



Report and Recommendation of the President to the Board of Directors

Project Number: 48302-001
November 2014

Proposed Loan Hatton National Bank Supporting Infrastructure Development (Sri Lanka)

This is the version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 October 2014)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.0077
\$1.00	=	SLRs130.3550

ABBREVIATIONS

ADB	–	Asian Development Bank
CAR	–	capital adequacy ratio
CBSL	–	Central Bank of Sri Lanka
CEO	–	chief executive officer
ESMS	–	environmental and social management system
GDP	–	gross domestic product
HNB	–	Hatton National Bank
IFI	–	international financial institution
LCB	–	licensed commercial bank
NIM	–	net interest margin
NPL	–	nonperforming loan
SMEs	–	small and medium-sized enterprises

NOTES

- (i) The fiscal year (FY) of Hatton National Bank ends on 31 December. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2013 ends on 31 December 2013.
- (ii) In this report, “\$” refers to US dollars unless otherwise stated.

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CONTENTS

	Page
I. THE PROPOSAL	1
II. THE FINANCIAL INTERMEDIARY	1
A. Investment Identification and Description	1
B. Business Overview and Strategy	3
C. Ownership, Management, and Governance	4
III. THE PROPOSED ADB ASSISTANCE	5
A. The ADB Assistance	5
B. Implementation Arrangements	5
C. Valued Added by ADB Assistance	5
IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT	6
A. Development Impacts, Outcome, and Outputs	6
B. Alignment with ADB Strategy and Operations	6
V. POLICY COMPLIANCE	7
A. Safeguards and Social Dimensions	7
B. Anticorruption Policy	7
C. Investment Limitations	7
D. Assurances	7
VI. RECOMMENDATION	8

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan of up to \$100,000,000 to Hatton National Bank (HNB) comprising (i) an A-loan of up to \$75,000,000 and (ii) a B-loan of up to \$25,000,000 for Supporting Infrastructure Development in Sri Lanka.

II. THE FINANCIAL INTERMEDIARY

A. Investment Identification and Description

2. Sri Lanka has achieved rapid rates of growth since the end of the civil war in 2009 (7.5% on average from 2010 to 2013), with growth expected to be 7%–8% over the medium term. Strategic challenges for this middle-income country include ensuring inclusive growth, increasing the role of the private sector, strengthening economic development and integrating post-conflict areas, and managing government spending and bolstering revenues. Key drivers of the economic growth include significant infrastructure investments and increased private sector output, as well as higher private consumption as a result of increasing per capita income.

3. Infrastructure development is critical to ensuring inclusive growth and supporting recovery in the post-conflict areas. The World Bank estimates Sri Lanka's annual investment needs in infrastructure (excluding telecommunications) to be about \$4 billion, or 4%–7% of gross domestic product (GDP), to support high GDP growth until 2024.¹ With respect to post-conflict areas, many people have limited access to basic services that are readily available to people living in other areas. The Government of Sri Lanka's 10-year policy framework for economic development—Mahinda Chintana: Vision for the Future—was released in 2010 and targets an 8% annual growth rate.² The central theme of the Mahinda Chintana is that, following the conflict, infrastructure will be critical in attracting investment for sustained high growth in the future. Key sectors for development have been highlighted as energy, solid waste management, telecommunications, transport, and water and sanitation.

4. Investments in infrastructure are significant, and will need to be met by both the public and private sectors. Although decreasing, the country's budget deficit remained elevated at 5.8% in 2013, mainly because the government did not raise fiscal revenues, particularly through much-needed tax reforms. Government revenues continued to contract from 17.3% of GDP in 2006 to about 12.0% in 2013.³ This is among the lowest in the world, limiting the government's ability to fund social and economic development. The government now relies on foreign borrowing, which funds about 50% of its fiscal deficit. Given these government funding constraints, the Mahinda Chintana notes the need for diversified sources of funding for infrastructure projects. It also states that expanding private sector participation and introducing pricing policies and efficiency gains are needed to generate more self-financing investments by state enterprises, which is important to reducing reliance on debt financing. It notes that the finance sector will be the catalyst for accelerated economic growth envisaged in the future.

