure will enable better risk management and enhance supervisory capacities, thus increasing efficiency. Training and capacity building will be provided under most activities. Additionally, education and awareness building activities where relevant, will be supported. The expected result is strengthened legal, regulatory, supervisory and governance framework, including the framework for supervision of the corporate bond market, expertise in risk based supervision, and powers of the SEC. Further, modernized IT infrastructure, with a focus on the Central Counterparty (CCP) system, market surveillance system, Standardized Business Reporting Format , platform for unit trust distribution and management information systems will be established.

- **Subcomponent 2c: Strengthening the capacity of IBSL for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US$9 million).** This subcomponent aims to support IBSL to better supervise and monitor the insurance sector. Enhancing the regulatory and supervisory framework and related IT infrastructure will enable sound and prudent management and oversight of the insurer's business as well as protection of the interest of policyholders. Training and capacity building will be provided under most activities. The expected result is strengthened legal, regulatory, and supervisory frameworks as well as enhanced supervisory expertise and powers of the IBSL with a focus on developing micro-insurance, restructuring of motor third-party liability insurance, strengthening reinsurance arrangements, and modernizing the IT infrastructure to enable risk based supervision.

Component 3: Project Implementation and Monitoring (IDA financing US$812,500)

29. **This component aims to provide support to the PSC and CPCU to guide and coordinate project operations, financial management (FM), procurement, social and environmental issues, and M&E under the project.** It will include costs for project management, M&E, training, and capacity building. To coordinate the activities among the three regulators and thus assist the PSC, the MoF will house the CPCU. The three regulators have identified staff who would form the project implementation teams within each institution, and any training and capacity building with regard to project management and M&E may be coordinated by the CPCU. Periodic monitoring reports and supporting research will provide accountability of program results.

B. Project Cost and Financing

30. **The lending instrument will be an IPF with an implementation period of five years.** As discussed above, the project will finance the achievement of results through two types of financing mechanisms: (a) results-based financing—where project funds will be disbursed against achieved selected key DLIs, based on results that trigger payments against Eligible Expenditure Programs (EEPs) and (b) traditional input-based financing in the form of goods and services. Project costs will be financed by an IDA credit of US$75 million equivalent (using IDA Scale Up Facility resources). The EEPs include costs of various activities needed to meet the project objectives – these amount to US$ 35.1 million (see Annex 3 for the full estimates). The World Bank will reimburse up to US$15 million against these EEPs subject to achievement of the DLIs. The project costs and financing summary is provided in Project Cost and Financing Table 2.

31. **The annual disbursement targets and the expected impact of each DLI are presented in Annex 1, Table 1 and Annex 2, Table 2.2.** The expected timing of various interim milestones have been identified. Annex 3 also includes the DLI verification protocols and a list of what constitutes eligible expenditures for each entity. The Financing Agreement (FA) will specify the EEP of each institution along with the budget estimates. The EEPs will enable the implementing entities and the government in achieving these mid-level reforms, thus paving the way to achieve the PDO. The verification of the achievement of the DLIs and the eligible expenditures will be tracked and monitored on a regular basis by the respective implementation teams and coordinated by the CPCU. For CBSL, SEC and IBSL disbursements of the amounts allocated to each of the respective DLIs will be made to the three respective segregated accounts open for component 1 at CBSL in the name of Deputy Secretary to Treasury (DST) to reimburse these eligible expenditures, conditional on their achievement of the relevant DLI targets. Similarly, for MoNP&EA disbursements of the amounts allocated to MoNP&EA DLIs will be made to the MoF consolidated fund. Annex 3, Table 3.3 provides a summary of the DLIs, the amounts allocated to each DLI target (referred to as ‘Total value’), and the lead institution responsible for their achievement and schedule of eligible expenditures for each entity along with budget estimates and codes (Annex 3 paragraph 23).

Table 2. Project Costs and Financing Summary

Project Components	Project Cost (US$, millions)	IDA Financing (US$, millions)	% Financing
Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing	15*	15	100
Component 2: Strengthening Regulators’ Capacity, Upgrading the Legal Regulatory Framework and Modernizing Financial Market Infrastructure	59	59	100
Subcomponent 2a: Strengthening the capacity of CBSL for supervision and regulation, and modernizing relevant financial infrastructure	*31*	*31*	*100*
Subcomponent 2b: Strengthening the capacity of SEC for supervision and regulation, and modernizing relevant financial infrastructure	*19*	*19*	*100*
Subcomponent 2c: Strengthening the capacity of IBSL for supervision and regulation, and modernizing relevant financial infrastructure	*9*	*9*	*100*
Component 3: Project Implementation and Monitoring	0.8125	0.8125	100
Front-end Fee**	0.1875	0.1875	100
Total Project Cost	75	75	100

Notes: * EEPs amounting to US$ 35.1 million is tracked in respect of component 1 (See Annex 3 para 23). IDA financing will cover 42.7 percent of this amount.

**The front-end fee payable by the recipient is equal to one quarter of 1 percent (0.25 percent) of the credit amount.

32. **Retroactive financing.** Retroactive financing facility under the project may be needed for eligible expenditures under Component 2 up to a maximum of US$11.8 million under conditions specified in Annex 3.

C. Lessons Learned and Reflected in the Project Design

33. **The project incorporates lessons learned from relevant operational work on financial sector development and financial infrastructure modernization in Sri Lanka and other countries.** Sequencing of activities is key to successful implementation. In this regard, the project has emphasized on starting with setting up the legal and regulatory framework and developing supervisory capacities. The project also reflects on lessons that IT modernization should be preceded by assessment/establishment of good business processes and workflows, so as to not entrench outdated processes in the new IT architecture design, which will yield poor results. Without strong fundamentals in the institutions being updated, modern IT architecture alone cannot be expected to achieve optimal results. Supervision capacity and skills development is also critical and should be carried out throughout the project. Another lesson learned is incorporating capacity development activities to handle various procurement activities as well as simplifying FM arrangements. Furthermore, in other previous projects elsewhere, the results-based instrument, specifically the use of DLIs with predefined implementation progress and performance targets, has contributed significantly to political ownership and donor coordination.

34. **In delivering this project, drawing on lessons from other similar projects, it will be important for the World Bank to leverage its broad and deep international experience and analytical foundations during implementation support.** While coordinating with other donors, the World Bank has expertise in assisting with most of the recommendations. Examples of such areas of expertise include regulation and supervision of banking institutions and NBFIs, government and corporate bond market development, insurance, investment fund management, capital market development, legal reforms, as well as the development of financial and IT infrastructure. In addition to funding assistance, the technical oversight and knowledge transfer from the World Bank staff inherent in the project implementation will benefit the country's capacity to implement this project. The importance of implementation support and coordination across implementing entities has been particularly emphasized by the regulators.

35. **For the project implementation, other important lessons learned to ensure success are:** (a) providing early attention to the detailed technical design and procurement plans for IT equipment; (b) identifying appropriate consultant services to support project implementation on an as-needed basis; (c) establishing strong and well-staffed project implementation teams with qualified staff with fiduciary, technical, and project implementation experience; (d) defining clear implementation arrangements for key project beneficiaries; (e) identifying quantifiable financial and other results indicators upfront to monitor project performance; and (f) formulating a detailed M&E framework with quantifiable targets. All these lessons have been addressed and incorporated into the project design. Appropriate implementation staff from respective implementing institutions/consultants are expected to be identified before project effectiveness. Each regulatory authority has already appointed a dedicated procurement officer and finance officer to their respective teams for the duration of the project. A strong implementation team is an important pillar for every World Bank Group–supported project, and counterparts are committed to maintain a well-structured and well-staffed project implementation team for this project too. Implementation arrangements, indicators, and the M&E framework are prepared and reflected in the Operations Manual (OM).

36. **The project also has important links to several World Bank Group activities, both ongoing complementary TA and projects under preparation.** This project complements well the broader change process pursued by other World Bank Group activities that are planned or under way in Sri Lanka to generate synergies in achieving the development outcomes targeted by the CPF:

- **Strengthening the public debt management and government bond markets in Sri Lanka.** The World Bank Group will be supporting Sri Lanka in its intention to set up a unified debt management office, along with developing and implementing a robust medium-term Debt Management Strategy (DMS). The World Bank Group is planning to provide capacity-building support to the Debt Management Unit that is being set up, including developing and implementing a medium-term DMS and specialized training. The project activities are important to enable the smooth implementation of the DMS through developing the bond market and investor base. Developing the debt markets also requires enabling market and legal infrastructure in parallel with proper supervisory and regulatory structures to ensure market access, discipline, and competition—this is being supported through a coordinated, parallel FIRST TA.

- **Improving Sri Lanka's pension system performance, coverage, and sustainability.** The performance of pension provident funds plays a central role in Sri Lanka's pension system. This project and the trust-funded TA project in preparation address the needed improvements in investment policy, investment management, and investment infrastructure while providing a platform for the ongoing dialogue of key policy reforms on the governance and supervision of pension funds as recommended by the 2015 FSAP. This change process on the asset side of the pension system complements well other World Bank Group activities on the liabilities side of the pension system concerning issues with aging, collection of contributions, and the identification and evidence of contributors and beneficiaries.

  Strengthening the governance of SOEs. This financial sector modernization project focuses on improvements in the legal, regulatory and supervisory framework governing the operations of the banking sector including State-Owned Commercial Banks (SOCBs). It opens the possibility for a policy dialogue on broader governance reform of SOFIs. SOFIs are somewhat unique compared with SOEs operating in the real sector of the economy because of the strong emphasis on governance of risk.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

37. **A high-level Project Steering Committee (PSC), will be established for the duration of the project, to ensure inter-regulatory coordination and provide policy guidance.** The three regulators and the government have agreed on this arrangement. The PSC will (a) ensure effective coordination and communication among the Implementing Entities, the Ministry of Finance (MoF) and the Ministry of

National Policies and Economic Affairs (MoNP&EA) – the Project executing agencies; (b) provide overall policy guidance and support to the Project Implementing Entities, the MoF and the MoNP&EA in the implementation of the Project; and (c) mobilize and ensure coordination with other relevant stakeholders. The PSC will be co-chaired by the Governor of the CBSL and the Secretary to the Treasury of MoF. The respective Chairmen and Directors General of the SEC and IBSL Deputy Governor of the CBSL, and Deputy Secretary to the Treasury of MoF will be the other members.

38. **To assist the PSC in overall coordination of the Project, a ministry-level Central Project Coordination Unit (CPCU) will be formed, which will be housed at the MoF and headed by a Project Director.** The CPCU will also be responsible for (a) carrying out overall project coordination including overall financial management (FM) and reporting, (b) carrying out quality control, as well as facilitate and coordinate procurement activities, (c) monitoring and evaluating the Project's performance, and(d) managing the Project-level grievance and complaints procedures pursuant to the Operations Manual (OM).

39. **The project implementing entities (CBSL, SEC, and IBSL) will form their respective project implementation teams.** Each implementing team will be headed by a Project Director and include staff for handling fiduciary and other functions. The implementation teams will be the focal point for all project activities, including handling internal implementation, and coordination with the PSC through the CPCU. Since the implementing entities (CBSL, SEC, and IBSL) are separate legal entities, all funds for Project activities will flow through the Government (MoF), which will grant funds to the CBSL, SEC, and IBSL. Hence, there will be individual project agreements between the World Bank and the three implementing entities (see also Annex 3 on implementation arrangements and Annex 4 on implementation support).

B. Results Monitoring and Evaluation

40. **A strong M&E framework to systematically track inputs, outputs, and outcomes will be integrated into the various components of the project and documented in the OM.** The project implementation teams will establish standard formats with baseline information, data, and guidelines for data collection and report updates of M&E to the PSC and the World Bank through the CPCU. The CPCU will be responsible for monitoring and coordinating this process and may recruit third-party firms as part of the M&E activities to conduct satisfaction surveys, where relevant. The PSC will provide strategic policy guidance and oversight of the project implementation. Further details are provided in Annex 3.

41. **The project will have gender-disaggregated client satisfaction surveys as one of the project results indicators.** Such evaluations will primarily focus on MSMEs including women, and population segments that come under the EPF program, to assess improvements in service delivery due to the implementation of the project.

42. **A midterm review of the project will be carried out within two years from the effectiveness of the project.** This review will assess the project's ability to achieve the PDO as measured by the key performance indicators and progress made toward achieving the DLIs. The results will inform the implementation and supervision of the project.

C. Sustainability

43. **The project promotes sustainability of the reforms through several angles.** First, by bringing key parts of the legal framework to international standards, the project will ensure that future regulatory initiatives and reforms are consistent with global principles for sound functioning of financial markets. Moreover, the continued policy dialogue and awareness building on the need to create a sound legal basis for effective functioning of financial markets will strengthen reform sustainability and broaden the pool of financial policy stakeholders and beneficiaries. With the broadened stakeholder pool, good practice reforms will be much harder to reverse and will contribute to sustainability of reforms.

44. **Second, the project invests in upgrading and creating new financial market infrastructure that will help complete markets and create permanent links supporting financial market functioning.** Such investments are harder to reverse because of their large cost, the cost of market adaptation required, and stability risk and efficiency losses that any unwinding of the investment could cause. Once the infrastructure proves its usefulness, the momentum created by market demand for further improvements of the infrastructure will help lock away any reversal threats. This includes increasing the number of users and types of transactions that will further enhance efficiencies of the infrastructure and its sustainability.

45. **Third, the selected mid-level reforms could help stimulate a market environment for endogenous efficiency gains that will demonstrate the usefulness of pro-private-sector reforms.** The targeted mid-level reforms can make important contributions towards level the playing field across financial subsectors and strengthen the role of the private sector in driving financial market solutions and development. The reforms can also stimulate further market efficiencies through better investment management of the pension provident funds. Furthermore, they could increase confidence in the market and boost further mobilization of resources. This demonstration effect of generating self-enforcing efficiencies could create an important momentum for further reforms and ensure the sustainability of the implemented ones.

46. **Fourth, the project helps build institutional and staff capacity in regulatory institutions and better inform policy makers.** It equips institutions and their staff with the ability to explain and prove the benefits of reforms with data analysis, share the knowledge of best international practices, and build effective alliance with the private sector to jointly promote market-based development. In turn, the joint advocacy of regulators and the private sector for financial sector reforms, the implemented and ensuing ones, will make the former more sustainable.

D. Role of Partners

47. **The chosen project focus areas are coordinated among the World Bank Group and also informed by development partner coordination.** The project builds on effective coordination across various Global Practices in addition to Finance and Markets—Macroeconomics and Fiscal Management, Social Protection and Labor, and Governance—and Treasury. The World Bank Group teams also coordinate with other development partners such as the IMF and ADB as well as United States Treasury Office of Technical Assistance to streamline and improve the effectiveness of development assistance. Additional World Bank Group and FIRST trust fund resources have also been mobilized to support the Government with financing for complementary financial sector areas. Activities supported by the International Finance Corporation

(IFC) in the private sector also have complementary focus on awareness building and literacy, upgrading the skills and capacity of MSMEs to access the broader financial system. All these are broadly in line with the recommendations of the 2015 Development FSAP and the 2012 Stability FSAP.

V. KEY RISKS

A. Overall Risk Rating and Explanation of Key Risks

48. **Key risks have been identified and rated in the Systematic Operations Risk-Rating Tool (SORT) presented in the project data sheet.** The overall risk of the project is rated Substantial. While key risks are contained, several risks remain at a substantial level. However, articulation in government policy, regulator requests, IMF standby conditionalities, an ADB capital market loan, and proactive donor coordination together with the strong commitment toward the project by the client serve as mitigants. The environmental and social risks are rated Low.

