



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

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Project Number: 49188-001  
October 2015

## Proposed Senior Loans LOLC Finance and LOLC Micro Credit (Sri Lanka)

This is an abbreviated 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 16 October 2015)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.007
\$1.00	=	SLRs143.07

## ABBREVIATIONS

ADB	–	Asian Development Bank
CAR	–	capital adequacy ratio
LOFC	–	LOLC Finance
LOLC	–	Lanka ORIX Leasing Company
LOMC	–	LOLC Micro Credit
MSMEs	–	micro, small, and medium-sized enterprises
NBFI	–	nonbank financial institution
NPL	–	nonperforming loan
SLC	–	specialized leasing company
SME's	–	small and medium-sized enterprises
TA	–	technical assistance

## NOTES

- (i) The fiscal year (FY) of LOLC Finance and LOLC Micro Credit ends on 31 March. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY2015 ends on 31 March 2015.
- (ii) In this report, "\$" refers to US dollars.

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## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) the proposed senior loan of up to \$75,000,000 to LOLC Finance (LOFC) consisting of (a) an A loan of up to \$30,000,000, and (b) a B loan of up to \$45,000,000; and (ii) the proposed senior loan of up to \$25,000,000 to LOLC Micro Credit (LOMC), for micro, small, and medium-sized enterprises (MSMEs) in Sri Lanka.

## II. THE FINANCIAL INTERMEDIARY

### A. Investment Identification and Description

2. Despite an average gross domestic product growth rate of 5.7% from 2012 to 2014, Sri Lanka had a poverty rate of 6.7% and an unemployment rate of 4.7%.<sup>1</sup> The government has identified small and medium-sized enterprises (SMEs) as key to sustainable economic growth.<sup>2</sup> In 2014, SMEs contributed to 20% of exports, 30% of the production value added in the manufacturing sector, and 70% of total employment, and were prominent in the leasing, agriculture, manufacturing, construction, and service sectors in Sri Lanka.<sup>3</sup> In 2014, SMEs contributed about \$75 billion (52%) to gross domestic product.<sup>4</sup> Although Sri Lanka has a large number of banks and nonbank financial institutions (NBFIs), it is estimated that there is an unbanked population of approximately 70%, with access to finance cited by an International Finance Corporation study as being the major limiting factor for MSMEs.<sup>5</sup>

3. The Asian Development Bank (ADB) has provided funding through its sovereign and nonsovereign operations to support economic development through the financial sector. Via its nonsovereign operations, much needed longer term funding was provided to financial institutions, targeting borrowers in post conflict areas and other underserved markets, including housing and infrastructure finance, and SME onlending. Short-term funding in support of trade was provided through ADB's Trade Finance Program. Given the need to fund MSME growth and expand access to finance to underserved customer segments, ADB identified two NBFIs as good candidates to reach the underbanked customer segments, which cannot easily obtain traditional bank financing. LOFC, ranked third in terms of total assets among NBFIs in Sri Lanka, is a licensed finance company that was established in 2003 and now has 140 branches and service outlets, offering leasing and hire purchase loans for commercial use as well as Islamic finance products to moderate to middle-income clientele. Its average loan size was

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<sup>1</sup> Government of Sri Lanka, Department of Census and Statistics. <http://www.statistics.gov.lk>  
[http://www.statistics.gov.lk/poverty/SpatialDistributionOfPoverty2012\\_13.pdf](http://www.statistics.gov.lk/poverty/SpatialDistributionOfPoverty2012_13.pdf); ADB. 2015. *Asian Development Outlook 2015: Financing Asia's Future Growth*. Manila;

<sup>2</sup> United National Front for Good Governance. 2015. *A New Country in 60 Months: Five Point Plan*. Colombo.

<sup>3</sup> Government of Sri Lanka, Ministry of Finance and Planning. 2015. *Annual Report 2014*. Colombo; R. Athukorala. 2010. SMEs generate US\$ 30 b+ to Sri Lankan economy. *Sri Lanka Daily Financial Times*. 9 November; H. Priyanth and S. Premaratne. 2014. Government SME Development Programs in Sri Lanka: A Review in the Lens of Transaction Cost Econo. *Sabaragamuwa University Journal*.13 (2).

<sup>4</sup> L. Wijeyewardena. 2015. Enhancing Financial Accessibility for Small and Medium-Sized Enterprises (SMEs): Lessons from National Practices on Improving Access to Finance in Asia and the Pacific. Manila. 2–3 September.