5. In line with the government's expectations for the finance sector's pivotal role in supporting economic development, the Central Bank of Sri Lanka (CBSL) on 2 January 2014 published its Road Map 2014, which was formulated with the aim of building a strong, dynamic,

¹ World Bank. 2013. *Investing in Infrastructure: Harnessing Its Potential for Growth in Sri Lanka*. Washington, DC.

² Ministry of Finance and Planning, Department of National Planning. 2010. *Mahinda Chintana: Vision for the Future*. Colombo. <http://www.treasury.gov.lk/publications/mahindaChintanaVision-2010full-eng.pdf>

³ International Monetary Fund. 2014. *IMF Country Report No. 14.285: Sri Lanka*. Washington, DC.

and internationally competitive finance sector with cross-border linkages and a significant overseas presence. Sri Lanka has 33 banks, many of which are small, and this number is disproportionate to its small population as well as the bank–population ratio of other emerging countries in Asia.⁴ However, the country’s banking sector remains concentrated with six large systemically important banks, including HNB. These six banks accounted for about 65% of sector assets at the end of 2013. The structure of the banking sector makes it more vulnerable to contagion risks while making it difficult for small banks to achieve economies of scale and diversification. Just below half the assets of the banking sector are with the public sector. The main objectives of CBSL’s consolidation plan are (i) a larger aggregate capital base for the remaining institutions,⁵ (ii) increased potential to finance large-scale transactions, (iii) increased investments by foreign investors, (iv) improved levels of efficiency and profitability, (v) availability of a full range of financial services at affordable costs, and (vi) more effective supervision. The consolidation plan is viewed as credit positive because it raises minimum capital requirements and introduces a timeline for the introduction of Basel III standards for banks, commencing in January 2015.⁶ In addition, CBSL has a target of five commercial banks reaching a total asset size of at least SLRs1 trillion. By increasing scale, these banks will be able to access international capital markets, which is challenging for the banks, and to provide large-scale funding needs for a high growth Sri Lankan economy.

6. ADB has been active in the finance sector since the conflict, providing much-needed longer-term debt to banks to support housing finance and small and medium-sized enterprises (SMEs) onlending, as well as supporting trade finance through ADB’s Trade Finance Program.⁷ In light of finance sector consolidation, ADB can play a significant role in the reform process and to support widening of access to finance, particularly in areas such as infrastructure finance. Many of the upcoming infrastructure projects are small, and some involve funding to provincial and quasi-government entities. As such, international financial institutions (IFIs) cannot fund these projects on a direct basis. To address the financing gap for these small infrastructure projects, ADB met with several banks to identify suitable financial institutions to support long-term funding. HNB is the second largest private commercial bank and an established market leader in the microfinance, SMEs, and infrastructure financing segments with over two decades of experience in lending to infrastructure projects.⁸ HNB has an extensive network and promotes inclusive finance. It has been providing funding for infrastructure projects since 1975 and it is one of the largest funders of renewable energy projects in Sri Lanka. HNB has maintained a relationship with ADB since 1990 as a lending conduit for sovereign loans for ADB’s development, infrastructure, SME, and agriculture targeted lending programs in Sri Lanka. It also became a member of ADB’s Trade Finance Program in 2008. As such, HNB is a strong candidate for long-term funding for infrastructure projects. This is ADB’s first nonsovereign

⁴ The banking sector comprises 24 licensed commercial banks (LCBs) and nine licensed specialized banks. As of the end of 2013, LCBs accounted for 48.7% of total financial system assets and 69.9% of banking sector assets. The two largest LCBs and the largest licensed specialized bank are state-owned.

⁵ The minimum capital requirement for commercial banks will increase from SLRs5 billion in 2014 to SLRs10 billion from 1 January 2016. A minimum total asset requirement of SLRs100 billion will also apply from 1 January 2016. For nonbank financial institutions, the minimum capital requirement will increase from SLRs200 million or SLRs300 million in 2014 (depending on the classification) to SLRs1 billion from 1 January 2016, with a further increase to SLRs1.5 billion from 1 January 2018.

⁶ Moody’s. 2014. Sri Lanka’s Plan to Consolidate Non-Bank Financial Institutions is Credit Positive. *Asia Pacific Weekly*. 27 January.

⁷ ADB. 2003. *Report and Recommendation of the President to the Board of Directors: Proposed Trade Finance Facilitation Program*. Manila.