49. **The substantial macroeconomic risk cannot be mitigated by the project.** The fiscal and external vulnerabilities make the macroeconomic risk substantial. The factor outside of the project that could mitigate the substantial macroeconomic risk is the IMF program in operation.[22]

50. **The substantial political and governance risk comes from a possible reversal of policy commitment and failure to implement targeted reforms.** The project directly supports the GoSL priority agendas for financial sector development, as highlighted in policy statement of the Prime Minister and further endorsed through the national budget recommendations for 2016 and 2017. Therefore, the GoSL is not anticipated to reverse its support for the objectives and activities proposed under the project. Furthermore, the proposed project is designed in close consultation with the regulators, the MoNP&EA, the MoF, and the Department of External Resources (ERD) of the MoNP&EA that show strong leadership and a promising drive for reform. The strong ownership of the reforms showed by all project counterparts serves as additional assurance. Finally, the project team proactively coordinated with other important donors such as the IMF, ADB, and United States Treasury Office of Technical Assistance to solidify broad-based advocacy and support for the reforms.

51. **The risks in sectoral strategies and policies are rated Substantial because of the still uncertain policy direction on some of the high-level financial sector issues.** The 2015 Development FSAP made several high-level policy recommendations on the strategy for the financial sector going forward. Although the GoSL has reflected a number of those in the 2016 budget, the commitment to their implementation is yet to be demonstrated. The team continues the policy dialogue on the most critical high-level policy reforms with some traction in building gradual consensus, which is a mitigating factor.

[22] The IMF program supports the Government's reform program and aims at reducing the fiscal deficit, rebuilding foreign exchange reserves, and introducing a simpler, more equitable tax system to restore macroeconomic stability and promote inclusive growth. By November 21, 2016, the IMF had disbursed the second tranche of US$162.6 million to Sri Lanka under its US$1.4 billion, three-year Extended Facility Program. The total disbursements are US$325.1 million.

52. **The institutional capacity for implementation and sustainability is also rated Substantial because the regulators' experience with donor projects varies significantly.** While the CBSL has previous experience in working with the World Bank on a lending project, this is the first such engagement for the SEC and IBSL. Therefore, they may not have sufficiently qualified/trained personnel for core project activities. Therefore, dedicated project implementation teams at each regulator with clear responsibilities and support from qualified consultants are planned to mitigate the project implementation risk. At the tactical level, the PSC will guide the project implementation across all three regulators with support from the CPCU. The PSC, in turn, will be accountable to the MoF as the financier of the project.

53. **The fiduciary risk is Substantial.** Though mitigated by the CBSL's track record of successfully completed lending projects, the SEC and IBSL have not undertaken lending projects previously and only have experience in working with the World Bank on trust-funded and other TA projects. This risk will be mitigated through the hiring and/or training of required staff to undertake the fiduciary functions. Procurement of large or similar goods and services (for example, IT equipment) will be coordinated by the CPCU based on bidding documents based on in-depth assessment from all concerned institutions.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analysis

54. **Improvements in financial infrastructure, regulatory and supervisory frameworks, and financial liberalization can positively affect the income growth on aggregate and for the bottom 40 percent earners.** The increased financial efficiency of the production of financial services and the resulting greater access to finance can help firms and individuals pursue more and greater economic opportunities. The supporting survey of literature that analyzed the direct effect of financial infrastructure, supervisory framework, and liberalization on efficiency and access to finance/inclusion is provided in Annex 5. The link from financial efficiency and inclusion to aggregate and bottom 40 percent income growth has been shown and estimated by Gould, Melecky, and Panterov (2016). Although this empirical evidence could help with conducting an economic analysis of the project, many more assumptions would have to be made to conduct a quantitative economic analysis in the specific country context for Sri Lanka. The likely quantitative imprecisions thus push one to favor a qualitative analysis presented above and supported by the Theory of Change section in Annex 5.

55. **The project benefits will be significant during the project implementation period but also extend beyond the duration of the project—indeed, most of the benefits will accrue after the project completion date while most costs will be incurred upfront.** Although some project activities could be more amenable to financial analysis, it is difficult to conduct a quantitative financial analysis for the entire project because of multifaceted links to financial market efficiency and even fiscal revenues. For instance, the project subcomponent on payments may seem more amenable to financial analysis using the conventional financial analysis supported by assumptions. However, financial benefits from decreasing Anti-Money Laundering/Combating the Financing of Terrorism risks, financial informality, and settlement risks as well as the potential of financial inclusion in payments to advance financial inclusion in other financial services (savings products, consumer credit, and agricultural insurance) could make any attempts at a quantitative financial analysis still very imprecise. The presented survey of research literature makes

a strong case for both positive economic and financial returns of the proposed project. This qualitative narrative in combination with example estimates of the financial returns from similar interventions in different country contexts could thus be most appropriate. A stylized example of the financial analysis is also presented in Annex 5.

B. Technical

56. **The rationale for the agreed technical design is strong.** The MSMEs are identified as crucial for the next phase of economic growth in Sri Lanka, contributing almost over 50 percent to GDP, yet facing huge constraints in accessing affordable finance for their investment and working capital needs. The project takes a market-enabling approach to boost access to finance for MSMEs rather than focusing on additional direct interventions that have proven ineffective so far (2015 FSAP). Only a market-wide approach can change the entrenched low-level performance of the financial sector and jump-start its competitiveness. The proposed project design addresses the challenge comprehensively by developing financial market infrastructure to address access and efficiency issues and by tackling key weaknesses in regulatory and supervisory capacity to enforce a level-playing field, financial transparency, and market discipline. Developing the debt market enables banks to move away from long-term financing of corporations and SOEs. The project addresses the operational weaknesses in capital markets by modernizing the IT framework and market infrastructure. Simultaneously, governance improvements will be instituted during the project tenure through legal reforms. Consolidated risk-based supervision will bring in financial soundness and efficiency gains. Overall, the project will support the development of the financial system in the direction that clearly benefits MSMEs that must become stronger economic actors in Sri Lanka.

C. Financial Management

57. **The proposed FM arrangements are in line with fiduciary requirements of Operations Policy (OP) 10.00.** The FM assessments have been completed and, based on the findings, the arrangements have been designed and agreed with the implementing entities. It has been agreed that separate project implementation teams will be set up in the CBSL, SEC, IBSL, and CPCU at MoF with the responsibility for overall FM arrangements under their respective components and activities. The teams will be equipped with sufficient staff, including FM staff with adequate experience and qualifications. The CBSL and MoF has some experience in handling a World Bank–financed project, although it was from some time ago. However, SEC and IBSL do not have experience in World Bank–financed operation or other donor-financed operations. Taking into consideration current capacity limitations, suitable risk mitigation measures have been agreed and included. FM risk is rated “Substantial” considering the limited exposure to donor-financed operations of the four entities. However, the risk rating will be revisited and will be reflected accordingly as the project moves into implementation. The implementing entities and the CPCU at the MoF have commenced training of relevant FM staff, and this will continue as needed.

58. **Disbursements will be report-based.** For components 2 and 3 each implementing entity (i.e. CBSL, SEC and IBSL) and the CPCU will have four Designated Accounts (DA) opened at the CBSL in the name of DST for disbursement purposes. For component 1 CBSL, SEC and IBSL will have three additional segregated accounts opened at the CBSL in the name of DST for disbursement purposes. Furthermore, under component 1 disbursements for MoNP&EA will be made to MoF consolidated fund. Interim unaudited financial reports (IUFRs) will be submitted by the Project implementation teams within 45 days of the end of the quarter. Each entity (i.e. CBSL, SEC, IBSL, CPCU, MoF [on behalf of MoNP&EA]) will submit a separate IUFR for their respective components. The Project will be subjected to an internal audit. The external audit of the Project will be carried out by the Auditor General of Sri Lanka. There will be four audit reports submitted for the three implementing entities and the CPCU. The due date for the submission of audit reports to the World Bank will be within six months of the end of the financial year. The FM arrangements for the DLI-based component are given in Annex 3. There are no overdue audit reports or ineligible expenditures under the main three implementing entities and the MoF (CPCU) of the Project.

D. Procurement

59. **The public procurement process in Sri Lanka is governed by the guidelines issued by the Department of Public Finance to supplement financial regulations and country-specific Standard Bidding Documents issued by the Institute for Construction Training and Development.** With the establishment of independent commissions, which were initiated through the 19th Amendment to the Constitution, the National Procurement Commission has been set up. The procurement function is not institutionalized yet in the public sector, and there is a lack of procurement professionals in the country. However, it is expected that with the establishment of the National Procurement Commission, the transparency and accountability of the procurement process could be addressed to a broader extent.

60. **Procurement under the project will be carried out by the three implementing entities namely, CBSL, IBSL, and SEC.** While the CBSL has experience of having implemented a World Bank-financed project, the other two entities' experience is limited to TA activities. Procurement for the project will be carried out under the 'Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits and Grants for World Bank Borrowers' (dated January 2011, revised in July 2014) (Procurement Guidelines), 'Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits and Grants by World Bank Borrowers' (dated January 2011, revised in July 2014) (Consultant Guidelines), and the provisions of the FA. The procurement will consist mainly of consultancies and procurement of IT services and goods, notably upgrade of payment systems including RTGSs, and consultancies and procurement for setting up the CCP and IT system to host the EPF asset and liability management and member information.

61. **A procurement assessment of the entities was carried out.** Although the entities have well-established procurement procedures and processes under the procurement rules of the GoSL, there is no recent experience of having implemented a project using World Bank Guidelines. Each of the implementing entities has identified dedicated procurement staff who will be trained in the use of the World Bank Guidelines. The procurement risk is rated Substantial. The proposed risk mitigating methods to counter the main risk of limited procurement capacity include having a procurement office staffed with dedicated specialists at the implementing entity level. In addition, focused procurement workshops to

deal with project-specific needs, particularly targeted at implementing entities nominated Procurement Committees, to facilitate smooth procurement decisions, contract management, and information-sharing systems, such as a project-specific website will be conducted. The implementing entities shall complete capacity building and training of relevant procurement staff satisfactory to the World Bank no later than two months after the effective date.

62. Procurement plans for component 2 (Subcomponents 2a, 2b, and 2c) for the first 18 months have been prepared by CBSL, IBSL, and SEC and will be approved by the World Bank in accordance with the applicable guidelines at the time of negotiations. Given that for the EEPs under the results-based financing component include only non–procurable operating expenditure, additional assessment is not needed for component 1.

E. Social (including Safeguards)

63. **The project will not make any direct investments to introduce any specific benefits through financial intermediation or financial services system targeted at particular communities/gender.** Nonetheless, the project benefits will be wide reaching and the project incentivizes participating regulatory authorities to

- develop the microfinance industry through the development of the regulatory and supervisory system,
- establish a financial consumer protection framework through assistance to development of the Financial Consumer Protection Authority,
- improve service delivery mechanisms in both the retail payment system and the large-value payment systems through modern infrastructure,
- improve access to the equity, corporate, and government bond markets through regulatory and infrastructure developments,
- improve the service delivery of the Employees' Provident Fund through a unified database and member information system, and
- develop a targeted micro-insurance framework to address low-value private insurance needs.

64. **These activities under the project will be delivered through the provision of modern financial infrastructure; legal, regulatory, and institutional capacity building; and TA to the regulators.** Therefore, from a social safeguards perspective, there will be no impact. Since there are no physical constructions involved, OP 4.12 (Involuntary Resettlement) is not triggered. Similarly, OP 4.10 (Indigenous Peoples) is not triggered for the Project. The above is true for both components 1 and 2 of the Project.

65. **However, there are a few risks the project could face during planning and implementation.** The risks identified are not necessarily safeguards related. Rather, the risks are related to potential discontent from the financial sector community, government officials, and political stakeholders against changes to the existing systems. Although the project aims to improve engagement with the stakeholders to ensure acceptance and buy-in, some of the potential risks identified are (a) resistance to the supported changes in the existing systems/infrastructure or adoption of new systems due to concerns about their exclusion or profit margins or the general resistance toward the use of technology and (b) reluctance from some of the government/regulatory staff to provide the necessary support for the new system to operate effectively.

66. **To mitigate these risks, the project will include the following**:

- Comprehensive training and awareness-raising activities emphasizing the benefits of the new systems jointly with the authorities and in conjunction with other World Bank Group activities through innovative means and project-specific information dissemination methods

- A robust Grievance Redress Mechanism (GRM) to receive, review, and resolve grievances from the public and stakeholders and provide timely feedback

- A Stakeholder Consultation and Engagement Strategy to coordinate and implement the project and to create stakeholder ownership of the new program. Already, the Project Steering Committee comprising all regulators, a ministry-level CPCU, and project implementation teams in each implementing regulatory authority are designed/established and represented by all three regulators and stakeholder ministries. The TA allocations as well as related other World Bank Group programs will develop a stakeholder engagement strategy and outreach activities to create buy-in and awareness among stakeholders and seek their inputs at key stages of the design and implementation of the project.

Gender Mainstreaming Strategy

67. **Although the financial sector modernization project components are not specifically designed to address gender equality, it is an important aspect to consider.** A well-defined financial sector modernization program can enhance inclusion and offer greater opportunities of financial access for women to respond to their needs and improve the social status in the household and intra-familial decision making. One of the main goals of financial sector modernization is to reduce current and future poverty and vulnerability by increasing equal opportunities to individuals and households to further household income and consumption access to resources (for example, microfinance) among other things. It is evident from international experience that such development support can also impact many other outcomes—increased employment, human development, and access to resources—and that those impacts are typically gender specific. The project will use a gender-disaggregated M&E system. The surveys and activities supported by the project will collect and maintain gender-disaggregated data to measure the inclusiveness and impact of the new microfinance regulatory framework. Another indicator will be the percentage of women beneficiaries among outstanding MSME loans.

F. Environment (including Safeguards)

68. **The project has been categorized as Category C, and no specific environmental safeguard policies are triggered as no major environmental impacts are attributed to the project interventions.** Conversely, it is expected that due to project activities, there is the possibility that e-waste will be generated through the upgrading of computer hardware under components 1–3, as old units may be replaced. Thus, as a due diligence measure to ensure that any e-waste generated is handled accordingly, the project OM includes a set of guidelines on the management of e-waste according to the national regulations, which meet the World Bank safeguard requirements.

Climate and Disaster Risk Screening

69. **The potential climate risk on the project investments will be Low.** The project is focused on strengthening three financial sector regulators' regulatory and supervisory capacity and providing financial infrastructure including the EPF data management system, electronic trading platform for government debt secondary trading, IT/surveillance systems, and RTGS to the CBSL to conduct large-value payments. All major infrastructure will be installed in the headquarters of the CBSL, SEC, and IBSL that are located in Colombo City (inside the CBSL and the World Trade Centre buildings). It has been assessed that the location of these three institutions is in the safest area within Colombo City with very low risks and impacts due to climate change and disasters based on historical data and future projections. It is to be noted that the project may positively affect MSMEs and individuals affected by a climate event by giving them access to insurance recourse more efficiently.

G. Other Safeguard Policies

70. **The citizen engagement process will comprise stakeholder consultations at each implementing entity (CBSL, SEC, and IBSL) level.** The regulators will be encouraged to launch communication and awareness campaigns to inform the public about the envisioned changes and to receive their suggestions for improvement. The stakeholders can also submit their views regarding any aspect of the new systems to project implementation teams at each implementing entity level. At a project management level, all regulators will participate in the project steering committee to review and resolve project-related issues and concerns. The project will also benefit from awareness and outreach activities planned under other World Bank financial sector projects. An engagement survey will be conducted at each implementing entity to seek feedback to ascertain whether the project delivery is to their satisfaction and was carried out in a transparent manner. The citizen engagement indicator will be the percentage of project beneficiaries who accept that project activities/services/results reflected their needs. This information could be collected as part of a survey conducted during the midterm review of the project.

H. World Bank Grievance Redress

71. **The project aims at establishing a robust grievance redress system (GRS).** Grievances and complaints that require careful attention, which have political and policy implications received by the implementing entities, will be forwarded to the project-level GRM. Project implementation teams under each implementation entity will submit such cases received by them to the CPCU. The CPCU will coordinate with the PSC on advice and action. This is very important in view of the different types of financial sector stakeholder risks that may be associated with the proposed project components and the probability of stakeholders from different financial sector groups seeking clarifications and answers for the grievances lodged by their members. Performance and effectiveness of this GRM will be measured by the percentage of grievances recorded and resolved.

