



Technical Assistance Report

Project Number: 49426-001
Capacity Development Technical Assistance (CDTA)
April 2016

Democratic Socialist Republic of Sri Lanka: Mobilizing Finance for Sri Lanka (Financed by the Financial Sector Development Partnership Special Fund)

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 April 2016)

Currency unit	–	Sri Lanka rupee (SLRe/SLRs)
SLRe1.00	=	\$0.0069
\$1.00	=	SLRs145.50

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
MOF	–	Ministry of Finance
MPI	–	Ministry of Plantation Industries
RPC	–	regional plantation company
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

NOTE

In this report, "\$" refers to US dollars.

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CAPACITY DEVELOPMENT TECHNICAL ASSISTANCE AT A GLANCE

1. Basic Data		Project Number: 49426-001	
Project Name	Mobilizing Finance for Sri Lanka	Department /Division	SARD/SAPF
Country	Sri Lanka	Executing Agency	Department of Development Finance, Ministry of Plantation Industries (MPI)
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Finance sector development		0.50
		Total	0.50
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Private sector development (PSD)	Promotion of private sector investment	No gender elements (NGE)	✓
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. TA Category:	B		
7. Safeguard Categorization	Not Applicable		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		0.50	
Capacity development technical assistance: Financial Sector Development Partnership Special Fund		0.50	
Cofinancing		0.00	
None		0.00	
Counterpart		0.01	
Government		0.01	
Total		0.51	
9. Effective Development Cooperation			
Use of country procurement systems		No	
Use of country public financial management systems		No	

I. INTRODUCTION

1. The Government of Sri Lanka has requested the Asian Development Bank (ADB) to support the modernization of the plantation sector via the issuance of “tea bonds” (offshore US dollar bonds) that would fund capital expenditures for plantations’ tea and rubber production and improve the access of Sri Lankan issuers to international capital markets. The government also requested ADB to formulate a plan for a venture capital fund for small and medium-sized enterprises (SMEs).¹ These requests are aligned with ADB’s interim country partnership strategy, 2015–2016 for Sri Lanka,² for they focus on one of its three pillars: catalyzing private investment and enhancing the effectiveness of public investment. The design and monitoring framework is in Appendix 1.³

II. ISSUES

2. Sri Lanka’s economic growth was over 8% during 2010–2012, when it reached middle-income status as classified by the International Monetary Fund. Weak external demand combined with the lag effect of monetary tightening in the previous year slowed growth to 3.4% in 2013, but improved tourism and exports helped the economy recover to 4.9% in 2014; in 2015, growth in Sri Lanka’s gross domestic product (GDP) was 4.8%.⁴ To sustain growth, Sri Lanka must enhance the productivity and global competitiveness of its export-oriented industries through increased capital investment for operational efficiency and innovation. Given the limited fiscal space of the government (with a 7.2% fiscal deficit and a 73.5% debt-to-GDP ratio in 2015), private sector investment should be especially encouraged. This is affirmed by the Economic Policy Statement delivered by the Prime Minister in 2015, which targets increased income by encouraging foreign investment and investment by individuals.⁵

3. To support investment and economic growth, resources would ideally be provided from a vibrant capital market. However, the financial market in Sri Lanka is dominated by banks. Measures of capital market depth in relation to GDP, such as stock market capitalization (28.4%), outstanding domestic private debt securities (0.9%), and outstanding government debt securities (41.8%), indicate a need for further development.⁶

4. Sri Lanka tea and rubber exports play a key role in the Sri Lankan economy. In 2015, Sri Lanka tea exports surpassed \$1.3 billion in foreign exchange earnings, which accounted for 12.8% of exports and about 1.6% of GDP. Around 10% of the population is dependent on the

¹ In the 2016 budget speech delivered by Finance Minister Ravi Karunanayake, the Government of Sri Lanka stated that it will initiate a venture capital “Fund of Funds” with the participation of financial institutions as shareholders (Government of Sri Lanka, Ministry of Finance. 2015. *Budget Speech—2016*. <http://www.treasury.gov.lk/images/depts/fpd/docs/budgetspeech/2016/bgtspeech2016E.pdf>). ADB is also invited to contribute to the fund. The fund will lend to responsible venture capital firms for a guaranteed minimum rate of return, and the venture capital firms will make equity investments in the SMEs. Subsequent to the budget speech, the government requested ADB to study the feasibility of establishing an SME venture capital fund (Supplementary Appendix A).

² ADB. 2015. *Interim Country Partnership Strategy: Sri Lanka, 2015–2016*. Manila.

³ The technical assistance (TA) first appeared in the business opportunities section of ADB’s website on 4 February 2016.

