



Sri Lanka: Enhancing Small and Medium-Sized Enterprises Financial Services Outreach

Project Name	Enhancing Small and Medium-Sized Enterprises Financial Services Outreach		
Project Number	50349-003		
Country	Sri Lanka		
Project Status	Approved		
Project Type / Modality of Assistance	Technical Assistance		
Source of Funding / Amount	TA 6903-SRI: Enhancing Small and Medium-Sized Enterprises Financial Services Outreach		
	Financial Sector Development Partnership Special Fund		US\$ 300,000.00
	Technical Assistance Special Fund		US\$ 500,000.00
Strategic Agendas	Environmentally sustainable growth Inclusive economic growth		
Drivers of Change	Governance and capacity development Knowledge solutions Partnerships Private sector development		
Sector / Subsector	Finance - Small and medium enterprise finance and leasing		
Gender Equity and Mainstreaming	Effective gender mainstreaming		
Description	A proposed ADB TA of \$800,000 for Enhancing Small and Medium-Sized Enterprises Financial Services Outreach will support implementation of the proposed Small and Medium-Sized Enterprises Credit Guarantee Institution Project in Sri Lanka (the ensuing project), which is a standby project for 2021 in the country operations business plan for Sri Lanka, 2021-2023.		

Project Rationale and Linkage to Country/Regional Strategy

Development challenge. Small and medium-sized enterprises (SMEs) are critical for Sri Lanka's sustainable economic growth. They are responsible for 52% of the country's gross domestic product. SMEs are arguably even more important for poverty reduction as they provide 45% of employment and considered as source of innovation. Despite their importance, SMEs struggle to access financing for business growth. Key constraints include banks' insufficient lending capacity, SMEs' limited business development capacity, networking, and insufficient policy and institutional framework. Those issues are more severe for women-owned WSMEs (WSMEs), which represents only around 8% among formal enterprises.

The Asian Development Bank has supported the Government of Sri Lanka to address the issues with strong focus on women empowerment through a series of loans, grants and TAs. In particular, Small and Medium-sized Enterprise Line of Credit Project has brought positive impacts in changing the behaviors of banks and SMEs. During 2016-2020, \$175 million worth of ADB loans have reached out to 3,539 SMEs, of which 1,339 (37.8%) are WSMEs, with semi-annual lending targets for participating banks and cofinancing grant for WSMEs. However, banks' heavy reliance on collateral-based-lending still remains, which results to further financial exclusions of many SMEs, in particular WSMEs, who do not have such collateral.

Impact of the coronavirus disease pandemic. The coronavirus disease (COVID-19) pandemic has severely impacted the SME sector in the country. Decline of global demand, supply chain disruption, and slowdown of local economic activities due to the social distancing and containment measures have caused many SMEs to face liquidity shortage which severely hampered business continuation. The government has provided economic relief measures targeting the vulnerable SMEs: (i) the Central Bank of Sri Lanka (CBSL) relaxed monetary policy, launched an LKR150 billion concessionary refinancing program to provide liquidity to SMEs; (ii) financial institutions were allowed to reschedule non-performing loans without downgrading asset classification; and (iii) the government announced a debt repayment moratorium on bank loans for SMEs until December 2021. In spite of these measures and although banks are well-capitalized, there is a risk that the lending capacity of the banks will decline as asset quality worsens and profitability declines due to prolonged impact of the pandemic.

In November 2020, ADB approved the third additional financing to the Small and Medium-sized Enterprise Line of Credit Project to provide affordable working capital financing through 10 local banks to SMEs under its Emergency Response Component (ERC). As of 30 September 2021, around \$37.5 million equivalent of the ERC were onlent to 1,260 SMEs, and 526 (42%) were without collateral against real estates or financial assets, which exceeds an original target of 20%. However, its outreach remains constrained. State-owned banks tend to provide non-collateralized subloans to rural micro enterprises but require personal guarantee, and private sector banks have less reliance on personal guarantee while merely meeting the minimum non-collateralized subloan target of 20%. To mobilize liquidity to a wider range of SMEs, a well-functioning credit guarantee scheme is critical for mitigating banks' risks especially under the current market environment. The credit guarantee scheme can also catalyze banks' lending to long-term capital investments to accelerate post-pandemic economic recovery and transformation. Notwithstanding, the COVID-19 pandemic has also created opportunities for economic diversification and innovation, including the rise of e-commerce and other knowledge-based services, which currently do not have much value for facilitating access to finance.

Sustainable SME credit guarantee. Recognizing the timely need for enhancing SME financing, the government requested ADB's support for developing an SME credit guarantee facility. The government has historically launched various SME credit guarantee schemes, but none has flourished. Market participants cite operational deficiencies and issues such as slow claims processing, limited guarantee coverage, and high premiums. In May 2021, the government has obtained its cabinet approval for establishing a financially sustainable SME credit guarantee institution (SMECGI) based on ADB's original proposal in 2017, which reflected lessons learned from previous local experiences and international best practices, including World Bank's principles for public credit guarantee schemes for SMEs.

