



# Report and Recommendation of the President to the Board of Directors

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Project Number: 52219-001  
January 2019

## Proposed Loan and Administration of Technical Assistance Grant Regional Development Bank Strengthening the Regional Development Bank Project (Guaranteed by the Democratic Socialist Republic of Sri Lanka)

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 9 January 2019)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.00547
\$1.00	=	SLRs182.60

## ABBREVIATIONS

ADB	–	Asian Development Bank
MSEs	–	micro and small enterprises
MSMEs	–	micro, small, and medium-sized enterprises
PAM	–	project administration manual
RDB	–	Regional Development Bank
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

## NOTE

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

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## PROJECT AT A GLANCE

1. Basic Data		Project Number: 52219-001	
Project Name	Strengthening the Regional Development Bank Project	Department /Division	SARD/SAPF
Country Borrower	Sri Lanka Regional Development Bank	Executing Agency	Regional Development Bank
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		50.00
		Total	50.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Knowledge solutions (KNS)	Pilot-testing innovation and learning	Effective gender mainstreaming (EGM)	✓
Partnerships (PAR)	Commercial cofinancing Private Sector		
Private sector development (PSD)	Promotion of private sector investment		
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	Yes	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG5, SDG8		
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: FI Involuntary Resettlement: FI-C Indigenous Peoples: FI-C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		50.00	
Sovereign Project (Regular Loan): Ordinary capital resources		50.00	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		50.00	
Note: An attached technical assistance will be financed on a grant basis by the Japan Fund for Poverty Reduction in the amount of \$1,000,000.			
Currency of ADB Financing: USD			



## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Regional Development Bank (RDB),<sup>1</sup> to be guaranteed by the Democratic Socialist Republic of Sri Lanka, for the Strengthening the Regional Development Bank Project. The report also describes the proposed administration of technical assistance (TA) to be provided by the Japan Fund for Poverty Reduction for the Enhancing Rural Micro and Small-Sized Enterprise Finance, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. Research from 2017 confirms earlier findings that limited access to finance is a key barrier for entrepreneurs in Sri Lanka.<sup>2</sup> One of the government's key policy tools to address this challenge is through RDB, whose mission is to strengthen the living standards of the rural population by providing affordable and accessible credit facilities. By statute, RDB is wholly owned by the government and other state-owned banks.<sup>3</sup> The project would provide long-term financing that would directly fund \$50 million of subloans to micro and small enterprises (MSEs) outside of Colombo and be structured to provide the regulatory capital that would leverage an additional \$533 million of lending (para. 11[ii]).

## II. THE PROJECT

### A. Rationale

3. **Micro, small, and medium-sized enterprises financial exclusion.** The Government of Sri Lanka's national development strategy targets achieving upper middle-income status with improved equity and protection of the vulnerable by 2025.<sup>4</sup> Creating one million new jobs in the formal economy and increasing the labor force participation rate, mainly with micro, small, and medium-sized enterprises (MSMEs), are cornerstones of the strategy.<sup>5</sup> MSMEs have higher growth potential, create more jobs, and, over time, increase the tax base at a quicker pace than larger enterprises. Because of their distribution across the whole country, they also contribute to reducing stubborn regional inequalities.

4. Access to finance is a key challenge for MSMEs, which face constraints to affordable financing both on the demand side, such as poor commercial viability and difficulty in meeting financial institutions' lending requirements; and on the supply side, such as financial institutions having operations poorly designed for MSMEs and an overreliance on collateral-based loans. As a result, only 30% of Sri Lankan firms have sufficient access to bank loans and other capital. Relative to its peer countries, this puts Sri Lanka last in South Asia and 31st among the 32 developing member countries of the Asian Development Bank (ADB) (footnote 2). These constraints are even greater for MSMEs that are led by women or located in rural areas.

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<sup>1</sup> Regional Development Bank was established under Act No. 41 of 2008 of Sri Lanka and is also doing business under "Pradeshiya Sanwardhana Bank," the Sinhala translation of its name.

<sup>2</sup> International Finance Corporation. 2017. [IFC MSME Finance Gap 2017](#). Washington, DC.

<sup>3</sup> The government holds 87.25% of RDB's shares, and the remaining shares are equally divided between three government-owned banks—the Bank of Ceylon, the National Savings Banks, and People's Bank.

<sup>4</sup> Government of Sri Lanka. 2017. *Vision 2025*. Colombo.

<sup>5</sup> Under Sri Lanka's [National Policy Framework for Small Medium Enterprise \(SME\) Development](#), MSMEs are defined as enterprises with annual turnover of less than SLRs750 million; and with fewer than 300 employees if in the manufacturing sector, or with fewer than 200 employees if in the services sector. This project focuses specifically on MSEs, which are defined as those with annual turnover of less than SLRs250 million or with fewer than 50 employees.