⁴ Government of Sri Lanka, Department of Census and Statistics, Ministry of National Policy and Economic Affairs. 2016. National Accounts Estimates of Sri Lanka: 4th Quarter of 2015 and the whole year of 2015. News release. 15 March. http://www.statistics.gov.lk/national_accounts/dcsna_r2/reports/press_note_2015_english.pdf

⁵ Government of Sri Lanka, Prime Minister’s Office. 2015. *Economic Policy Statement made by Hon Prime Minister, Ranil Wickremesinghe in Parliament on 5th November 2015*. http://www.pmooffice.gov.lk/download/press/D00000000009_EN.pdf

⁶ Central Bank of Sri Lanka. 2015. *Annual Report of the Monetary Board to the Hon. Minister of Finance for the Year 2014*. Colombo.

industry, which employs 2 million workers directly and indirectly.⁷ Rubber is a similarly important component of the plantation sector and earns approximately 60% of tea's export earnings. A financing gap is expected for regional plantation companies (RPCs) as they plan to modernize their facilities and to invest in research and development and marketing for value-added products to meet the new and changing needs of the global market.⁸ However, the government budget is too constrained to provide subsidized loans or bank guarantees as it has done in the past, and traditional commercial bank loans are costly and too short in maturity to match the envisaged long-term capital investments.

5. SMEs, which are responsible for 30% of the country's GDP, are critical for Sri Lanka's economic growth. SMEs are especially important for poverty reduction, as they provide 35% of employment.⁹ Despite their importance, SMEs struggle to access financing. In January 2016, ADB approved a \$100 million line of credit to SMEs to improve their access to medium-term debt financing, and the attached technical assistance (TA) will assess the feasibility of an SME credit guarantee facility.¹⁰ Although these interventions address debt financing, equity capital is still a constraint on SMEs. The venture capital industry is in a nascent stage, with only 0.1% of total assets in the financial system of Sri Lanka in 2014.¹¹ This is partly due to a lack of risk management expertise and insufficient funding from long-term strategic investors for further growth.¹²

6. This TA aims to mobilize domestic and international private investment for two of Sri Lanka's important drivers for inclusive growth—plantations and SMEs—through innovative financial solutions. Thereby, capital markets will be developed,¹³ domestic and foreign investment encouraged, and fiscal space created.

III. THE CAPACITY DEVELOPMENT TECHNICAL ASSISTANCE

A. Impact and Outcome

7. The impact will be increased foreign investment and investment by individuals, aligned with the Economic Policy Statement of the government (footnote 5). The outcome will be strengthened ability of RPCs and SMEs to access private investment from capital markets.

B. Methodology and Key Activities

8. The three TA outputs will support the TA outcome. Output 1 will be a study on the feasibility of tea bonds issued by RPCs and partially guaranteed by ADB for the modernization and expansion of their operations. The TA will assess the RPCs' medium- and long-term capital

⁷ Sri Lanka Tea Board. 2015. *Tea Market Update*. Colombo. (January–March 2015, Volume 11 No. 1). <http://www.pureceylontea.com/index.php/tea-market-updates/send/6-tea-market-update/98-first-quarter-2015>

⁸ The RPCs are 22 large firms that dominate Sri Lanka's tea industry. Although almost all are privately managed, their land is provided under a 50-year lease from the government, which maintains some decision-making authority in each of the RPCs.

⁹ Government of Sri Lanka, Ministry of Finance, Department of Development Finance. 2014. *Performance Report—2013*. Colombo.

¹⁰ ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project*. Manila.

¹¹ Central Bank of Sri Lanka. Financial System Stability. http://www.cbsl.gov.lk/htm/english/05_fss/pv/f_1.html

¹² I. Hettiarachchi. 2015. Review of 2016 budget proposals to boost Venture Capital and SMEs. *Daily Mirror*. 22 November. <http://www.dailymirror.lk/96405/review-of-2016-budget-proposals-to-boost-venture-capital-and-smes>

¹³ ADB is in policy discussions with the Government of Sri Lanka for a capital markets reform program. Any initial findings from this TA may be proposed for inclusion in the capital markets reform program.

requirements and financing options, including the tea bonds. The tea bonds would have a natural partial foreign currency hedge because RPCs have sufficient future revenue flows linked to hard currencies. Output 2 will undertake due diligence for the operationalization of an SME venture capital fund to increase SMEs' access to equity capital. This is complementary to ADB's ongoing SME credit line (footnote 10). A final report that analyzes the demand, business model, fund ownership, and corporate governance of the SME venture capital fund will be submitted to the government for endorsement. For both tea bonds and the SME venture capital fund, the impact of government financial assistance on the national budget will be reviewed and taken into account for the structuring options to enhance strategic budgeting. Output 3 will support knowledge building. Since both the tea bond and the SME venture capital fund are new concepts to the public and private sectors in Sri Lanka, this output will educate relevant stakeholders on these new financing instruments.