The ensuing project. ADB will support the government's vision to create a sustainable mechanism for credit guarantee operations, rather than launching a short-term measure for easing credit to SMEs. For this reason, the ensuing project, Small and Medium-sized Enterprises Credit Guarantee Institution Project, is being designed towards a sustainable operation of SMECGI. It should be well-funded, profitable, efficiently managed, removed from political influence, operated with the highest level of corporate governance and risk management practices with support from the central bank. Those principles will ensure SMECGI retains a strong credit rating to attract participating financial institutions (PFIs). SMECGI will be incorporated under the Companies Act and be jointly owned by the government and the PFIs that will access SMECGI's credit guarantee services. The joint ownership structure will mitigate the risks of adverse selection and moral hazard by PFIs in originating and monitoring guaranteed loans. PFIs will nominate board directors to reflect their relevant views as guarantee service users and equity investors in SMECGI operations.

The project's outcome is SME access to finance enhanced, and the project outputs are: (i) corporate and regulatory framework for SMECGI established (project output 1), (ii) financially sustainable guarantee institution operationalized (project output 2), and (iii) SME financial outreach enhanced (project output 3). ADB's \$100 million loan will be used for the government to subscribe SMECGI's capital for its initiation and expansion of credit guarantee services to SMEs.

ADB is currently supporting the government and PFIs in finalizing a shareholders' agreement for incorporation of SMECGI, its articles of association, and a guarantee participation agreement to ensure that SMECGI's ownership, corporate governance, supervisory, and operational frameworks are in line with international best practices. Once an appropriate corporate legal framework for SMECGI is established, subject to approval of the ensuing loan, ADB will be ready for its first loan disbursement of \$50 million to the government. The government will then use the loan proceeds for its equity investment into SMECGI. Together with the PFIs' investments, SMECGI will build up its initial paid-in capital of \$55.6 million-\$62.5 million. Prior to starting its guarantee operations, SMECGI shall develop its operational systems, arrangements and guidelines of credit guarantee services in compliance with ADB's applicable policies, such as in the aspects of financial management, governance, and safeguards.

The second loan disbursement of \$50 million is expected to finance the government's second large equity investment in SMECGI to provide growth capital. Prior to the second disbursement, ADB will ensure that (i) SMECGI will have catalyzed PFIs' new lendings to eligible SMEs by providing the total guarantee amount exceeding 1.5 times of the amount of initial capitalization (i.e., \$83.4 million-\$93.8 million) in line with principles for ADB's financial intermediation loans, and (ii) SMECGI will have been on a sustainable growth path while achieving its development objectives, including promoting financial inclusion of WSMEs. This will be facilitated by upgrading its operational frameworks, obtaining a high credit rating, formulation of a long-term strategy to seek external financing, and development of its gender-responsive and climate change resilient businesses.

Impact	
Project Outcome	
Description of Outcome	
Progress Toward Outcome	
Implementation Progress	
Description of Project Outputs	
Status of Implementation Progress (Outputs, Activities, and Issues)	
Geographical Location	Nation-wide
Summary of Environmental and Social Aspects	
Environmental Aspects	
Involuntary Resettlement	
Indigenous Peoples	
Stakeholder Communication, Participation, and Consultation	
During Project Design	
During Project Implementation	
Business Opportunities	

Consulting Services	ADB will engage the consultants following the ADB Procurement Policy (2017, as amended from time to time) and its associated project administration instructions and/or staff instructions. All the disbursements under the TA will be made in accordance with ADB's Technical Assistance Disbursement Handbook (2020, as amended from time to time).
Procurement	The procurement of consulting services will follow the ADB Procurement Policy (2017, as amended from time to time) and its associated project administration instructions and/or staff instructions.

Responsible ADB Officer	Hoshino, Takuya
Responsible ADB Department	South Asia Department
Responsible ADB Division	Public Management, Financial Sector and Trade Division, SARD
Executing Agencies	Department of Development Finance 1st Floor, The Secretariat, Colombo 01, Sri Lanka Ministry of Finance The Secretariat Building Colombo 01 Sri Lanka

Timetable	
Concept Clearance	-
Fact Finding	-
MRM	-
Approval	10 Jan 2022
Last Review Mission	-
Last PDS Update	10 Jan 2022

TA 6903-SRI

Financing Plan/TA Utilization						Cumulative Disbursements		
ADB	Cofinancing	Counterpart				Total	Date	Amount
		Gov	Beneficiaries	Project Sponsor	Others			
800,000.00	0.00	0.00	0.00	0.00	0.00	800,000.00	-	0.00

Project Page	https://www.adb.org/projects/50349-003/main
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