ADB

Technical Assistance Consultant's Report

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Sri Lanka: Small and Medium-Sized Enterprises Line of Credit Project
(Financed by the Japan Fund for Poverty Reduction)

Prepared by

KPMG

Colombo, Sri Lanka

For Ministry of Finance's Department of Development Finance

Asian Development Bank

KPMG

CGS Draft Final Report

Credit Guarantee Scheme

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6. The work performed by us under this engagement was as considered necessary at the given point in time.

7. Our deliverables reflect our observations as at 26 July 2016, the date on which we conducted our analysis.

Glossary

ADB	Asian Development Bank
AGF	African Guarantee Fund
bn	Billion
CBN	Central Bank of Nigeria
CBSL	Central Bank of Sri Lanka
CGC	Credit Guarantee Corporation
CGCMB	Credit Guarantee Corporation Malaysia Berhad
CGS	Credit Guarantee Schemes
CGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises
CRIB	Credit Information Bureau
DMC	Developing Member Country
EAD	Exposure At Default
ECAIs	External Credit Assessment Institutions
FI	Financial Institutions
FNG	Fondo Nacional de Garantia S. A.
FOGAPE	Fondo de Garantìa para Pequeños Empresarios
GDP	Gross Domestic Production
GOI	Government of India
GOSL	Government of Sri Lanka
IDA	International Development Agency
KODIT	Korea Credit Guarantee Fund
KRW	South Korean Won
LC	Letter of Credit
LE	Large Enterprises
LGD	Loss Given Default
LKR	Sri Lankan Rupee
LTL	Long-Term Loans

MICE	Multivariate Imputation by Chained Equations
mn	million
MoF	Ministry of Finance
N	Nigerian Naira
NAFIN	National Financiera
NBFI	Non-Banking Financial Institution
NBV	Net Book Value
NFCGC	National Federation of Credit Guarantee Corporations
NPAT	Net Profit After Tax
NPL	Non-Performing Loans
p.a.	Per Annum
PCI	Participating Credit Institutions
PD	Probability of Default
Perum Jamkrindo	Perum Jaminian Kredit Indonesia
PPE	Property, Plant and Equipment
RBL	Results-based Lending
ROE	Return on Equity
ROI	Return on Investment
Rs.	Rupees
SBCG	Small Business Credit Guarantee Corporation
SLECIC	Sri Lanka Export Credit Insurance Corporation
SME	Small and Medium Enterprises
SOCI	Statement of Comprehensive Income
STL	Short-Term Loans
TESKOMB	Union of Credit and Guarantee Cooperatives for Tradesmen and Craftsmen of Turkey
Vs.	Versus
YoY	Year-on-Year

Contents

Engagement Overview

The principal objective of the Asian Development Bank (ADB) in undertaking this project is to design a Credit Guarantee Scheme (CGS) for Sri Lanka which could provide guarantees to Small and Medium Enterprises (SMEs) on an ongoing basis. For this purpose, KPMG was engaged by the ADB as the consulting firm, to develop a viable business plan for the proposed CGS which will be presented to the Ministry of Finance (MoF). This includes a demand analysis, options for the optimal corporate structure and financial projections (refer *Annexure 01: 'Approach & Methodology'* including the sources of information). Also, KPMG will organize a seminar for representatives from the SME sector and financial institutions, among others, to obtain their feedback on the proposal. The ADB will monitor the progress of the project through Steering Committee Meetings that will be scheduled as required, to discuss the draft final report before finally presenting the same to the MoF.

Background and Objectives

Reiterating the Importance of SMEs to the Growth of Sri Lanka

SMEs are the backbone of the economy, accounting for a majority of enterprises, the labour force and eventually contribution to the GDP.

Potential

The SME sector has a vast potential in generating high level of socio-economic benefits to a developing country with a low level of investment. According to Government estimates, around 80 percent of businesses in Sri Lanka are classified as SMEs, and they contribute over 50 percent to the GDP of the country. Of the total employment in the country, SMEs account for 35 percent. If limitations to their growth are addressed, there is the potential to increase SMEs' contributions even further.

Challenges Faced by SMEs

Some of the most important issues faced by SMEs are access to finance, high interest rates and the lack of acceptable collateral. SMEs also face challenges from an inability to adapt to rapidly changing market demands, changing technology and constraints in capacity in relation to knowledge, innovation and creativity.

The low level of financial inclusion, limited access to finance, lack of a proper data base, insufficient use of IT, undeveloped sales channels and the lack of research and development are some reasons leading to the slow growth of SMEs. Please refer to *Annexure 02: Outcomes of the Survey* which analyses the survey conducted by KPMG to identify the limitations faced by SMEs, reasons for denial of credit by Financial Institutions (FIs), and initiatives taken by organizations such as the Chambers and FIs to enable SMEs to gain access to finance.

Difficulty in Gaining Access to Finance

SMEs experience difficulty in raising funds when compared with large enterprises (LEs) because LEs are perceived to have a lower risk of default and are able to submit clear financial records.

For SMEs there is an asymmetric information problem between the lenders and the borrowers. FIs should closely and continuously monitor their borrowers, but it is costly to do so for small loans. Therefore, requiring collateral is the easiest way for FIs to reduce the risk of lending to SMEs.

In Sri Lanka, the financial sector has mainly adopted collateral based lending. Yet, land ownership is limited, and even those that own land often do not have a clear title. This lack of collateral is a fundamental impediment to the growth of the SME sector.

SMEs already have access to finance through private informal lenders and small investment companies. However, the cost of such financing is exorbitant. Creating access to the formal financial sector creates a path not only to lower cost borrowing but also to obtaining advisory services, a range of financial products and a wealth of information on markets.

Credit Guarantee Schemes (CGS)

In order to overcome these issues, the key initiative that has emerged across many economies is the creation of Credit Guarantee Schemes (CGS) for SMEs. By absorbing/sharing the associated risk and reducing the dependence on collateral, these schemes encourage FIs to lend more to SMEs and to lend at more competitive rates.

The guarantees are provided at a cost. Such cost, however, can be recovered by the borrower in that the FI is willing to lend at a lower rate given the lower risk.

An Inducement to Financial Institutions

In addition to providing an alternative to collateral requirements, the CGS will indirectly enhance underwriting skills by encouraging banks to focus on cash flow analysis. Another benefit for FIs would be the reduced risk weightage in terms of capital adequacy. Lending to the SME sector carries a weight of 75% at present. Based on BASEL II the risk weighting for corporates rated by approved External Credit Assessment Institutions (ECAIs) may be 20% for AAA to AA- rated entities. Therefore the risk weighting could be reduced based on the rating of the credit guarantee institution and approval of the Central Bank of Sri Lanka. Thus, FIs will be able to lend more against their capital.

Analysis of the Local Context for a Credit Guarantee Scheme

A five-year demand forecast was carried out. The demand was assessed separately for banks and Non-Banking Financial Institutions (NBFIs) based on existing loan portfolios and the impact the CGS would have on lending. The potential demand is estimated to increase from LKR 54bn in 2017 to LKR 68bn in 2021. However, due to the small size of SME loans which shall result in a high volume of loan processing, the CGS will not be able to fully meet this demand in its initial years. As the number of employees gradually increases and their processing becomes more efficient, the CGS's portfolio will reach the potential demand. Please refer *Annexure 03: Demand Analysis* for details.

Lessons Learned from Previous Local Initiatives

In developing the CGS, feedback from FIs that participated in previous national CGSs was taken into account. The FIs had negative experiences with the previous CGSs. In particular, claim processing delays, difficulty to trigger the guarantee, the percentage of the cover and the cost of premiums were cited. Furthermore clarification of a CGS's legal aspects is crucial before the implementation. In a recent World Bank project, the proposed CGS, which was to be operated through the Sri Lanka Insurance Corporation, never materialized.

While all PFIs interviewed expressed keen interest, their previous negative experiences should be addressed. It is therefore essential for the CGS to clearly communicate mechanisms, criteria and conditions, provide incentives as considered appropriate to outweigh past negative experiences and engage stakeholders on a regular basis.

Credit Guarantee Systems

Japan Fund for Poverty Reduction

Credit Guarantee Systems

Most CGSs have Government support in order to subsidize credit to SMEs and to support targeted sectors and regions. Some CGSs have even subsidised the premium payable. The CGTMSC in India, while providing higher guarantee cover to smaller loans, applies concessionary premiums with lower fees for marginalized borrowers. CGSs such as the AGF Africa and KODIT Korea, link the pricing to a risk rating model. In the Malaysian CGC the borrower applies online for a guarantee which the Credit Guarantee Corporation reviews, after which lenders are invited to bid online. In Chile-FOGAPE and Mexico's National Guarantee, the guarantees are issued through auction. The primary purpose of all CGSs studied was to implement Government policies towards selective sectors. Refer to Refer *Annexure 04: Capital Ownership Examples* and *Annexure 05: Examples of CGSs Implemented and Practiced* for a detailed evaluation of selected CGSs.

