

## SECTOR ASSESSMENT (SUMMARY): FINANCE (SMALL AND MEDIUM-SIZED ENTERPRISES FINANCING)

### 1. Sector Performance, Problems, and Opportunities

1. Several studies confirmed access to finance as the most significant constraint to growth for small and medium-sized enterprises (SMEs).<sup>1</sup> Studies also revealed that the difficulties that SMEs have in accessing credit in Sri Lanka are the result of (i) shortcomings within SMEs, including poor financial literacy, lack of market knowledge, and lack of transparency; (ii) shortcomings within financial institutions, including a risk-averse banking culture, heavy reliance on collateral, and lack of understanding of genuine SME-oriented banking practices; and (iii) shortcomings within market infrastructure, including insufficient mechanisms to improve information asymmetries in SME banking.

#### a. Small and Medium-Sized Enterprises

2. The gap analysis under Asian Development Bank (ADB)-supported technical assistance (TA) for SME cluster development found that most SMEs have a limited capacity to develop bankable projects even in relatively competitive export-oriented clusters such as food, rubber, and information and communication technology (ICT) or business process outsourcing.<sup>2</sup> SMEs do not have sufficient business skills, such as marketing, production, operations management, financial planning and management, and entrepreneurship. Also, their value chain links are not strong enough to give them access to market information, such as on clients' needs or required product and service quality. Although several donor agencies have directly provided business development training to SMEs, the need for capacity development is still huge.<sup>3</sup>

#### b. Financial Institutions

3. **Banks.** The government has significant control over the banking system, with two state-owned banks accounting for 35% of total assets. At the end of 2016, the banking system consisted of 32 licensed banks—25 licensed commercial banks (including 12 branches of foreign banks) and 7 licensed specialized banks. The asset base of the banking industry expanded by SLRs969 billion to SLRs9 trillion during 2016, at an annual growth rate of 12.0%. The increase in assets was mainly attributed to an increase in lending to SLRs825 billion, which was mainly funded by a 16.5% growth in deposits. Most banks regard SME loans as a strategic priority in the medium and long term, and have been expanding their network and accessibility throughout the country. In 2016, 70 new banking outlets were opened. Despite the business growth, the banking industry continued to manage its risks prudently by maintaining a comfortable level of liquidity and capital and ensuring credit quality.<sup>4</sup> The gross nonperforming loan (NPL) ratio declined from 3.2% to 2.6% during 2016. Profitability has been stable, with a return on assets (ROA) between 1.3% and 1.7%, and an interest margin of 3.5%–4.1% between 2012 and 2016. High-quality loan portfolios with low profitability indicate that banks may be able to take more risk in the underserved SME segments without jeopardizing their financial stability.

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<sup>1</sup> A. Wijesinha and N. Perera. 2015. *Banking on SME Growth: Concepts, Challenges and Policy Options to Improve Access to Finance in Sri Lanka*. Colombo: Institute of Policy Studies of Sri Lanka; and International Finance Corporation. 2011. *Enterprise Surveys: Sri Lanka Country Profile*. Washington: World Bank.

<sup>2</sup> ADB. 2016. *Technical Assistance for SME Cluster Development and Financial Innovation*. Manila.

<sup>3</sup> Development Coordination (accessible from the list of linked documents in Appendix 2 of the Report and Recommendation of the President).

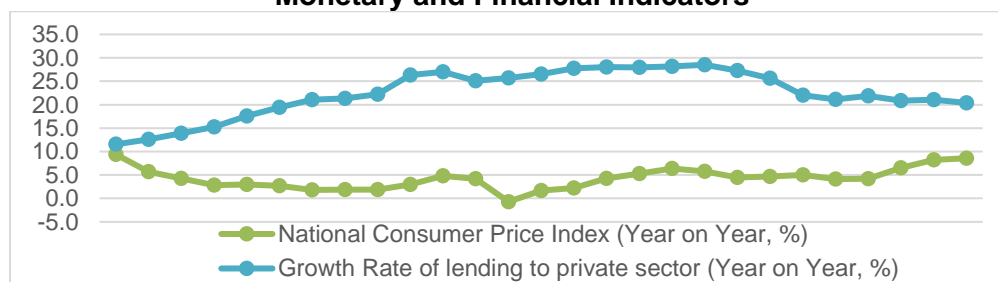
<sup>4</sup> Financial Analysis (accessible from the list of linked documents in Appendix 2 of the Report and Recommendation of the President).