<sup>5</sup> As of the end of 2014, there were 34 banks and 56 NBFIs in Sri Lanka. Central Bank of Sri Lanka. 2014. *Annual Report 2014*. Colombo; D. Parker. 2012. Prepaid Cards forecast to follow prepaid mobile phones in Lanka. *Daily News*. 10 April. International Finance Corporation. 2013. *Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises*. Washington, DC; International Finance Corporation. 2011. *Sri Lanka Country Profile*. Washington, DC.

\$15,000 as of FY2014. LOMC, ranked seventh in terms of total assets among NBFIs in Sri Lanka, started operations in 2009 as a specialized leasing company (SLC) and provides individual and group loans and leases to MSMEs, including farmers and women in rural areas in Sri Lanka.<sup>6</sup> Women borrowers account for 70% of its loan and/or lease portfolio. It has 128 branches and service outlets throughout 10 provinces in Sri Lanka and, as March 2015, had 249,000 clients.<sup>7</sup> LOMC's average loan size was \$4,000 as of FY2014. LOFC and LOMC are substantially owned by the Lanka ORIX Leasing Company (LOLC) Group, Sri Lanka's largest NBFIs, which received funding from ADB in 2007.<sup>8</sup> By targeting these two companies that prioritize financial inclusion, ADB will be able to reach a wider customer income base across the MSME segment.

## **B. Business Overview and Strategy**

4. LOLC Group, the first leasing company in Sri Lanka, was established in 1980 through a government initiative to support SME access to credit. It is one of the largest financial services conglomerates offering an array of products and a pioneer in the leasing industry in Sri Lanka. It had total assets of SLRs246.0 billion as of FY2015 and a market capitalization of SLRs49.1 billion as of 30 August 2015. The LOLC Group has 274 branches across the country. SME and microfinance businesses are core focus areas of the group, accounting for as much as 42% of its revenue. The group's financial solutions combine funding with advisory and technical support, which together help improve the supply chain and marketing linkages for MSME customers.

5. LOFC's loan book was SLRs57.9 billion as of FY2015. LOFC will broaden its funding base with international financial institution and commercial funding. Small LOFC units will be established in LOLC Group branches to leverage cross-selling opportunities and expand LOFC's presence beyond its 140 branches. LOFC will continue to enhance the services of its Islamic finance unit, Al-Falaah, by introducing a range of deposit and savings products, and by expanding its services using the ORIX Realtime internet platform.<sup>9</sup>

6. It has a large rural presence with 128 branches, with an expected 175 branches by 2018. LOMC sources its funding primarily through international financial institutions and social impact investors.<sup>10</sup>

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<sup>6</sup> SLCs are unable to take deposits. The government is working on suitable legislation for the microfinance sector which would enable LOMC to take deposits. The act is expected to become effective in 2016. Group loans are taken on a joint liability basis (with a minimum of three members) where the repayment obligation is borne by all the members in case of default.

<sup>7</sup> LOMC and LOFC have shared premises in 128 branches and service outlets of which 100 are outside Colombo, including 47 in the north and east, which will help LOFC and LOMC better assess and serve the postconflict areas, as well as customers outside of Colombo.

<sup>8</sup> ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Secured Loans to the Republic of the Maldives and Democratic Socialist Republic of Sri Lanka for the South Asian Small and Medium-Sized Enterprise Leasing Facility*. Manila; ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Democratic Socialist Republic of Sri Lanka for the People's Leasing Company Limited and Commercial Leasing Company Limited*. Manila; ICRA Lanka. 2014. ICRA Lanka re-affirms the [SL] A- rating with a stable outlook. News release. 12 October.

<sup>9</sup> A platform that combines the use of the internet, smartphones and basic mobile phones to facilitate consumer participation across the country.

<sup>10</sup> European Bank for Reconstruction and Development, Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (Dutch De, ResponsAbility, Proparco, Symbiotics, and Blue Orchard)

## C. Ownership, Management, and Governance

7. The LOLC Group is Sri Lanka's largest nonbank financial conglomerate, with 118 companies in finance, agriculture, plantations, renewable energy, leisure, construction, manufacturing, and trading. The Nanayakkara family, the founders of the LOLC Group, owns 53% of the LOLC Group, the ORIX Corporation of Japan owns 30%, and the remaining 17% is publicly held.