Credit Guarantee Schemes – International Precedents

Based on the survey carried out by KPMG, CGSs can have a variety of ownership models. However, the main categories could be described as follows:

Public Model: The CGS is entirely owned by the Central Government and, in countries where the devolution process is most developed (for example, Japan), by administrative bodies (the 'enlarged public' sector). The model includes: KODIT (South Korea), Perum Jamkrindo (Indonesia), the Japanese CGC scheme and Thai SBCGC. Guarantees are promoted and backed by the public sector because facilitating SMEs' access to credit is regarded as a 'public asset'.

Public-Private Model: These CGSs are publicly-and-privately-held. In addition to the Government, other investors are FIs, chambers of commerce and, in some cases, state-owned funds. The model includes: KGF (Turkey), Garantiqa (Hungary) and OSEO Garantie (France).

Private Model: The CGS is privately-held and public bodies might hold only minimum or residual interests. The promoters are FIs (indirect mutualism) and the enterprises that benefit from the guarantee (direct mutualism). This model includes SGR Valenciana (Spain) and Eurofidi (Italy).

Country	CGS	Ownership Model		
		Public	Public-Private	Private
Brazil	FUNPROGER	✓		
Canada	Canada Small Business Financing Program	✓		
France	OSEO Garantie		✓	
Germany	Bürgschaftsbank Baden- Württemberg			✓
India	Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)	✓		
Indonesia	Perum Jaminan Kredit Indonesia (Perum Jamkrindo)	✓		
Italy	Eurofidi			✓
Japan	52 Credit Guarantee Corporations (CGC)	✓		
South Korea	Korea Credit Guarantee Fund (KODIT)	✓		
Turkey	TESKOMB (Union of Credit and Guarantee Cooperatives for Tradesmen and Craftsmen of Turkey)		✓	
Chile	Fondo de Garantìa para Pequeños Empresarios (FOGAPE)		✓	
Colombia	Fondo Nacional de Garantìa S.A. (FNG)		✓	
Hungary	Garantiqa Hitelgarancia		✓	
Malaysia	Credit Guarantee Corporation Malaysia Berhad (CGCMB)		✓	

Portugal	SPGM Sociedade de Investimento S.A.s		✓	
Spain	Sociedad De Garantìa Reciproca De La Comunitat Valenciana		✓	
Thailand	Small Business Credit Guarantee Corporation (SBCG)	✓		

Ownership Structure Options

Although this study initially considered a structure with majority private ownership, the projected returns on equity are too low for the entity to rely entirely on private investment; for this same reason, credit schemes internationally are dependent on government support. Therefore, the study focused on three options:

1. Option 01: Public - Operated by the division in the CBSL that currently conducts credit guarantee programs
2. Option 02: Public-Private - Establish as an extension of an existing similar institution
3. Option 03: Public-Private - Establish as a separate entity as an NBFI

Benefits and Drawbacks of the Ownership Structure Options

Option 01 Operated by CBSL (Public)	**Benefits**
	• CBSL has managed the majority of Sri Lanka's previous CGSs; therefore, it has the understanding and experience to manage a scheme of this nature. • CBSL already has established evaluation and monitoring mechanisms to review the performance the CGS.
	Drawbacks
	• Although the CBSL has been operating numerous credit guarantee schemes, they have been of low volume and sector focused (e.g. Agriculture). Hence, CBSL may not have the resource capacity to operate a large scale and complex scheme. • The schemes operated by the CBSL have so far been temporary as proposed to self-sustaining.

Option 02 Extension of an Existing Similar Institution (Public-Private)	• The proposed institution is the Sri Lanka Export Credit Insurance Corporation (SLECIC), which was created by Act No. 15 of 1978 and commenced operations on 08 February 1979. The SLECIC is a statutory body which operates under the Ministry of Finance & Planning. The SLECIC is committed to providing attractive and innovative export credit insurance and guarantee support services.
	Benefits
	• An already profitable entity with a net surplus of approximately LKR 90mn with a capitalization of 75%. • The organization is accustomed to issuing credit guarantees and has established relationships with the FIs.
	Drawbacks

	• The organisation provides export focused credit guarantees and hence the period of lending is significantly shorter than the tenor of CGS's guarantees. • If the CGS is to be established, SLECIC would require a significant structural change that could impact the entire operating model of the organisation. • Even though the organisation is fully Government owned, it has no regulatory body. In addition the risk weight given by the CBSL for this institution is 50%. • Incorporate the CGS under SLECIC would require a legal amendment that would require a considerable amount of time to be passed.

Option 03 Separate Entity as an NBFI (Public-Private)	**Benefits**
	• A separate entity would be best positioned to recruit experienced management. • Having an independent balance sheet would engender financial accountability. • The entity would be under the direct purview of the Department of Supervision of Non-Bank Financial Institutions of the CBSL, which has the required experience and skills to monitor an entity of this nature. • A separate legal entity facilitates clear corporate governance. Similar to the Credit Information Bureau of Sri Lanka, the board of directors could comprise both government and private sector representation.
	Drawbacks
	• A new entity would entail higher start-up costs.

Conclusion

As the CGS would entail unprecedentedly large and complex operations, the existing mechanisms in the CBSL or SLECIC are not easily transferable. To ensure sustainability and appropriate supervision by CBSL, it should be incorporated as a separate entity as an NBFI.

Funding

To reduce dependency, bureaucracy and Government intervention and increase transparency, funding should include non-government sources. This practice, which has proven successful in many schemes operating in industrial economies, has the further advantage of reducing moral hazard on the part of guarantors, lenders and borrowers. Please refer *Annexure 06: Capital Funds Composition in Global CGSs*.

Considering the recommended ownership structure and the limited ROE projections, there are two potential capital structuring options.

Capital Structuring Options

- **Equity from FIs that will avail of the CGS:** Equity investment could be a precursor to becoming a client of the CGS. Contributions could be a percentage of the FIs' SME portfolios or fixed (e.g., LKR 500mn by Banks and LKR 200mn by NBFIs). In either case, the government is still expected to provide a large majority of the equity.
- **Subordinate debt from the capital markets:** Subordinate debt can attract private investment despite the low ROEs. Moreover, a capital structure of 80% equity and 20% subordinate debt is unlikely to undermine a credit rating of AA or higher.

Benefits and Drawbacks of the Capital Structuring Options

Option	Benefits	Drawbacks
Option 01 Equity from FIs that will avail of the CGS	• Enhance private participation in the governance model • Higher transparency of operations • Less political influence due to broader shareholding base • Less burden on public funds	• Because of the low ROEs, contributions are likely to be limited
Option 02 Subordinate debt from the capital markets	• Higher return on equity • Cheaper capital source than equity • Tax benefit of interest servicing • The bonds' issuance would support the growth of Sri Lanka's corporate debt market	• Higher leverage and hence higher credit risk

Conclusion

The CGS should incorporate both options. By having FIs make a token contribution to the credit guarantee scheme, it gives them ownership in the CGS's development and success. Using subordinated debt to fund a portion of the CGS' capital, the government's contribution is reduced without increasing leverage to a level that would undermine the credit rating.

Operational Structure Options

Operational Structure Options

The proposed operational model is detailed below:

Selective Versus Portfolio Approach

The decision on how guarantees are to be extended is influenced by the objectives of the scheme. Depending on whether it aims to ensure high quality of guaranteed loans or reach a maximum number of borrowers, the guarantee scheme may either adopt the selective approach or the portfolio (also known as global) approach.

Approach	Benefits and Drawbacks
Selective : Guarantees extended on a case-by-case basis	**Benefits**
	• A direct relationship between the guarantor and the borrower exists since the former investigates every single loan application and selects which ones to guarantee. • This reduces the probability of moral hazard on the part of the lender (and thus default costs) and ensures that guaranteed borrowers are indeed in the targeted risk category. Therefore, the quality of loans guaranteed by way of a selective approach is likely to be higher.
	Drawbacks
	• The overall guarantee and credit volume will be considerably lower. • High unit costs.
Portfolio: Reach a larger number of borrowers by selecting a specific sector	**Benefits**
	• Enables a considerable expansion of activity by reducing time-consuming and cost-intensive screening. • The economies of scale arising from increased business volume will allow more cost-effective operations. • Lenders become aware that by standardising loan appraisals and monitoring procedures, the costs of servicing SMEs can be reduced.
	Drawbacks
	• Additionality may be lower if a large proportion of low risk borrowers, which could have qualified for non-guaranteed loans, are included in the portfolio. • Default rates may be higher because transactions are not individually screened.

