



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

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Project Number: 49273-001  
January 2016

## Proposed Loan and Administration of Technical Assistance Grant Democratic Socialist Republic of Sri Lanka: Small and Medium-Sized Enterprises Line of Credit Project

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 8 January 2016)

Currency unit – Sri Lanka rupee (SLRe/SLRs)

SLRe1.00 = \$0.00695

\$1.00 = SLRs143.95

## ABBREVIATIONS

ADB	–	Asian Development Bank
BPO	–	business process outsourcing
ICT	–	information and communications technology
PAM	–	project administration manual
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

## NOTE

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

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## PROJECT AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 49273-001</b>	
<b>Project Name</b>	Small and Medium-Sized Enterprises Line of Credit Project	<b>Department /Division</b>	SARD/SAPF
<b>Country Borrower</b>	Sri Lanka Government of Sri Lanka	<b>Executing Agency</b>	Ministry of Finance
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Finance</b>	Small and medium enterprise finance and leasing		100.00
		<b>Total</b>	<b>100.00</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Institutional development	Effective gender mainstreaming (EGM)	✓
Knowledge solutions (KNS)	Pilot-testing innovation and learning		
Partnerships (PAR)	Implementation		
Private sector development (PSD)	Private Sector Promotion of private sector investment		
<b>5. Poverty Targeting</b>		<b>Location Impact</b>	
Project directly targets poverty	No	Nation-wide	High
<b>6. Risk Categorization:</b>	Low		
<b>7. Safeguard Categorization</b>	<b>Environment: FI Involuntary Resettlement: FI Indigenous Peoples: FI</b>		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>100.00</b>	
Sovereign Credit line (Loan): Ordinary capital resources		100.00	
<b>Cofinancing</b>		<b>2.00</b>	
Japan Fund for Poverty Reduction		2.00	
<b>Counterpart</b>		<b>17.70</b>	
Others		17.70	
<b>Total</b>		<b>119.70</b>	
<b>9. Effective Development Cooperation</b>			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed loan to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project, and (ii) the proposed administration of technical assistance (TA) to be provided by the Japan Fund for Poverty Reduction for Cluster Development and Small and Medium-Sized Enterprise Finance Innovation.<sup>1</sup>

2. Despite being a source of economic growth and employment, small and medium-sized enterprises (SMEs) often struggle to access bank loans. SME loans are generally riskier and costlier for banks to administer. The project and TA will address this issue by (i) providing a credit line to increase the supply of SME credit through an innovative auction that will allow banks to factor in the higher costs of SME loans; and (ii) the TA increasing the number of creditworthy SMEs by supporting three of Sri Lanka's most important industry clusters.<sup>2</sup>

## II. THE PROJECT

### A. Rationale

3. SMEs are critical for Sri Lanka's economic growth. They are responsible for 30% of the country's gross domestic product and 35% of employment. SMEs are arguably even more important for poverty reduction as they are effective at generating employment—at 51%, the employment–population ratio in Sri Lanka is one of the lowest in developing Asia. Moreover, with large corporations almost exclusively based in Colombo, SMEs drive business activity in other regions of the country and are key to reducing regional disparities.

4. Despite their importance, SMEs struggle to access the banking system. A recent survey identified collateral requirements, high interest rates, and unsatisfactory client support among the constraints. Because female entrepreneurs generally lead smaller businesses, their challenges are compounded.<sup>3</sup>

5. Banks, however, have a reasonable bias for larger enterprises. SME loans are more expensive. Risks are higher because of insufficient collateral, shorter operating histories, informal recordkeeping, and lack of registration. These higher risks often translate into higher credit losses. Operating expenses are also higher because some of the costs of originating and administering a loan are fixed regardless of the loan size. Banks cannot always recover these costs through higher pricing.

6. A simple solution would be to subsidize SME lending. Through a subsidy, banks could have a financial incentive to reach these more difficult borrowers without charging usurious rates. But subsidies can distort the market in ways that ultimately undermine financial stability and harm the intended beneficiaries. During the 2008–2009 global financial crisis, sectors that were benefiting from government subsidies were among the most severely impacted.