### 1. LOLC Finance

8. **Ownership.** LOFC's main shareholders are the LOLC Group (90.0%) and Saakya Capital (4.6%).<sup>11</sup> LOFC is listed on the Colombo Stock Exchange. As of 30 August 2015, LOFC had a market capitalization of SLRs11.5 billion.<sup>12</sup>

9. **Management.** LOFC benefits from a strong management team. Ashan Nissanka, the current chief executive officer, has been with the LOLC group since 1998 and with LOFC since inception. Members of LOFC's senior executive management team have strong academic and professional backgrounds, and most have extensive banking experience. There are two management committees that meet monthly or biweekly as needed: Assets and Liabilities Committee, and Head Office Credit Committee.<sup>13</sup> Together, these committees help support and promote an effective risk management structure, and careful monitoring and compliance with regard to policies and procedures.<sup>14</sup>

10. **Governance structure.** LOFC's board comprises seven members who bring extensive international banking and other professional experience to LOFC. The board includes three independent nonexecutive directors and one nonexecutive director. The board is responsible for approving LOFC's strategic plan and key policies, and for monitoring their implementation through the board committees, management committees, and key management personnel, who are appointed by the board.<sup>15</sup>

### 2. LOLC Micro Credit

11. **Ownership.** LOMC's shareholders are the LOLC Group (80%) and Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (Dutch development Bank) (20%).

12. **Management.** LOMC has a strong management team headed by Ravi Tissera, who has extensive experience in development banking and has been with LOMC since it began as a subsidiary of the LOLC Group in 2009. Members of LOMC's senior executive management team have good academic and relevant professional backgrounds. There are two management committees that meet monthly or biweekly as needed: Assets and Liabilities Committee, and

<sup>11</sup> Saakya Capital comprises 11 individual shareholders, with no individual owning more than 0.39% of the shareholding.

<sup>12</sup> Colombo Stock Exchange. LOFC Company Profile. [http://www.cse.lk/company\\_info.do?symbol=LOFC.N0000](http://www.cse.lk/company_info.do?symbol=LOFC.N0000) (accessed 30 August 2015).

<sup>13</sup> Generally, Head Office Credit Committee approval is required for unsecured credit applications exceeding SLRs25 million and secured credit applications exceeding SLRs249 million.

<sup>14</sup> LOLC Finance and LOLC Micro Credit Board of Directors and Senior Management and Lanka ORIX Leasing Company Organizational Chart (accessible from the list of supplementary documents in Appendix 2).

<sup>15</sup> LOLC Finance and LOLC Micro Credit Board of Directors and Senior Management (accessible from the list of supplementary documents in Appendix 2).

Head Office Credit Committee.<sup>16</sup> An overview of LOMC's senior management team and organizational chart is in the Ownership, Management, and Governance linked document.<sup>17</sup>

13. **Governance structure.** LOMC's board of directors comprises six members who bring extensive international banking and other professional experience to LOMC. The board includes two independent nonexecutive directors and three nonexecutive directors. The roles of the board chair and the chief executive officer are separate. The board is responsible for approving LOMC's strategic plan and key policies, and for monitoring their implementation through the board committees and senior management personnel, who are appointed by the board (footnote 17).

## D. Financial Performance

### 1. LOLC Finance

14. **Capital.** LOFC is well capitalized, with a tier 1 capital adequacy ratio (CAR) of 13.1% and total CAR of 18.1% in FY2015 (compared with 13.1% as of FY2014). The increase in CAR from FY2014 to FY2015 was due to the issuance of unsecured redeemable subordinated debentures in January 2015 amounting to SLRs5.0 billion. LOFC remains well above the regulatory minimums of 5% for the tier 1 capital ratio and 10% for the total CAR, which gives the finance company good absorptive capacity.<sup>18</sup> To support LOFC's portfolio growth and its healthy capital position, LOFC has not paid any dividends from 2000 to 2015.

15. **Earnings and profitability.** LOFC had a net income of SLRs1.48 billion in FY2015, compared with SLRs1.0 billion as of FY2014. As of FY2015, net interest income was SLRs5.9 billion (FY2014: SLRs4.4 billion) and noninterest income was SLRs1.3 billion (FY2014: SLRs0.9 billion). Net interest income increased 34% in FY2015 from FY2014 due to (i) the existing lending portfolio yielding above current market rates; and (ii) significant growth in the portfolio. The net interest margin remained high at 10.5% in FY2015 (FY2014: 9.5%). The cost-to-income ratio increased slightly from 47.5% in FY2014 to 48.0% in FY2015; operational efficiencies are expected in 2015–2018 following heavy investments in technology. As of FY2015, return on assets increased to 2.5% (2014: 1.9%) and return on equity to 20.4% (2014: 16.7%).