5. **ADB support for access to finance.** To help address this problem, ADB has provided comprehensive support for MSME financing in Sri Lanka.<sup>6</sup> ADB approved a \$100 million Small and Medium-Sized Enterprises (SME) Line of Credit Project in February 2016 that focused on underserved MSMEs, such as those located in rural areas, led by women, and startups, and was fully disbursed by January 2018.<sup>7</sup> Based on the successful achievement of its performance indicators, ADB approved two additional financing projects: (i) a \$75.0 million loan (January 2018)<sup>8</sup> and (ii) a \$12.5 million project and TA grant (June 2018) that targeted women entrepreneurs and was funded by the Women Entrepreneurs Finance Initiative.<sup>9</sup> These two projects, which began disbursing in 2018, are *on track* to achieving their performance indicators. Several nonsovereign projects also complement these sovereign initiatives.<sup>10</sup> Notwithstanding these efforts, MSME financial inclusion remains a priority for Sri Lanka and has been prioritized in ADB's country partnership strategy, 2018–2022.<sup>11</sup>

6. **Regional Development Bank.** RDB is a state-owned licensed specialized bank that the government formed by merging six provincial development banks in May 2010 under the Pradesiya Sanwarhana Bank Act No. 41 of 2008. RDB's mandate is to improve rural living standards by providing accessible and affordable financial services. It is one of the 10 participating banks in ADB's SME Line of Credit Project and has been proactively utilizing ADB's funds for enhancing MSMEs' access to finance. Its focus on women and borrowers that are rural MSEs is evident in its performance in the SME Line of Credit Project (Table 1). Despite its key role in expanding MSE's access to finance and having sound financials, RDB requires additional capital to fund future growth.

**Table 1: Regional Development Bank's Performance in Asian Development Bank's Small and Medium-Sized Enterprise Line of Credit Project, as of August 2017**

Items	Regional Development Bank	Other State-Owned Banks <sup>a</sup>	Peer Private-Sector Banks <sup>a</sup>
Average loan size (\$'000)	16.7	44.4	98.8
% of SMEs led by women (in number)	31.1	25.9	26.3
% of SMEs outside of Colombo (in value)	96.3	88.0	82.1

SMEs = small and medium-sized enterprises.

<sup>a</sup> Other state-owned banks are the People's Bank and the Bank of Ceylon. Peer private-sector banks exclude banks that the Central Bank of Sri Lanka has identified as systematically important and include DFCC Bank, NDB Bank, and Nations Trust Bank.

Source: Asian Development Bank estimates.

7. **External environment.** The proposed support to RDB comes amid a challenging outlook for Sri Lankan banks. Sri Lanka started implementing higher regulatory capital ratios effective 1 January 2019. To implement Basel III many banks raised capital to avoid a reduction in loan

<sup>6</sup> Summary of Asian Development Bank's Support for Small and Medium-Sized Enterprise Finance Sector in Sri Lanka (accessible from the list of linked documents in Appendix 2).

<sup>7</sup> ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project*. Manila. Although the project is titled "small and medium-sized enterprise (SME)", the eligible sub-borrowers include micro enterprises as per the government's definition of SMEs.

<sup>8</sup> ADB. 2017. *Report and Recommendation of the President to the Board of Directors. Proposed Loan for Additional Financing to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project*. Manila.

<sup>9</sup> ADB. 2018. *Additional Financing: Small and Medium-Sized Enterprises Line of Credit Project in the Democratic Socialist Republic of Sri Lanka*. Manila.

<sup>10</sup> Development Coordination (accessible from the list of linked documents in Appendix 2).

<sup>11</sup> ADB. 2017. *Country Partnership Strategy: Sri Lanka, 2018–2022—Transition to Upper Middle-Income Country Status*. Manila.



growth.<sup>12</sup> Monetary conditions have been tightening with three policy rate increases since February 2016 in a bid to contain inflation. However, in April 2018, the Central Bank of Sri Lanka cut the policy lending rate in part to reduce an increase in real lending rates, following a deceleration in inflation. Further, Sri Lanka commenced implementing a new account standard on financial instruments, Sri Lanka Accounting Standards (SLFRS) 9, in 2018. This accounting standard will increase banks' resiliency, but, in the short term, it will require many banks to record higher provisions.<sup>13</sup> Moreover, although the government has taken steps to stabilize macroeconomic conditions through an International Monetary Fund Extended Fund Facility and a moderate buildup of foreign currency reserves, it is still contending with a marginal fiscal position,<sup>14</sup> upcoming foreign debt repayments, and rising oil prices.<sup>15</sup> In these circumstances, bank lending tends to become more conservative, with MSMEs generally shouldering the consequences, particularly RDB's rural and MSE clients.<sup>16</sup>