C. Cost and Financing

9. The TA is estimated to cost \$510,000, of which \$500,000 will be financed on a grant basis by the Financial Sector Development Partnership Special Fund and administered by ADB.¹⁴ The government will provide counterpart support in the form of counterpart staff and other in-kind contributions.

D. Implementation Arrangements

10. The TA will be administered by ADB. The executing agency for the tea bonds is the Ministry of Plantation Industries (MPI), while that for the SME venture capital fund is the Ministry of Finance's Department of Development Finance. The SME venture capital fund will be implemented in consultation with a steering committee established under the SME credit line (footnote 10), whose members include the secretary to the treasury (chair), Department of Development Finance, ADB, Central Bank of Sri Lanka, Export Development Board, Federation of Chamber of Commerce and Industry of Sri Lanka, and others that may be considered appropriate by the government. The TA will be implemented from July 2016 to March 2017.

11. The TA will require 9 person-months of international consulting services and 9 person-months of national consulting services. A consulting firm will be engaged by ADB in accordance with ADB's Guidelines on the Use of Consultants (2013, as amended from time to time). Due to the highly specialized expertise needed, an international consulting firm in association with national consultants will be selected and engaged by ADB using the quality- and cost-based selection method with a quality-cost weighting of 90:10. An output-based (lump-sum) contract will be used. The outline terms of reference for the consultants are in Appendix 3. All the disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time). Procurement will be carried out in accordance with ADB's Procurement Guidelines (2015, as amended from time to time).

12. The progress of the TA project will be discussed with the government and other stakeholders on a regular basis. The consultants' reports are to be shared with government officials and market participants through periodic meetings, dissemination seminars, and workshops, which are expected deliverables for output 3.

¹⁴ Established by ADB. Financing partner: the Government of Luxembourg.

IV. THE PRESIDENT'S DECISION

13. The President, acting under the authority delegated by the Board, has approved ADB administering technical assistance not exceeding the equivalent of \$500,000 to the Democratic Socialist Republic of Sri Lanka to be financed on a grant basis by the Financial Sector Development Partnership Special Fund for Mobilizing Finance for Sri Lanka, and hereby reports this action to the Board.

DESIGN AND MONITORING FRAMEWORK

Impact the TA is Aligned with			
Foreign investment and investment by individuals increased (Economic Policy Statement 2015) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Ability of RPCs and SMEs to access private investment from capital markets strengthened	a. By 2018, at least \$100 million of the foreign investment portfolio is raised through “tea bonds” (offshore US dollar bonds) (2016 baseline: \$0) b. By 2018, an SME venture capital fund is established by the government (2016 baseline: not applicable)	a. Bond prospectus b. Incorporation documents	Tea bond pricing or terms are not competitive with alternative financing. Sri Lanka’s laws make an offshore bond collateralized by future sales legally untenable. The SME venture capital fund is unviable because there are very few SMEs with a business model suitable for venture capital or because there are insufficient divestment options.
Outputs 1. Study on the feasibility of tea bonds completed 2. Due diligence for the operationalization of an SME venture capital fund to increase SMEs’ access to equity capital undertaken 3. Knowledge building activities undertaken	1. By Q4 2016, a report on tea bonds is submitted to the MPI (2016 baseline: not applicable) 2. By Q4 2016, a report on due diligence for the operationalization of an SME venture capital fund is submitted to a steering committee established under the SME credit line (2016 baseline: not applicable) 3a. By Q1 2017, a seminar on tea bonds is conducted (2016 baseline: 0) 3b. By Q1 2017, a seminar on an SME venture capital fund is conducted (2016 baseline: 0)	1. Consultant’s report 2. Consultant’s report 3a-b. Consultant’s report	