Ideally, both approaches could be combined. If a certain type of enterprise (e.g. those owned by indigenous entrepreneurs) is to be promoted, irrespective of its specific project, the portfolio approach could be used. Other enterprises will have to be selected individually. Alternatively, loans up to a certain amount may qualify for portfolio guarantees, whereas larger loans are assessed on a case-by-case basis.

However, especially in the period following the creation of a scheme, the selective approach is advisable. This allows for the establishment of a good relationship between the guarantor and the lenders and allows the CGS to gain expertise because undertaking the riskier portfolio approach.

To reduce the administrative expense of the selection approach, FIs can submit guarantee applications in bulk. Processing will still however be done on an individual basis. FIs are expected to evaluate credit in line with their normal criteria and rate them in line with a rating model issued by the CGS. The guarantee application has to be supported by a copy of the FI's internal memorandum and approval, the accepted letter of offer and the FI's confirmation that the documentation has been completed in line with the letter of offer.

> Conclusion
>
> A combined approach is proposed to be followed for the implementation of the CGS. In the initial phase, due to the low volume of guarantees, the CGS would undertake a selective approach which would enable a careful screening process. As this may result in higher costs and inefficiency, it is recommended for FIs to submit the guarantees 'batch wise'. As it gains experience and sophistication, the CGS could experiment with a portfolio approach.

Risk Distribution

An improperly designed guarantee scheme can increase moral hazard among borrowers by inadvertently decreasing the consequences of default. The extent to which each party should share the risk is a delicate balancing act.

The guarantee cover could be structured in any of the following ways:

- Full Capital: The whole amount of default is covered by the CGS.
- Proportionate: The amount in default is split equally between the FI and the CGS.
- First Loss: The first few instalments in default would be covered by the guarantee up to a specified percentage (%) of the loan. The FI would cover the remaining amount in default. In this case, the default is postponed till the cover limit is reached before being categorized as a Non-Performing Loan in the FIs' books.
- Second Loss: Similar to First Loss but the FI will bear the initial defaults up to a pre-specified percentage (%) of the loan, from which point the CGS will cover the remaining amount in default.

Based on FI feedback, the accepted structure is a proportionate approach. However, the guarantee cover needs to be high enough to encourage lender participation and yet low enough to limit moral hazard. Based on the 'International survey on guarantee market players' – KPMG 2011, out of 70 guarantee schemes analysed:

- 17% cover 50% of the risk
- 8% cover 100% of the risk
- The remainder (75%) cover from 60% to 80% of the risk

It is recommended to set a guarantee cover of 67% which is comparable to the coverage requested by the FIs but would also provide a politically-acceptable ratio that for every Rs 1 of guarantee Rs 1.5 of

> Conclusion
>
> The accepted structure is a proportionate approach where the amount in default will be borne by the two parties based on the guarantee cover. As the proposed guarantee cover is 67%, in the case of a default, 67% would be borne by the CGS and 33% would be borne by the FI.

SME loan is extended.

Fees

Guarantee schemes derive their income from fees and the investment return on those fees. Fees can be charged upfront or annually, dependent either on the amount of the guarantee or the underlying loan.

If an annual fee is charged, an additional, partly non-refundable application or registration fee (commission) should also be levied to recover the initial costs incurred and to discourage unjustified applications.

For the CGS, an upfront fee is most suitable because an annual premium is more difficult to administer and is exposed to default risk. The CGS will also earn more investment income from an upfront fee, which will help the CGS to charge fees at a subsidized rate.

It is proposed to vary the fee based on the risk profile of the customer. The financial model prepared has considered input provided by the FIs and has categorised the risk profiles into three main categories. The categories and the proposed annual fees are noted below:

Category A	Category B	Category C
Registered businesses, operating for over 3 years with sound profitability, proper books of accounts, tested borrowers/ established relationships with banks and/or finance companies and an asset base which can be collateralised if required.	Registered businesses with a relationship with a bank or a finance company and maintains some form of accounts and record keeping.	Informal businesses, which will undertake registration, with no existing relationship with a bank or a NBFI.
Proposed fee: 1% p.a.	Proposed fee: 1.5% p.a.	Proposed fee: 2% p.a.

Investment Policy

The CGS's investment policy should be consistent with its mandate and strategic objectives. The investment policy should be guided by appropriate portfolio management criteria aimed at minimizing risks. The investment policy should also define permissible asset classes and provide guidance on concentration risk vis-à-vis individual exposures, liquidity profile, and sectorial and geographical concentrations.

Although the CGS could consider outsourcing fund management, in order to ensure that the funds are managed in the most independent and effective manner, it would probably be more cost efficient for it to manage its own investments, at least initially, given that the investment policy would not be complex.

Leverage

High leverage would enable the CGS to mobilise more credit for SMEs. Yet, high leverage can also turn into a weakness, and the CGS would become more vulnerable to default events.

Conclusion

Based on the 'International survey on guarantee market players' – KPMG 2011, the ratio of issued credit to guaranteed credit is between 5 to 1 and 20 to 1. Although the CGS could consider more leverage after its operations are well established, a leverage of 1.5 times is initially proposed to achieve a credit rating of at least AA, which would offer counterparts capital relief.

Claims and Recoveries

Claims

Claims will be paid on evidence of payment that is overdue for six months. FIs should submit evidence of efforts made towards recovery, restructure/rescheduling, or initiating legal action. If the CGS suspects that a claim was invalidly submitted, it reserves the right to audit the FI and recover any unauthorized claims.

Recoveries

Post claims, FIs are expected to continue their efforts to recover. The CGS should increase the proportion of recoveries due to the FIs to incentivise diligent recovery efforts.

India CGTMSE Recoveries Process

The recoveries process of the India CGTMSE was explored in order to understand the process of an existing CGS. The process could be briefly described by way of the following example:

The guarantee coverage is assumed to be 75% of the outstanding amount, the loan value is Rs. 5mn and the loan defaults at an outstanding of Rs. 5mn:

The lender initiates the recovery process, and within the stipulated time (say 6 months), the claim will be lodged by the lender. The CGS makes an initial claim payment for 75% of the guaranteed amount (i.e. Rs. 2.81mn), after which the lender shall continue the recovery process.

Recovery Scenario 01: No recoveries

- The lender claims the remaining guaranteed amount (i.e. Rs. 0.94mn) and closes the account.

Recovery Scenario 02: Rs. 4mn of recoveries

- The loss sharing ratio is 75:25 based on which the loss of Rs. 1mn will be shared. Upon the recovery of Rs. 4m, the lender shall retain the amount due to them minus the loss share which is 25% of the unrecovered amount (Rs. 5mN – Rs.0.25mn = Rs. 4.75mn) and return the balance to CGS.

Recovery Scenario 03: Recoveries more than the amount outstanding

- The lender retains the recovered amount and refunds the initial claim received from the CGS.

> Conclusion
>
> Claims can be submitted to the CGS upon the lapse of 6 months from the initial date of default. In this context, not all payments that are delayed will end up in default. An initial default will often correct itself within 6 months.
>
> If a facility defaults in its initial stage, the FI would incur a substantial loss because the capital recovered and interest income would be low. If however, the loan defaults at a later stage, a considerable portion of the loan would have been recovered together with substantial interest.
>
> In the former situation, the FI has greater incentives to push for recoveries. In such cases, the CGS and the FI could share recoveries 50:50. In the latter situation, the FI has little incentive to undertake recoveries, and the CGS may have to increase the FI's proportion of recoveries to 67% to induce it.
>
> As the CGS gains expertise, it could consider subrogating, leading the recoveries, and sharing them with the FI consistent with the original risk sharing.
>
> Another method would be to auction the defaulted loan to a third party that would then assume responsibility for collection.

Financial Feasibility

The financial model has been prepared based on a capital structure which includes up to 20% subordinated debt, priced at a risk premium 2% above comparable government securities.

Based on discussions with FIs, the Chambers of Commerce and the SMEs, a 2% guarantee fee is the maximum that FIs would be willing to pay. Although a 2% guarantee fee allows for the CGS to be profitable, the profits do not cover the implicit cost of capital. Therefore, the guarantee fee would be subsidized.