8. **Value added by ADB assistance.** This uncertain outlook makes ADB's assistance to RDB more important particularly because ADB's value addition in this project is multifaceted. First, in addition to creating leverage, as discussed in detail in para. 11 below, ADB's loan will provide RDB with needed liquidity. As monetary conditions have tightened, RDB has had to source a larger proportion of its funding from time deposits, which are more expensive and make ADB's funding more needed. Second, ADB's funding will have a 12.75-year tenor. Previous projects have monitored how long Sri Lankan banks have lent to the same clients with and without access to ADB's long-term funding. The loans made with ADB funding have on average a 20% longer tenor. These longer tenors make MSMEs' capital investments easier to afford. Third, as discussed in detail in para. 22 below, the project includes an attached TA that will strengthen the operational capacity of RDB across multiple areas, including deposit mobilization, loan origination, asset-liability management, and safeguards. Fourth, helping Sri Lanka to implement Basel III will promote financial stability, which is especially important because of the increasing downside risks to emerging markets following the end of the United States Federal Reserve's quantitative easing and start of the credit tightening cycle. Fifth, ADB played a key role in the project design. In June 2017, ADB identified that RDB—although operating effectively—was facing capital constraints that would become more serious with Basel III implementation. After consulting with RDB and the government, ADB prepared an analysis on the size of the capital shortfall and need for TA support. This analytical work led the Government of Sri Lanka to request a loan from ADB for tier 2 support for RDB and serves as the foundation for the project.

9. **Subordination.** ADB's loan will help RDB meet the Basel III requirements because it will be subordinated to RDB's obligations to its depositors and other senior lenders.<sup>17</sup> This constitutes the project's main innovation. Banks' capital structures are broadly divided into three layers. The top layer consists of depositors and other senior lenders. The bottom layer consists of equity and

<sup>12</sup> Basel III: Implementation in South Asia (accessible from the list of linked documents in Appendix 2). Basel III, an internationally agreed set of measures developed by the Basel Committee on Banking Supervision, is a response to the global financial crisis with the objective to make banks more resilient through strengthening minimum requirements for capital and liquidity.

<sup>13</sup> Provisions are losses that banks recognize in anticipation of not being able to fully recover customer loans. Banking regulations and accounting standards govern how much banks must provide for such provisions.

<sup>14</sup> The marginal fiscal position comes against a positive development on the primary balance that was marginally in surplus in 2017.

<sup>15</sup> International Monetary Fund. 2018. [\*Sri Lanka: Third Review under the Extended Arrangement under the Extended Fund Facility and Request for Modification of Performance Criterion-Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka\*](#). Washington, DC.

<sup>16</sup> Despite these challenges, MSME financial performance under ongoing ADB projects in Sri Lanka has been acceptable. For the SME Line of Credit Project, the gross nonperforming loan ratio was 7% as of August 2017.

<sup>17</sup> RDB borrows from the government and other financial institutions.

other forms of tier 1 capital. Subordinated loans and other forms of tier 2 capital lie in between. In the event of liquidation, tier 1 capital is the first to sustain losses, followed by tier 2 capital, which would be written down or converted into equity, and finally senior debt. ADB's loan to RDB will be part of this middle layer.

10. **Rationale for sovereign-guaranteed subordinated loan.** There are two primary reasons for the proposed structure. First, ADB's loan will not contribute to RDB meeting the higher regulatory capital ratios required under Basel III unless it qualifies as tier 2 capital, and subordination as well as limitations on events of acceleration of loan maturity are basic criteria for tier 2 capital.<sup>18</sup> Second, it addresses the government's fiscal challenges. Sri Lanka's budget is subject to the Fiscal Management (Responsibility) Act, which sets spending and guarantee limits. Sri Lanka has available headroom under its guarantee limit and welcomes a structure under which ADB directly provides tier 2 capital to RDB while preserving its spending headroom for other priorities.

11. **Alignment with ADB's Strategy 2030.** ADB's tier 2 loan will provide needed support to RDB and Sri Lanka and help ADB meet its commitments under Strategy 2030, which calls for ADB to do the following.<sup>19</sup>

- (i) **Support innovative financial products.** The proposed tier 2 loan is a first for sovereign operations. This innovation will allow ADB to support a bank whose performance is solid (para. 24) but would have been challenging to finance through its nonsovereign operations given the subordination and long tenor.<sup>20</sup>
- (ii) **Increase the leverage of its own financing.** Under a normal credit line, ADB's loan would support an equal amount of lending to subprojects. This project will do the same. However, once ADB's subordinated loan is on RDB's balance sheet, RDB can count it toward the central bank's requirement to hold SLRs12.5 of regulatory capital for every SLRs100 of risk-weighted assets. Because MSME loans carry a 75% risk weighting in Sri Lanka, ADB's loan will provide the regulatory capital for an additional \$533 million of lending—leveraging ADB's loan 10.7 times.<sup>21</sup>
- (iii) **Increase its support for banks to help increase their capacity, quality, and reach, particularly for low-income populations.** Financial inclusion is closely correlated with reduced poverty, and RDB plays a unique role in the Sri Lankan banking system in promoting financial inclusion among rural low-income populations (para. 6) that other licensed banks and even nonbank financial institutions cannot replicate.
- (iv) **Accelerate progress in gender equality in developing member countries through financial inclusion.** The project is classified *effective gender mainstreaming* and expands training that is being provided to 750 women under ongoing TA projects in Sri Lanka to an additional 500 women. The loan will also require RDB to onlend to at least 500 women-led enterprises and effect institutional