⁸ HNB was awarded Bank of the Year 2013 in Sri Lanka for the second consecutive year by the United Kingdom-based *The Banker* magazine, Best Managed Bank in Sri Lanka at the Asian Banker Summit 2013, and was rated the sixth most valuable brand in Sri Lanka by Brand Finance Lanka (affiliated with Brand Finance UK) for 2013.

financial institution initiative targeting the infrastructure sector in Sri Lanka, and supports the central theme of the government's policy framework for economic development, while complementing previous initiatives that have targeted other sectors critical for economic growth such as SMEs, trade, and housing finance.

B. Business Overview and Strategy

7. HNB commenced operations in 1888 as a specialized bank to cater to the tea industry. It has evolved from a small local bank to the second largest private bank in the country. HNB has achieved this growth both organically and through acquisitions: it acquired Mercantile Bank in 1974, the Sri Lanka unit of Emirates Bank International in 1989, and the Colombo branch of Banque Indosuez in 1996. HNB was incorporated as a limited liability and publically traded commercial bank in 1970. Its ordinary shares and unsecured subordinated debt are listed on Colombo Stock Exchange.⁹

8. HNB provides services through its key business segments—corporate, SMEs, personal banking, development banking, and microfinance. It has the largest network of all private sector banks (250 branches); and its wide outreach via ATMs, internet, and mobile banking channels has helped build its strong brand. HNB has made significant investments in information technology and its service delivery platform, and considers this a core differentiating factor in terms of market positioning. It believes this will allow it to offer a greater number of services to its target market segments, as well as provide HNB with substantially greater outreach than its competitors, thereby achieving greater market penetration in the retail and SME segments. On 1 October 2014, HNB signed an agreement to buy 51% of Prime Grameen Micro Finance. This acquisition, which is subject to regulatory approvals, will strengthen HNB's pioneering role in the development of rural Sri Lanka by expanding its microfinance operations.

9. **Infrastructure finance.** As noted, HNB has been active in infrastructure financing since 1975. It established a project finance unit in 1982, and the team has built a strong track record and is financing a wide range of infrastructure opportunities in the public and private sectors. It has also acted as a participating credit institution in IFI projects targeting infrastructure development. These include a World Bank Energy Services Delivery Project (1997–2002) and the Renewable Energy for Rural Economic Development Scheme (2003–2008), and the Post Tsunami Credit Line of the European Investment Bank. Despite HNB's long record in infrastructure financing, it has never reported a loss in this segment. HNB maintains sound credit quality through careful selection of projects at the business development stage. The project finance team has its own technical experts (including civil engineers) and HNB hires independent experts to assess the technical risks for infrastructure projects. Credit management for corporate borrowers, including infrastructure financing, is centralized at the head office. HNB maintains a dedicated infrastructure credit administration cell of six people in the risk management team, responsible for overseeing progress on each project, including disbursement, monitoring of work completed, stage releases, and reporting.

⁹ All commercial banks in Sri Lanka, aside from the two large state-owned banks, are required to partially list their stock on Colombo Stock Exchange.

C. Ownership, Management, and Governance

1. Ownership

10. HNB's two largest single shareholders are government entities—Sri Lanka Insurance Corporation and the Employees Provident Fund. The remaining large shareholders are listed in Table 1 and are companies involved in trade, manufacturing, import–export, and beverages.

Table 1: Hatton Nation Bank's Voting Shareholding Structure^a

Shareholders	% of Shares Held
Sri Lanka Insurance Corporation	14.9
Employees' Provident Fund	10.0
Jayawardena family ^b	18.2
Captain family	8.3
Sonetto Holdings Ltd.	4.6
Franklin Templeton	4.3
National Savings Bank	2.9
Other investors (each holding <2.7%)	36.8
Total	100.0

^a Based on shareholdings on 30 June 2014.

^b Jayawardena family shares are held through Milford Exports (8.1%), Stassen Exports (7.0%), and Distilleries Co. of Sri Lanka (3.1%).

Source: Hatton National Bank.

2. Management

11. HNB has a strong management team. J. Alles, previously the chief operating officer, became chief executive officer (CEO) on 1 July 2013. The deputy general manager (risk and credit quality) was then promoted to chief operating officer. Members of HNB's senior executive management team have strong academic and professional backgrounds, most with extensive banking experience in Sri Lanka and abroad.