4. **Nonbank financial institutions.** Nonbank financial institutions (NBFIs) include 46 licensed finance companies (LFCs) and 7 specialized leasing companies (SLCs) with a combined network of 1,313 branches. While the NBFIs segment represents only 7.3% of assets, it plays a vital role in SME lending. First, their loan products correspond to the demands of many SMEs, such as for finance leases, hire purchases, revolving loans, secured term loans, factoring, and microfinance. Second, LFCs and SLCs, along with microfinance institutions, often serve as the entry point into formal finance and provide SMEs with an opportunity to develop a credit history and financial acumen. The NBFIs segment has recently experienced robust growth. Its total assets expanded by 21.7% to SLRs1,211.9 billion during 2016, which was funded largely through borrowings. The asset quality remained manageable and the profitability is sufficiently high. The ROA is 4.0% with an interest margin of 7.9% in 2016. The gross NPL ratio decreased from 6.7% to 5.3% during 2016. However, some LFCs were distressed, and the Central Bank of Sri Lanka (CBSL) enforced a resolution plan to improve their financial position. Overall, given that their funding structures entail significant refinancing risk, NBFIs need to improve their financial risk management to increase sustainably their lending capacity to SMEs.

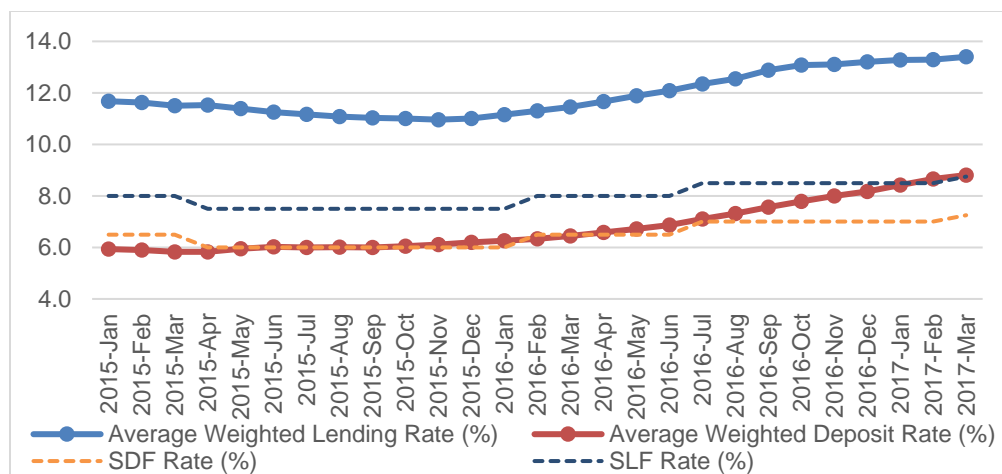
5. **Liquidity condition of finance sector.** CBSL tightened its monetary policy stance during 2016 to retain excessive growth of monetary and credit aggregates so as to contain the possible buildup of demand-driven inflationary pressures in the economy. CBSL raised the statutory reserve ratio from 6.0% to 7.5% in January 2016. It also increased its other key policy interest rates, the standing deposit facility rate and standing lending facility rate, by 0.5% in February 2016, 0.5% in July 2016, and 0.25% in March 2017. This monetary tightening has coincided with the International Monetary Fund (IMF) extended fund facility, approved in June 2016, to strengthen the external position of the country and achieve broader economic reforms.<sup>5</sup> In line with the IMF's guidance, an enhanced monetary policy framework was introduced, which targets an inflation rate within a band of 4% to 6% over the medium term. Inflation remained broadly within the target band as of late 2016.

6. With monetary tightening, the expansion of private sector credit decelerated to 21.9% by the end of 2016, from its peak of 28.5% in July 2016. It continued to decline to 4.5% during the first 5 months of 2017, compared with 6.2% during the same period in 2016. Although private sector credit has been expanding, its pace is expected to slow as tight monetary conditions are gradually transmitted to higher real lending rates, which have increased from 6.6% as of July 2016 to 7.5% as of July 2017.

**Monetary and Financial Indicators**



<sup>5</sup> International Monetary Fund. 2016. *Staff Report for the 2016 Article IV Consultation and Request for a Three-Year Extended Arrangement under the Extended Fund Facility*. Washington DC.



SDF = standing deposit facility, SLF = standing lending facility.

Source: Central Bank of Sri Lanka.