<sup>18</sup> To comply with tier 2 capital requirements, ADB—or Sri Lanka following a guarantee call—may accelerate the maturity of any outstanding principal only in the event of bankruptcy or liquidation.

<sup>19</sup> ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

<sup>20</sup> There are examples of tier 2 loans through ADB's nonsovereign operations: ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Subordinated Loan to the International Bank of Azerbaijan*. Manila; and ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance to Credo Microfinance Organization, FINCA Bank Georgia, and TBC Bank for the Financial Inclusion for Micro and Small Business Growth in Georgia*. Manila.

<sup>21</sup> (\$50 million ADB subordinated loan) / (0.125 regulatory capital requirement \* 0.75 risk-asset weighting for MSME loans) = regulatory capital for \$533.33 million of MSME lending.

reforms that will enable RDB to better serve these clients.

- (v) **Facilitate common frameworks in financial regulations and supervision.** RDB's compliance with the Basel III requirements are important for it and the broader stability of the Sri Lankan banking sector given other large state banks have already received capital infusions (para 13). If one of the government-owned banks were not to comply, it would undermine the credibility of the central bank and provide other banks with a precedent for ignoring regulations.

12. **Risk management of an innovative approach.** Although subordination carries financial and reputational risks, these are appropriately managed. If RDB were to default, a tier 2 loan would recover less than loans from senior creditors. However, this risk to ADB is fully mitigated by Sri Lanka's guarantee, which is payable on first demand even if senior creditors have not been paid. The government would then subrogate (i.e., step into ADB's place to enforce the loan). ADB's Treasury Department has confirmed that the proposed sovereign-guaranteed loan poses no special risk to ADB's credit rating or its preferred creditor status. ADB has also mitigated the reputational risk of the innovative product failing by communicating clearly with the government about the implications of subordination. Moreover, the following circumstances make it highly favorable to pilot this innovation: (i) ADB knows the Sri Lankan banking sector well and has a successful track record in the sector, (ii) the borrower is financially sound (para. 24) and is under stringent supervision by the central bank, (iii) the central bank started to enforce Basel III on first of January 2019, and (iv) the attached TA will help to strengthen further the borrower's operations and management.

13. **Sustainability.** Since the loan size is less than the estimated tier 2 funding gap through 2022, the government has requested ADB to consider providing additional financing as may be required. Additional financing could be justified if the project is satisfactorily implemented. Beyond ADB's project, support for strengthening operational capacity of RDB will support higher profitability, strengthen organic balance sheet growth, and provide the groundwork for possible strategic investments in RDB, including from ADB's nonsovereign operations. As for the sustainability of other state-owned banks, the two systemically important institutions—Bank of Ceylon and People's Bank—each received SLRs5 billion (\$27.3 million) capital increases at the end of 2017 to meet the Basel III requirements.<sup>22</sup>

14. **Lessons learned.** The proposed loan draws from the recommendations of the thematic evaluation Support for Small and Medium-Sized Enterprises, 2005–2017 published in August 2018. That evaluation highlighted that access to finance operations has at times lacked development focus. Accordingly, under the project, ADB has restricted eligible subprojects to MSEs outside of Colombo, limited the maximum size of subloans to SLRs50 million (\$273,822), required at least 500 subloans to be lent to women,<sup>23</sup> and is providing capacity development to RDB through the attached TA. The evaluation also identified shortcomings in implementation and monitoring results. However, this loan will benefit from the precedent of the SME Line of Credit Project that established a robust monitoring system with which RDB has been complying. There is also an intrinsic incentive for RDB to achieve the project's objectives. Because the loan is less than RDB's total tier 2 capital needs over the next 5 years, there would be grounds for additional financing if RDB performs well. The evaluation also noted that support for policy reforms has delivered good results. As part of the attached TA, ADB will prepare an assessment of the government's various initiatives for MSME access to finance with the intent of expanding those

<sup>22</sup> The Central Bank of Sri Lanka recognizes six licensed banks as systemically important. The other four are privately owned.

<sup>23</sup> An SME is defined as an SME led by women when at least 51% of its enterprise ownership is controlled by women, at least 60% of senior managers are women, or at least 50% of board members are women.

projects that are working well and winding down or reforming those that are not.