3. Governance Structure

12. HNB has a sound governance structure. Its board consists of 10 directors, six of whom are considered independent. The former deputy governor of CBSL chairs the board. The CEO sits on the board as the only executive member. The board members have a well-balanced knowledge base spanning public finance, monetary policy, manufacturing, banking, investment, engineering, and accounting. According to the statutes of HNB, the maximum tenure for a board member is 9 years (i.e., 3-year terms, with the possibility of being reelected three times) and no term limits exist for the CEO. New board members are vetted by the nomination committee and approved by the board, with the consent of CBSL.¹⁰

¹⁰ Sri Lanka was identified as a strategically deficient jurisdiction by Financial Action Task Force (FATF) standards in February 2010. However, during 2013, FATF noted Sri Lanka's significant progress in improving its regime for combatting money laundering and the financing of terrorism and Sri Lanka is therefore no longer subject to FATF's monitoring process under its ongoing global compliance process for combatting money laundering and the financing of terrorism.

III. THE PROPOSED ADB ASSISTANCE

A. The ADB Assistance

13. The assistance consists of a loan of up to \$100 million comprising an A-loan of up to \$75 million and a B-loan of up to \$25 million, with a tenor of up to 7 years. The loan will be used by HNB to onlend for infrastructure projects, including renewable energy projects. Pricing will be market-based. A portion of the risk on the A-loan may be transferred to counterparties that are eligible under ADB's policies.

B. Implementation Arrangements

14. HNB will provide ADB with financial reports at predetermined regular intervals and as requested, including (i) unaudited financial statements on a quarterly basis, (ii) audited financial statements on an annual basis, (iii) compliance certificates for agreed-upon financial covenants, (iv) reporting on characteristics of the infrastructure loan portfolio, and (v) annual reporting on selected development indicators agreed between ADB and HNB. Annual reports on safeguards and social protection compliance will also be required.

C. Value Added by ADB Assistance

15. **Supporting banking sector reform.** The Sri Lankan finance sector is undergoing significant reform through a consolidation process, requiring banks to hold higher levels of capital as it moves toward Basel III implementation in the coming years. CBSL has a target of five commercial banks each reaching a total asset size of at least SLRs1 trillion to create institutions with enough scale to be able to access international capital markets, which is very challenging and expensive for the banks. In addition to the two large state-owned banks, HNB is expected to be one of the remaining three institutions in this bracket. By working with one of Sri Lanka's leading private commercial banks through this process and providing long-term debt financing and balance sheet support, ADB has a unique opportunity to support reform and promote private sector participation in the Sri Lankan finance sector. CBSL considers that institutions such as ADB have an important role to play by working closely with the larger banks as they undertake reform.

16. **Greater access to finance for infrastructure development.** Following the end of the civil war in 2009, HNB is seeking to play an active role in supporting national development through the provision of financing support for infrastructure development, which is a key development focus for the Government of Sri Lanka. HNB is one of the largest commercial bank lenders to infrastructure projects in Sri Lanka, particularly in the lesser developed provinces, including the Northern Province. The proposed assistance is expected to fill a much-needed gap for long-term financing for infrastructure projects in the most underdeveloped regions of the country. The project is also expected to catalyze additional sources of long-term financing through potential B loan participation.

17. **Adherence to market leading standards.** ADB's engagement with HNB will play an important role in developing and supporting HNB's adherence to high corporate governance standards, as well as the adoption of market leading risk management, social, and environmental standards—thereby enhancing risk management, environmental, and social responsibility at one of Sri Lanka's largest financial institutions.

IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impacts, Outcome, and Outputs

1. Impacts

18. ADB's financing to HNB is expected to contribute to two impacts. First, it will help increase access to finance for much-needed infrastructure development in Sri Lanka. Second, it will contribute to increasing the level of private credit in the banking system. These impacts will be reflected in (i) a rise in the ratio of private banking sector credit to GDP, and (ii) an increase in the share of infrastructure and construction loans to total banking sector loans.

2. Outcome

19. ADB's funding will support HNB's infrastructure portfolio to grow sustainably. Key performance indicators include (i) growth in HNB's infrastructure portfolio, and (ii) maintenance of sound asset quality.