7. The Asian Development Bank (ADB) is proposing an innovative solution. Instead of lending to participating banks at the average deposit rate or some other benchmark, the project

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

<sup>2</sup> Clusters are a geographical proximate group of interconnected companies. For example, the Sri Lankan tea cluster includes tea producers, processors, exporters, and other support services.

<sup>3</sup> Institute of Policy Studies of Sri Lanka. 2014. *Female Entrepreneurship and the Role of Business Development Services in Promoting Small and Medium Women Entrepreneurship in Sri Lanka*. Colombo.

will require participating banks to bid on the funds. Banks can adjust their bids to account for the higher costs of SME lending. In effect, the auction will establish the market price for banks borrowing to onlend to underserved SMEs. The auction price is expected to be lower than participating banks' normal borrowing costs, and will preserve their financial incentive to lend to SMEs. This will also mitigate the risk of poor disbursement, a common challenge among SME credit lines. Moreover, it will promote economic efficiency because banks that establish the most effective SME lending programs will be positioned to submit the most competitive bids.

8. ADB's support for SMEs in Sri Lanka is particularly timely. First, it is aligned with government efforts to develop SMEs to create more and better employment opportunities.<sup>4</sup> Second, SMEs' demand for credit is robust and not fully met. During due diligence, multiple banks commented that their client requirements easily exceed project size.<sup>5</sup> Finally, ADB's interim country partnership strategy, 2015–2016 for Sri Lanka emphasizes private sector development, including projects that promote finance sector development.<sup>6</sup> This would be the first sovereign project in Sri Lanka under the new ADB partnership strategy to address these priorities.

9. **Lessons.** The project draws from the experience of previous credit lines in Sri Lanka and from ADB experience in other developing member countries. The most recent ADB-supported SME development project in Sri Lanka was a \$50 million credit line approved in 2007.<sup>7</sup> Although the project is rated *successful*, it encountered difficulties in disbursing to SMEs outside of Colombo. The current project's auction mechanism is designed explicitly as a market-based response that will incentivize participating banks to reach these more challenging borrowers.<sup>8</sup>

10. More broadly, ADB's experience is that credit lines have to reach beyond credit supply and also address credit demand. Sri Lanka's institutions are generally favorable in this regard. The country has a credit information bureau, a movable property registry, and a relatively strong insolvency framework.<sup>9</sup> To further support credit demand, the attached TA will include support for business development services and financial literacy training, which are particularly important in extending financial services to borrowers outside the formal system.

## B. Impact and Outcome

11. The impact will be increased employment opportunities for SMEs aligned with government policy (footnote 4). The outcome will be strengthened SMEs' access to finance.

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<sup>4</sup> Government of Sri Lanka. 2015. *Manifesto, New Democratic Front, A Stable Country, Maithri, Compassionate*. Colombo (President Maithripala Sirisena's election manifesto); and Government of Sri Lanka, Ministry of Finance. 2015. *Statement by the Minister of Finance on Hundred Day Revolution*. Colombo (The revised budget speech).

<sup>5</sup> Economic Analysis (accessible from the list of linked documents in Appendix 2).

<sup>6</sup> ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka, 2015–2016*. Manila.

<sup>7</sup> ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Regional Development Project*. Manila.

<sup>8</sup> Lessons from Previous Credit Lines for Small and Medium-Sized Enterprises (accessible from the list of linked documents in Appendix 2).

<sup>9</sup> Assessment of the Finance-Enabling Environment for Small and Medium-Sized Enterprises (accessible from the list of linked documents in Appendix 2).

## C. Outputs

12. The project's output will be increased financing to SMEs through formal intermediaries. The TA outputs will be (i) innovative SME financing schemes, (ii) enhanced capacity of SMEs in targeted clusters to access financial services, and (iii) strengthened international competitiveness of the information and communication technology and business process outsourcing (ICT–BPO) cluster.

13. The outputs support the outcome on two levels. From the supply side, the credit line—deployed through the auction mechanism—and research into SME credit guarantee schemes will make more financing available to SMEs that banks would otherwise not find creditworthy. From the demand side, the attached TA will help female entrepreneurs develop their businesses and access formal financing. It will provide targeted support to develop ICT–BPO, one of Sri Lanka's most promising export-generating clusters.