<p>Key Activities with Milestones</p> <p>1. Study on the feasibility of tea bonds completed</p> <p>1.1 Consult local and domestic stakeholders (including the MOF, MPI, CBSL, SEC, and tea brokers) and provide a draft tea bond feasibility study that analyzes RPC demand (to include RPCs' medium- and long-term capital requirements and financing options), investor demand, revenue pooling, and bond structuring; the contingent liability on the sovereign debt sustainability; and the legal and regulatory environment for offshore bond issuance by Q3 2016</p> <p>1.2 Provide a final tea bond feasibility study by Q4 2016</p> <p>2. Due diligence for the operationalization of an SME venture capital fund to increase SMEs' access to equity capital undertaken</p> <p>2.1 Consult local and domestic stakeholders (including the MOF, CBSL, SEC, SMEs, and financial institutions) and provide a draft SME venture capital fund due diligence report by Q3 2016 that includes a demand analysis, a business plan (to include financial projections), fund ownership, corporate governance, and an analysis of government financial support to an SME venture capital fund on the sovereign debt sustainability</p> <p>2.2 Provide a final SME venture capital fund due diligence report by Q4 2016</p> <p>3. Knowledge building activities undertaken</p> <p>3.1 Prepare materials and provide administrative support for a seminar for RPCs and other sector stakeholders on the proposed tea bonds by Q1 2017</p> <p>3.2 Prepare materials and provide administrative support for a seminar for SMEs and other sector stakeholders on the proposed SME venture capital fund by Q1 2017</p>
<p>Inputs</p> <p>Financial Sector Development Partnership Special Fund: \$500,000</p> <p>Note: The government will provide counterpart support in the form of counterpart staff and other in-kind contributions.</p>
<p>Assumptions for Partner Financing</p> <p>Not applicable.</p>

CBSL = Central Bank of Sri Lanka, MOF = Ministry of Finance, MPI = Ministry of Plantation Industries, Q = quarter, RPC = regional plantation company, SEC = Securities and Exchange Commission, SMEs = small and medium-sized enterprises, TA = technical assistance.

^a Government of Sri Lanka, Prime Minister's Office. 2015. *Economic Policy Statement made by Hon Prime Minister, Ranil Wickremesinghe in Parliament on 5th November 2015*. http://www.pmooffice.gov.lk/download/press/D00000000009_EN.pdf

Source: Asian Development Bank.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Amount
Financial Sector Development Partnership Special Fund^a	
1. Consultants	
a. Remuneration and per diem	
i. International consultants	300.2
ii. National consultants	54.0
b. International and local travel	60.0
c. Reports and communications	6.0
2. Workshops, seminars, and conferences ^b	40.0
3. Miscellaneous administration and support costs	2.0
4. Contingencies	37.8
Total	500.0

Note: The technical assistance is estimated to cost \$510,000, of which contributions from the Financial Sector Development Partnership Special Fund are presented in the table above. The government will provide counterpart support in the form of counterpart staff and other in-kind contributions. The value of government contribution is estimated to account for 2% of the total technical assistance cost.

^a Established by ADB. Financing partner: the Government of Luxembourg.

^b The costs of workshops, seminars, and conferences are budgeted for conferences in Sri Lanka on "tea bonds" (offshore US dollar bonds) and the small- and medium-sized enterprise venture capital fund to be attended by government officials, banks, and other stakeholders.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. An output-based (lump-sum) contract will be used. A consultant firm will be required to deliver six deliverables:

- (i) By September 2016, submit draft “tea bond” (offshore US dollar bond) feasibility study (15% of lump-sum payment).
- (ii) By December 2016, submit final tea bond feasibility study (25% of lump-sum payment).
- (iii) By September 2016, submit a draft report on the small and medium-sized enterprise (SME) venture capital fund (15% of lump-sum payment).
- (iv) By December 2016, submit a final report on the SME venture capital fund (25% of lump-sum payment).
- (v) By March 2017, conduct a seminar for government officials, regional plantation companies (RPCs), and other sector stakeholders on the proposed tea bonds (10% of lump-sum payment).
- (vi) By March 2017, conduct a seminar for government officials, SMEs, and other sector stakeholders on the proposed SME venture capital fund (10% of lump-sum payment).

2. A consulting firm will be required to identify a team leader in its technical proposal. The team leader will develop and oversee the work and support effective coordination of all team inputs. The team leader will manage the team and coordinate closely with stakeholders. In close coordination with the executing agencies, the Ministry of Plantation Industries (MPI) and the Ministry of Finance (MOF), the team leader will perform tasks in a timely manner.