72. **Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit *http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service*. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VII. RESULTS FRAMEWORK AND MONITORING

Results Framework
COUNTRY : Sri Lanka
Sri Lanka Financial Sector Modernization Project

Project Development Objectives

The Project Development Objective (PDO) is "to contribute to increasing financial market efficiency and use of financial services among micro, small and medium enterprises (MSMEs) and individuals".

The project will achieve the PDO through modernizing financial market infrastructure, upgrading the legal and regulatory framework for the financial system, and strengthening the institutional capacity of financial sector regulators (Central Bank of Sri Lanka, [CBSL]; Securities and Exchange Commission of Sri Lanka, [SEC]; and Insurance Board of Sri Lanka, [IBSL]).
On account of its comprehensive approach to creating an enabling environment for robust financial development, the project is also expected to advance financial inclusion through (a) increased financial efficiency and competition and (b) the greater reach and financial connectivity of MSMEs and individuals that the new and more inclusive financial market infrastructure shall enable.

Project Development Objective Indicators

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Name: (1) Increased transactions of retail electronic payments on the modernized infrastructure (measured by the cards issued under NCS to total debit cards in the system– target 15%)		Percentage	1.00	15.00	Annual	LankaClear/ CBSL	CBSL

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Description: All numbers are from LankaClear statistics and estimates. Cards issued under NCS projected to increase once National Card Switch (supported by this project) is enabled. This is the fourth part in common payment switch. Total number of debit cards includes cards issued by international issuers as well.							
Name: Increased participation (trading) in the secondary market Central Government bonds (measured by the growth in secondary market trades of Central Government Debt in value terms—target 5%)		Text	LKR 6591 Billion	5% increase from base line	Annual	CBSL	CBSL
Description: Baseline numbers are based on the CBSL (LankaClear) statistics. Secondary market trades of central government debt are defined as outright purchases/sales of Treasury-Bills and Treasury-Bonds as reported by primary dealers.							
Name: (3) Increased share of private insurance companies (newly issued) insurance policies (measured by the growth of insurance premiums to GDP—target 3%)		Percentage	1.05	3.00	Annual	IBSL	IBSL
Description: The baseline data is from IBSL statistics. Total insurance premiums/GDP The target is to reach the Asian average.							

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Name: Increased financial soundness of MFIs (measured by establishing and complying with the regulatory minimum capital requirement (MCR) by MFIs—target all MFIs complying with (MCR) Regulation)		Text	MCR not established	All MFIs are complying with MCR	Annual	CBSL	CBSL

Description: Baseline and targeted achievement monitored by the CBSL's newly minted Microfinance Supervision Department. MCR for deposit-taking MFIs that are licensed by the CBSL is one measure of financial soundness.

Intermediate Results Indicators

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Name: CBSL has undertaken consolidated risk-based supervision of banks on both solo and group wide basis, and performs risk assessment on a stand-alone and consolidated basis (Basel Core Principles for effe		Text	Non compliant	Compliant. CBSL produces 2 consolidated risk based supervision reports for identified financial	annual	CBSL, mid term review+ end period through FSAP	CBSL

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
				groups.			
Description: Information collected by the CBSL midterm review + end period confirmation through FSAP. Also, through DLI verification confirmed by the Chairman of FSOC. http://www.bis.org/publ/bcbs230.pdf							
Name: RTGS new system with multi-currency settlement and convertibility features and the Scripless Securities Settlement System (SSSS) with Central Depository System operational		Text	New system Not operational	New RTGS and SSSS with CDS operational .	Annual	CBSL midterm review + end period through FSAP	CBSL
Description: Information collected by the CBSL midterm review + end period confirmation through FSAP							
Name: SEC's regulatory framework and supervisory practices have a significantly high level of observance of the International Organization of Securities Commission's (IOSCO) Objectives and Principles of Se		Text	3 of 38 principles fully implemented, 13 of 38 Broadly implemented, 17 of 38 partially implemented; 6 of 38	At least 28/38 principles observed.	Annual	SEC midterm review + end period confirmation through FSAP	SEC

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
			not implemented; 1 of 38 not applicable				

Description: Information collected from IOSCO Assessment, 2016; by the SEC midterm review + end period confirmation through FSAP
The IOSCO Objectives and Principles of Securities Regulation sets out 38 principles of securities regulation, which are based upon three objectives of securities regulation. These are

- protecting investors,
- ensuring that markets are fair, efficient and transparent, and
- reducing systemic risk.

https://www.iosco.org/about/?subsection=display_committee&cmtid=19&subSection1=principles

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Name: IBSL's regulatory framework and supervisory practices have a significantly high level of observance of the International Association of Insurance Supervisors-Insurance Core Principles (IAIS-ICPs)		Text	Largely observed (6 of 26 principles; partially observed 3 of 26 principles; assessed yet not finalized 10 of 26 principles; not assessed 7 of 26	At least 12/26 principles observed and 6/26 principles partially observed.	Annual	IBSL midterm review + end period confirmation through FSAP	IBSL

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
			principles)				
Description: Information collected from IAIS peer review documents (from 2013 2016); by the IBSL midterm review + end period confirmation through FSAP There are 26 Insurance Core Principles. http://www.iaisweb.org/page/supervisory-material/insurance-core-principles//file/58067/insurance-core-principles-updated-november-2015							
Name: CBSL & LankaClear Assessment of Observance of the CPSS_IOSCO Principles for Financial Market Infrastructures completed		Text	Not assessed	All applicable PFMIs Observed or Broadly Observed by each FMI type (i.e., 18/18 observed or broadly observed or not applicable for RTGS; 21/21 observed or broadly observed or not applicable for CSD/SSS).	Annual	CBSL midterm review + end period confirmation through FSAP	CBSL

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Description: Information collected by the CBSL midterm review + end period confirmation through FSAP There are 24 PFMIs (18 applicable for RTGS; 21 applicable for CSD/SSS).							
Name: Regulatory and supervisory framework with proportionate risk-based supervision for microfinance established and operational		Text	Non-operational	Operational	Annual	CBSL midterm review + end period confirmation through FSAP	CBSL
Description: Information collected through the CBSL midterm review + end period confirmation through FSAP RBS framework established, staff trained, and actual assessment of all registered MFIs done.							
Name: Central Counter Party system established for the securities market		Text	Non operational	Pilot runs started.	Annual	SEC midterm review + end period confirmation through FSAP	SEC
Description: Information collected through the SEC midterm review + end period confirmation through FSAP							
Name: Regulatory and supervisory framework for financial consumer protection established and in use		Text	Non-existent	Regulations issued and FIs abide by FCP law. Framework	Annual	CBSL midterm review + end period confirmation through FSAP	CBSL

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
				in use.			
Description: Information collected through the CBSL midterm review + end period confirmation through FSAP Legal, regulatory, and institutional infrastructure for FCP is established and in use. [Assumption : Government decides to establish FCPA under CBSL]							
Name: Outstanding MSME Loans from commercial banks (Note: Value of total loans granted by commercial /development banks)		Text	Published disaggregated data not N/A. (total estimated around LKR 685 Billion)	Publishing of SME data Total loans granted by banks increased by 30%	Semi-annual	CBSL midterm review + end period confirmation through FSAP.	CBSL
Outstanding MSME Loans from commercial banks by females (% of total commercial bank loans)		Text	Not available/ gender disaggregation not done	Data available and published	Semi-annual	CBSL	CBSL
Description: Information to be collected through the CBSL midterm review + end period confirmation through FSAP. Other surveys can be used as well. Value of total small and medium enterprise loans granted annually by banking sector – data available through the MoF (Annual Report) (No one definition available for small and medium enterprises in Sri Lanka)							

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Baseline estimated using 2014/15 data in the MoF Annual Report							
Name: Outstanding Microfinance lending from licensed microfinance institutions		Text	None (not licensed yet)	Data available and published	Semi-annual	CBSL midterm review + end period confirmation through FSAP	CBSL
Outstanding Microfinance lending from licensed institutions to women (% of MFI loans)		Text	None (not licensed yet)	Data available and published	Semi-annual	CBSL	CBSL
Description: Information to be collected through the CBSL midterm review + end period confirmation through FSAP. Other surveys can be used as well.							
Name: Outstanding Corporate Debt (% of GDP)		Percentage	1.00	15.00	Annual	SEC	SEC
Description: Information to be collected through the SEC							
Name: Year-end stock market capitalization (% of GDP)		Percentage	27.00	50.00	Annual	SEC	SEC
Description: Information to be collected through the SEC							
Name: Change in investment		Text	90-95% in	less than	Annual	CBSL midterm review + end	CBSL

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
portfolio composition of EPF (% in government securities)			governmen t securities	89% in governmen t securities		period through FSAP	
Description: Information to be collected from the EPF department (CBSL)							
Name: Citizen engagement indicator of percentage of project beneficiaries that feel project activities/services/results reflected their needs.		Percentage	0.00	75.00		survey - midterm review and at project end	CPCU
Description: Information to be collected through a survey - midterm review and at project end							

Target Values

Project Development Objective Indicators

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
(1) Increased transactions of retail electronic payments on the modernized infrastructure (measured by the cards issued under NCS to total debit cards in the system– target 15%)	1.00	1.00		7.00		15.00	15.00
Increased participation (trading) in the secondary market Central Government bonds (measured by the growth in secondary market trades of Central Government Debt in value terms—target 5%)	LKR 6591 Billion	LKR 6,591 billion	1.7% increase from baseline value	2.0% increase from baseline value		5.0% increase from baseline value	5% increase from base line
(3) Increased share of private insurance companies (newly issued) insurance policies (measured by the growth of insurance premiums to GDP—target 3%)	1.05	1.05		1.50		3.00	3.00
Increased financial soundness of MFIs (measured by establishing and complying with the regulatory minimum capital requirement (MCR) by MFIs—target all MFIs complying with (MCR) Regulation)	MCR not established	MCR not established		MCR Regulation established and monitored		All MFIs are complying with MCR	All MFIs are complying with MCR

Intermediate Results Indicators

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
CBSL has undertaken consolidated risk-based supervision of banks on both solo and group wide basis, and performs risk assessment on a stand-alone and consolidated basis (Basel Core Principles for effe	Non compliant	non-compliant		Partially compliant framework established. The CBSL produces at least one consolidated supervision report for identified financial groups.		Compliant. The CBSL produces two consolidated supervision reports for identified financial groups	Compliant. CBSL produces 2 consolidated risk based supervision reports for identified financial groups.
RTGS new system with multi-currency settlement and convertibility features and the Scripless Securities Settlement System (SSSS) with Central Depository System operational	New system Not operational	New system not operational		Partially operational in pilot stage		New RTGS and SSSS with CDS operational	New RTGS and SSSS with CDS operational.
SEC's regulatory framework and supervisory practices have a significantly high level of observance of the International Organization of Securities Commission's (IOSCO) Objectives and Principles of Se	3 of 38 principles fully implemented, 13 of 38 Broadly implemented, 17 of 38 partially implemented; 6 of 38 not	3 of 38 principles fully implemented, 13 of 38 Broadly implemented, 17 of 38 partially implemented; 6 of 38 not implemented;		SEC Law amendment enacted. Regulations in compliance with IOSCO principles		At least 28 of 38 principles observed	At least 28/38 principles observed.

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
	implemented; 1 of 38 not applicable	1 of 38 not applicable.					
IBSL's regulatory framework and supervisory practices have a significantly high level of observance of the International Association of Insurance Supervisors- Insurance Core Principles (IAIS-ICPs)	Largely observed (6 of 26 principles; partially observed 3 of 26 principles; assessed yet not finalized 10 of 26 principles; not assessed 7 of 26 principles)	Largely observed (6 of 26 principles; partially observed 3 of 26 principles; assessed yet not finalized 10 of 26 principles; not assessed 7 of 26 principles)		Insurance Law amendments enacted. Regulations in compliance with International Association of Insurance Supervisors – Insurance Core Principles.		At least 12 of 26 principles observed and 6 of 26 principles partially observed	At least 12/26 principles observed and 6/26 principles partially observed.
CBSL & LankaClear Assessment of Observance of the CPSS_IOSCO Principles for Financial Market Infrastructures completed	Not assessed	not assessed		Guided Self-assessment completed		All applicable PFMIs observed or broadly observed by each FMI type (that is, 18 of 18 observed or broadly observed or not applicable for RTGS; 21 of 21 observed or broadly observed or not applicable	All applicable PFMIs Observed or Broadly Observed by each FMI type (i.e., 18/18 observed or broadly observed or not applicable for RTGS; 21/21 observed or broadly observed or

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
						for CSD/SSS)	not applicable for CSD/SSS).
Regulatory and supervisory framework with proportionate risk-based supervision for microfinance established and operational	Non-operational	not operational	law passed, department established - not fully operational	Partially operational - Regulatory framework established		Operational	Operational
Central Counter Party system established for the securities market	Non operational	non-operational		partially operational		Pilot runs started	Pilot runs started.
Regulatory and supervisory framework for financial consumer protection established and in use	Non-existent	non-existent		Law on FCP drafted/FCP authority established		Regulations issued and financial institutions abide by FCP law Framework in use	Regulations issued and FIs abide by FCP law. Framework in use.
Outstanding MSME Loans from commercial banks (Note: Value of total loans granted by commercial /development banks)	Published disaggregated data not N/A. (total estimated around LKR 685 Billion)	disaggregated data not available		Data collection on SME sector commenced. SME definition established		Publishing of small and medium enterprise data Total loans granted by banks increased by 30%	Publishing of SME data Total loans granted by banks increased by 30%

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
Outstanding Microfinance lending from licensed microfinance institutions	None (not licensed yet)	none - not licensed yet		data collected		data available and published	Data available and published
Outstanding Corporate Debt (% of GDP)	1.00	1.00		5.00		15.00	15.00
Year-end stock market capitalization (% of GDP)	27.00	27.00		35.00		50.00	50.00
Change in investment portfolio composition of EPF (% in government securities)	90-95% in government securities	90-95 in government securities		maximum of 92 in government securities		less than 89 in government securities	less than 89% in government securities
Citizen engagement indicator of percentage of project beneficiaries that feel project activities/services/results reflected their needs.	0.00	0.00		50.00		75.00	75.00
Outstanding MSME Loans from commercial banks by females (% of total commercial bank loans)	Not available/ gender disaggregation not done	gender disaggregation not done hence data not available		data collection started		data available and published	Data available and published
Outstanding Microfinance lending from licensed institutions to women (% of MFI loans)	None (not licensed yet)	non - MFIs not licensed yet		data collected		data available and published	Data available and published

ANNEX 1: Disbursement Linked Indicators and Disbursement Linked Results

COUNTRY : Sri Lanka
Sri Lanka Financial Sector Modernization Project

Table 1. Disbursement Linked Indicators and Disbursement Linked Results

Disbursement Linked Indicators	Responsible Institutions	Total Amount for DLI	DLR for Year 1 (Date of the Financing Agreement –December 2017)	DLR for Year 2 (January–December 2018)	DLR for Year 3 (January–December 2019)	DLR for Year 4 (January–December 2020	DLR for Year 5 (January 2021–Closing Date)
1: CBSL - Implement Consolidated, Risk-Based Supervision of the Financial System **Enabling Result: Implementation of investment and TA on risk-based and consolidated supervision**							
DLI 1: Adoption of a consolidated risk-based approach to supervision of financial institutions	DLR 1.1–1.3: CBSL DLR 1.1 and 1.2: SEC DLR 1.1 and 1.2: IBSL	US$4 million	DLR 1.1: The FSOC agrees through the MoU that CBSL will be the lead consolidated supervisor	DLR 1.2: Implementation of the MoU evidenced by a minimum of four (4) meetings (from four (4) quarterly sessions in one (1) year) of the FSOC, confirmed by the Chairman of FSOC	DLR 1.3: Based on the MoU, CBSL produces two (2) consolidated risk based supervision reports for identified financial groups for FSOC meeting, confirmed by the Chairman of FSOC	—	—