## D. Investment and Financing Plans

14. The project is estimated to cost \$117.7 million (Table 1).<sup>10</sup>

**Table 1: Financing Plan**

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank	100.0	85.0
Ordinary capital resources (loan)	100.0	85.0
SME contribution	17.7 <sup>a</sup>	15.0
<b>Total</b>	<b>117.7</b>	<b>100.0</b>

SMEs = small and medium-sized enterprises.

<sup>a</sup> SMEs will contribute equity to the project at a level consistent with market norms. Based on discussions with participating banks, the average contribution is estimated at 15%.

Source: Asian Development Bank.

15. With 3 years as the estimated duration of an SME loan, banks can reuse the funds an average of 3.3 times during the 10-year borrowing period. ADB's \$100 million is expected to support \$392 million of SME subprojects.<sup>11</sup>

16. The government has requested a loan of \$100 million from ADB's ordinary capital resources to help finance the project. The loan will have an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions as set forth in the loan and project agreements. The loan will be disbursed in eight tranches of approximately \$12.5 million each. Each tranche will have a 10-year term and a disbursement-linked bullet

<sup>10</sup> Every \$1 of ADB investment is expected to catalyze an average of \$0.177 of private sector investment on the assumption that the banks will require SMEs to fund on average 15% of a subproject's cost with equity. Banks will have discretion to determine the SMEs' equity contributions as per market norms and the nature of the credit risk. As a reference, subborrower equity would typically range from 33% to 50% of the project cost for uncollateralized commercial loans, 20% to 30% for commercial real estate loans, and less than 10% for working capital loans. Although not part of the banks' disbursements to SMEs, ADB will require the banks to hold \$0.10 of capital for each \$1 they lend under the project to SMEs. This equity capital, along with loan loss reserves, are the first defenses against any SME payment defaults and ensure that the banks are incentivized to originate creditworthy SME subloans.

<sup>11</sup> Estimated loan duration based on interviews of banks during fact finding.  $(\$100 \text{ million ADB funding} + \$17.7 \text{ million estimated average SME equity contribution}) \times (10 \text{ years}) / (3\text{-year estimated average loan duration}) = \$392 \text{ million}$ .

repayment. Based on the foregoing, the average loan maturity is 12.25 years, and there is no maturity premium payable to ADB.

## **E. Implementation Arrangements**

17. The ADB loan to the government will be in US dollars. The government will relend the local currency equivalent to participating banks in amounts and at interest rates determined through eight semiannual auctions. At each auction, \$12.5 million equivalent will be available.<sup>12</sup> The resulting loans to participating banks will have 10-year tenors and bullet repayments; the government will bear the foreign exchange risk.<sup>13</sup> The auction mechanism is described in the project administration manual (PAM); an independent third party in consultation with ADB and the government will develop more detailed operating procedures.<sup>14</sup>

18. The independent third party will administer the auction on behalf of the Ministry of Finance.<sup>15</sup> ADB will oversee the independent third party in consultation with a steering committee, with members including the secretary to the Treasury (chair), Department of Development Finance, ADB, Central Bank of Sri Lanka, Export Development Board, Federation of Chambers of Commerce, and others who may be considered appropriate by the government.

19. In winning an auctioned loan, participating banks have discretion to establish the rate, tenor, and other terms of onlending.<sup>16</sup> However, they must commit to reaching SMEs that currently struggle to access formal finance. Banks will not be allowed to participate in any subsequent auctions until they have achieved SME onlending targets. Specifically,

- (i) 10% of the number of subloans is to first-time borrowers from a licensed commercial or specialized bank;
- (ii) 5% of the number of subloans is to SMEs led by women;<sup>17</sup> and
- (iii) 50% of the amount of subloans is lent cumulatively to targeted SMEs, which include SMEs that are (a) located outside of Colombo District, (b) borrowing for working capital, (c) led by women, or (d) first-time borrowers from a licensed commercial or specialized bank.