3. **Structured finance specialist** (1 international, 3 person-months). The international structured finance specialist should have a graduate degree in finance, business, or a related field, preferably from an internationally respected institution, and have a minimum of 10 years of experience in investment banking or a related field, preferably at a leading institution. He or she must have experience in bond structuring. Experience in structured instruments, guarantees, and South Asia (particularly in Sri Lanka) is an advantage. The specialist will perform the following tasks:

- (i) Consult with international and domestic stakeholders, including the Prime Minister’s office, MOF, MPI, Planters’ Association of Ceylon, tea brokers, domestic and international rating agencies, arrangers and underwriters, potential investors, and trustees.
- (ii) Identify the 10-year capital expenditure needs of the RPCs for tea and rubber production and potential sources of funding to meet those capital expenditures. Based on this assessment, the specialist will recommend a 10-year capital raising strategy for the sector that would include, among other funding sources, Asian Development Bank (ADB) credit-enhanced offshore bonds;
- (iii) For the tea bonds, develop the business model (i.e., legal structure, ownership, contractual arrangements) for the special purpose vehicle that would borrow on behalf of the RPCs.
- (iv) Explore the possibility of pooling the RPCs’ revenues to include domestic and international legal impediments, and using these pooled revenues to improve tea bonds’ credit ratings.
- (v) Document precedent transactions and lessons learned.
- (vi) Identify any deficiencies in the beneficiaries’ internal controls or financial auditing that would impede bond issuance, and develop an action plan to address those deficiencies.

- (vii) Identify any activities funded by the capital expenditures that would likely be classified as category A for environment, indigenous peoples, or involuntary resettlement under ADB's Safeguard Policy Statement (2009).
- (viii) Advise on the bonds' optimal structure, i.e., their tenor, size, amortization schedule, security package, size and structure of the ADB partial credit guarantee, targeted credit rating, indicative pricing, and all-in cost.
- (ix) Compare the merits of the proposed bond issuance structure with those of alternative financing modalities (e.g., commodity-backed international bank loans) in terms of both financial attractiveness and capital markets development.
- (x) Present, as required, to the MPI or other stakeholders.
- (xi) Prepare and disseminate three reports: an inception report by June 2016, a draft final report by September 2016, and a final report by December 2016.
- (xii) Deliver at least one seminar for government officials, RPCs, and other sector stakeholders that explains the structure, advantages, and risks of the proposed tea bonds by March 2017.

4. **Structured finance specialist** (1 national, 3 person-months). The national structured finance specialist will support the work of the international structured finance specialist. He or she should have a graduate degree in finance, business, or a related field and have a minimum of 10 years of experience in Sri Lanka's financial sector.

5. **Small and medium-sized enterprise finance specialist** (1 international, 4 person-months). The international SME finance specialist should have a postgraduate degree in finance, business administration, or economics, preferably from an internationally respected institution. Experience in raising or divesting private equity or venture capital or in working in a private equity or venture capital fund is required. Experience in South Asia (particularly in Sri Lanka) or in SME financing would be advantageous. The specialist will perform the following tasks:

- (i) Prepare an inception report by June 2016.
- (ii) Submit a draft report that includes a demand analysis, international precedents (to include lessons learned therefrom), business plan (to include financial projects), divestment strategy and risks, structuring and ownership options (to include partnerships as a subsidiary of an existing entity, or as a public or public-private venture), risk management and capitalization, and corporate governance by September 2016. If the fund is not projected to be financially viable in a conservative base case scenario, include options for government subsidy.
- (iii) Present, as required, to the steering committee established under the SME line of credit, which will also oversee the development of the SME venture capital fund.¹
- (iv) Based on the feedback from the steering committee, submit a final report by December 2016.
- (v) Deliver at least one 1-day seminar for government officials, SMEs, and other sector stakeholders that explains the structure of the proposed SME venture capital fund by March 2017.

6. **Small and medium-sized enterprise finance specialist** (1 national, 4 person-months). The national SME finance specialist will support the work of the international SME finance specialist. He or she should have a graduate degree in finance, business, or a related field and have a minimum of 10 years of experience in SME financing in Sri Lanka.

¹ ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Democratic Socialist Republic of Sri Lanka for the Small and Medium-Sized Enterprises Line of Credit Project*. Manila.

7. **Legal specialists** (1 international, 1 person-month; and 1 national, 1 person-month). The legal specialists will advise the structured finance and SME finance specialists on all the domestic and international legal requirements for bond issuance (including the establishment of a special purpose vehicle that borrows on behalf of the RPCs, the feasibility of using future sales to collateralize the bond, and other legal issues that could shape the bonds' structure) and for the establishment of the SME venture capital fund.

8. **Fiscal policy specialists** (1 international, 1 person-month; and 1 national, 1 person-month). The fiscal policy specialists will advise the structured finance and SME finance specialists on the strategic budgeting considerations for bond issuance and for the establishment and operationalization of the SME venture capital fund. The fiscal policy specialists will review the absorption capacity of the government budget for contingent liabilities from a sovereign guarantee on the tea bonds and for fiscal support for the SME venture capital fund, and report to the relevant fiscal authorities in the MOF as well as the Debt Management Office in the Central Bank of Sri Lanka.