Disbursement Linked Indicators	Responsible Institutions	Total Amount for DLI	DLR for Year 1 (Date of the Financing Agreement –December 2017)	DLR for Year 2 (January–December 2018)	DLR for Year 3 (January–December 2019)	DLR for Year 4 (January–December 2020	DLR for Year 5 (January 2021–Closing Date)
DLR 1: DLR Allocations by Institutions	—	—	(CBSL - US$0.5 million SEC – US$0.25 million IBSL – US$0.25 million)	Maximum (CBSL – US$0.5 million SEC – US$0.25 million IBSL – US$0.25 million) Based on the following rule: (4 quarterly meetings held in the year – 100%; 3 quarterly meetings held in the year – 75%; 2 quarterly meetings held in the year – 50%; and 1 quarterly meeting held in the year – 25%)	Maximum (CBSL - US$2 million) Based on the following rule: (2 consolidated risk based supervision reports are produced – 100% and 1 consolidated risk based supervision report is produced – 50%)	—	—

Disbursement Linked Indicators	**Responsible Institutions**	**Total Amount for DLI**	**DLR for Year 1 (Date of the Financing Agreement –December 2017)**	**DLR for Year 2 (January–December 2018)**	**DLR for Year 3 (January–December 2019)**	**DLR for Year 4 (January–December 2020**	**DLR for Year 5 (January 2021–Closing Date)**
2: MoNP&EA/CBSL - Establish institutional and regulatory framework for Financial Consumer Protection Enabling Result: Implementation of legal and regulatory framework for FCP and development of institutional capacity for FCP across all financial services							
DLI 2: Establishment of the Financial Consumer Protection Authority across all financial services under an independent authority or an authority under the CBSL	DLR 2.1: MoNP&EA DLR 2.2: CBSL	US$3 million	DLR 2.1: MoF or MoNP&EA submits a cabinet memorandum requesting approval to establish an independent authority or authority under the CBSL to conduct FCP for all financial services, and such request is approved by the cabinet	DLR 2.2: If the decision of the cabinet is to establish FCPA under CBSL, CBSL Monetary Board issues decision to establish FCP department within CBSL*	—	—	—
DLR 2: DLR Allocations by Institutions	—	—	(MoNP&EA ** - US$2 million)	(CBSL - US$1 million)	—	—	—

Disbursement Linked Indicators	Responsible Institutions	Total Amount for DLI	DLR for Year 1 (Date of the Financing Agreement –December 2017)	DLR for Year 2 (January–December 2018)	DLR for Year 3 (January–December 2019)	DLR for Year 4 (January–December 2020	DLR for Year 5 (January 2021–Closing Date)
3: CBSL - Improve the investment management and performance of EPF Enabling Result: Modernization of investment management systems and TA on investment management strategy							
DLI 3: Establish an information system for holistic management of EPF's assets (investment) and liabilities (collections) and adopt a diversified investment strategy	DLR 3.1: MoNP&EA DLR 3.2: CBSL	US$3 million	—	DLR 3.1: MoNP&EA, in consultation with the Ministry of Labour, submits cabinet memorandum, requesting approval to bring the management of EPF's collections (liabilities) and investments (assets) into common information management system under CBSL, and such a request is approved by the cabinet	DLR 3.2: CBSL Monetary Board issues decision to adopt a diversified investment strategy to reach adequate replacement income for retirees	—	—
DLR 3: DLR Allocations by Institutions	—	—	—	(MoNP&EA** - US$2 million)	(CBSL - US$1 million)	—	—

Disbursement Linked Indicators	Responsible Institutions	Total Amount for DLI	DLR for Year 1 (Date of the Financing Agreement –December 2017)	DLR for Year 2 (January–December 2018)	DLR for Year 3 (January–December 2019)	DLR for Year 4 (January–December 2020	DLR for Year 5 (January 2021–Closing Date)
4: SEC - Eliminate threats to financial stability in securities settlement Enabling Result: Reinforces the effects of investment and TA on capital market development and financial market efficiency							
DLI 4: Establishment of DvP mode of settlement for corporate securities to minimize possible risks to financial stability	DLR 4.1: SEC DLR 4.2: SEC DLR 4.3: SEC	US$1.5 million	DLR 4.1: SEC & CSE adopt rules and regulations necessary to enable the settlement of the corporate equity segment on DvP basis	DLR 4.2: Successful CSE Business Continuity Planning test involving the DvP arrangement completed	DLR 4.3: SEC undertakes on-site or off-site inspection/ audits one year after enabling DvP to ensure DvP is happening	—	—
DLR 4: DLR Allocations by Institutions	—	—	(SEC - US$0.5 million)	(SEC - US$0.5 million)	(SEC - US$0.5 million)	—	—

Disbursement Linked Indicators	Responsible Institutions	Total Amount for DLI	DLR for Year 1 (Date of the Financing Agreement –December 2017)	DLR for Year 2 (January–December 2018)	DLR for Year 3 (January–December 2019)	DLR for Year 4 (January–December 2020	DLR for Year 5 (January 2021–Closing Date)
5: IBSL – Increased competition in insurance market Enabling Result: Reinforces the positive effects of investments and capacity-building activities in the insurance sector to enable private insurance market and competition for greater efficiency and inclusion							
DLI 5: Restructuring of the NITF by separating the underwriting and reinsurance businesses	DLR 5.1: NITF*** DLR 5.2: IBSL DLR 5.3: MoNP&EA	US$3.5 million	DLR 5.1: NITF Board issues decision to restructure NITF by separating the underwriting and reinsurance businesses DLR 5.2: IBSL issues no objection to the separation	DLR 5.3: MoNP&EA submits cabinet memorandum, requesting to approve the proposed restructuring of NITF, and such a request is approved by the cabinet	—	—	—
DLR 5: DLR Allocations by Institutions	—	—	(MoNP&EA** - US$1 million) (IBSL - US$0.5 million)	(MoNP&EA** - US$2 million)	—	—	—

Note: * In the event CBSL is not the FCPA, the funds allocated to DLR 2.2 will be reallocated in consultation between the Association and the Recipient. ** Funds disbursed in respect of DLRs 2.1, 3.1, 5.1 and 5.3 are to be transferred to consolidated fund under the MoF; *** NITF is a fully owned state enterprise under the MoNP&EA. Funds disbursed to all other DLRs related to CBSL, SEC and IBSL will be transferred to three segregated accounts opened at CBSL, under the name of DST, for component 1.

ANNEX 2: DETAILED PROJECT DESCRIPTION

1. The proposed project will have three components (and will finance the front end fee), and the costing details are presented in table 2.1 below:

Table 2.1. Costs by Component

Project Components	Project Cost, US$, millions
Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing	15
Component 2: Strengthening Regulators' Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure	
Subcomponent 2a: Strengthening the capacity of CBSL for supervision and regulation, and modernizing relevant financial infrastructure	31
Subcomponent 2b: Strengthening the capacity of SEC for supervision and regulation, and modernizing relevant financial infrastructure	19
Subcomponent 2c: Strengthening the capacity of IBSL for supervision and regulation, and modernizing relevant financial infrastructure	9
Component 3: Project Implementation and Monitoring	0.8125
Front-end Fee	0.1875
Total Project Cost	**75**

2. The following sections describe in detail the components and subcomponents of the project.

Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing (IDA financing US$15 million)

3. The implementation of selected mid-level reforms through DLIs in component 1 enables corresponding input based financing component (component 2) and reinforces the overall positive impact of the project. The project components, are based on the 2015 FSAP recommendations. The part of the component 2 that each DLI enables is described in table 2.2 under the heading 'Enabling Results'. The DLI actions have been discussed with the GoSL and financial sector regulators during the policy dialogue following the dissemination of the 2015 FSAP report. The GoSL and financial sector regulators are fully supportive of the DLIs. The funding will be disbursed to the government and financial sector regulators responsible for DLRs—the CBSL, IBSL, and SEC (see Table 2.2 column 'Responsible Institutions').

4. The individual DLIs and result-based financing are summarized in Table 2.2. Annex 1, Table 1 includes the annual disbursement targets and the expected impact of each DLI. Each DLI has time-bound disbursement-linked targets, which, from a disbursement perspective, are independent of each other. Noncompliance with a DLI target in a period means that the disbursement of funds associated with that DLI target will be withheld until the target is met; yet, it does not affect disbursement against targets of other DLIs. The timelines for all DLRs are indicative, and all DLRs can be achieved before the project closing date to be eligible for disbursement. The borrower can request disbursement against the achievement of

the DLI at the end of each year after its achievement has been formally verified by the World Bank where necessary (See Annex 1, Table 1 and Annex 2, Table 2.2).

5. Eligible actions and activities will be tracked and monitored on an annual basis by the designated staff of the CBSL, SEC, and IBSL serving in the implementation teams and in case of DLIs 1.3 and 4.3, verified by FSOC (Chairman) and a relevant third party respectively. This process will be coordinated through the CPCU. Disbursements of the amounts allocated to each DLI will be made annually to the responsible institutions conditional on their achievement of the relevant DLI targets. Table 2.2 provides an overall summary of the five enabling DLIs with relevant DLI targets to be met, the rationale for DLIs, the responsible institutions for their implementation, the amounts allocated to each DLI target (column 'Amount'), and the DLRs (the last column). Note that DLRs 1.2 and 1.3 are scalable. Other DLRs are non-scalable. The scalability formula is given in Annex 1, Table 1 under DLRs 1.2 and 1.3.

Table 2.2. Supporting Selected Mid-Level Reforms through Results-Based Financing

DLIs for Selected Mid-Level Reforms	Responsible Institutions	Amount (US$, millions)	Disbursement–Linked Results (DLRs)
1: CBSL - Implement Consolidated, Risk-Based Supervision of the Financial System **Enabling Result: Implementation of investment and TA on risk-based and consolidated supervision**			
DLI 1: Adoption of a consolidated risk-based approach to supervision of financial institutions Rationale: Consolidated supervision under the CBSL's purview per Basel Committee on Banking Supervision Core Principles. Banking Core Principle (#12) suggests that for better systemic risk management as well as crisis preparedness and resolution, the banking supervisor should supervise the financial groups on a consolidated basis.	DLRs 1.1–1.3: CBSL; DLRs 1.1 and 1.2: SEC; DLRs 1.1 and 1.2: IBSL;	4	1.1 The FSOC agrees through MoU that CBSL will be the lead consolidated supervisor (US$1 million) 1.2 Implementation of the MoU evidenced by a minimum of four (4) meetings (from four (4) quarterly sessions in one (1) year, confirmed by the Chairman of FSOC (US$1 million) 1.3 Based on the MoU, CBSL produces two (2) consolidated risk based supervision reports for identified financial groups for FSOC meeting confirmed by the Chairman of FSOC (US$2 million)

DLIs for Selected Mid-Level Reforms	Responsible Institutions	Amount (US$, millions)	Disbursement–Linked Results (DLRs)
2: MoNP&EA/CBSL - Establish Institutional and Regulatory Framework for Financial Consumer Protection **Enabling Result: Implementation of legal and regulatory framework for FCP and development of institutional capacity for FCP across all financial services**			
DLI 2: Establishment of the Financial Consumer Protection Authority across all financial services under an independent authority or an authority under the CBSL Rationale: A comprehensive legal and regulatory framework for FCP should be developed with clear rules that apply across all providers of financial services. Institutional arrangements should be set up that ensure thorough, objective, timely, and fair implementation and enforcement of such rules. The challenges are that setting up a new, separate entity requires significant investment of time and resources. It should be noted that this will not affect the protection of the interest of investors objective of the SEC.	DLR 2.1: MoNP&EA DLR 2.2: CBSL	3	2.1 MoF or MoNP&EA submits a cabinet memorandum requesting approval to establish an independent authority or authority under the CBSL to conduct FCP for all financial services, and such request is approved by the cabinet (US$2 million) 2.2 If the decision of the cabinet is to establish FCPA under CBSL, CBSL Monetary Board issues decision to establish FCP department within CBSL* (US$1 million)
3: CBSL - Improve the investment management and performance of EPF **Enabling Result: Modernization of investment management systems and TA on investment management strategy**			
DLI 3: Establish an information system for holistic management of EPF's assets (investment) and liabilities (collections) and adopt a diversified investment strategy (These actions will not affect the current responsibilities of the Ministry of Labor, but will facilitate comprehensive/efficient access to information and better diversification of assets.) Rationale: These actions will facilitate comprehensive/efficient access to information and better diversification of assets to ensure adequate replacement income for the members.	DLR 3.1: MoNP&EA DLR 3.2: CBSL	3	3.1 MoNP&EA submits cabinet memorandum, requesting approval to bring the management of EPF's collections (liabilities) and investments (assets) into common information management system under CBSL, and such a request is approved by the cabinet (US$2 million) 3.2 CBSL Monetary Board issues decision to adopt a diversified investment strategy to reach adequate replacement income for retirees (US$1 million)

DLIs for Selected Mid-Level Reforms	Responsible Institutions	Amount (US$, millions)	Disbursement–Linked Results (DLRs)
4: SEC - Eliminate threats to financial stability in securities settlement **Enabling Result: Reinforces the effects of investment and TA on capital market development and financial market efficiency**			
DLI 4: Establishment of DvP mode of settlement for corporate securities to minimize possible risks to financial stability Rationale: To mitigate credit (principal) risk, the DvP mode of settlement should be implemented on a priority basis in the corporate equity segment. In the existing scheme, securities are netted and settled on T+0, while the net funds position is settled on T+3. Participants and the CDS are exposed to credit, liquidity, and settlement risks, which in extreme circumstances can lead to systemic risk.	DLRs 4.1–4.3: SEC	1.5	4.1 SEC & CSE adopt rules and regulations necessary to enable the settlement of the corporate equity segment on DvP basis (US$0.5 million) 4.2 Successful CSE Business Continuity Planning test involving the DvP arrangement completed (US$0.5 million) 4.3 SEC undertakes on-site or off-site inspection/audit one year after enabling DvP to ensure DvP is happening (US$0.5 million)
5: IBSL - Increased competition in insurance market **Enabling Result: Reinforces the positive effects of investments and capacity-building activities in the insurance sector to enable private insurance market and competition for greater efficiency and inclusion**			
DLI 5: Restructuring of the NITF by separating the underwriting and reinsurance businesses	DLR 5.1: NITF DLR 5.2: IBSL DLR 5.3: MoNP&EA	3.5	5.1 NITF Board issues decision to restructure NITF by separating the underwriting and reinsurance businesses (US$1 million) 5.2 IBSL issues no objection to the separation (US$0.5 million) 5.3 MoNP&EA submits cabinet memorandum, requesting to approve the proposed restructuring of NITF, and such a request is approved by the cabinet (US$2 million)

*Note: *In the event CBSL is not the FCPA, the funds allocated to DLR 2.2 will be reallocated in consultation between the Association and the Recipient.*

Component 2: Strengthening Regulators' Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure (IDA financing US$59 million)

6. The project will also finance selected investments (IT and other goods and non-consulting services) and consultancy services (TA) through the traditional input-based financing mechanism. The input-based component is spread over three subcomponents: (a) Subcomponent 2a: Strengthening the capacity of CBSL for supervision and regulation, and modernizing relevant financial infrastructure (US$31 million); (b) Subcomponent 2b: Strengthening the capacity of SEC for supervision and regulation, and modernizing relevant financial infrastructure (US$19 million); and (c) Subcomponent 2c: Strengthening the capacity of IBSL for supervision and regulation, and modernizing relevant financial infrastructure (US$9 million);

7. The goods and services procured under the various components have been selected to be financed under this modality (rather than through the DLI mechanism) because they (a) are considered significant and critical investments required for meeting the PDO and (b) require specialized TA for the procurement process and/or international tenders. As a result, procurement capacity-building support will be provided to assist the Government in implementing these activities and also build the medium-term capacity to procure such goods and consultancy services.

Subcomponent 2a: Strengthening the capacity of CBSL for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US$31 million)

8. The proposed regulatory and supervisory capacity enhancements will focus on strengthening risk-based supervision (RBS) framework for banks and NBFIs, establishing consolidated supervision, developing a regulatory and institutional framework for microfinance, establishing a financial consumer protection framework, and strengthening and consolidating the legal and regulatory frameworks to be in line with international standards.