Capital Structure and Guarantee Activity					
Figures in LKR mn	**2017**	**2018**	**2019**	**2020**	**2021**
Capital Structure					
Paid in Capital	11,200	11,200	11,200	11,200	11,200
Subordinated Debt					2,800
Retained Profit/Loss	339	965	1,619	2,329	3,007
Total Capital	**11,539**	**12,165**	**12,819**	**13,529**	**17,007**
Guarantees					
Outstanding Guarantees		**3,206**	**7,169**	**11,719**	**18,414**
Leverage		**0.26**	**0.56**	**0.87**	**1.08**

Statement of Comprehensive Income

Figures in LKR mn	2017	2018	2019	2020	2021
Income					
Fees		95	245	458	770
Interest Earned	646	1,373	1,519	1,683	2,163
Total Income	**646**	**1,468**	**1,764**	**2,141**	**2,933**
Expenses					
Start-up Cost	10				
Salaries		75	83	91	100
Admin Costs		16	18	19	21
Provisions		218	455	720	1,122
Interest	-	-	-	-	419
Depreciation	20	20	20	20	36
Total Expenses	**30**	**329**	**575**	**850**	**1,699**
Profit Before Taxes	**616**	**1,139**	**1,189**	**1,290**	**1,234**
Taxes Paid @ 45%	277	512	535	581	555
Profit After Taxes	**339**	**626**	**654**	**710**	**679**

Statement of Financial Position

Figures in LKR mn	2017	2018	2019	2020	2021	2022
Assets						
Net Book Value	80	60	40	20	64	28
Cash and Cash Equivalents	11,459	12,654	14,026	15,555	20,179	22,470
	11,539	**12,714**	**14,066**	**15,575**	**20,243**	**22,498**
Equity and Liabilities						
Equity	11,200	11,200	11,200	11,200	11,200	11,200
Subordinated Debt	-	-	-	-	2,800	2,800
Retained Earnings	339	965	1,619	2,329	3,007	3,793
Guarantee Provision		218	487	792	1,240	1,785
Fees in Advance		331	760	1,255	1,996	2,921
	11,539	**12,714**	**14,066**	**15,575**	**20,243**	**22,498**

ROE Computation

Figures in LKR Mn	2017	2018	2019	2020	2021
Net Income	626	654	710	679	785
Shareholders' Equity	12,165	12,819	13,529	14,207	14,993
ROE	**5.15%**	**5.10%**	**5.25%**	**4.78%**	**5.24%**

Conclusion

The financial model is viable with the NPAT being LKR 339mn in the year of inception and increasing to approximately LKR 785mn in the 5th year.

Given the ROE ranges from 5.15% to 5.25%, private investors will not be incentivized to invest. This reiterates the need for the CGS to be set up as a Public-Private-Partnership (PPP) following a 'Public-Private Model' with FIs encouraged to make nominal equity investments as a means to share the funding responsibilities for establishing the CGS and to reduce moral hazard.

Other Factors

Centralisation

In order to extend the scheme to disadvantaged regions, it might be necessary to develop a branch network. However, based on the maturity of the fund and success rate over the years, decentralisation could be considered at a later time.

Conclusion

The CBSL has established provincial/regional offices. Furthermore, the Chamber of Commerce has a district chamber in each of the districts. Given the operational expenses of complexities of establishing a branch network in the initial years, the CGS should coordinate with these offices to reach disadvantaged regions.

Target Groups

SME classification will follow the definition of the Ministry of Industry and Commerce, which is depicted below:

Sector/Size	Criteria	Medium	Small	Micro
Manufacturing Sector	Annual Turnover	LKR 251 – 750Mn	LKR 16 – 250Mn	Less than LKR 15 Mn
	No. of Employees	51 - 300	11 – 50	Less than 10
Service Sector	Annual Turnover	LKR 251-750Mn	LKR 16-250Mn	Less than LKR 15 Mn
	No. of Employees	51 - 200	11 - 50	Less than 10

The ineligible loans could be defined as follows:

- Consumer purchases
- Manufacture or selling of arms and munitions and services
- Activities violating the rights of workers
- Activities violating international or local laws
- Currency speculation
- Securities investment

- Real estate speculation
- Financial intermediaries, except for microfinance institutions
- Drugs or narcotics
- Money laundering
- Financing of terrorism
- Activities that violate the guidelines of bilateral or multilateral donors contributing to the CGS
- Purchase of three-wheelers
- Illegal environmentally hazardous
- Gaming or gambling activity

Eligible Financial Institutions

The guarantee scheme will be open to all licensed local commercial banks and to NBFIs which are externally rated by a recognized rating agency as BB and above and that have invested in the CGS's equity. The participating FI must maintain credit quality according to loan eligibility criteria.

Type of Finance Targeted

Working capital may be important for sustaining employment in enterprises which could become insolvent due to insufficient short-term credit; funds for investment are essential for the creation of employment and subsequent economic growth. It is proposed to provide guarantees for both purposes.

Restrictions should also be established on the size and tenor of the loans and total exposure to any single borrower or lender.

Conclusion

Within the limits of legitimate and prudent banking activities,, the CGS should be widely accessible to facilitate the growth of the SME sector.

Governance Structure

The proposed governance structure is similar to the Credit Bureau of Sri Lanka which was established as a publicly owned institution.

The board of directors should include approximately eleven members, to be appointed by the GOSL, with representation from the CBSL, Ministry of Trade and Commerce, each of the Chambers of Commerce, Government owned banks, private owned banks, finance companies, and a minimum of three independent directors with expertise in the SME Sector, Legal and Financial.

As the CGS will have access to sensitive information of the FIs, in order to address the concern of confidentiality of information, ex-financial sector personnel could be recruited.

Conclusion

An internal code of ethics should be in place for the management and all employees.

Strong risk management is vital. Comprehensive risk management should be in place to facilitate prudent operation. Similarly, under the direction of the board, committees should be in place to review all vital aspects, in line with what is commonly practiced by entities in the financial sector.

Regulation and Supervision

Credit guarantees do not insure the borrower who, under normal circumstances, loses the pledged assets in the case of default. Rather, credit guarantees are closely tied to bank lending. Thus, CBSL would be the most appropriate regulator for CGS given its expertise in lending products.

Other Criteria

FIs are expected to act in good faith at all times and if at any time, the bona fides is doubted, the guarantee company reserves the right to carry out an inspection/audit and at its own discretion suspend the grant of further guarantees. Similarly, if the claims being submitted by a particular FI is abnormally high, the company may decide to suspend the issue of further guarantees.

If any sector or geographical location appears to be the subject of an abnormal number of claims, a similar approach will be adopted.

ADB Results-based Lending

Sri Lanka: Credit Guarantee Scheme

ADB's Results-Based Lending (RBL) programs

Results-based lending (RBL) is a performance-based form of financing, where disbursements are linked to the achievement of results rather than to upfront expenditures, as is the case with traditional investment lending.

Results-based financing links disbursements directly to the achievement of program results and not to evidence of program expenditures. Results are measured by clearly defined disbursement-linked indicators.

When RBL is the choice of financing modality, the ADB and its partners are held accountable for achieving program results, whereas the ADB's traditional investment lending mainly focuses on transaction-based inputs, e.g. contact awards/disbursement, that may (or may not) contribute to achieving the intended project objectives. RBL provides an added tool for the ADB to better meet the needs of its Developing Member Countries (DMC) and improve development effectiveness. Its objectives are to:

- increase government's accountability and incentives to deliver and sustain results,
- improve the effectiveness and efficiency of government-owned sector programs,
- promote institutional development,
- support country ownership,
- reduce transaction costs, and
- Support development coordination and harmonization when more than one development agency is involved in a program.

In order to implement a successful RBL, the respective government institution is expected to abide by the policies and guidelines set by the ADB for the purpose of ensuring the expected result are achieved by the program. The payment disbursement will be directly linked to acting upon the agreed program policies and rather than on the actual expenditure, the expected amount will be disbursed.

Conclusion

RBL could be an optimal loan modality for this project because it provides tranche release against clearly measurable and quantifiable actions, can finance the government's equity contribution (unlike ADB's financial intermediary loans), and is intended for situations where the financing need is not driven by macroeconomic factors (unlike ADB's program loans).

Summary of Proposed Options for the Implementation of the CGS

Indicator	Proposed Option
Structure	Public-Private-Partnership (PPP) following a 'Public-Private Model'
Government Institution vs. Legally Separate Entity	Creation of a legally separated entity as an NBFI
Funding	80% equity contributed by the GOSL and minority by financial intuitions and 20% as quasi equity
Corporate Governance	Similar to the Credit Bureau of Sri Lanka, established as a publicly owned institution. The board of directors to be approximately 11 members with a minimum of three independent directors.
Centralisation	A centralized scheme operating through the branch network of the FIs
Selective vs. Portfolio Approach	• Initially a selective approach • As the scheme matures, adoption of a combination
Type of Finance Targeted	Both working capital and funds for investment
Risk Distribution	• Distribution of risk among all participating parties (guarantor, lender and borrower) • Losses would be shared proportionately • Guarantee coverage of 67%, applying to loan principal • Premium is based on the risk profile of the borrowers • For capital expenditures, borrower is required to infuse a minimum contribution of 20% of the project cost
Fees	To be collected upfront
Defaults and Claims	• Clear definition of trigger conditions and timely claims handling • Vigorous post-claim loss recovery
Leverage	An initial leverage of 1.5 to ensure that the CGS achieves a domestic credit rating of at least AA
Supervision and Control	• CGS subject to prudential standards and supervision, including capital adequacy requirement, applicable for a NBFI • The regulator to be the CBSL

Annexures

Annexures

Annexure 01: Approach and Methodology

Our approach began with a demand analysis and selecting segments within the SME sector, to gather information/data in relation to the requirements for credit (loans), restricted access to credit, the ease of starting a new business venture, reasons for the stagnation and failure of existing businesses. This also entailed meeting and discussing issues and opportunities with the players in the SME sector which includes Chambers of Commerce (including regional), Entrepreneur Societies, branch and regional offices of Financial Institutions (FIs).