## B. Impact and Outcome

15. The project is aligned with the following impact: MSME access to finance enhanced.<sup>24</sup> The project will have the following outcome: RDB's capacity to serve its client MSMEs strengthened.<sup>25</sup> The project area is national.

## C. Outputs

16. **Output 1: RDB's operations expanded.** The project will provide \$50 million for RDB to expand its MSME lending, and the attached TA will support a deposit marketing campaign to source low-cost funding for future growth.

17. **Output 2: RDB's operational capacity strengthened.** Under this output, ADB will support RDB to develop a strategy to increase outreach to underserved clients (including women), introduce sex-disaggregated management information system reporting, develop and implement an ADB-approved environmental and social safeguards system, strengthen asset-liability management, and train loan officers in credit evaluation.

18. **Output 3: Capacity of MSEs to access financial services enhanced.** This output will enable RDB to train 500 women entrepreneurs who are its current and prospective clients how to prepare a business plan. These women are in addition to 750 other women being trained under an ongoing TA in Sri Lanka. RDB will offer successful graduates of the training program a 0.50% discount on the interest rate of their subsequent loan.

## D. Summary Financing Plan

19. The project is estimated to cost \$50 million for which RDB has requested a regular loan from ADB's ordinary capital resources with a sovereign guarantee. The loan will have a 12 years and 9 months term with a bullet payment at maturity; an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a commitment charge of 0.15% per year; and such other terms and conditions set forth in the draft loan and guarantee agreements. Based on the repayment terms, the average maturity is 12 years and 9 months, and there is no maturity premium payable to ADB.<sup>26</sup> The government is not charging RDB a guarantee fee, but RDB will be responsible for the foreign exchange risk.

20. The summary financing plan is in Table 2. ADB will finance \$50 million of subprojects consisting of subloans to MSEs outside of Colombo with the maximum size of a subloan capped at SLRs50 million (\$273,822).<sup>27</sup>

<sup>24</sup> Government of Sri Lanka. 2017. *Vision 2025*. Colombo.

<sup>25</sup> The design and monitoring framework is in Appendix 1.

<sup>26</sup> The government is providing counterpart funding through tier 1 equity. In December 2017, it injected SLRs2.5 billion (\$15.4 million) of tier 1 and is planning to inject further tier 1 equity by 2019 through merging RDB with Lankaputhra Development Bank, another state-owned bank with excess tier 1 equity.

<sup>27</sup> There is no sectoral restriction or target on MSE subprojects. At corporate level, RDB's gross loan exposure is widely distributed across agriculture (23.7%), construction/housing (24.6%), manufacturing (16.4%) and trading (15.6%) in 2017.

**Table 2: Summary Financing Plan**

<b>Source</b>	<b>Amount (\$ million)</b>	<b>Share of Total (%)</b>
Asian Development Bank		
Ordinary capital resources (regular loan)	50.0	100.0
<b>Total</b>	<b>50.0</b>	<b>100.0</b>

Note: The government is providing counterpart funding through tier 1 equity for the Regional Development Bank to comply with Basel III capital requirement.

Source: Asian Development Bank estimates.

## **E. Implementation Arrangements**

21. The implementation arrangements are summarized in Table 3 and described in detail in the project administration manual (PAM).<sup>28</sup> RDB will onlend to sub-borrowers at a market-determined interest rate.

**Table 3: Implementation Arrangements**

<b>Aspects</b>	<b>Arrangements</b>
Implementation period	February 2019–February 2022
Estimated completion date	February 2022
Estimated loan closing date	August 2022
<b>Management</b>	
(i) Oversight body	Steering committee chaired by the secretary of Ministry of Public Enterprise and Kandy City Development or its successor and initially comprising: (i) representatives from the relevant departments of the Ministry of Finance and Economic Affairs; (ii) a representative from the Department of External Resources; (iii) the general manager, chief financial officer, and one deputy general manager from RDB; and (iv) a representative from ADB.
(ii) Executing agency	Regional Development Bank
(iii) Key implementing agency	Regional Development Bank <sup>a</sup>
(iv) Implementation unit	Regional Development Bank. The chief financial officer will lead the implementation unit with the support of 10 staff.
Procurement	Procurement of goods, works, and non-consultancy services will follow the ADB Procurement Policy and the Procurement Regulations for ADB Borrowers (2017, as amended from time to time). Procurement will be undertaken by the individual beneficiary; fitness for purpose can be achieved by using established private sector and commercial practices.
Retroactive financing	Retroactive financing will be allowed up to 20% of the loan amount for subprojects that meet eligibility criteria, including safeguard requirements, incurred prior to loan effectiveness but no earlier than 12 months before the signing of the loan agreement.
Disbursement	The loan proceeds will be disbursed following ADB's <i>Loan Disbursement Handbook</i> (2017, as amended from time to time) and detailed arrangements agreed between RDB and ADB. RDB will semiannually submit withdrawal requests to ADB for the equivalent amount of the expected eligible subloans from micro and small enterprises for the coming 6 months. ADB will disburse these advances to an RDB bank account.