9. The project will also support the EPF that is managed by the CBSL by establishing an Enterprise Resource Planning IT solution, a standardized platform for assets and liability management, and a single database and clean data set of the EPF members. Streamlining the investment management of the EPF will secure adequate replacement income for members and deepen local capital markets while more efficient data management will be beneficial for the members as well as management.

10. Assistance for financial market infrastructure (FMI) will include upgrading or replacement of the large-value payment system and related infrastructure (RTGS) with enhanced functionalities such as multicurrency support and convertibility, participant monitoring system; revamping of Scripless Securities Settlement System and Central Depository System; fulfilling hardware and networking requirements to implement BCP (data center); providing consultation services for the National Payment Council; establishing a supervisory guidance and cyber-resilient framework for FMIs; establishing a guided self-assessment of the RTGS system; assistance for migration to International Organization for Standardization messaging standard 20022 for payment systems; establishing a domestic market foreign exchange monitoring mechanism; Treasury management system; and strengthening of CBSL IT infrastructure (upgrade/replace FinNet to facilitate risk-based supervision of banks, NBFIs, and MFIs, and for Financial Intelligence Unit). These improvements will facilitate a safe and efficient operation of financial market infrastructures, which is essential to maintain and promote financial stability and economic growth. The

support will also include assistance (hardware/software and consultancy support for implementation) to set up a Common Card and Payment Switch that is part of the Monetary Board–approved National Payment Switch.

11. There is no clear strategy for comprehensive market reforms targeting the primary market (including issuance policy), secondary markets, and market infrastructure for the bond markets. The proposed assistance to the CBSL in developing the government bond market will focus on procurement of the CCP system to facilitate the government bond market electronic transactions and related activities.[23] These measures will result in reduced fragmentation, improved price formation, improved transparency and predictability in the primary market, enhanced secondary market liquidity, and a more diversified investor base.

Subcomponent 2b: Strengthening the capacity of SEC for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US$19 million)

12. The project will support the strengthening of the risk-based regulatory and supervisory capacity of the SEC by the implementation of a risk-based supervision and risk-based capital structure for market intermediaries; training and capacity building of SEC to implement the RBS approach; and developing the legal, regulatory, and operational framework for market intermediaries to be in line with IOSCO principles.

13. Support to improve market infrastructure will include the establishment of an online market surveillance system, IT infrastructure, and online reporting system to streamline regulatory filing, enabling Standardized Business Reporting Format, and establishing a CCP, a common back office system, and an IT platform for unit trusts.

14. The project will also support developing the corporate bond market. The corporate bond market remains underdeveloped mainly due to the lack of appetite by corporate entities that are able to raise (mainly short-term) funds from banks at prime interest rates. Without an alternate avenue of long-term financing from the NBFI sector and capital markets, the corporate sector is vulnerable to potential risks including financing, maturity mismatch, and interest rate risks. These impediments also affect the capacity to manage some of the fiscal challenges associated with the government fiscal deficits and the contingent liabilities arising from an aging population, natural hazards, and the economic vulnerability of the poor. The proposed activities will focus on strengthening issuance regulations, procedures, and supervision framework for the corporate bond market; analysis of supply issues, including assessment and mapping of current and potential issuers such as SOEs and subnationals; analysis of types of instruments with maturities and recommendations to address regulatory/tax bottlenecks; and specific analysis of SOE governance standards as well as demand-side investor base analysis. Further, a comprehensive diagnostic and action plan for secondary market architecture (corporate bonds)/enabling an over-the-counter platform, a mechanism for price dissemination and valuation as well as measures to improve the secondary market, and market development workshops/trainings will also be facilitated.

[23] Central government bond market development activities (enabling an institutional framework for market development; analysis of supply issues in the primary market; design and implementation support for issuance policy and liability management, analysis of auction data for transparency and better price formation; analysis of demand issues related to investor base and preparation of an action plan to address these issues; and secondary market operations and market liquidity) will be supported by a FIRST trust-funded programmatic project under preparation.

Subcomponent 2c: Strengthening the capacity of IBSL for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US$9 million)

15. Institutional capacity building will include activities such as strengthening risk-based regulatory and supervisory capacity of the IBSL that will facilitate the complete migration of the IBSL to an RBS framework; strengthening the corporate governance practices of the entire industry; setting up of an early warning system and introducing Enterprise Risk Management; development of a dedicated micro-insurance regulatory and supervisory framework; review/restructuring of existing distribution systems, commission structures, and related regulations; updating of mortality and morbidity tables; and setting standards for the use of reinsurance and other forms of risk transfer.

16. Another area of support includes strengthening the compulsory motor third-party liability insurance; legal framework and review of market practices to identify improvements in data collection and premium and reserve calculation, as well as identifying the potential for the establishment of an Insurance Information and Monitoring Center. Assistance to review the National Reinsurance Policy is also proposed, including evaluation of reinsurance arrangements filed by insurance companies (program, adequacy, retention, and so on), fronting transactions and coinsurance transactions, and so on.

17. With regard to strengthening infrastructure, the project proposes to support developing and implementing an IT strategy including cybersecurity infrastructure and an online information reporting mechanism to facilitate better RBS that includes diagnostic tools and a risk scoring system. This will also facilitate information sharing with other regulators for consolidated supervision.

Component 3: Project Implementation and Monitoring (IDA financing US$812,500)

18. This component will provide support to the project implementing entities in management and coordination, technical operation, financial management, procurement, social and environmental safeguards, and M&E. The implementation of this component will be coordinated by the CPCU. It will include costs for project management, M&E, capacity building etc. All three regulators have identified senior officials to lead their respective implementation teams with adequately qualified staff members assigned. If required, the said implementation teams as well as the CPCU will engage/train additional staff, including recruitment of consultants to manage and monitor project activities.

Front-end Fee: (IDA financing US$187,500)

19. The front-end fee payable by the recipient shall be equal to one quarter of 1 percent (0.25 percent) of the credit amount.

ANNEX 3: IMPLEMENTATION ARRANGEMENTS

COUNTRY : Sri Lanka
Sri Lanka Financial Sector Modernization Project

Project Institutional and Implementation Arrangements

1. The project implementation support arrangements reflect the multiple implementing entities, project components, and the arrangements that are/will be in place to address implementation issues and risks that are identified in the SORT. The implementation strategy will be revisited and may be adjusted for efficiency during implementation. The institutional responsibilities and arrangements for project implementation will be as follows:

2. **Project Steering Committee (PSC). A high level Project Steering Committee (PSC) will be established to ensure inter-regulatory coordination and provide policy guidance during the project implementation.** The three regulators and government have agreed on this arrangement. The PSC will be co-chaired by the Governor of the CBSL and the Secretary to the Treasury of MoF. The respective Chairmen and Directors General of the SEC and IBSL Deputy Governor of the CBSL, and Deputy Secretary to the Treasury of MoF will be the other members. The PSC will meet quarterly or at other times, as may be necessary, to discharge the following functions:

(a) Provide overall policy guidance and support to the three regulators, MoF, and MoNP&EA in the implementation of the project

(b) Mobilize and ensure coordination with other relevant stakeholders

(c) Approve the OM and any rules and regulations related to project implementation

(d) Review the physical/financial progress of the project in coordination with the CPCU and project implementation teams

(e) Provide guidance to solve implementation problems and grievances

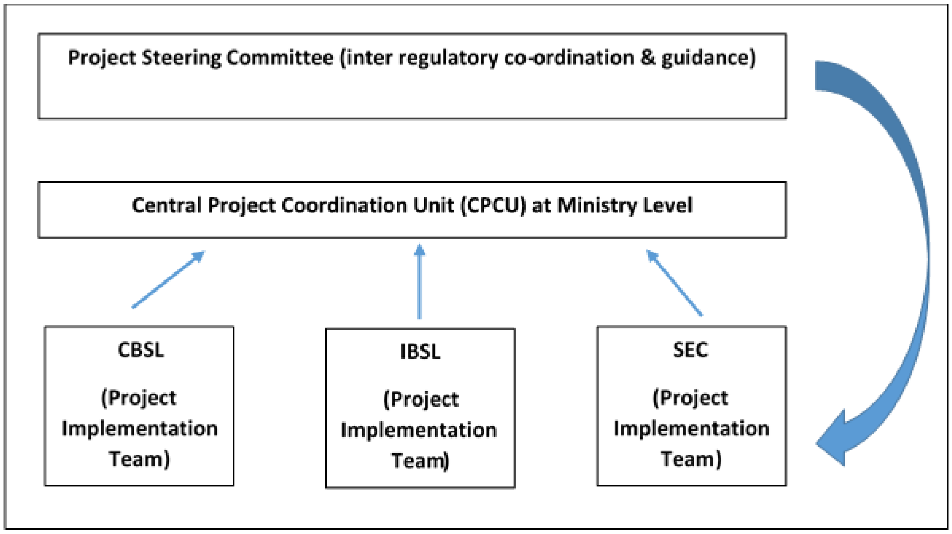
(f) Provide any other guidance deemed necessary for project effectiveness

3. **Ministry-level CPCU.** The MoF will house a CPCU. The role of the CPCU will be to coordinate and monitor project activities in close collaboration with the implementing entities. The CPCU will be led by a CPCU Project Director and will be adequately staffed. Guidelines of the Management Services Circular No. 1/2016 will determine the formation of the unit, its members' ranks, and so on. The CPCU will also ensure that project implementation follows both the Government and Association rules and regulations. The CPCU will be responsible for facilitating and coordination of procurements, all M&E activities, project

reporting, and managing the project-level grievance and complaints procedures. To facilitate efficient procurement functioning of the project, focused procurement workshops (particularly targeted at implementing entities' nominated Procurement Committees) will be conducted. The CPCU will also be responsible for M&E of the project in coordination with the three regulators, for which targeted training will be provided as well. Annual reports, midyear reviews, and DLI-related audits will be produced by the CPCU and presented to the World Bank and PSC for their information. Further, the CPCU will manage the grievance and complaints procedure and coordinate with the PSC on advice and action.

4. **Project implementation teams.** The three regulators—the CBSL, IBSL, and SEC—will be the implementing entities for the project. Each implementing entity has set up a project implementation team, led by a Project Director, including fiduciary and other staff who will be responsible for the implementation of the activities under their respective project components and the DLIs where required. Since the implementing entities are separate legal entities, all funds for project activities will flow through the Government (MoF) who will grant funds to the CBSL, SEC, and IBSL. Hence, there will be individual project agreements between the World Bank and the three implementing entities.

Figure 3.1. Project Implementation Arrangement



Financial Management

5. FM responsibility will rest with each of the project implementation teams established under the CBSL, SEC, IBSL, and the CPCU at the MoF for the respective components that each of the entities will handle. FM responsibilities include: (a) ensuring compliance with all financial covenants in the project legal agreements; (b) obtaining funds from the IDA Scale Up Facility Credit and managing such funds in an efficient, effective, and transparent manner; (c) furnishing financial reports and project audit reports to IDA; and (d) carrying out overall management of payments and accounting functions of the project and any other requests relating to FM made by the World Bank's task team.

6. IDA credit proceeds will be used to finance eligible expenditures that are necessary to meet the development objectives of the project with due attention to considerations of economy and efficiency in accordance with the provisions of the FA. If the World Bank determines that the credit has been used to

finance ineligible expenditures, the amounts used for such expenditures shall be refunded to the World Bank by the Government. All fund transfers would be between bank accounts and no cash transfers would take place.

7. **FM staffing.** In each of the project implementation teams at the CBSL, SEC, IBSL, and CPCU, the FM unit will be headed by a qualified and experienced accountant who would preferably have prior experience in FM under World Bank or donor-financed projects. The accountants, who will be full-time staff at each entity, will provide guidance and direction to ensure that the FM arrangements are implemented to the satisfaction of the Government and the World Bank. FM support staff, assigned or recruited for the project by the team, will work under the accountant to support the management of routine accounting and the project's FM activities. The accountants in the project implementation teams will be responsible for managing day-to-day FM activities, including project budgeting, disbursement planning and forecasting, operation of the designated account (DA), including claiming replenishments, disbursement of project funds, making project payments, maintaining books and records for project financial transactions, submission of quarterly IUFRs, preparation of annual project financial statements, and interacting with project internal and external auditors on audit issues and follow-up.

8. FM staff in the project implementation teams, will be required to periodically get trained in the areas related to: (a) submission of claims to the World Bank disbursements unit under the IUFR-based electronic disbursement method; (b) awareness and training to understand the project design/concept and other innovative arrangements; and (c) additional measures required to handle the DLI-based component. A significant portion of the training effort will be concentrated in the initial 18 months of implementation of the project to maximize impact.

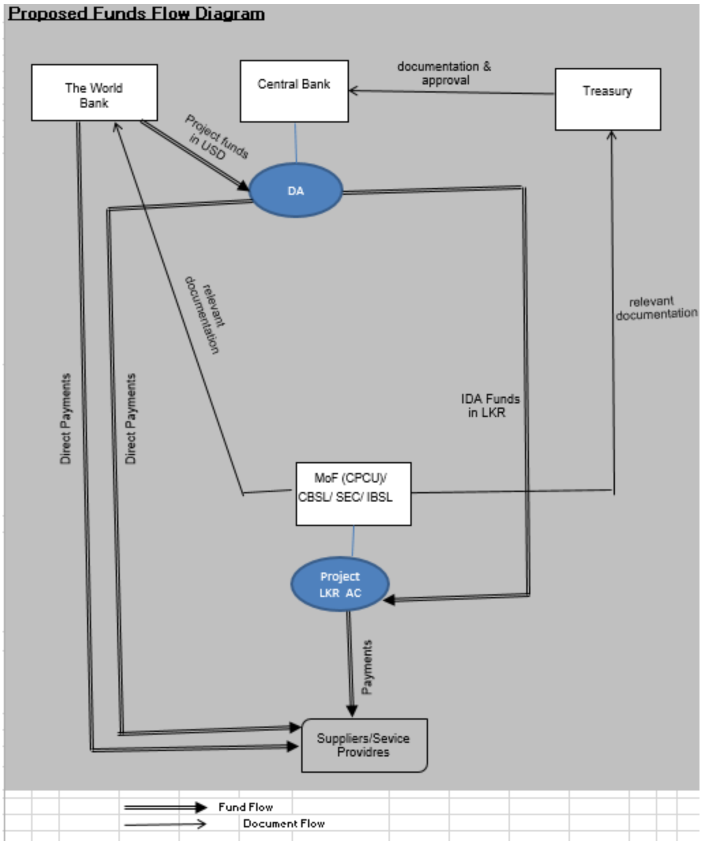
9. **Budgeting.** The CBSL, SEC, IBSL, and CPCU will forecast the required resources to be budgeted for the project under their respective components. These forecasts will be incorporated into the respective ministry's budget (the MoNP&EA in the case of the CBSL and SEC, and MoF in the case of IBSL as well as CPCU (at the MoF) for activities carried out under Component 3) which is then submitted to the MoF. A separate budget code (line item) will be set up each for CBSL, SEC, IBSL, and for project activities carried out by the CPCU, under MoNP&EA and MoF. The ministries will receive budget allocations from the Treasury for the project. The project implementation teams will prepare detailed implementation plans in line with the detailed project budget to clearly specify the funding requirement for each component and activity. The teams can implement the activities under the project by using the budgetary provision provided for the project under the foreign funds.

10. **Fund flow and disbursement arrangements.** To implement components 2 and 3, four separate DAs will be opened for CBSL, SEC, IBSL, and the CPCU. As regularly done for all other investment lending operations of Sri Lanka, the DAs will be opened in the name of Deputy Secretary to Treasury (DST) and as such the DAs will become part of GoSL Treasury system. The DAs will be operated and managed by the respective project implementation teams, which will maintain separate sets of accounts for the components under their respective responsibilities. Disbursements will be report-based. The project implementation teams will each submit quarterly IUFRs to the World Bank within 45 days of the end of each quarter. The World Bank will advance funds to the DAs in adequate amounts to meet forecasted expenditures for the next six months, as reflected in the respective IUFRs. Withdrawal applications will be prepared by the project implementation teams and replenishments to the DAs will be based on the IUFRs approved by the World Bank. The specific format of IUFRs, designed in accordance with the guidelines

issued by the World Bank has been agreed during negotiations and will be attached to the disbursement letter. The correspondence related to funds flow and disbursements requests by CBSL, SEC and IBSL will be copied to CPCU as required during project implementation.