3. Outputs

20. The outputs of the project are (i) increased infrastructure finance, and (ii) an environmental and social safeguards system. The debt financing will result in HNB having additional financial resources for infrastructure project development.

B. Alignment with ADB Strategy and Operations

21. Finance sector development and infrastructure development are two of the five core specializations under Strategy 2020¹¹ and its midterm review where ADB will focus its operations and best support its agenda.¹² ADB aims to strengthen its support to the finance sector at the regional and national levels by helping develop financial infrastructure, institutions, and delivery of products and services to promote inclusive growth. Through such initiatives, ADB will continue to assist in channeling funding into the most productive investments, as well as continue to build the capacity of financial institutions by introducing international best practices. The project supports institutional and finance sector development and the deepening of the finance sector by increasing the capacity of a sound commercial bank in Sri Lanka to expand lending for infrastructure development projects. The proposal is, therefore, consistent with Strategy 2020 and its midterm review.

22. The proposed project is directly aligned with the government's development policy framework for 2010–2016, which aims to accelerate economic growth, improve access to finance, address inadequate and poor quality of infrastructure as a major constraint to rapid economic growth, and increase the low level of private sector investment. ADB's 2012–2016 country partnership strategy for Sri Lanka is built on the government's development policy framework and Strategy 2020, and calls for ADB support for private sector development, including projects that accelerate the pace of private sector participation and promote finance sector development.¹³ The project also supports inclusive and sustainable economic growth as outlined in the country partnership strategy, as the project will contribute to these objectives

¹¹ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

¹² ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

¹³ ADB. 2011. *Country Partnership Strategy: Sri Lanka, 2012–2016*. Manila.

through infrastructure development. It is also consistent with ADB's country operations business plan to catalyze private investment and promote inclusive growth in Sri Lanka and to support finance sector development through ADB's Private Sector Operations Department.¹⁴ ADB has supported the private finance sector since the conflict. It provided a \$15 million senior loan to DFCC Vardhana Bank in 2012 to support housing finance and a \$15 million senior loan to Nations Trust Bank in 2013 to support SME finance in Sri Lanka. Eight Sri Lankan banks are active in ADB's Trade Finance Program. The proposed project will build on ADB's work and support reform efforts in the finance sector.

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

23. The project is classified category FI for impacts on the environment, involuntary resettlement, and indigenous peoples. The investment's potential environmental and social impacts, its risks associated with HNB's existing and likely future portfolio, and its commitment and capacity for environmental and social management have been assessed. HNB will not use the ADB funding for onlending to infrastructure projects that are category A for impacts on the environment, involuntary resettlement, or indigenous peoples. Enhancements have been identified to HNB's environmental and social management system (ESMS) for compliance with ADB's Safeguard Policy Statement (2009), and the borrower commits to establish an updated ESMS satisfactory to ADB before disbursement for the financing of infrastructure projects. HNB will apply ADB's prohibited investment activities list, ensure that investments abide by applicable national laws and regulations, and comply with ADB requirements. The ESMS will include arrangements to comply with national labor laws and ADB's social protection strategy¹⁵ to ensure adherence to internationally recognized core labor standards, including provisions prohibiting discrimination against women in hiring and providing equal pay for equal work for men and women.

B. Anticorruption Policy

24. HNB was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

C. Investment Limitations

25. The proposed loan is within the medium-term country, industry, group, and single investment exposure limits for nonsovereign investments.

D. Assurances

26. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),¹⁶ the Government of Sri Lanka will be requested to confirm that it has no objection to the proposed assistance to HNB. ADB will enter into suitable finance and investment documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

¹⁴ ADB. 2014. *Country Operations Business Plan: Sri Lanka, 2014–2016*. Manila.

¹⁵ ADB. 2001. *Social Protection*. Manila.

¹⁶ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

V. RECOMMENDATION

27. 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 up to \$100,000,000 to Hatton National Bank comprising

(i) an A-loan of up to \$75,000,000 from ADB's ordinary capital resources, and
(ii) a B-loan of up to \$25,000,000 to be funded by participating commercial bank(s),
for Supporting Infrastructure Development in Sri Lanka, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Takehiko Nakao
President

11 November 2014