20. Public and private domestic banks in good standing with the Central Bank of Sri Lanka are eligible. The eligibility criteria includes (i) central bank confirmation that the applicant is in good regulatory standing (including corporate governance, reputation, integrity, and anti-money-laundering procedures), (ii) compliance with the central bank's regulatory capital norms, and

<sup>12</sup> For example, if institution X bids \$3 million at 10%, institution Y \$8 million at 8%, and institution Z \$12 million at 6%, then X would receive \$3 million at 10%, Y \$8 million at 8%, and Z \$1.5 million at 6%.

<sup>13</sup> The government will receive the difference between its borrowing rate (set in dollars) and the auction rate (set in Sri Lanka rupees) as compensation for the foreign exchange risk with a minimum foreign exchange charge of 1%.

<sup>14</sup> Project Administration Manual (accessible from the list of linked documents in Appendix 2). The eligibility criteria for participating financial institutions, and criteria for subborrowers and subloans are attached to the PAM.

<sup>15</sup> ADB will follow ADB's Procurement Guidelines (2015, as amended from time to time) in recruiting the independent third party, whose work will be funded under the attached TA.

<sup>16</sup> Eligible subborrowers must meet the government's SME definition of annual turnover of less than SLRs750 million, fewer than 300 employees if a manufacturer, or fewer than 200 employees if in the service sector. Other requirements are that the SME is economically and financially viable, not a related party to the participating bank, and not borrowing for the purpose of a "three-wheeler" business. Eligible subloans will be fully funded via the ADB project but must be SLRs50 million or less. No more than 50% of funds can be used as subloans for working capital.

<sup>17</sup> Defined as led by a woman, at least 51% of the enterprise ownership is controlled by women, at least 60% of senior managers are women, or at least 50% of board members are women.



(iii) tangible equity of at least SLRs1 billion.<sup>18</sup> Based on these criteria as well as ADB's own due diligence on the banks' financial strength, financial management, integrity, and governance, 10 banks were invited to participate.<sup>19</sup>

21. After the first two semiannual auctions, ADB and the steering committee will review the auction's effectiveness and may agree to make modifications. In the unlikely event that more fundamental changes are required, ADB in consultation with the steering committee may elect to revert to a conventional first-come, first-serve distribution system with the borrowing rate for participating banks fixed at Sri Lanka's average weighted deposit rate.

22. Additional implementation arrangements are summarized in Table 2 and described in detail in the PAM.

**Table 2: Implementation Arrangements**

<b>Aspects</b>	<b>Arrangements</b>
Implementation period	March 2016–May 2020
Estimated completion date	31 May 2020
Loan closing date	30 November 2020
<b>Management</b>	
(i) Oversight body	Steering committee, including the secretary to the Treasury (chair), Department of Development Finance, ADB, Central Bank of Sri Lanka, Export Development Board, Federation of Chambers of Commerce, and others considered appropriate by the government
(ii) Executing agency	Ministry of Finance
(iii) Implementing agency	Department of Development Finance
(iv) Implementation unit	Project management unit, under the leadership of the director general, Department of Development Finance
Disbursement	The loan proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and detailed arrangements agreed upon between the government and ADB.
Procurement	Loan funds will be used as described in ADB's <i>Procurement Guidelines</i> (2015, as amended from time to time) for loans to financial intermediaries (para. 3.12).

ADB = Asian Development Bank.

Source: Asian Development Bank.

### III. TECHNICAL ASSISTANCE

23. The attached TA will support three of the outputs.<sup>20</sup> It will fund the administration of the auction and will study the introduction of an SME credit guarantee scheme to Sri Lanka (output 2).<sup>21</sup> The TA will be implemented from February 2016 to May 2020.

<sup>18</sup> Sri Lanka is in the process of implementing Basel III; the exact capital requirements will change during the program as implementation progresses.