11. **Each entity will also open a dedicated Sri Lanka rupee account.** The project implementation teams will operate their accounts to make payments for eligible expenditures and track the inflow and outflow of project funds. Exchange losses arising due to the transfer from the DAs to Sri Lanka rupee account will not be considered eligible expenditure and will not be absorbed under the IDA credit. The project implementation teams have the option of requesting a direct payment to suppliers by (a) the CBSL, using the proceeds in the DAs or (b) the World Bank against the credit for large payments.

Figure 3.2. Financial Sector Modernization Project - Proposed Fund Flow



12. **Accounting policies and procedures.** All project funds for components 2 and 3, will be disbursed through the four DAs opened at CBSL, and will be routed through the implementation teams who will be responsible for funding expenditures, accounting for them, and reporting on the financial and physical progress of the project. The accounting and FM staff in each team will liaise closely with technical staff, where a systematic verification of invoices will need to be carried out before payment. The project's accounting practices will be governed by the entities' own financial regulations and applicable circulars. CBSL, SEC and IBSL will maintain their overall accounts on accrual basis based on the Sri Lanka Public

Sector Accounting Standards accrual basis standards.[24] Bank accounts will be reconciled on a monthly basis and trial balances and financial statements will be prepared on monthly basis to facilitate monitoring of the progress of the project.

13. **Accounting system.** CBSL, SEC and IBSL have their own computerized accounting system. It is proposed to use the same system for generation of financial information of the project, by creating a separate module/ledger for the same. The system will need to facilitate generation of expenditure reports by budget classification/component and subcomponents, thus enabling comparison with the budget/components and effective monitoring of expenditure. A separate chart of accounts will be established for the project to enable separate accounting. CPCU will use a manual/excel based accounting system initially for the project activities implemented by them.

14. **Internal audit.** The project will be subjected to an internal audit. It is proposed to use the existing internal audit arrangements prevailing at the CBSL, SEC, IBSL, and MoF for the project's internal audit. Accordingly, the project activities would also be audited by the internal auditors of the respective entities and will issue a separate audit report for the same. The internal auditors will assess whether the funds have been disbursed on a timely basis and used effectively and efficiently for the intended purposes. The internal audit will also examine the physical and qualitative aspects of the assets procured under the project. This will provide further assurance on the legitimacy and the eligibility of the payments made from the credit proceeds. The findings of the internal audit team will be reviewed by an internal audit committee appointed for each entity. The project implementation teams will share the internal audit reports with the World Bank at agreed intervals.

15. **External audit and audit reports.** In line with the existing auditing arrangements that are prevailing in each of the four entities, it is proposed that the external audit of the project will be carried out by the Auditor General's Department of Sri Lanka (AGDSL). The external auditing arrangements are discussed with the CBSL, SEC, IBSL, MoF (on behalf of the CPCU), and AGDSL and were agreed upon. The project implementation teams will include the project accounts also in the overall entity financial statements for auditing by the AGDSL in the case of CBSL, SEC and IBSL. The audit will cover all project activities carried out by the project entities and all payments made from the project accounts in addition to the regular audit of these entities. It is agreed that a separate disclosure will be made on the entity audit reports of CBSL, SEC, IBSL, and MoF with regard to the observations related to the project. However, in the case of CPCU and MoNP&EA (DLI part), a separate audit on project financial statements will be carried out by the AGDSL. The audit will be conducted annually. Audit reports will be submitted to the World Bank within six months after the end of the financial year. The project implementation teams at the CBSL, SEC, IBSL and CPCU are responsible for the timely submission of the annual audited entity financial statements/annual audit project financial statements to the World Bank. The following audit reports will be monitored in the World Bank's Audit Reports Compliance System in PRIMA.[25]

[24] For World Bank purposes, documentation of expenditures will be done on cash basis.
[25] Portfolio and Risk Management.

Table 3.1. Audit Reports

Implementing Entity	Audit Report	Auditor	Date
CBSL	Entity Financial Statements	Auditor General	June 30 each year
SEC	Entity Financial Statements	Auditor General	June 30 each year
IBSL	Entity Financial Statements	Auditor General	June 30 each year
CPCU (MoF) & MoNP&EA (DLI part)	Project Financial Statements	Auditor General	June 30 each year

16. **Financial covenants.** The financial covenants of the project include: (a) audited annual entity financial statements to be submitted to the World Bank no later than six months of the following financial year and (b) IUFRs to be submitted to IDA no later than 45 days following the end of the reporting quarter.

17. **Implementation support plan.** The FM risk rating is Substantial. Consistent with a risk-based approach to FM supervision, FM supervision activities will consist of desk reviews of internal and external audit reports, including verification of the adequacy of the resolution of major audit observations, and reviewing quarterly IUFRs, supplemented by dialogue with implementation teams as needed, especially during the initial years of project implementation. The FM supervision mission will be conducted at least once every six months. Other supervision tools and resources, such as transaction reviews, site visits, etc., will be used in an effort to periodically monitor the adequacy of the FM system. In addition to the regular FM implementation support, the World Bank team will provide training, capacity building, and knowledge sharing for FM staff, internal audit staff, and the external auditor.

Disbursements

18. **Disbursement categories.** IDA will finance 100 percent of eligible expenditures, for goods, works, non-consulting services, consulting services, training and workshops, and incremental operating costs of the project, including taxes. The implementing entities (CBSL, SEC and IBSL) will cover the salaries and allowances of their staff working for the project. The funds will be disbursed through the designated accounts for components 2 and 3 of the Project. For component 1, CBSL, SEC and IBSL disbursements of the amounts allocated to each of the respective DLIs will be made to the three respective segregated accounts opened at CBSL in the name of Deputy Secretary to Treasury (DST) to reimburse these eligible expenditures, conditional on their achievement of the relevant DLI targets. Similarly, for MoNP&EA disbursements of the amounts allocated to MoNP&EA DLIs will be made to the MoF consolidated fund.

19. **Incremental operating costs.** Incremental operating costs include the normal expenditures of the project, such as reasonable costs of goods and services required for the day-to-day implementation of the project, including maintenance of vehicles and equipment, fuel, office supplies, utilities, consumables, office rental and maintenance, bank charges, advertising expenses, travel of staff (including per diems, accommodation), and salaries of selected contracted support staff, but excluding salaries and salary top ups of civil servants of the Government.

20. The proceeds of the IDA credit will be disbursed against eligible expenditures in the categories as shown in Table 3.2.

Table 3.2. Disbursement Categories

Category	Amount of the Credit Allocated (US$)	Percentage of Expenditures to be Financed (inclusive of Taxes)
(1) EEP under Component 1 of the Project: (a) MoNP&EA* (b) CBSL (c) SEC (d) IBSL	 7,000,000 5,000,000 2,000,000 1,000,000	100 up to the respective DLR values
(2) Goods, non-consulting services, consultants' services, incremental operating costs, and training and workshops: (a) under Subcomponent 2a of the project (b) under Subcomponent 2b of the project (c) under Subcomponent 2c of the project	 31,000,000 19,000,000 9,000,000	100
(3) Non-consulting services, consultants' services under Component 3, incremental operating costs, and training and workshops under Component 3 of the project	812,500	100
(4) Front-end Fee	187,500	Amount payable pursuant to Section 2.03 of the Financing Agreement in accordance with Section 3.01 (a) of the General Conditions
TOTAL AMOUNT	75,000,000	

* Category 1: The funds amounting to USD 7 Million disbursed in respect of DLR actions performed by MoNP&EA, will be disbursed to the MoF consolidated fund. The funds amounting to USD 8 Million disbursed in respect of DLR actions performed by CBSL, SEC and IBSL will be disbursed to three segregated accounts opened for CBSL, SEC and IBSL at CBSL in the name of DST.

21. **DLI-based component.** Eligible expenditures and activities will be tracked and monitored on a regular basis by the designated staff of the CBSL, SEC, IBSL, MoNP&EA and CPCU and verified by a third-

party as needed. Disbursement against achievement of the DLIs at any point will be made after its achievement has been formally verified by the World Bank. Disbursements of the amounts allocated to each DLI will be made, conditional on their achievement of the relevant DLI targets. Annex 2, Table 2.2 provides an overall summary of the five enabling DLIs with relevant DLI targets to be met, the responsible institutions for their implementation, the amounts allocated to each DLI target (column 'Amount'), and the DLRs (the last column). Table 3.3 provides the beneficiary of funds on completion of the DLR action.

Table 3.3. Proposed Disbursement of Funds for DLIs

DLI	Total Value (US$, millions)	MoF (US$, millions)	CBSL (US$, millions)	SEC (US$, millions)	IBSL (US$, millions)
DLI 1: Adoption of a consolidated risk-based approach to supervision of financial institutions	4	—	3	0.5	0.5
DLI 2: Establishment of the Financial Consumer Protection Authority across all financial services under an independent authority or an authority under the CBSL	3	2	1	—	—
DLI 3: Establish an information system for holistic management of EPF's assets (investment) and liabilities (collections) and adopt a diversified investment strategy	3	2	1	—	—
DLI 4: Establishment of DvP mode of settlement for corporate securities to minimize possible risks to financial stability	1.5	—	—	1.5	—
DLI 5: Restructuring of the NITF by separating the underwriting and reinsurance businesses	3.5	3	—	—	0.5
Total	15	7	5.0	2.0	1.0

22. **Under the DLI approach,** for CBSL, SEC and IBSL, payments will be made to the three segregated accounts opened in the name of DST at the CBSL, when the agreed DLRs are met and a certification of agreed statement of EEPs are submitted to the World Bank through the CPCU. These three Sri Lanka Rupee accounts would be operated by the respective PIEs and withdrawal applications would be submitted by the PIEs. For MoNP&EA, payments will be made to the MoF consolidated fund when the agreed DLRs are met and a certification of agreed statement of EEPs are submitted to the World Bank through the CPCU. Disbursements will be based upon the borrower fulfilling two requirements: (a) achievement of agreed DLRs, documented in a DLI report, verified by the World Bank and (b) a certification of the EEP statements

(where EEPs value should be greater than the DLI amount claimed). After verification of the DLIs achieved, the respective institution will submit a request for payment of the DLI amount. Details of the EEPs of respective implementing entity along with the budget codes are reflected in the financing agreement. Since the budgeted EEP amounts are more than the allocations in the withdrawal table the first incurred and paid EEPs would be taken for disbursement purposes.

23. Disbursements to the government/project implementing entities for each reporting period will be based on the lower of (a) the total allocated amount for each of the DLI targets, which are met and verified in the reporting period of the government/project implementing entities and (b) the total expenditures incurred and paid on EEPs by the government/project implementing entity in the reporting period. If total expenditures on EEPs for the reporting period are less than the total DLI amount achieved for the reporting period, the undisbursed amount will be rolled over to the subsequent reporting period. Similarly any excess of the total DLI amount achieved against the total expenditures on EEPs for any period will be rolled over to the subsequent period for comparison with the total expenditure (including rolled over expenditure, if any) of the subsequent reporting period. EEPs can also be rolled over for subsequent period until the closing date by the government/project implementing entities for disbursement purposes as mentioned in the first part of the paragraph. The IUFR format will be designed to track both separately to prevent excess claims. The eligible expenditure program for each entity along with budget estimates and codes are as below.

(a) the budget estimates for MoNP&EA for 2017 and 2018 amounts to US$17,000,000. The categories and the budget codes are: (i) salaries and wages; (ii) overtime and holiday payment; (iii) other allowances; (iv) domestic travel; (v) foreign travel; (vi) postal and communication; (vii) electricity and water; (Budget head 104: 1001, 1002, 1003, 1101, 1102, 1402, 1403)

(b) the budget estimates for CBSL for 2017 and 2018 amounts to US$14,000,000. The categories and the budget codes are: (i) salaries and wages (GL Code: 80001-80003); (ii) overtime (GL Code: 80201, 80301); (iii) holiday payment (GL Code: 80801-80803; 81001; 81002); (iv) other allowances (GL Code: 80401-80405); (v) domestic travel (GL Code: 86517); (vi) foreign travel (GL Code: 86512); (vii) postal communication (GL Code: 86502); (viii) electricity and water (GL Code: 84010; 84011; 84013)

(c) the budget estimates for SEC for 2017 and 2018 amounts to US$2,900,000. The categories and the budget codes are: (i) salaries and wages (GL Code: 330000; 330200; 331000; 357000; 334600); (ii) overtime and holiday payment (GL Code: 334500; 335600; 334800); (iii) other allowances (GL Code: 336000; 336200; 349000; 349100; 335500; 334700; 333500; 334000); (iv) domestic travel (GL Code: 340700; 346500); (v) foreign travel (GL Code: 337000; 337100); (vi) postal communication (GL Code: 365000; 365500); (vii) electricity and water (GL Code: 341600)

and

(d) the budget estimates for IBSL for 2017 to 2021 amounts to US$1,200,000. The categories and the budget codes are: (i) media notices (GL Code: PE 3454); (ii) telephone costs (GL Code: PE 3440); (iii) IAIS annual subscription (GL Code: PE 3618); (iv) foreign travel (GL Code: PE 3370) and (v) salaries (GL Code: PE 3303).

24. For this Project, eligible expenditures under component 1 are defined as non-procurable operational expenditure items (except what is included in the negative list). The negative list includes:

(a) Any activities that will involve construction of new or expansion of existing buildings and structures (except minor repairs, maintenance, or renovation), other activities that will require an expansion of the physical area on which the offices or branches of the implementing entities are located, or activities that will have an impact on physical cultural resources

(b) Any expenditure toward activities already being financed by other development partners/donors

(c) Any expenditure related to weapons and ammunition

(d) Medical expenses

(e) Court expenses and investigations-related expenses

(f) Entertainment expenses

25. **DLI reporting and verification.** The project is expected to become effective in May 2017. Post effectiveness, the CPCU will gather evidence in coordination with the implementing entities and forward a report to IDA on the achievement of the DLIs on a regular basis. The World Bank will then confirm the evidence of DLI achievement and expenditure against agreed eligible expenditures. On confirmation, the respective implementing entity can forward a withdrawal application for the payment to the value of the DLI amounts and related EEPs.

26. **Retroactive financing.** Retroactive financing facility under the project may be needed for eligible expenditures under Category (2) up to a maximum of US$11.8 million (CBSL US$ 6.2 million, SEC US$ 3.8 million and IBSL US$ 1.8 million). Retroactive financing is permitted for activities based on the following conditions: (a) the activities are included in the project description and are eligible under the Credit Agreement; (b) the payments are for items procured in accordance with applicable World Bank procurement guidelines; (c) payments do not exceed 20 percent of the credit amount; (d) the payments were made by the borrower not more than 12 months before the expected date of Credit Agreement signing; and (e) these activities comply with the World Bank fiduciary and safeguard policies and procedures. The date after which payments may be made under retroactive financing provisions is agreed and recorded in the Credit Agreement. Any payments made by the borrower in expectation of retroactive financing are at the borrower’s risk and do not commit the World Bank to approve the credit or to cover these expenditures from the credit, if these are not found eligible under the project. Implementing entities have already appointed the FM staff before incurring this expenditure.