Based on the findings from the demand analysis, KPMG developed the business plan encompassing all technical aspects of the guarantee scheme such as the guarantee fund, coverage and fees. Understanding the intricacies of the demand for an CGS in conjunction with direction from the regulatory bodies enabled KPMG to propose the options for the optimal structure for incorporating the CGS, the regulatory and governance framework and operations.

Data Sources

The Demand Analysis was carried out based on the input received/extracted from the below sources:

a) Published financial information on the lending portfolios of the local commercial banks

b) Interviews conducted with Stakeholders

KPMG conducted interviews with banks and NBFIs on their SME lending. This provided guidance on the approach required in engaging all relevant stakeholders in the formation of the CGS, input on the nature of the loan portfolio, sectors, reasons for rejection, and impact on the lending if an CGS is introduced and ensuring its sustainability.

c) Chamber of Commerce and Regional/District Chambers

KPMG met with the Secretary General of the Chamber of Commerce in Colombo and discussed the project and the intended approach. It was suggested that KPMG initially access the 25 District Chambers for data as well as their views on the SME segments. KPMG communicated with all chambers and its members to ascertain the need for the CGS in terms of SMEs. This also involved meeting selected entrepreneurs and understanding their concerns in relation to the access to finance and the practical difficulties they face when securing credit.

KPMG visited regional Chambers and devised a survey to obtain the relevant information/data from the relevant parties (i.e. SMEs, District Chambers and Regional Banks). This information was incorporated into the demand analysis.

d) World Bank

KPMG conducted discussions with the World Bank to obtain their views on the Credit Guarantee Scheme which was proposed but not implemented in Sri Lanka.

e) Regional Chambers

The below sources were referred in order to develop the options for the detailed business plan.

a) A study of Similar CGS Schemes Implemented Locally and Globally

KPMG analysed a number of credit guarantee schemes that were implemented around the world and in Sri Lanka. CGS's implemented in Sri Lanka by the CBSL for SMEs (SMAP- Small and Medium Enterprise Assistance Project launched in September 1997), India (CGTMSE India), Indonesia MSME, Jamkrindo Indonesia, Korea Credit Guarantee Fund (KODIT), Japanese credit guarantee corporation, Malaysia CGC, Ireland, Chile FOGAPE, Mexico national Guarantee, Costa Rica and AGF, were studied.

Through this analysis, our aim was to gain key insights into the applicability of a CGS in Sri Lanka and potential bottlenecks during the implementation faced by the earlier schemes.

b) A study of Similar Local Bodies in the Industry

Similar local bodies were analysed to develop structural, operational and governance options for the proposed CGS. In this regard the SLECIC and CRIB were considered and KPMG held discussions with the key management personnel of these institutions to gather the required information as well as their views for the proposed CGS.

Japan
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Poverty
Reduction

Annexure 02: Outcomes of the Survey

KPMG carried out a survey across the island to identify the common limitations faced by SMEs in obtaining access to finance, the reasons for denial for credit and the initiatives the FIs and the other bodies (e.g. Chambers of Commerce) have taken to educate and create access to finance for SMEs in Sri Lanka.

The summary of the survey results are illustrated below.

SMEs Visited

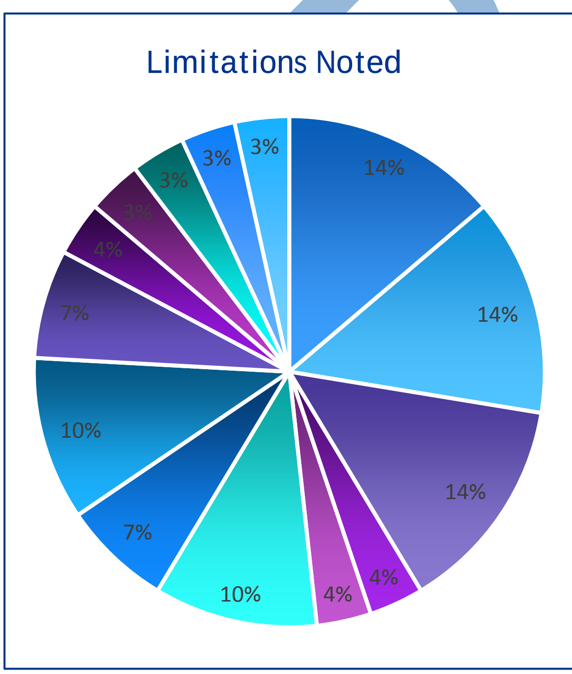
Area	No. of SMEs Visited
Southern	20
Central	17
Eastern	38
Northern	7
Sabaragamuwa	20
Uva	20
Western	10

Table 01

Visits were conducted for the purpose of understanding the limitations faced by SMEs in accessing finance, the average loan size, the average tenor and the purpose for which credit is required.
SMEs that represent a wide range of sectors were visited to obtain their views.
The sectors include:
Manufacturing, tourism, women entrepreneurs, healthcare, gold, trading, contractors, agriculture, restaurant, fisheries sector, hoteliers, IT service providers, etc.

The responses received are summarized as below:

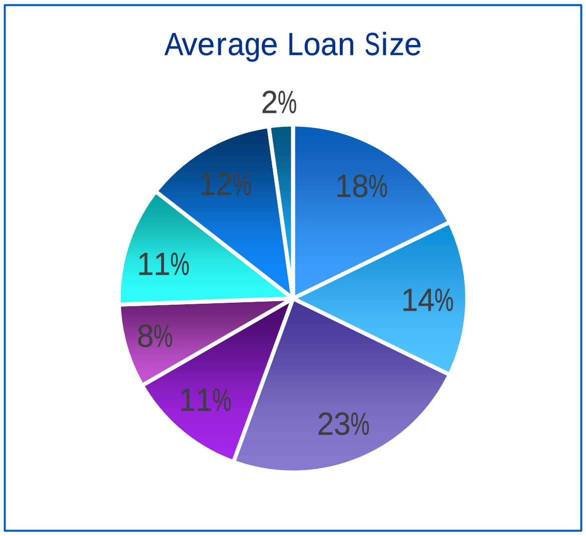
01. Limitations noted: The limitations faced by the SMEs in accessing finance are illustrated in Diagram 01.



14%	No proper business plan
14%	Lack of collateral
14%	Appearing in CRIB as irregular
3%	Expansion without a plan and a proper market survey
3%	Lacking capacity to repay
10%	Operating without sufficient capital
7%	Lack of adequate skills
10%	No proper financial records and methods of book-keeping
7%	Insufficient cash flows to support borrowings
4%	Lacking title to property to support borrowing
3%	No proper market survey
3%	The financial institutions not having sufficient staff to monitor projects
3%	Improper style of management
3%	Misuse of funds

Diagram 01

02. The average loan size: The expected average size of loan ranged from a maximum of LKR 200mn to a minimum of LKR 250,000.



18%	200,000-1000,000
14%	1000,000-2000,000
23%	2000,000-4000,000
11%	4000,000-6000,000
8%	6000,000-10,000,000
11%	10,000,000-15,000,000
12%	15,000,000-50,000,000
2%	50,000,000-200,000,000

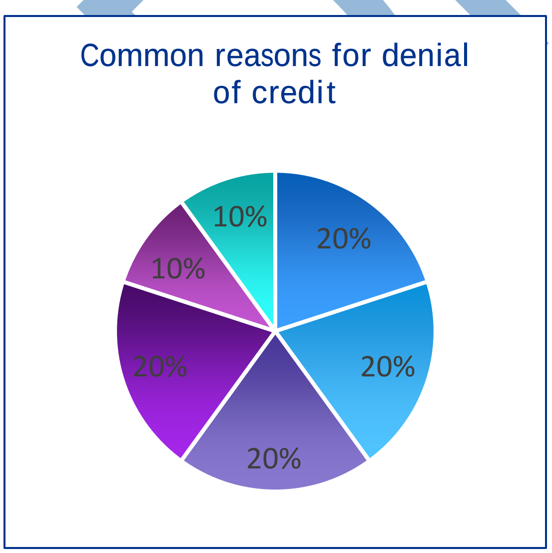
Diagram 02

03. The average tenor ranged from 3 years – 10 years.

04. The purposes for obtaining credit were identified as being for one or more of the following:
   a) Purchase of Land
   b) Construction of building
   c) Purchase of machinery
   d) Working capital

FIs Visited

The survey was extended to obtain the views of the Financial Institutions which have considerably large SME lending portfolios and an island-wide branch network. The main problem of access to finance was put forward to FIs and the reasons provided for denial of credit are summarised below.