<sup>19</sup> Bank of Ceylon, Commercial Bank, DFCC Bank, Hatton National Bank, National Development Bank, Nations Trust Bank, People's Bank, Regional Development Bank, Sampath Bank, and Seylan Bank. Note that the participation of two of these banks is contingent on their compliance with the criteria that their audited net nonperforming loan ratio be less than or equal to 5%. ADB and the steering committee may invite additional banks or nonbank financial institutions, which will then be subject to the same criteria and due diligence.

24. The government requested that the attached TA focus on the ICT–BPO, fruits and vegetables, and rubber clusters, which have positive potential to increase Sri Lanka’s exports. The TA will support business development services and financial literacy training for female entrepreneurs in all three clusters (output 3) and branding of and the promotion of female participation in the ICT–BPO cluster (output 4). The focus on ICT–BPO is particularly timely as this is an opportunity to attract international clients looking for a secondary location to complement their ICT–BPO operations in India.

25. The TA is estimated to cost \$2.1 million, of which \$2.0 million will be financed on a grant basis by the Japan Fund for Poverty Reduction and administered by ADB. The Ministry of Finance will be the executing agency. The Ministry of Finance’s Department of Development Finance will be the implementing agency for the TA component supporting output 2. The Export Development Board will be the implementing agency for the TA component supporting outputs 3 and 4. The government will provide counterpart support in the form of office accommodation, remuneration of the project management unit and other staff, and other in-kind contributions.

#### **IV. DUE DILIGENCE**

##### **A. Economic and Financial**

26. The project is economically and financially viable. Economically, the gains are likely to come from the project’s requirement to lend to SMEs that cannot access the banking system. Providing SMEs with better access to finance has a multiplier effect because SMEs can borrow to (i) invest in more productive technologies, and (ii) enlarge their businesses to achieve economies of scale. These gains are especially significant in economies, such as Sri Lanka’s, where unmet SME credit demand is significant.<sup>22</sup>

27. Financially, participating banks will assess the creditworthiness of each SME subloan and will have discretion to charge loan premiums that are sufficient to cover the risks and administration of the subloan. Additionally, ADB has reviewed the soundness of each participating bank and concluded that they have the financial track record to make these credit decisions and the financial strength to repay funds borrowed via the project.

##### **B. Governance**

28. ADB’s financial management and integrity due diligence on each participating bank indicates moderate risk. The program’s design includes several governance mechanisms, including (i) steering committee oversight, (ii) independent third-party administration, (iii) transparent disclosure of auction results to eliminate real or perceived conflicts of interest, and (iv) other measures detailed in the PAM. With these measures in place, the overall financial management arrangements are considered adequate.

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

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<sup>20</sup> Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

<sup>21</sup> Based on the availability of additional TA resources, the scope of the output may be expanded to also study the introduction of an SME venture capital fund.

<sup>22</sup> Economic Analysis (accessible from the list of linked documents in Appendix 2).

### C. Poverty and Social

30. **Poverty impact.** Although Sri Lanka has made notable progress in reducing poverty, regional imbalances remain. SMEs struggle to borrow for working capital because they often lack real estate or financial assets that banks require as collateral. In response, the project will primarily target SMEs that have less access to financial resources but have a key role in reducing income and social imbalances. Specifically, these SMEs are (i) located outside of Colombo District, (ii) borrowing for working capital without pledging financial assets or real estate, (iii) led by women, and (iv) first-time borrowers from a licensed commercial or specialized bank. The expected impacts of the project include employment creation and increased income, especially among the targeted SMEs.

31. **Gender and social dimensions.** Sri Lanka's low female labor participation rate of 39% suggests a large pool of untapped human resources for national economic development. One measure to address this is to support women's greater involvement in SMEs. Thus, the project is categorized as effective gender mainstreaming because of its large potential to contribute to women's empowerment and gender equity. In view of this, the project requires 5% of subborrowers to be SMEs led by women. Furthermore, the attached TA aims to strengthen female entrepreneurship and capacity in three clusters (ICT-BPO, fruits and vegetables, and rubber), as well as support the promotion of careers in ICT-BPO among female students and graduates.