### c. Market Infrastructure

7. Despite the mixed results in the World Bank's Doing Business Report in the table below, the market infrastructure for SME banking is satisfactory:

- (i) **Credit information systems.** The Credit Information Bureau of Sri Lanka (CRIB) issues reports containing credit information to over 90-member institutions (including all the licensed banks, LFCs, and SFCs) and the public through its credit information management system.<sup>6</sup> The member institutions are required to submit transaction data on their borrowers to the CRIB every month. The CRIB plans to upgrade the credit information management system to meet emerging requirements and future demand, such as the inclusion of credit data from microfinance institutions.
- (ii) **Collateral and bankruptcy law.** The CRIB established an electronic searchable collateral registry, the secured transaction registry system, and issued regulations for its operation. This system enables lenders to take any movable property as collateral by registering it upon execution of the loan transaction. However, statutory changes are needed to make the system more effective, and Sri Lanka has been preparing a new secured transactions act with World Bank assistance.
- (iii) **Registering property.** The government has taken measures to enhance the reliability of property rights. In 2012, Sri Lanka made registering property faster by introducing an electronic system at the land registry in Colombo. A grant announced in 2017 from the Millennium Challenge Corporation is expected to provide additional support for land registration.
- (iv) **Resolving insolvency.** The commencement of proceedings is almost at the international best practice. Creditors generally have strong participatory rights during bankruptcy, and there is a framework to extend "super senior" positions to creditors that extend new credit after the commencement of bankruptcy proceedings.

<sup>6</sup> The CRIB was established in 1990 in the form of a public-private partnership, whereby the CBSL holds the majority of equity while commercial banks and other lending institutions hold the rest.

### Indicators on Enabling Environment for Credit: Doing Business 2017

|            | Getting Credit                    |     | Strength of Legal Rights Index | Registering Property | Resolving Insolvency |
|------------|-----------------------------------|-----|--------------------------------|----------------------|----------------------|
|            | Depth of Credit Information Index |     |                                |                      |                      |
|            | 0–100 [# rank]                    | 0–8 | 0–12                           | 0–100 [# rank]       | 0–100 [# rank]       |
| Sri Lanka  | 40 [# 118]                        | 6   | 2                              | 46.76 [#155]         | 46.73 [# 75]         |
| India      | 65 [# 44]                         | 7   | 6                              | 50.00 [#138]         | 32.75 [#136]         |
| Pakistan   | 50 [# 82]                         | 7   | 3                              | 40.70 [#169]         | 45.01 [# 85]         |
| Bangladesh | 25 [#157]                         | 0   | 6                              | 27.58 [#185]         | 27.02 [#151]         |

Source: World Bank. 2017. *Doing Business 2017*. Washington, DC.

8. To further enhance SMEs' access to finance, Sri Lanka needs to achieve the level of international best practice by (i) establishing a credit guarantee institution to promote non-collateralized lending to SMEs and (ii) developing a credit risk database that will be shared with banks to refine their internal risk rating models for mainstreaming risk-based pricing.<sup>7</sup>

## 2. Government's Sector Strategy

9. The Government of Sri Lanka has adopted the National Policy Framework for SME Development in early 2017 to articulate government policies and strategies aimed at promoting microenterprises and SMEs to achieve balanced economic growth, equitable regional development, employment creation, and productivity improvements. The Ministry of Finance and Mass Media (MOF) runs several concessional loan schemes and subsidy schemes for microfinance enterprises and the agriculture sector. MOF started to provide an interest subsidy program (Jaya Isura) with a total size of SLRs750 million to cover up to 50% of the interest cost of SME loans with an interest rate not exceeding 13%.<sup>8</sup> CBSL also operates many concessionary finance schemes. Through its five credit schemes, it disbursed about SLRs8.4 billion to 13,810 SME beneficiaries during 2016.<sup>9</sup> The government also encourages financial institutions to reach out to SMEs by enhancing their financial facilities and business advisory services for SMEs.

## 3. ADB Sector Experience and Assistance Program

10. Since 2016, ADB has originated three projects to provide comprehensive support for SME development: a \$100 million SME credit line and two TA grants.<sup>10</sup> The credit line has exceeded its inclusive lending targets, which focus on previously unbanked SMEs, women-led SMEs, and SMEs located outside of Colombo, and is expected to fully disburse ahead of schedule in early 2018.<sup>11</sup> One of the TA projects is (i) providing capacity building for export-oriented SME clusters to connect them with global value chains and improve the bankability of SME projects, and (ii) supporting the establishment of a SME credit guarantee institution. The other TA project researched how to improve SMEs' access to venture capital. The proposed additional financing of the existing SME credit line will enhance ADB's comprehensive support and maintain the reform momentum.

<sup>7</sup> A credit guarantee institution and credit risk database will be introduced by another ADB SME project in 2018.