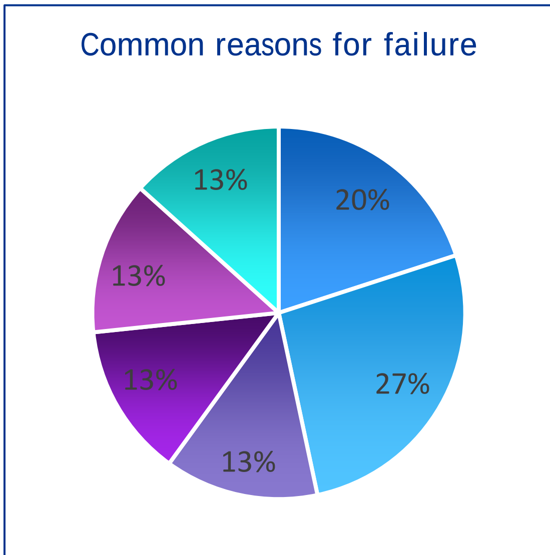


20%	Appearing in CRIB as irregular
20%	Over-trading / Insufficient equity/ No proper financial records and methods of book-keeping/ Lacking capacity to repay/ Insufficient cash flows to support borrowings
20%	Lack of sufficient business know - how / adequate skills / Market knowledge / No proper business plan / Expansion without a proper plan
20%	Issues relevant to collateral / Lack of title to property to support borrowing / Request not complying with bank credit policy
10%	Financial indiscipline / Unsatisfactory servicing of previous facilities
10%	Inability to gauge the level of activity and profits / Unrealistic project proposal/ Misuse of funds / t High gearing

Diagram 03

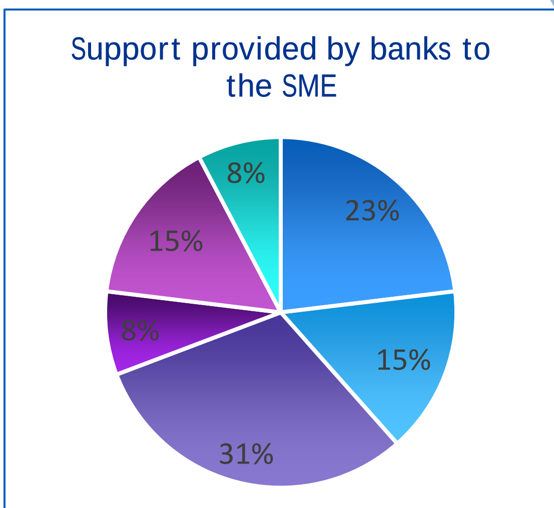
Chambers of Commerce

The survey also included interviewing Chambers of Commerce and obtaining their views on the common reasons for the failure of SMEs and the initiatives taken by the banks and the Chambers to strengthen SMEs.



20%	Lack of succession / Poor planning / Lack of personal involvement/ Expanding without a proper plan / Overtrading
27%	Diversion into unrelated areas and/or withdrawal of business funds for consumption
13%	Lack of commitment and the required knowledge on the industry / Commencing projects without adequate knowledge
13%	Market for products and the high degree of competition and financial constraints / Inconsistent government policies
13%	No fall back capital to bounce back from unexpected events / Dependency on informal sector for borrowing at high interest
13%	Outdated technology / Unprepared to learn and implement new technology

Diagram 04



23%	Awareness programmes on products and services provided by the banks
15%	Training on financial literacy, accounting and management
31%	Creating linkages from within its clientele (informally)
8%	Sourcing Entrepreneurs for support through the Divisional Secretariat and the Trade Chambers
15%	Link with other institutions in providing training and other awareness
8%	Creation of a database with the support of CBSL divisional secretaries and the trade chambers

Diagram 05

Conclusion

Having visited and discussed ground level issues with SME entrepreneurs, and representatives of the financial services sector, the Chamber officials in the different districts, some provincial offices of the CBSL and entrepreneur societies, it is clearly evident that the challenges confronting the SME sector are many. Tailor-made solutions cannot be applied across the sector, as the issues vary from entity to entity as proven through the feedback received.

Lack of collateral, non-acceptability of available assets as collateral, appearing as defaulters on previous borrowings or as guarantors of defaulters, non-practice of formal accounting/financial record keeping, no proper management, lack of succession planning, expansion without market study and without sufficient equity (overtrading) are the major shortcomings that surfaced.

Programs to create awareness of financial products and services, financial literacy, accounting and bookkeeping, creating linkages, and facilitating field visits were among the common support measures.

Although the various bodies have taken steps to address the issues, the challenges confronting the sector remain. It is therefore essential that a formalized follow-up and monitoring mechanism is implemented.

Japan Fund for Poverty Reduction

Annexure 03: Demand Analysis

(Currency: LKR mn)	2016	2017	2018	2019	2020	2021
Banks						
Cumulative SME Lending Portfolio						
Forecasted Cumulative SME Lending Portfolio	764,484	792,099				
Annual Loan Disbursement	24,890	27,614				
Percentage of Annual Loan Disbursement Attributable to the CGS		50%				
Annual Loan Disbursement Attributable to the CGS		13,807				
Projected Growth in Demand due to the Introduction of the CGS		15%				
Projected YoY Growth in Demand for CGS			5.80%	5.80%	5.80%	5.80%
Banking Sector Total Demand to be catered by the CGS		40,233	42,566	45,035	47,647	50,411
% Considered		10%	15%	20%	30%	40%
Demand Considered for the Feasibility Calculation		4,023	6,385	9,007	14,294	20,164
NBFIs						
Annual Loan Disbursement	60,000	63,480				
YoY Growth			5.80%	5.80%	5.80%	5.80%
Percentage of Annual Loan Disbursement Attributable to the CGS		20.00%				
Annual Loan Disbursement Attributable to the CGS		12,696				
Projected Growth in Demand due to the Introduction of the CGS		10%				
NBFI Sector Total Demand to be catered by the CGS		13,966	14,776	15,633	16,539	17,499
% Considered		10%	15%	20%	30%	40%
Demand Considered for the Feasibility Calculation		1,397	2,216	3,127	4,961	6,999
YoY Total Demand for CGS		**5,420**	**8,601**	**12,134**	**19,256**	**27,164**

Assumptions used in the Demand Analysis	
Data Gathering:	➢ The total loan portfolio of licensed commercial banks vs. the SME loan portfolio of the respective banks was considered ➢ The total SME loan portfolio was considered since the loan disbursement figures available are insufficient for analysis ➢ Both of the above information was collected primarily from the following sources: i) Bank Annual Reports ii) MoF Annual Reports
Definitions:	➢ Loan Portfolio: Total of all loans held by a bank or finance company on any given day. ➢ Loan Disbursements: Loan disbursements are the amounts that have been paid out to the borrowers by the bank
SME Lending Figures (Banking Sector)	➢ In order to arrive at the missing figures in the total SME lending portfolio, the growth trend % of the ratio of the total lending portfolio was taken against the SME lending portfolio for the years available and calculated. ➢ SME lending values were available from 2012-2014 for 10 Banks and 6 banks had more than 3 data points available. Considering this actual ratio, a missing value treatment was done using MICE (Multivariate Imputation by Chained Equations) which is a better methodology compared to the mean imputation and k- nearest neighbour approach. ➢ By multiplying the two matrices (SME Lending Ratio and Total Lending), SME Lending value metrics was calculated. Then the missing value treatment was done using the MICE method. The values were aggregated to arrive at the SME lending. The Theta Method was used to generate a

	forecast for the next 2 years. Forecast error was calculated as 21.43%. However, it is not possible to capture the error due to the missing value treatment, therefore, the forecast error is expected to be more than the aforementioned value. ➢ There was no missing value treatment carried out for the total value as interpolating missing value for a high value such as this may result a very high inaccuracy.
The Average percentage increase in SME lending after the introduction of the CGS	➢ KPMG visited banks across the island and obtained the view of the key management personnel on the impacts an CGS would have on their SME lending portfolio taking into account factors related to their specific region as well as wider ranging issues. From which we were able to arrive at a figure which represented a rise in SME lending as a result of the introduction of a CGS
Basis for consideration of external factors	According to government estimates, around 80 per cent of businesses in Sri Lanka that fall under SMEs contribute to over 50 percent of the Gross Domestic Production (GDP) of the country. Of the total employment in the country, SMEs accounts for a share of 35 percent. Source :http://www.dailymirror.lk/72983/smes-will-be-critical-to-sustain-economic-growth-next-5-years
Loan rejection rate	The loan rejection rate was obtained during the visits to the banks. However it should be noted that many banks mentioned that they do not maintain any information for reporting purposes hence refrained from disclosing the same.
GDP Annual Growth Rate 2016 – 2018	CBSL
Number of SME establishments	Annual Survey of Industries Reports from 2007 to 2012
AWPR (Average Weighted Prime Lending Rate)	CBSL Source: http://www.cbsl.gov.lk/htm/english/08_stat/s_5.html