### D. Safeguards

32. The project category for environment, involuntary resettlement, and indigenous peoples is financial intermediary, in accordance with ADB's Safeguard Policy Statement (2009). The project complies with ADB's information disclosure and consultation requirements. Subproject selection criteria will ensure that participating banks finance only SME subprojects with no involuntary resettlement or indigenous peoples impacts (category C). For environment, participating banks can decide to (i) exclude all subprojects with environmental impacts (categories A and B) or (ii) exclude subprojects with significant impacts (category A) but include subprojects with impacts that are not significant (category B). ADB will require participating banks electing for the latter to maintain, as part of their overall management system, an environmental management system that complies with ADB requirements and national laws.<sup>23</sup>

### E. Risks and Mitigating Measures

33. The project carries an overall medium risk. Its benefits are expected to outweigh its costs. Major risks and mitigating measures are summarized in Table 3 and described in detail in the risk assessment and risk management plan.<sup>24</sup>

<sup>23</sup> ADB must approve the environmental management system of any participating bank that would like to lend to subprojects that are category B for environment. If ADB has not approved a participating bank's environmental management system at project inception, the Public Management, Financial Sector and Trade Division, in consultation with safeguard specialists, may subsequently do so after the completion of satisfactory due diligence. For further details, see the Environmental Management System Framework (accessible from the list of linked documents in Appendix 2).

<sup>24</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

**Table 3: Summary of Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigating Measures</b>
Participating banks could collude in the auctions.	The attached TA will provide a third party to administer the auction. With 10 participating banks, collusion will be difficult to enforce. The auction administrator will publish auction bids to provide transparency. ADB and the steering committee will review the auction's performance after the first two auctions and can implement changes if needed. These could include, in the extreme, replacing the auction with a first-come, first-serve funding distribution.
The SME credit guarantee scheme is not viable because the price of the guarantee deters financial intermediaries.	Guarantee pricing has deterred similar previous schemes. The government may need to consider a subsidized capital structure or other such incentives to ensure the credit guarantees are affordable.
Participating banks cannot disburse the funds to SMEs due to pricing or SME credit risks.	The auction mechanism will allow participating banks to factor in pricing and higher credit risks when developing their bids.
PFI or SMEs are not interested in cluster-based lending due to insufficient financial incentives.	The associated TA will prepare one cluster-based loan, which can have a demonstration effect and encourage other potential borrowers.

ADB = Asian Development Bank, PFI = participating financial institution, SMEs = small and medium-sized enterprises, TA = technical assistance.

## **V. ASSURANCES AND CONDITIONS**

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

35. The government has agreed with ADB on certain covenants for the project, which are set forth in the loan and project agreements. The government has also agreed with ADB on the following conditions for effectiveness: (i) the auction arrangement has been finalized and confirmed by ADB; and (ii) for the first auction under the project, ADB confirms the amounts to be allocated and their interest rates for applicable participating banks.

## **VI. RECOMMENDATION**

36. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and, acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve

- (i) the loan of \$100,000,000 to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a commitment charge of 0.15% per year, repayment terms as described in para. 16 of this report, and such other terms and conditions set forth in the draft loan and project agreements; and

- (ii) the administration by ADB of technical assistance not exceeding the equivalent of \$2,000,000 to the Democratic Socialist Republic of Sri Lanka for the Cluster Development and Small and Medium-Sized Enterprise Finance Innovation, to be provided by the Japan Fund for Poverty Reduction on a grant basis.