Procurement

Procurement Considerations in the Fiduciary Assessment

27. **Assessment of the entities' capacities to implement procurement.** In its review of the three implementing entities—CBSL, IBSL, and SEC, the World Bank's fiduciary team identified the main procurement issues and risks that might affect the project. Areas identified as contributing to procurement risks are: (a) limited experience of procurement staff and lack of knowledge in implementing procurement under World Bank Guidelines; (b) limited experience in selecting consultants; (c) lack of a system for regularly monitoring procurement performance and compliance; (d) limited experience in dealing with complaints and fraud and corruption issues; and (e) limited or no experience in managing complex procurement and contracts. The proposed action plan includes: (i) putting in place an effective capacity-building project for the implementing entities; (ii) drafting a procurement manual or including a procurement chapter in the OM; (iii) assigning dedicated procurement staff to the project; (iv) designing an effective independent complaint-handling system; (v) establishing a procurement M&E system in the procuring entities; (vi) strengthening contract administration systems of the three implementing entities; and (vii) setting up a project-specific website that covers all the project implementing entities.

28. **Procurement risks and mitigating measures.** Due to the combination of the above identified areas for attention, the overall procurement risk is considered Substantial. The main risk lies with the limited procurement capacity and the need to ensure public access to project-specific information. Mitigating measures may include (a) the ministry-level CPCU to facilitate and coordinate procurements, with dedicated procurement/technical staff from the implementing entities working closely with the CPCU; (b) procurement workshops and clinics to deal with project-specific needs; (c) workshops addressing contract management; and (d) information sharing systems, such as the project-specific website.

Procurement Arrangements

29. **All goods, consulting services and non-consulting services** under Component 2 will be procured in accordance with the World Bank's 'Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits and Grants for World Bank Borrowers' (dated January 2011 and revised July 2014) and 'Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits and Grants by World Bank Borrowers (dated January 2011 and revised July 2014). Items to be procured will include consultancies and goods (for example, office equipment), management information systems, trainings, workshops, consumables, minor refurbishments.

30. **The following methods will be applicable** for all goods and non-consulting services to be procured under Component 2, consistent with the World Bank's Procurement Guidelines:

(a) International Competitive Bidding

(b) National Competitive Bidding (NCB)

(c) Shopping

31. **Procurement conducted under NCB.** To ensure economy, efficiency, transparency, and consistency with the Procurement Guidelines, all goods, works, and non-consultant services procured under the NCB method will be subject to the following requirements:

(a) Only the model NCB bidding documents agreed with the World Bank shall be used for bidding.

(b) Invitations for bids will be advertised in at least one widely circulated national daily newspaper, and bidding documents will be made available at least 21 days before, and issued up to, the deadline for submission of bids.

(c) The qualification criteria will be stated in the bidding documents and if a registration process is required, a foreign firm, declared as the lowest evaluated responsive bidder, shall be given a reasonable time for registering, without let or hindrance.

(d) Bids will be opened in public in one location, immediately after the deadline for the submission of bids, as stipulated in the bidding document (the bidding document will indicate the date, time, and place of bid opening).

(e) Except in cases of force majeure or exceptional situations beyond the control of the implementing entity, extension of bid validity will not be allowed.

(f) Bids will not be rejected merely on the basis of comparison with an official estimate.

(g) Except with the prior concurrence of the World Bank, there will be no negotiation of price with bidders, even with the lowest evaluated bidder.

(h) A bid security will apply only to the specific bid and a contractor's performance security will apply only to the specific contract for which they are furnished.

(i) Bids will not be invited on the basis of percentage premium or discount over the estimated cost, unless agreed with the World Bank.

32. **Selection of consultants.** Consultant services required will include expertise in M&E, FM, procurement, and specialized fields, training, and environmental and social sciences. Short lists of consultants for services estimated to cost less than US$300,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines.

33. **The following methods will apply for selection of consultants**, consistent with the relevant sections of the World Bank's Consultant Guidelines:

(a) Quality- and Cost-Based Selection

(b) Quality-Based Selection

(c) Least-Cost Selection

(d) Selected under a Fixed Budget

(e) Selection Based on the Consultants' Qualifications: for services estimated to cost less than US$200,000 equivalent per contract, in accordance with the provisions of paragraph 3.7 of the Consultant Guidelines

(f) Selection of Individual Consultants based on the procedures set forth in paragraphs 5.2 and 5.3 of the Consultant Guidelines

(g) Selection of Particular Types of Consultants - United Nations Agencies

34. **The World Bank's standard request for proposal document** will be used for all consultant services. The document may be customized, as appropriate, for small-value assignments (less than US$300,000).

35. **Composition of procurement committees and technical evaluation committees**. The appointment of procurement committees and technical evaluation committees will follow government procedures.

36. **Procurement information and documentation.** Procurement information will be reported as follows: (a) complete procurement documentation for each contract, including bidding documents, advertisements, bids received, bid evaluations, letters of acceptance, contract agreements, securities, complaints (if any), and their resolution and related correspondence will be maintained by the implementing entity in an orderly manner, readily available for audit; (b) contract award information will be promptly recorded and contract rosters as agreed will be maintained; and (c) each project implementing entity will submit semiannual reports with (i) revised cost estimates, where applicable, for each contract; (ii) status of ongoing procurements, including a comparison of originally planned and actual dates of the procurement actions, preparation of bidding documents, advertising, bidding, evaluation, contract award ,and completion time for each contract; and (iii) updated procurement plans, including any revisions in dates, for procurement actions.

Frequency of Procurement Supervision

37. **The World Bank will monitor the procurement performance on a sample basis.** The capacity assessment of the implementing entities recommended semiannual implementation support missions to review procurement actions on a sample basis.

38. **One or more dedicated procurement staff members or consultants will be assigned to procurement monitoring, reporting, training, and guidance.** Semiannual procurement progress reports to be provided to the World Bank will include status updates, procurement monitoring reports, and analysis of agreed intermediate outcome indicators. The CBSL, IBSL, and SEC will develop an effective monitoring mechanism during the first six months of the project.

Table 3.4. Thresholds for Procurement Methods and Prior Review for the Procurement to be Carried out under the Project

Expenditure Category	Contract Value (Threshold)	Procurement Method	Contracts/Processes Subject to Prior Review
Goods and non-consulting services	≥ US$1,000,000	International Competitive Bidding	All contracts
	< US$1,000,000	NCB	First contract and all contracts over US$500,000 equivalent (all other contacts subject to post review)
	≤ US$50,000	Shopping	None
Consultant services (firms)	> US$300,000	All competitive methods; advertise internationally	First contract and all contracts over US$200,000 equivalent
	≤ US$300,000	All competitive methods; advertise locally	First contact under each method and all contracts over US$200,000 equivalent
	< US$200,000	Selection Based on the Consultants' Qualifications	
		Selection of Particular Types of Consultants – United Nations Agencies	All contracts
Individual consultants		Selection of Individual Consultants (Section V of Consultant Guidelines)	All contracts over US$100,000 equivalent

39. **Proposed 18-month procurement plan**. The three procuring entities will maintain and update the procurement plan, which will provide the basis for the procurement methods and prior review requirements. It will also be available in the project database and in the World Bank's external website. The procurement plan will be updated in agreement with implementing entities biannually or as required to reflect actual project needs and improvements in institutional capacity.

ANNEX 4: IMPLEMENTATION SUPPORT PLAN

COUNTRY : Sri Lanka
Sri Lanka Financial Sector Modernization Project

Strategy and Approach for Implementation Support

1. The World Bank will support the three implementing entities (three regulators: CBSL, IBSL, and SEC) in the implementation of the project and will also provide all technical advice necessary to facilitate the achievement of the PDO. The three parties have agreed that the inter-regulatory coordination of the project will be under the PSC. In addition, the MoF will also assist in the overall project coordination by setting up the CPCU.

2. Separate project implementation units will be set up at all three regulators, and they have identified senior officials to lead their respective implementation units with adequately qualified staff members assigned. The teams will engage/train additional staff, including recruitment of consultants to manage and monitor project activities as required.

3. Further, all three regulators have regular consultations with key stakeholders (such as industry associations, banks, insurance companies, and other relevant financial institutions), and this will continue during implementation.

4. Procurement for the project will be carried out in accordance with the World Bank's 'Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits and Grants by World Bank Borrowers' dated January 2011 and revised in July 2014, 'Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits and Grants by World Bank Borrowers' dated January 2011 and revised in July 2014, and the additional provisions mentioned in the Legal Agreement.

5. The project will have several high-value contracts where each regulator will be procuring IT infrastructure and services - IT systems and goods. Separate bidding documents for all major IT and business process review contracts will be prepared by the respective implementation teams with support from consultants where required. The PSC will provide guidance to ensure compatibility of resources for harmonized supervisory capabilities and will ensure efficient coordination via CPCU. The World Bank task team for project preparation has provided necessary inputs and advice—both technical and fiduciary to the three regulators in this important project preparatory exercise.

6. Throughout the project duration, the World Bank team will closely monitor the project during semiannual implementation support missions. During the implementation support missions, the World Bank will ensure that the financial arrangements agreed upon are respected and will assess if any additional training or support is needed. The World Bank team will review and clear the audit terms of reference, review the audit reports and IUFRs received, and provide its feedback on time. The project team will also be responsible for reviewing all prior review procurement contracts, if any.

7. TA support under the project will largely be provided by consultants, and the World Bank team will review their terms of reference and the deliverables and engage in reviewing the TA performance during implementation support missions.

8. The World Bank's implementation support will follow a risk-based approach. At least two implementation support visits will be carried out annually, with additional visits if needed. The audit reports and the interim and annual financial statements, in addition to the management letter, will be reviewed on a regular basis by the World Bank FM Specialist, and the results or any issues will be followed up during implementation support visits. It is proposed that the project task leadership will, to the extent possible, also be shared between a headquarters and a country office–based staff. Also, during the World Bank's implementation support missions, the project's FM and disbursement arrangements will be reviewed to ensure compliance with the World Bank requirements and to assess the FM performance for the Implementation Status and Results Report.

9. The World Bank's fiduciary team, based in Colombo, will advise and support the three regulators in FM and procurement. The respective project implementation teams will be in charge of all the procurements and contract management under their respective project components, and their staff will be provided specific training on issues such as World Bank procurement and strengthening financial controls, including internal audit.

10. The World Bank implementation support team will consist of technical specialists from its Finance and Markets Global Practice and cross-cutting practices where needed as well as specialists in operations, procurement, FM, safeguards, and M&E. The World Bank's external communications specialist will advise on the project's communications strategy.

11. Technical specialists will review project documents, including terms of reference, bidding documents, and consultant reports. They will also conduct site visits to assess progress in the field and consult with the financial sector stakeholders, including think tanks, on project implementation progress.

Implementation Support Plan and Resource Requirements

12. During project implementation, support will be provided as indicated in Tables 4.1 and 4.2:

Table 4.1. Implementation Support Plan

Time	Focus	Skills Needed	Resource Estimate (US$)	Partner Role
First 12 months	Fiduciary and safeguards management; technical components; operationalizing Components 1 and 2; M&E; baseline communications; and strategy and awareness building	Please refer to table 4.2.	160,000	—
12–60 months	Project management and implementation support	Please refer to table 4.2.	160,000 per year	—

Table 4.2. Skills Mix Required

Skills Needed	Number of Staff Weeks	Number of Trips	Comments
Financial Sector Specialist and Task Team Lead	25	Minimum of three per year	Overall supervision and implementation support
Financial Sector Specialist	25	Colombo based	Overall supervision and implementation support
Banking Sector Specialist	8	Minimum of two per year	Will provide technical support in the implementation of component 2
Insurance Sector Specialist	8	Minimum of two per year	Will provide technical support in the implementation of component 2
Bond Market Specialist	8	Minimum of two per year	Will provide technical support in the implementation of component 2
Financial Law Specialist (Legal Counsel)	6	One per year as needed	Will provide technical support in the implementation of component 2
IT Infrastructure, including Cybersecurity, Specialist	10	Minimum of two per year	Will provide technical support in the implementation of components 1–3
Payment Systems Specialist	14	Minimum of two per year	Will provide technical support in the implementation of components 1–3
Legal Counsel	2	One per year as needed	Will provide legal support in the implementation
Fiduciary specialists	10	Colombo based	Will support supervision

ANNEX 5: ECONOMIC AND FINANCIAL ANALYSIS

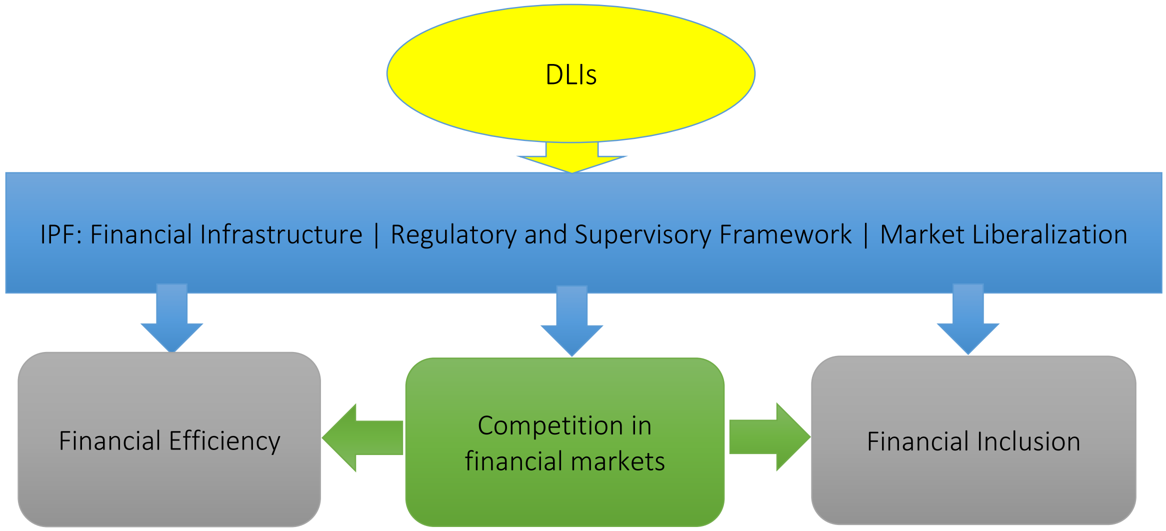
COUNTRY : Sri Lanka
Sri Lanka Financial Sector Modernization Project

Theory of Change for Improving Financial Inclusion through Regulation

1. **The project investment and TA components are enabled by DLIs (see the results chain in Figure 5.1).** The results-based financing in Component 1 of the project ensures that all preconditions and policy actions are met for the IPF components to be successfully implemented. These preconditions and policy actions are based on the 2015 FSAP recommendations for the relevant areas the IPF is targeting. For example, for the IPF to assist in establishing the institutional and regulatory framework for FCP, the MoNP&EA or MoF must issue the policy decision to establish the Financial Consumer Protection Authority across all financial services under the CBSL. Furthermore, the CBSL Monetary Board must issue the decision to establish the FCP department within the CBSL. The concrete parts of the IPF that each DLI enables are described in annex 2, Table 2.2.

2. **Modernizing financial infrastructure, improving the regulatory and supervisory framework for the financial system, and liberalizing financial markets can help boost financial efficiency and inclusion.** The effects can be direct as well as indirect (see the flow in Figure 5.1). The direct effects work through the reduction of transaction costs, lowering of information asymmetries, and enhancing distribution mechanisms. The indirect effects work through increased competition among financial firms, which, in turn, has a positive impact on financial efficiency and inclusion.

Figure 5.1. The Enabling role of DLIs for the IPF Components and the Direct and Indirect Effects of the IPF on Financial Efficiency and Inclusion



Modernizing Financial Infrastructure

3. **The modernization of financial infrastructure can increase competition and generate large efficiency gains by reducing transaction costs of financial services.** IFC and World Bank (2011) estimates reductions in transaction costs of up to 80 percent when financial infrastructure is modernized (payment systems, credit bureaus, collateral registries, remittances, and securities settlements). This cross-country analysis also finds a strongly negative correlation between the financial infrastructure development and the interest rate spread. Other empirical studies also show significant positive impact of reforms modernizing the financial infrastructure. For instance, Humphrey et al. (2003) estimate an average decrease of about 24 percent in bank operating costs for 12 European countries that implemented payment system reforms. Access to credit history and information about potential borrowers promotes competition in the banking sector (Dell'Ariccia, Friedman, and Marquez 1999). In turn, competition in the financial sector enhances the efficiency of financial services production and access to finance (see GFDR 2013 for a comprehensive literature review).