Assumptions used for the Financial Model	
Guarantee Activity	
Average repayment period :	The average repayment period was arrived at based on the discussions held with the banks and NBFIs Banks : The average repayment period was considered to be 5 years NBFIs : The average repayment period was considered to be 3 years
Funds	The total equity infusion was assumed as LKR 11.2bn
Leverage factor	The leverage factor was considered to be a maximum of 1.5 times.
SME lending	The SME lending value was obtained from the Demand Analysis conducted.
Amount repaid	The assumption considered for the repayment is based on the average tenor of the loan Year 01 Settlement: The settlement of the new loans granted in year 01 are assumed to be paid only 50% of the annual repayment value as grant of loans will take place throughout the year. Year 02 onwards settlement: The annual settlements from year 02-05 has been considered as fully recovered
Guarantee cover	The acceptable guarantee cover was considered as 67%, based on the discussions with the local banks and NBFIs
Customer Profiling	

The customer profiling was done for both the bank and NBFI portfolios. Based on the assumptions used for the 'Projection', category A was not considered for the analysis. Further, the balance loan portfolio was segregated on an equal basis for the Category B and C. The outstanding balance was also calculated based on the same proportions, which was subsequently used for the calculation of the "Expected Loss"	
The Expected Loss was calculated based on the following assumptions:	
Probability of Default (PD) -	The PD rates were arrived at by considering the published information by the CBSL and banks The sector wise exposure was extracted from the published annual reports of banks The sector wise NPL figures were extracted from the financial soundness report published by the CBSL The weighted average NPL was derived as 5% which was considered as the Category B, PD for the banking sector A further 2% was added on the above figure to arrive at the PD rate for Category C The NPLs were compared with the NBFI figures which represented an approximate difference of 2%. This was incorporated to the PD rate of 5% and applied to the NBFI sector PD
Loss Given Default (LGD)	The LGD was considered to be 100% of the outstanding
Exposure at Default (EAD)	Was considered to be the total outstanding allocated to each sector based on the total outstanding.
The actual claims paid were assumed to be 5% from the total outstanding for both sectors.	
An average claims paid rate of 5% was considered for both the banking and the financial sectors of Sri Lanka	

Statement of Comprehensive Income (SOCI)	
Fees	The fees have been accounted for based on the requirements for revenue recognition.
Interest earned/expense	The Interest earned is based on the treasury bill rate as published by CBSL 20th May 2016 (10.48%). The risk premium is considered to be 2% on the 10 year bond rate as published by CBSL 26th June 2016 at 12.98%.
Start-up / replacement cost	The start-up cost was assumed to be LKR 10mn, which shall include preliminary working capital expenses such as, business registration, location arrangements, etc.
Salaries	The salary figures were assumed based on the salary expenses of a similar institute operating in Sri Lanka

Employees	Amount
Directors	1,320,000
23 employees @ 70,000	19,320,000
CEO	9,600,000
Other HoDs	18,000,000
	48,240,000
Gratutity provision 1.5 times	**72,360,000**

PPE	The PPE composition is assumed to be as follows:

	Total	Vehicles	Computers & Software	Furniture & Fittings	Office Equipment
Cost (1-3)	100	20	30	30	20
C/ F Depreciation Rate	25%				

Tax rate	The tax rate includes the financial services VAT @ 15% and NBT

Annexure 04: Capital Ownership Example

Capital Ownership

	Government	Financial Institutions	Central Bank	Banking Supervisor - National Public Agencies	Private companies	Other
OSEO Garantie - France	✓	✓				✓
Garantiqa – Hungary	✓	✓				
Perum Jamkrindo- Indonesia	✓					
Eurofidi – Italy		✓				
KODIT – South Korea						
SGR Valenciana - Spain	✓	✓				
SBCGC – Thailand	✓	✓	✓	✓	✓	
KGF - Turkey	✓			✓		✓

Note : with reference to OSEO, 'other' relates to other owners; with reference to KGF, 'other' relates to industrial and business organisations

Source: International survey on guarantee market players: 2011 KPMG Advisory

Annexure 05: Examples of CGS Implemented and Practiced

Country	CG Structure
Indonesia MSME	**Capital**: Loans up to 500 mn IDR towards Micro, and SMEs feasible but not bankable. 100% funded by participating banks and partially guaranteed by the Government through the credit guarantee institution **Tenor**: a) Up to 20mn IDR (no checking information, no collateral, maximum period 18 months) b) 20mn to 500 mn (subject to checking information of Debtor, collateral and 18 months) c) Working capital up to 3 years (can extend to 6 years) d) Investment maximum 5 years (can extend to 10 years) e) Investment for plantation perennials maximum 13 years (cannot extend) **Cover**: Guarantee for Government upstream sectors (agri, fisheries, marine, small industry and forestry) 80% of credit, other sectors 70% **Registration**: Participating banks use an online system for credit guarantee activities **Premium:** Guarantee fee 3.25% *period*coverage Maximum cover per institution IDR 2 bn and per end user 100mn **Risk mitigation:** Banks with high NPLs, a pre claim method for claim submitted, to ensure that the bank has granted loans in line with the credit manual of the bank and government regulations
Jamkrindo Indonesia	**Capital**: 100% owned by the Government 5239 billion Indonesian Rupiah **Objectives:** • Main purpose is to implement government policies towards Micro and SME sectors • Provides guarantees to SMEs and Cooperatives in lease financing, factoring, consumer finance, and also to purchase goods, Islamic guarantees, for service contracts, construction, procurement, counter bank, distribution and surety bonds • Guarantees issued both to Banking and Non-Banking Financial Institutions • Demand due to lack of collateral to access funding and weak capital structure **Premium:** For a large company, additional 0.5% p.a. is added to the final fee rate
Korea Credit Guarantee Fund (KODIT)	**Capital:** The capital fund was initially KRW 32 billion and the outstanding credit guarantee was KRW 101 billion Contributions from Government, and FIs The leverage ratio prescribed by law is 20 times the capital fund. The ratio is kept around 10 times the fund **Objective**: • Credit Guarantee for SMEs lacking security, promote financial accommodation, help drive away bad credit and create efficient management and utilization of credit information • CGs for start-ups, youth start-ups, maturity stage, M n A guarantee, CG of Bond issued by SMEs **Cover**: Coverage ratio linked to the credit rating. (rating / 10 years or less / Longer than 10 years) AAA. — 50% — 50% AA ~A — 75% — 70% BBB+ ~BBB- — 85% — 75% BB+~ B- — 85% — 80% If an enterprise is not able to accept the standard coverage ratio, it is required to pay additional guarantee fee of 0.2 % pa per 5% of coverage ratio **Premium:** Basic fee ranging from 0.5% to 2.0% p.a. of the guarantee amount is computed by the corresponding rating of the applicant. The final fee is decided by adding or subtracting a certain rate to the basic fee, depending on the applicant's current situation or type of guarantee product.