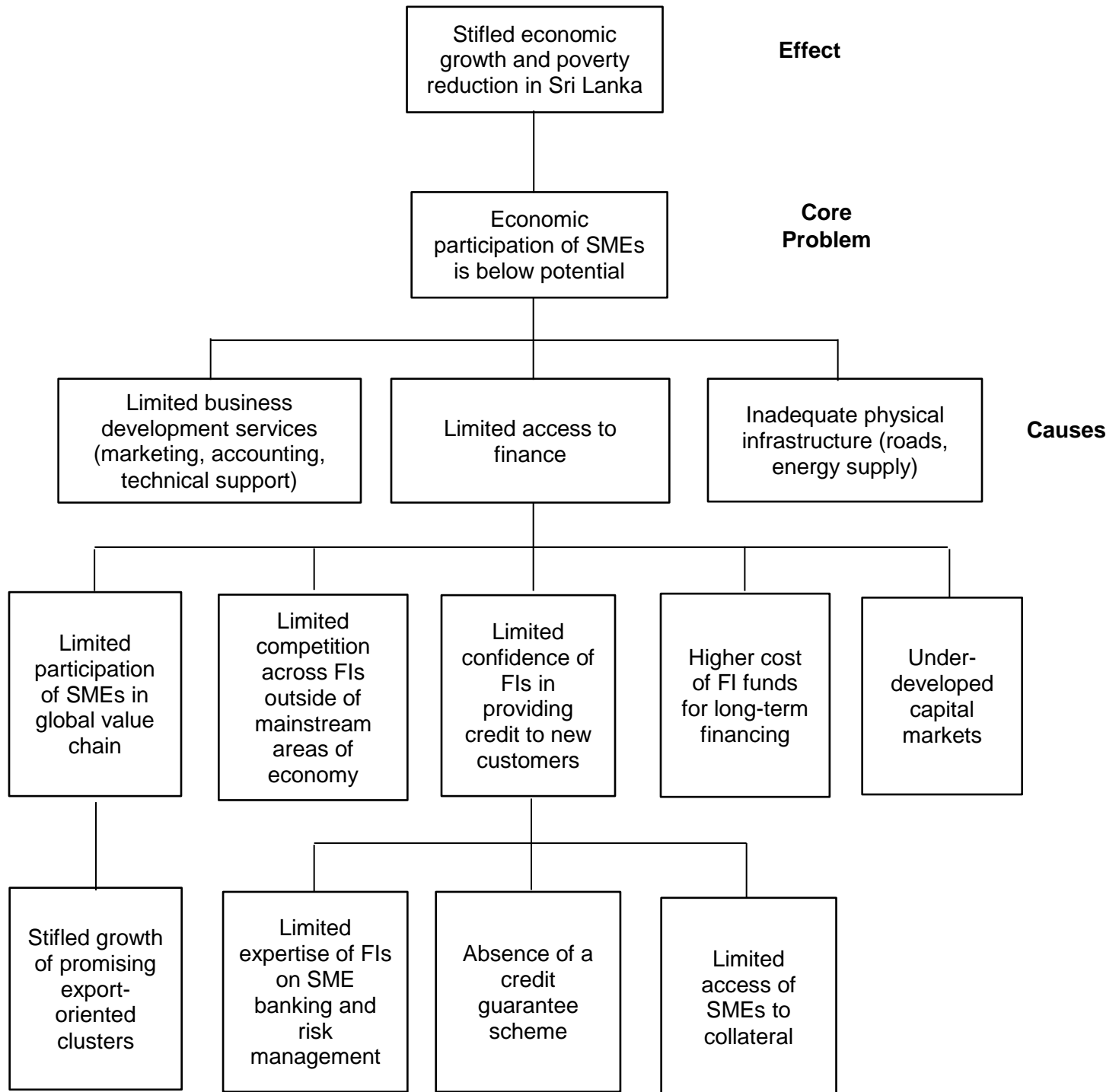
<sup>8</sup> A 50% interest subsidy will be given to those SMEs with a turnover from SLRs25 million to SLRs250 million. A 25% subsidy will be given to those SMEs with a turnover from SLRs250 million to SLRs750 million.

<sup>9</sup> Central Bank of Sri Lanka. 2017. *Annual Report 2016*. Colombo. In its budget speech 2016, the government announced to transfer all CBSL schemes to MoF&MM to consolidate them for more target oriented approach.

<sup>10</sup> ADB. 2016. *Technical Assistance for SME Cluster Development and Financial Innovation*. Manila and ADB. 2016. *Technical Assistance for Mobilizing Finance to Sri Lanka*. Manila.

<sup>11</sup> Summary of Project Performance (accessible from the list of linked documents in Appendix 2 of the Report and Recommendation of the President).

### Problem Tree for Small and Medium-Sized Enterprise Financing



FI = financial institution (bank or nonbank financial institution), SMEs = small and medium-sized enterprises.  
Source: Asian Development Bank.