Stephen Groff  
Vice-President

21 January 2016

## DESIGN AND MONITORING FRAMEWORK

<b>Impact the Project is Aligned with:</b>			
Employment opportunities for SMEs increased (President Maithripala Sirisena's election manifesto and the revised budget speech) <sup>a</sup>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting</b>	<b>Risks</b>
<p><b>Outcome</b></p> <p>SMEs' access to finance strengthened</p>	<p>1. By 2020, \$50 million lent via the credit line to SMEs that are (i) located outside of Colombo District, (ii) borrowing for working capital, (iii) led by women,<sup>b</sup> or (iv) new borrowers (2015 baseline: 0)</p> <p>2. By 2016, a report on a national credit guarantee scheme for SMEs endorsed by the steering committee</p> <p>3. By 2017, at least one cluster-based loan is financed (2015 baseline: 0)</p> <p>4. By 2018, at least 60% of female entrepreneurs trained under the project have applied for business loans or have business plans endorsed by a business development service provider (2015 baseline: 0)</p>	<p>1. Consultant's quarterly monitoring report</p> <p>2. Steering committee minutes</p> <p>3. Loan documentation or confirmation from the lender</p> <p>4. Consultant's final report</p>	<p>PFI collude in the auctions.</p> <p>Credit guarantee scheme is not viable because the price of the guarantee deters financial intermediaries.</p>
<p><b>Outputs</b></p> <p>1. Financing to SMEs through formal intermediaries increased</p> <p>2. Innovative SME financing schemes developed</p>	<p>1. By 2020, \$100 million to participating banks disbursed (2015 baseline: 0)</p> <p>2a. By June 2016, auction management unit and auction procedures for the project established, and first auction carried out</p> <p>2b. By 2016, a report on a national credit guarantee scheme for SMEs submitted to the steering committee</p>	<p>1. Consultant's quarterly monitoring reports</p> <p>2a. Consultant's inception and first quarterly monitoring reports</p> <p>2b. Consultant's final report</p>	<p>Participating banks cannot disburse the funds to SMEs due to pricing or SME credit risks.</p>

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
3. Capacity of SMEs in targeted clusters to access financial services enhanced	3a. By 2017, at least one cluster-based loan presented to the banks (2015 baseline: 0) 3b. By 2018, 500 actual and potential female entrepreneurs from SMEs in the three clusters (ICT–BPO, fruits and vegetables, and rubber) trained in business development and management (including financial literacy) (2015 baseline: 0)	3a-b. Consultant's final report	PFIs or SMEs are not interested in cluster-based lending due to insufficient financial incentives.
4. International competitiveness of the ICT–BPO cluster strengthened	4a. By 2017, international branding campaign of ICT–BPO cluster launched 4b. By 2017, at least 500 women participate in career events on working in the ICT–BPO cluster (2015 baseline: 0)	4a-b. Consultant's final report	
<b>Key Activities with Milestones</b>			
<b>1. Financing to SMEs through formal intermediaries increased</b>			
1.1 Conduct eight auctions during Q1 2016–Q3 2019			
1.2 Submit quarterly and/or annual performance reports and a completion report on auction results by Q2 2020			
<b>2. Innovative SME financing schemes developed</b>			
2.1 By June 2016, establish an auction management unit and auction procedures for the project, and carry out the first auction			
2.1.1 Establish an independent administration unit for the auction mechanism by Q1 2016			
2.1.2 Establish operating rules for the auction mechanism, including a dissemination plan for auction results, by Q1 2016			
2.1.3 Conduct first auction by Q2 2016			
2.2 By December 2016, submit a report on a national credit guarantee scheme for SMEs to the steering committee			
2.2.1 Collate all relevant information on undertaking a demand analysis for the NCGS for SMEs by Q1 2016			
2.2.2 Provide a business plan, based on the demand analysis, for the NCGS and structure options for establishing the NCGS, including as partnerships and subsidiary of existing entities, by Q2 2016			
2.2.3 Specify NCGS incorporation options, including fund ownership arrangements and capital requirements, by Q2 2016			
2.2.4 Organize a seminar on the NCGS, and provide draft reports, including capitalization and structuring options, and presentation materials to seminar participants by Q2 2016			
2.2.5 Submit a proposal on the NCGS to the steering committee by Q2 2016			
<b>3. Capacity of SMEs in targeted clusters to access financial services enhanced</b>			
3.1 By 2017, present at least one cluster-based loan to the banks			
3.1.1 Identify a potential borrowing cluster by Q3 2016			
3.1.2 Establish the special purpose vehicle or other collaboration that will borrow on behalf of SMEs in the cluster by Q4 2016			
3.1.3 Structure the loan and prepare the loan proposal by Q1 2017			
3.2 By 2018, train 500 actual and potential female entrepreneurs from SMEs in the three clusters (ICT–BPO, fruits and vegetables, and rubber) in business development and management (including financial literacy)			
3.2.1 Conduct a gender-responsive value chain analysis of the three targeted clusters, and develop a strategy for expanding female entrepreneurship and financing and helping women move up the value chain in the three clusters by Q2 2016			
3.2.2 Provide business development services to female entrepreneurs as per the recommendations of the analysis by Q3 2016			
3.2.3 Assess the capability development needs of female entrepreneurs and design training modules on business development and management (including financial literacy) in the three clusters based on the identified capability development needs by Q3 2016			