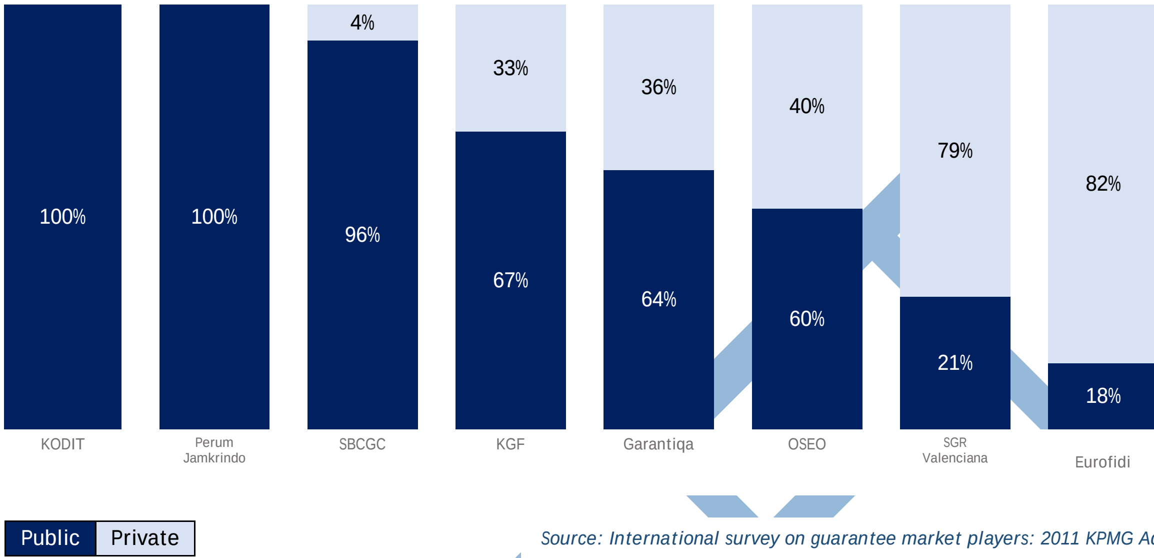
Sri Lanka - CBSL for SMEs SMAP- Small and Medium Enterprise Assistance Project , launched in September 1997	**Cover :** Guarantee cover varied with loan size Variable covers of 60% - 90% were extended depending on the size of the loan. The guarantee amount was limited to the principal amount in default The scheme was implemented under an agreement signed between the GOSL and IDA (International Development Agency) under which CBSL was called upon to establish a Credit Guarantee Scheme for SMEs **Loan Size**: Maximum loan size LKR 10mn **Premium:** Premium payable annually at the beginning of each calendar year at the rate of 1% of the amount guaranteed and outstanding of the loan at the end of each immediate preceding year. When a loan is disbursed in more than one instalment, the premium on such instalment (other than the first instalment) will be payable from the date of disbursement of such instalment. **Recovery :** • The PCI should take prompt and effective steps to recover such arrears. • Where the instalment of the loan remains unpaid for more than three months from due date, the PCI should send a report to the CBSL giving the current status of the project/ borrower • If it continues to be in arrears, such report should be filed regularly with the CBSL at half yearly intervals, until such time the PCI files the claim • It's always up to it to keep CBSL informed of action taken and developments from time to time • The PCI is also obligated to take any action for the purpose of effective recovery • Recovery action should be continued even after the settlement of a claim under the guarantee • The PCI should not write off such loan without prior approval of CBSL. If the PCI fails to institute legal action within the period specified by the CBSL at the time of such claim and to continue such action until the recovery proceedings are concluded, the CBSL reserves the right to recover any sums paid in settlement of a claim • All amounts recovered after payment of a claim should be shared between the PCI and CBSL in the same proportion as the Guarantee or the amount guaranteed, whichever is lower • The extent of the guarantee will be the same % of guarantee determined for the loan • Claims will however be entertained if PCI has filed legal action or furnished to the CBSL a written undertaking to institute legal action not later than 9 months from the date of such claim
Japanese credit guarantee corporation	**Capital:** Japanese CGCs receive 75% from local governments and 24% from FIs. **Regulator:** All CGCs have the legal status of a public institution and are under the umbrella of the National Federation of Credit Guarantee Corporations. (NFCGC) **Loan Size:** The size threshold of eligibility to guarantees varies by industry • In manufacturing, SMEs are eligible for guarantees if they have less than 300 employees, whereas for the retail sector the upper threshold is set at 50. • Maximum capitalization is also an eligibility criteria for SMEs. **Premium:** Fees vary from 0.5 to 2.2%

Malaysia CGC	**Regulator:** Established in 1972 by Bank Negara (Central Bank) and all the commercial banks. **Operating Model:** • The borrower applies online for a guarantee • The CGC reviews the application, after which lenders are invited to bid online for the application • The scheme also provides a portal to SMEs with easily accessible comparative information about available guarantee options
Ireland	**Establishment:** In April 2012, the Government announced the creation of a first credit guarantee scheme. **Cover:** Guarantees at 75% coverage rate to banks for loans up to 1mn Euro. **Target Group:** Commercially viable SMEs which have a good performance, solid business plan and a defined market for their goods and services
Chile FOGAPE	**Capital:** Initial capital of $13 million, and by now it has reached $50 million. Its revenues stems from returns on investments, recovered loans, and commissions paid by borrowers. **Cover:** • Coverage rates are determined by auctions which take place 4 to 6 times a year • Banko Estado can influence the coverage rate by setting reservation prices which depend on the type of product. For LTLs and contingent credits, coverage must not exceed 80% for STL s the maximum is 70% • Banko Estado can exclude banks if their previous default rates exceed a given threshold or if banks use less than 90% of the guarantees previously acquired • Between 2006 and 2010 coverage rates increased from 65% to 77%. In 2011 it reduced to 68% as the number of credit guarantees increased from 25,000 in 2006 to 64,000 in 2010 **Regulators:** • The scheme is government owned and managed by the state owned bank Banko Estado, which also manages the auctions • In the auctioning process, banks can acquire guarantee rights for three types of credit, depending on their maturity • About half of credit guarantees rights are for long term credits, 30% are for short term credits and the remaining 20% are for contingent operations such as LCs • In each bid, banks indicate the amount of the guarantee rights they wish to acquire as well as the maximum coverage rate associated with the guarantee • Credit guarantee rights are assigned starting with the bid indicating the lowest coverage rate. Subsequently, bids with higher coverage rates are assigned until the total amount of credit guarantees' rights equals total bids • After a bank has been assigned credit guarantees' rights, FOGAPE specifies the details of the CGs contract, in particular the fees charged to the borrower and the coverage rate
Nigeria (ACGSF)	**Capital:** Formed under the military government in 1977 with an initial capital base of N100 million distributed between the Federal Government (60% equity) and the Central Bank of Nigeria – CBN (40%). **Regulator:** The ACGSF is exclusively managed by a Board set up under the supervision of the CBN (management agent). **Cover:** N20, 000 for individuals without collateral required. With collateral, the limit of the guarantee is N500, 000 and for corporate bodies and corporative societies it is N5 million. The fund bears the liability of 75% of the amount in default.

Mexico National Guarantee	**Regulator:** Modelled on the Chilean system, The National CGs Fund is approved by the Mexican Congress each year through reserved resources from the SME Fund created in 2004 to integrate 4 enterprise support funds. **Loan Distribution:** The credit guarantee's funds are distributed through two channels, the banking system and the nonbank financial system The banking system, the Government through the SME Fund and NAFIN (National Financiera) allocates funds to the commercial banks in two ways: 1. Through an auction (portfolio basis) 2. Through counter guarantees In the auction model, banks make bids for funds (paying for the right to offer guaranteed loans) in which the bidder provides the factor by which they will leverage any guarantees provided and the interest rate charged on such loans. **Premium: The successful bidders are the banks prepared to offer the highest leverage and the lowest interest rates.**
AGF (African Guarantee Fund)	**Operating Model:** AGF operates as a non-bank financial institution with a Board of Directors responsible for the overall affairs of the company and a Chief Executive Officer heading the day to day operations. **Coverage:** This translates in a guaranteed maximum coverage rate of 50% of the financing. Equity and Resource mobilization is limited at 50% and 100% respectively. **Premium:** Price-to-Risk model is used for guarantees availed to FIs. Where prices may vary across banks depending on quality of portfolio as measured by among others, default rate. • Individual Guarantee: Utilization Fee – 1.75%; Facility Fee – 0.75% • Portfolio Guarantee: Utilization Fee – 2.0%; Facility Fee – 0.75% • Counter Guarantee: Utilization Fee – 1.75%; Facility Fee – 0.75%
India (CGTMSE India)	**Capital:** Trust Fund USD 530mn (GOI contributing 425 USD, SIDBI USD 105mn) **Target Sectors:** micro enterprises, women entrepreneurs, on selected regions. Incentivizing / boosting lending to those selected areas. **Guarantee Cover:** 85% to 50% in line with the size of the loan. Smaller loans having a higher % of the guarantee. **Premium :** With a minimum one time premium/fee of: • 1% and maximum of 1.5% for the General category • 0.75% to 1.5% for the Special category • The lesser fee being applied for the lower end of the loans. Similarly, an annual fee ranging from 0.5% to 0.75% was levied on the same basis and payable before a specified date every year **Recovery:** Filing of lawsuits is a precondition for submission of a claim, with a prescribed lock in period of 18 months **Tenor:** The tenor of the guarantee was from the payment of the initial fee and up to the agreed tenor of the loan with limitations for loans granted for working capital. **Registration:** Upon approval and disbursal, the registration is facilitated online.

Annexure 06: Capital Funds Composition

Capital funds composition (Public/Private), %



Source: International survey on guarantee market players: 2011 KPMG Advisory

Japan Fund for Poverty Reduction

kpmg.com/socialmedia

kpmg.com/app

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