4. **Modernizing financial infrastructure can promote financial inclusion in three ways by reducing transaction costs, lowering information asymmetries, and enhancing distribution mechanisms.** IFC and World Bank (2011) finds a strong positive correlation between the estimated financial infrastructure index and the number of bank accounts per 1,000 adults. The literature highlights the beneficial role of efficient credit registries for the access to finance for firms, especially MSMEs. Beck, Demirguç-Kunt, and Maksimovic (2004) find that in more concentrated banking markets, firms of all sizes face higher financing obstacles—with greater obstacles faced by smaller firms. They also find, however, that an efficient credit registry can make these obstacles insignificant. Financial infrastructure development is especially important to ease access to finance for MSMEs in the absence of well-developed institutions (Beck and Demigurc-Kunt 2006).

Improving Regulatory and Supervisory Framework

5. **Enhanced supervision and stronger regulatory framework can help improve financial efficiency.** Barth et al. (2013) find that while greater capital regulation stringency is only marginally associated with greater bank efficiency, strengthening of supervisory powers is positively associated with bank efficiency in countries with independent supervisory authorities; independence coupled with a more experienced supervisory authority tends to enhance bank efficiency. Enforcing greater financial transparency is also positively associated with bank efficiency. Bouheni et al. (2014) highlight a positive correlation between capital adequacy and banks' profitability after analyzing bank-level data of European banks. Banking sectors are also more competitive in economies with regulatory frameworks that ensure greater contestability (GFDR 2013).

6. **Effective and enabling regulatory and supervisory framework for banks and NBFIs can help boost access to finance including by MSMEs.** Countries that lag the most on financial inclusion have also the largest gaps in supervisory capacity and quality of banking supervision (Sahay et al. 2015). The supervisory and regulatory framework affects access to finance also through their beneficial impact on financial efficiency (Ardic, Mylenko, and Saltane 2011). Countries in which banks have less-efficient structures also show lower levels of SME financing. More generally, Beck et al. (2006) find that institutional development is the most important country characteristic that can explain the cross-country variation in financing obstacles for firms. In addition, Demirgüç-Kunt, Martínez Pería, and Tressel (2015) find that legal

efficiency and better contract enforcement can promote greater use of longer-term debt by small and medium enterprises. In addition, the impact of broadening the access to credit on banking stability depends on the quality of supervision (Sahay et al. 2015). Sufficiently high levels of supervisory quality can ensure that financial inclusion in credit can be positively associated with bank capital buffers and resilience.

Liberalizing Financial Markets

7. **Market liberalization can enhance financial efficiency and access to finance by enabling useful financial innovation.** Tighter regulations on bank entry, restrictions on bank activities, and regulations that inhibit the freedom of bankers to conduct their business are negatively associated with bank efficiency (Demirgüç-Kunt, Laeven, and Levine 2004; Lin et al. 2010; and Barth et al. 2013). Demirgüç-Kunt, Laeven, and Levine (2004) further emphasize that bank regulations cannot be viewed in isolation from the overall institutional framework. Restrictions on bank activities exacerbate the impact of bank concentration on financing obstacles, which are more pronounced for MSMEs (Beck, Demirguç-Kunt, and Maksimovic 2004). For example, removing activity restrictions in a concentrated banking system alleviates the negative impact of bank concentration on access to finance. Similarly, Claessens and Laeven (2004) show that financial systems with greater foreign bank entry and lack of entry and activity restrictions (the limits imposed on commercial banks to engage in securities insurance and real estate activities) have a higher competitiveness score. The degree of competition in the financial sector then enhances the efficiency of the production of financial services and access to finance (see GFDR 2013 for a comprehensive literature review).

Economic Analysis

8. **The proposed PDO aims to support Sri Lanka to contribute to increasing financial market efficiency and further contribute to improving MSME finance by modernizing financial market infrastructure, upgrading the legal framework for the financial system and strengthening institutional capacity of financial sector regulators, and helping diminish restrictions on financial sector activities and the Government's involvment in the financial sector.** In particular, the financial sector modernization project will support the country in achieving (a) a more efficient financial system with better transparency and governance to boost responsible credit intermediation at competitive prices, (b) greater access to finance for MSMEs to boost their investment, and (c) deeper and more transparent capital markets supported by improved government debt management.

9. **It is planned to achieve the objectives by investing in the modernization of the financial infrastructure and improvement in the capacity of regulators in areas of better processes and governance to carry out their core functions.** These investments are expected to result in cost savings and higher efficiency for all participants. The market infrastructure modernization is also expected to lead to more regular, detailed, and reliable data for regulators to better supervise, monitor, and implement oversight functions as well as for better risk management. Additionally, modernizing infrastructure and developing the bond markets will lead to a deeper financial market and smoother implementation of the government DMS. A strong regulatory framework and efficient market infrastructure are the foundation for a stable, efficient, and inclusive financial system and a catalyst for economic growth.

10. **The methodology of the economic and financial analysis is based on relevant cross-country empirical studies.** Improvements in financial infrastructure, regulatory and supervisory frameworks, and financial liberalization have a substantial potential impact on growth through improvements in the financial efficiency of the production of financial services and the access to finance of firms and households as detailed in the theory of change. A survey of literature that analyzed the direct effect of financial infrastructure, supervisory framework, and liberalization on efficiency and access to finance is used as a guide for calibrating the impact of this project. Table 5.1 summarizes the findings of the survey. It illustrates the substantial impacts of scaling up in financial infrastructure, supervision, and financial liberalization on financial efficiency and access found in the empirical literature. In addition, the estimation results from the analysis of Gould, Melecky, and Panterov (2016) that studies the effect of financial development, including financial efficiency and access to finance, on aggregate income growth are used. The estimated projected impact of the modernization does not account for the additional positive effects on enhancing competition, which could further boost the efficiency and access to finance and hence economic growth.

11. **Since the lifespan of the project benefits extends beyond the duration of the project, most of the benefits will accrue after the completion date, while most costs will be up front.** In addition, some of the project's benefits are not quantifiable, in particular, the supervisory and oversight capacity building and training under all three regulators. In light of the above, the analysis includes both a quantitative and qualitative discussion of the project costs and benefits and concludes with a discussion on the rationale for public intervention and the value addition of the World Bank Group.

Table 5.1. Summary of Related Literature

	Financial Efficiency		Access to Finance	
	Explanatory Variable	**Coefficient**	**Explanatory Variable**	**Coefficient**
Financial infrastructure	**IFC and World Bank (2011)** **Effect on transaction cost through** • improvement in overall financial infrastructure index	up to 80%	**Beck, Demirguç-Kunt, and Maksimovic (2004):** • Well-developed credit registry eliminates the positive relationship between concentration and financing obstacles. **Beck, Demirguc-Kunt, and Martinez Peria (2006):** **Effect of credit information index on the number of days to process SME loans applications** • Minimum balance for consumer loans • Minimum balance for open saving account	-0.833 −0.126 −0.039

	Financial Efficiency		Access to Finance	
	Explanatory Variable	**Coefficient**	**Explanatory Variable**	**Coefficient**
Supervisory and regulatory framework	**Barth et al. (2013)** **Effect on bank efficiency score of** • average tenure of supervisors, • independence of supervisory authority* official supervisory power, and • strength of external audit	0.0051 0.029 0.0036 0.0110	**Sahay et al. (2015)** • Gaps in supervisory capacity are the largest in countries that also lag the most with regard to financial inclusion.	50% less gaps in supervisory quality in high FA vs low FA countries
Financial liberalization	**Barth et al. (2013)** **Effect on bank efficiency score of** • government ownership and • bank activity restrictions **Demirgüç-Kunt, Laeven, and Levine 2004** **Effect on net interest rate margin of** • activity restrictions and • banking freedom	−0.0025 −0.013 1.4 −0.96	**Beck, Demirguç-Kunt, and Maksimovic (2004):** • Less government interference in banking diminishes the association of concentration with financing obstacles.	—

Note: Only coefficients significant at 5 percent level are reported. Barth et al. (2013): the dependent variable is bank efficiency score estimated with DEA. Beck, Demirguç-Kunt, and Maksimovic (2004): results are based on interaction of the respective variables with concentration.

Rationale for Public Funding (for Overall Project)

12. **The main rationale for the GoSL borrowing from IDA and investing these public resources in key financial sector regulators is the necessity to improve the financial sector's performance in channeling necessary financial services and affordable credit to the market, which is an important factor for economic growth and alleviates the fiscal burden in the long-run.** The underdeveloped capital and insurance markets contribute less than their fair share to economic growth and long-term financing. Strengthening financial market infrastructure creates a vital public good, while strengthening the financial sector regulators' capacity on regulation and supervision will help mitigate financial stability risks and deepen the market. The related TA is an important intervention to ensure financial sector development, which can help support the GoSL's development objective.

Financial Analysis

13. **Financial analysis of the project is conducted using the expected actual investments and highly conservative estimates of project benefits.** The total investments are expected to be US$75 million spanned over five years. The main risks that need to be addressed include (a) the need for capacity development of the CBSL, SEC, and IBSL to manage IDA resources; (b) inadequate documentation of policies and procedures; and (c) a weak mechanism for allocation of budget for training and capacity building of staff at the CBSL, SEC, and IBSL in line with project roles and responsibilities.

14. **Project benefits are estimated using conservative calibrations, results of empirical studies mentioned earlier, and projected aggregate income for the year 2020.** Table 5.2 details the projected economic impact on aggregate income through improvements in efficiency and access to finance. The impact of improvements in supervisory framework and financial liberalization on financial efficiency is based on estimation results of Barth et al. 2015. A conservative 10 percent scaling up in supervision and financial liberalization is assumed. The rest of the linkages from infrastructure, supervision, and liberalization, respectively, to efficiency and access are calibrated. For a very conservative projection, an impact of 3 percent increase for each of the linkages is assumed. Further, the effect of improvements in efficiency and access to finance on aggregate income is estimated by taking into account the results of Gould et al. 2016. The resulting contribution to the growth in GDP per capita is 0.18 percentage points. Considering solely the effect after the completion period, the corresponding net present value (NPV) for a pessimistic discount rate of 5 percent is US$59 million. The benefits of the project are expected to last after the implementation period; so, the computed NPV is only a lower bound. The NPV and internal rate of return (IRR) still have positive values—US$5 million and 2 percent, respectively—even when considering the extreme scenario of 1 percent increase for each linkage.

Table 5.2. Projected Contribution to Aggregate Income - NPV and IRR

The Impact of Modernization on Aggregate Income					Project NPV and IRR			
Impact of	**Efficiency (%)**	**Firm Access to Finance (%)**	**Household Access to Finance (%)**	**Total Growth Effect (%)**	**Project Contribution to 2020 Aggregate Income***	**Discount Rate (%)**	**NPV**	**IRR (%)**
Financial infrastructure	3	3	3	0.05	—	—	—	—
Supervision and regulation	8.70	3	3	0.08	—	—	—	—
Financial liberalization	3.80	3	3	0.05	—	—	—	—
Overall effect of the modernization	16	9	9	—	—	—	—	—
Contribution to growth in GDP per capita	0.09 pp	0.05 pp	0.03 pp	0.18 pp	171.18 million	5%	59 million	12

Note: * The projected 2020 aggregate income assumes annual growth rates in GDP per capita and population equal to the 2014–15 growth rates; pp = Percentage point.

Project Impact

15. **Financial market infrastructure, regulatory, and supervisory capacity and financial market liberalization can boost development impact of finance.** Modernizing financial infrastructure through technology investments in hardware and software, a better integrated, modern national payments system in full compliance with international standards, and capacity building will result in tangible benefits. Among those are the following: enhanced security and efficiency of financial transactions; more access points and distribution channels; interoperability and better intermediation costs; effective market surveillance, reporting/monitoring tools, and compliance management system for the regulators and supervisors; enhanced reliability, coverage, and usage of the standardized platform/database for the EPF; and enhanced efficiency in the internal operations of the regulators. These will further increase the ability to mitigate stability-related risks.

16. **By reforming the outdated legal framework in Sri Lanka, the project addresses one key impediment to financial sector development.** The legal framework and its laws are not in line with international standards and do not enable the achievement of the current economic aspiration of Sri Lanka. Sound policies, comprehensive laws, and enabling regulations constitute the foundation for financial market functioning and growth. The purpose of the financial legal framework is not an end in itself; it exists to address potential market failures. To address the risks and challenges faced by the finance industry and the overall economy, regulators have to constantly use a variety of tools to promote market development while undertaking system-wide risk monitoring and taking remedial actions. This is possible only when the regulators have most up-to-date robust key legislation providing sufficient legal powers as well as rules governing their own conduct.

17. **Strengthening the legal and regulatory framework and supervisory capacity of the three regulators has substantial payoffs.** Through the adoption of an RBS framework, they will be able to apply limited resources more effectively to focus on financial institutions that are generating greater risks than others. In so doing, the regulators and the identified financial institutions will be able to work together to mitigate those risks before they develop into crisis proportions. Such actions will reduce the threats to the stability of the entire system. The costs of financial crises and financial instability are well documented, with regard to direct fiscal costs, as well as its effect to freeze credit markets. With risk aversion compounding the problem, this can push many of the vulnerable poor back into further distress/deprivation. For instance, the financial crisis of 2008 globally pushed 120 million people below the poverty line and created 22 million new unemployed persons in just a single year in the aftermath of the crisis. Thus, such capacity strengthening serves to mitigate the risk of such occurrences and avoid such costs.

18. **In the short to medium term, the implementation of the proposed government bond market development measures is expected to deliver several positive results, namely reduced fragmentation, improved price formation, transparency and predictability in the primary market, enhanced secondary market liquidity, and a more diversified investor base.** At the financial system level, strengthened government bond market as a reliable source of price references for other financial and capital market products will contribute to reduced vulnerability to financial shocks and facilitate the development of a deeper, liquid, and more stable capital market in Sri Lanka, increasing the range of long-term financing instruments. As the government bond market develops and starts playing an anchoring role for other fixed-income products, actions are required to stimulate the growth of the non-government bond market.

Greater issuance of non-government fixed-income products will support economic growth by providing a valuable channel for both the real and financial sectors of the economy.

19. **Enabling access to long-term financing by developing the bond markets can boost private investment.** This comprehensive project will initiate the process of building experience in long-term funding to meet investment needs of exporters and MSMEs. This is contextually very relevant and can contribute to Sri Lanka's objective of moving toward upper MIC status. It can help spur growth and employment and enable the export-oriented and competitive MSME sectors to upgrade production lines and respond to the market demand. This will enable crowding in—different financial institutions with different approaches to risks may participate in this market, facilitating a more optimal financing structure. Overall risk sharing/mitigation framework will enable entities with different risk appetites to take risks depending on their capacity to manage them and to receive adequate compensation for the risks taken. Finally, market development will accelerate by also attracting foreign investors/internationally compliant systems and streamlined issuance systems that will enable the development of a credible yield curve.

20. **Increased insurance penetration supports resilience of economic growth and risk-taking while helping the country and its citizens manage the impact of bad shocks.** Sri Lanka is exposed to natural disasters, including floods. Overall, be it the country's farmers who face production risks, the general public facing rising costs for quality healthcare and lacking adequate insurance, or vehicle owners exposed to higher risks given traffic conditions, the demand for insurance cuts across various segments. Further, with income growth, awareness, and consumer demand, additional pressure on the supply side to increase choices and improve the quality of insurance products coverage is expected. Hence, developing the insurance sector provides a social protection mechanism to individuals, and by managing and diversifying the risks of individuals and companies, it also enables the development of other productive economic activities.

21. **Strengthening the regulatory and supervisory capacity of the three regulators has substantial benefits.** Better regulated and supervised financial markets will accelerate market development, contribute more to economic growth in the long run, and increase access to financial services by firms and households. Access to long-term financing instruments that will be facilitated through the strengthening of the capital market will be important to deepen the financial market in the future and provide alternative investment vehicles to market participants.

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MAP OF SRI LANKA