16. **Loan portfolio and asset quality.** LOFC's gross loan portfolio grew 29.4% from SLRs44.7 billion in FY2014 to SLRs57.9 billion in FY2015. Innovative customer-oriented solutions and increased accessibility contributed to loan growth.<sup>19</sup> LOFC maintains a diversified portfolio in terms of concentration by sector. The largest industry concentrations were loans for trade, which comprised 33% of the loan portfolio, followed by transportation and services (29%), manufacturing (13%), agriculture (8%), construction (8%), and others (9%) as of the end of FY2015.<sup>20</sup> The average loan tenor was 50 months.<sup>21</sup> Additionally, all MSME leases are collateralized by their underlying lease assets.

<sup>16</sup> Branch managers have a limit of SLRs500,000 for individual and group loans; anything above this limit has to be approved by regional managers. Other approval levels are similar to those of LOFC.

<sup>17</sup> Ownership, Management, and Governance (accessible from the list of linked documents in Appendix 2).

<sup>18</sup> Government of Sri Lanka, Central Bank of Sri Lanka. 2015. *Annual Report 2014–2015*. Colombo; LOLC Finance. 2014. *Annual Report 2014*. Colombo.

<sup>19</sup> These included more ATMs and products specially catered to LOFC's Islamic finance unit.

<sup>20</sup> Other sectors included economics and social (accounting, internet, computers); tourism; and quarrying (transportation of stones and granite).

<sup>21</sup> The 5% of loans that are unsecured require at least two guarantors and a clean credit profile from the Credit Information Bureau of Sri Lanka.

17. Although there was economic uncertainty due to the change in government in January 2015, LOFC had strong growth in the loan portfolio and, as a result, strengthened its underwriting and monitoring capacity and LOFC engages in minimal related party lending (12.7% of total equity, compared with the Central Bank of Sri Lanka's limit of 20.0%).

18. **Funding and liquidity.** LOFC shifted its funding strategy in FY2015. Although LOFC's main source of funding was deposits, this decreased to 69.0% of total liabilities as of FY2015 (FY2014: 90.8%).<sup>22</sup> The decrease in deposits by 21.8% (as a percentage of total liabilities) was due to LOFC's shift toward bank and corporate borrowings to take advantage of lower interest rates. In addition, bank borrowings accounted for 22.3%, trade and other payables accounted for 7.2%, and derivatives and tax liabilities accounted for 1.5% of total liabilities. LOFC's loan-to-deposit ratio was 140.2% in FY 2015 (2014: 105.0%).<sup>23</sup> Foreign exchange risk was low with an open position of 2.16% as of FY2015. LOFC uses forward exchange contracts to hedge open positions.

## 2. LOLC Micro Credit

19. **Capital.** LOMC has maintained a healthy capital position with a CAR greater than 20% from 2012 to 2015. This was supported by 100% retention of profits and fresh capital infusions in FY2012 and FY2013 amounting to SLRs890 million. LOMC is well capitalized with a tier 1 capital ratio and CAR of 19.7% as of FY2015 (FY2014: 25.5%).<sup>24</sup> The decrease in CAR from FY2014 to FY2015 was due to loan book expansion and LOMC incurring additional costs to introduce new banking operations and expand its rural network. However, LOMC remains well above the regulatory minimum of 5% for tier 1 capital ratio and 10% for total CAR. The tier 1 capital ratio and total CAR are targeted to reach 24% by FY2018.

20. **Earnings and profitability.** LOMC had a net income of SLRs1.1 billion as of FY2015, representing strong growth of 54.7% from its FY2014 net income of SLRs730 million. As of FY2015, net interest income was SLRs4.5 billion (FY2014: SLRs3.1 billion) and noninterest income was SLRs496.6 million (FY2014: SLRs406.8 million). The net interest margin increased from 13.6% in FY2014 to 16.8% in FY2015 due to higher yields from MSME loans and strategic market positioning. The cost-to-income ratio improved to 43.5% in FY2015 (FY2014: 42.9%) due to operational efficiencies. The cost-to-income ratio is expected to remain below 50% through FY2018. As of FY2015, return on assets increased to 3.9% (FY2014: 3.0%) and return on equity increased to 22.5% (FY2014: 17.9%).