ADB = Asian Development Bank, RDB = Regional Development Bank.

<sup>a</sup> The Department of Development Finance, Ministry of Finance and Economic Affairs, will be the implementing agency for the study on the effectiveness of government financial inclusion programs, which is funded under the attached technical assistance.

Source: Asian Development Bank.

<sup>28</sup> Project Administration Manual (accessible from the list of linked documents in Appendix 2).

### III. ATTACHED TECHNICAL ASSISTANCE

22. The attached technical assistance is an integral part of the project. It will support RDB's deposit marketing campaign under output 1 (para. 16), the operational capacity development of RDB described under output 2 (para. 17), the training of women entrepreneurs described under output 3 (para. 18), and a study on the effectiveness of Sri Lanka's efforts to promote financial inclusion (para. 14). The TA is estimated to cost \$1,050,000, of which \$1.0 million will be financed on a grant basis by the Japan Fund for Poverty Reduction and administered by ADB and the remainder is in-kind contribution from RDB and the government. RDB will be the executing agency for all TA outputs except for the study on the effectiveness of government financial inclusion programs with an emphasis on women borrowers, which the Department of Development Finance of the Ministry of Finance and Economic Affairs will implement. RDB and the government will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, and other in-kind contributions.

### IV. DUE DILIGENCE

#### A. Economic and Financial

23. Economically, the gains will come from (i) RDB's increased lending capacity to MSMEs and (ii) the project's requirements to lend to rural MSEs, which typically struggle to access the banking system.<sup>30</sup> There are also important positive externalities from this project's contribution to a well-capitalized banking system.

24. Financially, RDB is dependably profitable despite having a business model that focuses on MSE lending, which carries higher nonperforming loan rates than lending to medium and large-sized enterprises, and an extensive branch network, which is central to RDB's mandate to serve rural areas. The attached TA will strengthen RDB's liquidity and market risk management. Capital is self-evidently weak, but the projected capital shortfall is the result of RDB's steady growth and Basel III's higher capital requirements and is not precipitated by financial losses.<sup>31</sup>

#### B. Governance

25. The overall integrity risk is *low* and the financial management risk is *moderate*. Integrity due diligence was carried out, and its risk was assessed *low*. Although RDB's financial management has limitations, such as cumbersome loan origination and evolving risk management, mitigations include (i) the capacity development for RDB under the attached TA, (ii) a robust project reporting system developed under the previous ADB projects in Sri Lanka, and (iii) RDB's satisfactory performance in those previous ADB projects. With these measures, the over financial management arrangements are considered *adequate*.

26. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and RDB. The specific policy requirements and supplementary measures are described in the PAM (footnote 27).

#### C. Poverty, Social, and Gender

27. **Poverty impact.** Although Sri Lanka has made notable progress in reducing poverty, regional imbalances remain. MSMEs struggle to borrow because they often lack the real estate

<sup>30</sup> Economic Analysis (accessible from the list of linked documents in Appendix 2).

<sup>31</sup> Financial Analysis (accessible from the list of linked documents in Appendix 2).

or financial assets that banks require as collateral. Therefore, the project targets rural MSEs that typically face the greatest financial barriers. The project impact includes employment creation and increased income, especially among the targeted MSEs.

28. **Gender and social dimensions.** The project is classified *effective gender mainstreaming*. It builds on and complements similar approaches followed in previous projects, such as the SME Line of Credit Project (2016), the ongoing JFPR TA (2016), and related Women Entrepreneurs Finance Initiative (We-Fi) Grant and TA Project (2018).<sup>32</sup> The project commits to women's empowerment and gender equity, including requirements for RDB to prepare a Board strategy to increase outreach to underserved clients (including women), to lend to at least 500 MSEs led by women, and to train 500 women entrepreneurs to prepare a business plan.<sup>33</sup> This emphasis is particularly important given Sri Lanka's low women labor participation rate of 39%, which suggests a large pool of untapped human resources for national economic development.

#### D. Safeguards

29. In compliance with ADB's Safeguard Policy Statement (2009), the project's safeguard categories are as follows:<sup>34</sup>

- (i) **Environment (category FI).** Subprojects with significant environmental impacts (category A) are excluded. Subprojects with environmental impacts that are not significant (category B) are initially excluded. ADB may subsequently allow category B subprojects, if RDB implements an environmental and social safeguard system acceptable to ADB.
- (ii) **Involuntary resettlement (category FI-C).** Subprojects with involuntary resettlement impacts (category A or B) are excluded.
- (iii) **Indigenous peoples (category FI-C).** Subprojects with indigenous peoples impacts (category A or B) are excluded.