<p>3.2.4 Launch initiatives to strengthen networks of female entrepreneurs by Q1 2017</p> <p>3.2.5 Train 500 actual and potential female entrepreneurs in business development and management (including financial literacy) in the three SME clusters by Q4 2018</p> <p><b>4. International competitiveness of ICT–BPO cluster strengthened</b></p> <p>4.1 By 2017, launch an international branding campaign for the ICT–BPO cluster</p> <p>4.1.1 Conduct a gap analysis on current international branding campaigns by other stakeholders in the ICT–BPO cluster and develop a strategy for strengthening EDB support for international branding of the ICT–BPO cluster by Q3 2016</p> <p>4.1.2 Launch an international branding campaign, including strengthening EDB’s business matching services, by Q1 2017</p> <p>4.1.3 Develop a product and/or service quality assurance mechanism for the ICT–BPO cluster, if practical, in partnership with organizations such as the Sri Lanka Association of Software and Service Companies by Q1 2017</p> <p>4.1.4 Facilitate the participation of at least 40 ICT–BPO staff attending a seminar on international branding of Sri Lanka’s ICT–BPO cluster by Q2 2017</p> <p>4.2 By 2017, have at least 500 women participate in career events on working in the ICT–BPO cluster</p> <p>4.2.1 Identify economic, social, and regulatory barriers that prohibit women from entering and staying in the ICT–BPO cluster; include an assessment of the cost and benefits of statutory prohibitions on women’s working hours; and develop a cluster strategy to attract female workers by Q3 2016</p> <p>4.2.2 Provide support for school career counselors to construct a strong network with ICT–BPO professionals by Q1 2017</p> <p>4.2.3 Launch a career forum for women with interest in the ICT–BPO cluster by Q1 2017</p> <p>4.2.4 Facilitate the participation of at least 500 women in career events on working in the ICT–BPO cluster by Q4 2017</p>
<p><b>Inputs</b>                  ADB: \$100 million (loan)                  Average estimated contribution of SMEs to subprojects: \$17.7 million (equity)</p> <p><b>Technical Assistance</b>                  Japan Fund for Poverty Reduction: \$2.0 million</p> <p><b>Assumptions for Partner Financing</b></p> <p>Not applicable.</p>

ADB = Asian Development Bank, BPO = business process outsourcing, EDB = Export Development Board, ICT = information and communications technology, NCGS = National Credit Guarantee Scheme, PFI = participating financial institution, Q = quarter, SMEs = small and medium enterprises

<sup>a</sup> Government of Sri Lanka. 2015. *Manifesto, New Democratic Front, A Stable Country, Maithri, Compassionate*. Colombo (President Maithripala Sirisena’s election manifesto); and Government of Sri Lanka, Ministry of Finance. 2015. *Statement by the Minister of Finance on Hundred Day Revolution*. Colombo (The revised budget speech).

<sup>b</sup> Led by a woman, at least 51% of enterprise ownership is controlled by women, at least 60% of senior managers are women, or at least 50% of board members are women.

Source: Asian Development Bank.



**LIST OF LINKED DOCUMENTS**

<http://adb.org/Documents/RRPs/?id=49273-001-3>

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

**Supplementary Documents**

15. Financial Management Assessment
16. Assessment of the Finance-Enabling Environment for Small and Medium-Sized Enterprises
17. Lessons from Previous Credit Lines for Small and Medium-Sized Enterprises
18. Comparison with the Proposed Loan and Technical Assistance Grant to the People's Republic of Bangladesh: Second Small and Medium Enterprise Development Project
19. Historical Performance and Financial Projections of the Participating Financial Institutions