21. **Loan portfolio and asset quality.** LOMC's gross loan portfolio increased 31.5% to SLRs26.1 billion as of FY2015 (FY2014: SLRs19.8 billion).<sup>25</sup> Growth was due to increased demand for three-wheelers and microgroup loans. LOMC maintains a diversified portfolio in terms of concentration by sector. The largest industry concentrations as of March 2015 were loans for services, which comprised 45% of the loan portfolio, followed by small businesses (34%) and agriculture (21%). The average loan tenor was about 54 months for individual loans and 18 months for group loans. With strong loan growth and improved underwriting measures, Asset quality for microloans as measured by NPLs (30 days past due, an industry standard for microfinance institution loans) improved from 0.9% in FY2014 to 0.5% in FY2015. LOMC's loan

<sup>22</sup> The sector growth was 48.5% as of December 2014.

<sup>23</sup> Sector average as of December 2014 was 154%.

<sup>24</sup> The sector average was a tier 1 capital ratio of 14.7% and total CAR of 16.6% as of the end of 2014.

<sup>25</sup> The sector average was 16% as of December 2014.

loss reserves for NPLs were high at 86.6% as of FY2015 (FY2014: 153.8%).<sup>26</sup> As of FY2015, exposure to the top 20 group obligors was very low at 2.2% of total capital, and LOMC engaged in minimal related party lending (8.0% of total equity).

22. **Funding and liquidity.** LOMC's main source of funding in FY2015 was borrowings (as an SLC, it cannot take deposits). As a result, this contributed to higher funding costs. As of FY2015, borrowings accounted for 83.3% of total liabilities (FY2014: 89.1%). Other liabilities included trade and other payables (11.3%); deferred tax liabilities (2.5%); and bank overdrafts, retirement obligations, and derivative financial instruments (2.9%). As of FY2015, LOMC maintained a liquid assets ratio of 18%, which was above the sector requirement of 10%. ADB funding will be beneficial to LOMC given the lack of longer tenor loans, robust loan growth, and the need for continued foreign funding given the shallow capital markets. LOMC uses forward exchange contracts to hedge foreign exchange risks to prevent any currency mismatch. As of FY2015, LOMC had an open currency exposure of 2.6%.

### III. THE PROPOSED ADB ASSISTANCE

#### A. The Assistance

23. The proposed ADB assistance consists of (i) a loan of up to \$75 million to LOFC comprising (a) an A loan of up to \$30 million and (b) a B loan of up to \$45 million; and (ii) a loan of up to \$25 million to LOMC. The A loan to LOFC will have a tenor of up to 7 years, and the B loan will have a tenor of up to 3 years. The loan to LOMC will have a tenor of up to 5 years. LOFC and LOMC will use the proceeds of the loans exclusively for onlending to eligible MSMEs.<sup>27</sup> ADB will also provide a capacity development technical assistance (TA) from an existing TA for an environmental and social management system, product development for mobile banking, and financial literacy training.<sup>28</sup>

#### B. Implementation Arrangements

24. Monitoring of the project will be carried out by ADB.<sup>29</sup> LOFC and LOMC will provide ADB with financial reports at predetermined intervals, including (i) audited and unaudited financial statements; (ii) compliance certificates for financial covenants; (iii) reporting on the MSME loan portfolio and gender action plan; and (iv) annual reporting on selected development indicators agreed between ADB, LOFC, and LOMC. Annual reports on safeguards and social protection compliance will also be required.

#### C. Value Added by ADB Assistance

25. **Improving access to stable and longer-tenor finance for micro, small and medium-sized enterprises through support of nonbank financial institutions.** The loan will provide critically needed longer tenor funding to MSMEs in Sri Lanka, whose ability to access funds has been constrained by the country's low level of finance sector development—including the

<sup>26</sup> LOMC. 2015. *Annual Report 2015*. Colombo. In addition to specific provisions for NPLs, LOMC does a collective impairment based on historical trends, probability of default, and timing of recoveries. For FY2015, this amounted to SLRs175 million and accounted for 1% of its performing loans.

<sup>27</sup> Eligible MSMEs are those with an annual turnover not exceeding SLRs600 million. Government of Sri Lanka, Central Bank of Sri Lanka. 2011. *Banking Act Direction No. 9 of 2011*. Colombo.