30. Safeguard due diligence concluded that RDB's overall lending entails minimal environmental, involuntary resettlement, or indigenous peoples impacts because of its MSE focus. ADB supported RDB in the Small and Medium Enterprise Line of Credit Project, and all subprojects financed through RDB under that project were *category C*. During due diligence, site visits of potential subprojects were also confirmed *category C*. RDB will screen subprojects against the Prohibited Investment Activities List, and a shortlist of category C subprojects will further guide subproject selection.<sup>35</sup> To strengthen RDB's capacity in safeguards and enable it to finance subprojects that may have safeguards impacts in the future, the attached TA will help RDB establish and staff an environmental and social safeguards system.

<sup>32</sup> ADB. (2016). *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project*. Manila; ADB. 2016. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for Cluster Development and Small and Medium-Sized Enterprise Finance Innovation*. Manila; and ADB. 2018. *Additional Financing: Small and Medium-Sized Enterprises Line of Credit Project in the Democratic Socialist Republic of Sri Lanka*. Manila.

<sup>33</sup> Gender Action Plan (accessible from the list of linked documents in Appendix 2). These 500 women are in addition to 750 women who are being trained under an ongoing JFPR TA and We-Fi TA in Sri Lanka.

<sup>34</sup> ADB. [Safeguard Categories](#).

<sup>35</sup> Environmental and Social Management System Arrangement (accessible from the list of linked documents in Appendix 2).

## E. Summary of Risk Assessment and Risk Management Plan

31. Significant risks and mitigating measures are summarized in Table 4 and described in detail in the risk assessment and risk management plan.<sup>36</sup>

**Table 4: Summary of Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigation Measures</b>
RDB defaults on ADB's loan because of credit losses.	The attached TA will strengthen RDB's credit risk management, and financial loan covenants and project reporting will provide early warning of deteriorating credit quality.
RDB defaults on ADB's loan because of a large fraud incidence.	The Central Bank of Sri Lanka is a reputable regulator. ADB has assessed RDB's integrity due diligence risk <i>low</i> . RDB's segregation of duties and the generally small size of its loans make it difficult to sustain a large fraud undetected over a long period of time.
RDB breaches ADB's loan covenant to meet the regulatory capital ratio for tier 1 because the government fails to inject growth capital.	The government has historically provided growth capital to RDB. RDB is small and politically important, so the government has strong incentive to do so in the future. ADB has also included a covenant restricting RDB's dividends so as to maximize tier 1 formation.

ADB = Asian Development Bank, RDB = Regional Development Bank, TA = technical assistance.

Source: Asian Development Bank.

## V. ASSURANCES

32. The government and RDB have assured ADB that implementation of the project shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and loan documents.

33. The government and RDB have agreed with ADB on certain covenants for the project, which are set forth in the draft loan and guarantee agreements.

## VI. RECOMMENDATION

34. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$50,000,000 to the Regional Development Bank, to be guaranteed by the Democratic Socialist Republic of Sri Lanka, for the Strengthening the Regional Development Bank Project, from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 12.75 years with a bullet repayment at maturity; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and guarantee agreements presented to the Board.

Takehiko Nakao  
President

17 January 2019

<sup>36</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).



## DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned with MSME access to finance enhanced (Vision 2025) <sup>a</sup>			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
<b>Outcome</b> RDB's capacity to serve its client MSMEs strengthened	a. By 2022, RDB's annual lending to MSMEs increased by 50% (2017 baseline: SLRs22 billion)  b. By 2022, Basel III regulatory capital requirements met (2018 baseline: Not applicable)  c. By 2022, RDB's savings deposit annual growth rate increased to 15% (2017 baseline: 12%)  d. By 2022, at least 60% of the 500 women clients trained by RDB submit a business plan that is assessed viable (2018 baseline: Not applicable) <sup>b</sup>	a. RDB's annual financial reports  b. RDB's annual financial reports  c. The savings deposit subtotal as reported in RDB's monthly Financial Position report  d. Consultant report	RDB defaults on ADB's loan because of credit losses.  RDB defaults on ADB's loan because of a large fraud incidence.  RDB breaches ADB loan covenant to meet the regulatory capital ratio for tier 1 because the government fails to inject growth capital.
<b>Outputs</b> <b>Output 1</b> RDB's operations expanded	1a. By 2021, RDB's deposit mobilization program, including a deposit product targeted for women, restructured and relaunched (2018 baseline: Not applicable)  1b. By 2022, \$50 million ADB loan disbursed to RDB for onlending to	1a. Consultant's final report  1b. Project management unit's	RDB's savings deposit growth rate is slow because a high interest rate environment encourages clients to open time deposits or because its deposit campaign is otherwise ineffective.