<sup>28</sup> ADB will complement the proposed investment with TA from the following: ADB. 2014. *Technical Assistance for Promoting Capacity Building in Financial Institutions in Emerging Countries in South Asia*. Manila.

<sup>29</sup> Details of Implementation Arrangements (accessible from the list of linked documents in Appendix 2).

absence of a well-developed capital market—which limits availability of such funding, particularly for NBFIs. ADB financing will support longer tenor leasing products and also allow for recycling of shorter-term microloans.

26. **Mobilizing cofinancing.** ADB will catalyze additional private sector funding through a syndicated loan that will enable the obligor to obtain additional funding. This funding will meet clients' needs for growth and funding diversification.

27. **Technical assistance.** ADB's TA will help develop an environmental and social management system, improve LOFC's deposit mobilization, and assist LOFC and LOMC with product development to increase their outreach to remote villages and farmers. Mobile banking will be further developed and financial literacy programs will be introduced to improve reach and address over indebtedness of household borrowers.

28. **Gender mainstreaming.** ADB will help strengthen the outreach efforts of LOFC and LOMC by targeting women entrepreneurs, and bolstering LOFC's and LOMC's internal policies pertaining to women. The project has gender targets and will be categorized as effective gender mainstreaming.<sup>30</sup>

#### D. Risks

29. **Political and economic conditions.** A new president took office in January 2015 and was reinstated in the parliamentary elections that took place on 17 August 2015. The recent change in leadership could lead to a continued temporary economic slowdown that could negatively impact the performance of LOFC and LOMC. To date, LOFC and LOMC have continued to see healthy demand for their products. Sri Lanka's overall outlook is currently positive, and gross domestic product is projected to expand 6.5% annually on average from 2015 to 2017.<sup>31</sup>

30. **Growth strategy and asset quality.** As LOFC's and LOMC's loan and lease portfolios continue to expand and as increasing numbers of first-time borrowers are extended credit, this could pose additional challenges for management of each company and impact asset quality.<sup>32</sup> Due diligence has determined that management of both companies have a sound understanding of all the risks associated with the increase in lending to MSMEs, and that LOFC and LOMC have implemented measures to mitigate these risks, including (i) robust credit underwriting policies and procedures; (ii) investment in technology and appropriate management information systems; and (iii) well-trained staff who are capable of engaging in rural lending.

31. **Currency risk.** LOFC and LOMC will borrow and repay in US dollars, although most MSME lending will be in Sri Lankan rupees. The companies will hedge ADB's loans through swap facilities with commercial banks and the Central Bank of Sri Lanka.

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<sup>30</sup> Women currently form 98% of all group loan accounts. Key targets are at least 10% of the \$30 million provided to LOFC and at least 20% of the \$25 million provided to LOMC are to women borrowers.

<sup>31</sup> International Monetary Fund. 2015. Executive Board Concludes Third Post Program Monitoring Discussion with Sri Lanka. News release. 5 May.

<sup>32</sup> NPL's 180 days overdue were 4.8% as of December 2014.

## IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

### A. Development Impact, Outcome, and Outputs

32. **Impact.** The transaction will broaden access to finance for MSMEs in Sri Lanka.
33. **Outcome.** The outcome will be the growth and sustainability of LOFC and LOMC to provide financial services to MSMEs in urban and rural areas.
34. **Outputs.** Outputs include LOMC's and LOFC's increased financial capacity to service and increase lending products to MSMEs and microfinance borrowers. LOFC and LOMC will provide access to longer-term funds for onlending to MSMEs, which will result in an increased number of MSME accounts and volume of loans. In addition, the ADB TA (footnote 32) will help LOFC and LOMC reach underserved customers and, together with other international financial institutions, further develop mobile banking as a transaction mode.