<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting Mechanisms</b>	<b>Risks</b>
	<p>MSEs (2018 baseline: 0)</p> <p>1c. By 2022, ADB loan funds 500 subloans to businesses led by women (2018 baseline: 0)</p>	<p>quarterly monitoring reports</p> <p>1c. Project management unit's quarterly monitoring reports</p>	
<p><b>Output 2</b> RDB's operational capacity strengthened</p>	<p>2a. By 2020, RDB board strategy to increase outreach to underserved clients, including women, approved (2018 baseline: Not applicable)</p> <p>2b. By 2020, management information system generates sex-disaggregated report(s) on loans and deposits (2018 baseline: Data available only through ad hoc queries)</p> <p>2c. By 2020, RDB drafts an ADB-approved environmental and social safeguards system (2018 baseline: Not applicable)</p> <p>2d. By 2021, RDB's new asset–liability committee reporting implemented (2018 baseline: Not applicable)</p> <p>2e. By 2022, 90% of RDB's loan officers have passed loan underwriting course (2018 baseline: Not applicable)</p>	<p>2a. Consultant's final report</p> <p>2b. Letter from the general manager and copy of sex-disaggregated report</p> <p>2c. Letter from the general manager and copy of environmental and social safeguard framework</p> <p>2d. Letter from the general manager and copy of asset–liability committee minutes</p> <p>2e. Consultant's final report</p>	
<p><b>Output 3.</b> Capacity of MSEs to access financial services enhanced</p>	<p>3a. By 2020, a white paper on evaluating the effectiveness of support programs of government MSMEs with an emphasis on women borrowers submitted to</p>	<p>3a. Consultant's final report</p>	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	<p>project steering committee (2018 baseline: Not applicable)</p> <p>3b. By 2022, at least 500 RDB women clients trained, including on how to prepare a business plan (2018 baseline: Not applicable)<sup>b</sup></p>	3b. Consultant's final report	

### Key Activities with Milestones

#### 1. RDB's operations expanded

- 1.1 Disburse \$25 million to RDB for onlending to MSEs (Q1 2019–Q1 2020).
- 1.2 Relaunch RDB's deposit mobilization program (Q2 2019–Q1 2021).
- 1.3 Disburse \$25 million for onlending to MSEs (Q2 2020–Q1 2022).

#### 2. RDB's operational capacity strengthened

- 2.1 Prepare a corporate strategy to increase outreach to underserved clients, including women (Q2 2019–Q1 2020).
- 2.2 Prepare a new risk management framework, including management and reporting of liquidity, interest rate risk, and foreign exchange risk (Q2 2019–Q1 2020).
- 2.3 Prepare an environmental and social safeguards system (Q2 2019–Q1 2020).
- 2.4 Upgrade loan origination system, revise credit scoring system, and correspondingly revise credit origination and risk management procedures (Q2 2019–Q1 2021).
- 2.5 Administer training to loan officers on loan appraisal (Q2 2021–Q1 2022).

#### 3. Capacity of MSEs to access financial services enhanced

- 3.1 Prepare a white paper evaluating the effectiveness of government MSME support programs with an emphasis on women borrowers (Q3 2019–Q1 2020).
- 3.2 Initiate women client training program (Q3 2019).

### Inputs

#### Financing

ADB: \$50 million (ordinary capital resources – regular loan)

#### Technical Assistance Grant

Japan Fund for Poverty Reduction: \$1.0 million<sup>c</sup>

ADB = Asian Development Bank; MSEs = micro and small enterprises; MSMEs = micro, small, and medium-sized enterprises; Q = quarter; RDB = Regional Development Bank.

<sup>a</sup> Government of Sri Lanka. 2017. *Vision 2025*. Colombo.

<sup>b</sup> The 500 women are in addition to 750 women who are being trained under ongoing ADB. 2018. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for Cluster Development and Small and Medium-Sized Enterprise Finance Innovation*. Manila.

<sup>c</sup> The Japan Fund for Poverty Reduction is a possible funding source subject to approval of the Government of Japan. Source: Asian Development Bank.

### **LIST OF LINKED DOCUMENTS**

[HTTP://WWW.ADB.ORG/DOCUMENTS/RRPS/?ID=52219-001-3](http://www.adb.org/documents/rrps/?ID=52219-001-3)

1. Loan Agreement
2. Guarantee Agreement
3. Sector Assessment (Summary): Micro, Small and Medium-Sized Enterprises Financing
4. Project Administration Manual
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Financial Analysis
8. Economic Analysis
9. Country Economic Indicators
10. Summary Poverty Reduction and Social Strategy
11. Risk Assessment and Risk Management Plan
12. Attached Technical Assistance Report
13. Gender Action Plan
14. Financial Intermediary: Environmental and Social Management System Arrangement

### **Supplementary Documents**

15. Financial Management Assessment
16. Summary of Asian Development Bank's Sovereign Support for Small and Medium-Sized Enterprises Finance Sector in Sri Lanka
17. Basel III Implementation in South Asia