### B. Alignment with ADB Strategy and Operations

35. **Consistency with ADB strategy and country strategy.** Under the Midterm Review of Strategy 2020, ADB aims to strengthen its support for the finance sector by supporting the development of financial infrastructure, institutions, and products and services, and by promoting inclusive growth.<sup>33</sup> Through such initiatives, ADB will continue to (i) help channel the region's savings into productive investments, and (ii) build the capacity of financial institutions by introducing international best practices. The proposed investment supports institutional and financial sector development through the deepening of the financial sector and the provision of funding for MSME onlending in urban and rural areas. Financial development will also be supported through the TA, which will strengthen the bank's onlending capacity (footnote 32). The project is also aligned with ADB's Gender Equality and Women's Empowerment Operational Plan, 2013–2020.<sup>34</sup>

36. **Consistency with sector strategy and relevant ADB operations.** The project is consistent with ADB's interim country partnership strategy and country operations business plan for Sri Lanka.<sup>35</sup> These are built on the government's development policy framework for economic development, including the President of Sri Lanka's election manifesto (footnote 3), which identified MSMEs as a strategic sector and called for support for private sector development projects that accelerate the pace of private sector participation and promote financial sector development. ADB has actively supported the private financial sector.<sup>36</sup> The project will further build upon ADB's work and support financial sector development in Sri Lanka.

## V. POLICY COMPLIANCE

### A. Safeguards and Social Dimensions

<sup>33</sup> ADB. 2012. *Midterm Review Strategy of 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

<sup>34</sup> ADB. 2013. *Gender Equality and Women's Empowerment Operational Plan, 2013–2020: Moving the Agenda Forward in Asia and the Pacific*. Manila.

<sup>35</sup> ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka, 2015–2016*. Manila; ADB. 2015. *Country Operations Business Plan: Sri Lanka, 2016–2018*. Manila.

<sup>36</sup> In 2012, ADB provided a \$15 million senior loan to DFCC Vardhana Bank for housing finance; in 2013, a \$15 million senior loan to Nations Trust Bank for SME finance; and in 2014, a \$100 million senior loan to Hatton Bank for infrastructure onlending. There are eight banks active in ADB's Trade Finance Program in Sri Lanka.

37. The investment is classified as category FI treated as C for impacts on the environment, involuntary resettlement, and indigenous peoples. The financial intermediaries' business activities have no adverse environmental impacts, and are unlikely to entail impacts on involuntary resettlement and indigenous peoples. The financial intermediaries will apply ADB's prohibited investment activities list, exclude all projects that will have adverse environment and social safeguards impacts through its sustainability policy, ensure that investments using ADB funds abide by applicable national laws and regulations, and comply with ADB's Safeguard Policy Statement (2009). The financial intermediaries will confirm this in their periodic reports to ADB and need not apply any other specific safeguard requirements.<sup>37</sup>

38. The financial intermediaries will comply with national labor laws and, pursuant to ADB's Social Protection Strategy (2001), will take measures to comply with internationally recognized core labor standards. LOFC and LOMC will report regularly to ADB on (i) their compliance with such laws and (ii) the measures taken. Information disclosure and consultation with affected people will be conducted in accordance with ADB requirements. Proactive gender features are included in the project design to support the project's effective gender mainstreaming category.<sup>38</sup>

#### **B. Anticorruption Policy**

39. LOFC and LOMC were 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**

40. The proposed loans are within the medium-term country, industry, group, and single investment exposure limits for nonsovereign investments.

#### **D. Assurances**

41. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),<sup>39</sup> ADB will proceed with the proposed assistance upon establishing that the Government of Sri Lanka has no objection to the proposed assistance to LOFC and LOMC. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

### **VI. RECOMMENDATION**

42. I am satisfied that the proposed loans would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve (i) the senior loan of up to \$75,000,000 to LOLC Finance (LOFC) comprising (a) an A loan of up to \$30,000,000 to be funded from ADB's ordinary capital resources, and (b) a B loan of up to \$45,000,000 to LOFC to be funded by participating commercial banks; and (ii) the senior loan of up to \$25,000,000 to LOLC Micro Credit to be funded from ADB's ordinary capital resources, both for

<sup>37</sup> Summary Poverty Reduction and Social Strategy, and Safeguards and Social Dimensions Summary (accessible from the list of linked documents in Appendix 2.)

<sup>38</sup> Gender Action Plan (accessible from the list of linked documents in Appendix 2.)

<sup>39</sup> ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

micro, small and medium-sized enterprises in Sri Lanka, with such terms and conditions as are in accordance with those set forth in this report, and as may be reported to the Board.

Takehiko Nakao  
President

26 October 2015

## **LIST OF LINKED DOCUMENTS**

1. Sector Overview
2. Ownership, Management, and Governance
3. Details of Implementation Arrangements
4. Contribution to the ADB Results Framework
5. Financial Analysis
6. Country Economic Indicators
7. Summary Poverty Reduction and Social Strategy
8. Safeguards and Social Dimensions Summary