



**Note to Task Teams:** The following sections are system generated and can only be edited online in the Portal.

# Combined Project Information Documents / Integrated Safeguards Datasheet (PID/ISDS)

Appraisal Stage | Date Prepared/Updated: 23-Dec-2016 | Report No: PIDISDSA19830



**BASIC INFORMATION**

**A. Basic Project Data**

Country Sri Lanka	Project ID P159303	Project Name Sri Lanka Financial Sector Modernization Project	Parent Project ID (if any)
Region SOUTH ASIA	Estimated Appraisal Date 30-Nov-2016	Estimated Board Date 26-Jan-2017	Practice Area (Lead) Finance & Markets
Lending Instrument Investment Project Financing	Borrower(s) Democratic Socialist Republic of Sri Lanka	Implementing Agency Insurance Board of Sri Lanka, Securities and Exchange Commission of Sri Lanka, Central Bank of Sri Lanka	

Proposed Development Objective(s)

The project development objective (PDO) is “to contribute to increasing financial market efficiency and use of financial services among MSMEs and individuals”.

The project will achieve the PDO through modernizing financial market infrastructure, upgrading the legal and regulatory framework for the financial system, and strengthening the institutional capacity of financial sector regulators (CBSL, IBSL, and SEC).

Components

Supporting Selected Mid-Level Reforms through Results-Based Financing  
Strengthening Regulators’ Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure  
Project Implementation and Monitoring

**Financing (in USD Million)**

Financing Source	Amount
International Development Association (IDA)	75.00
<b>Total Project Cost</b>	<b>75.00</b>

Environmental Assessment Category

C - Not Required



Decision

The review did authorize the preparation to continue

**Note to Task Teams:** End of system generated content, document is editable from here.

Other Decision (as needed)

## B. Introduction and Context

### Country Context

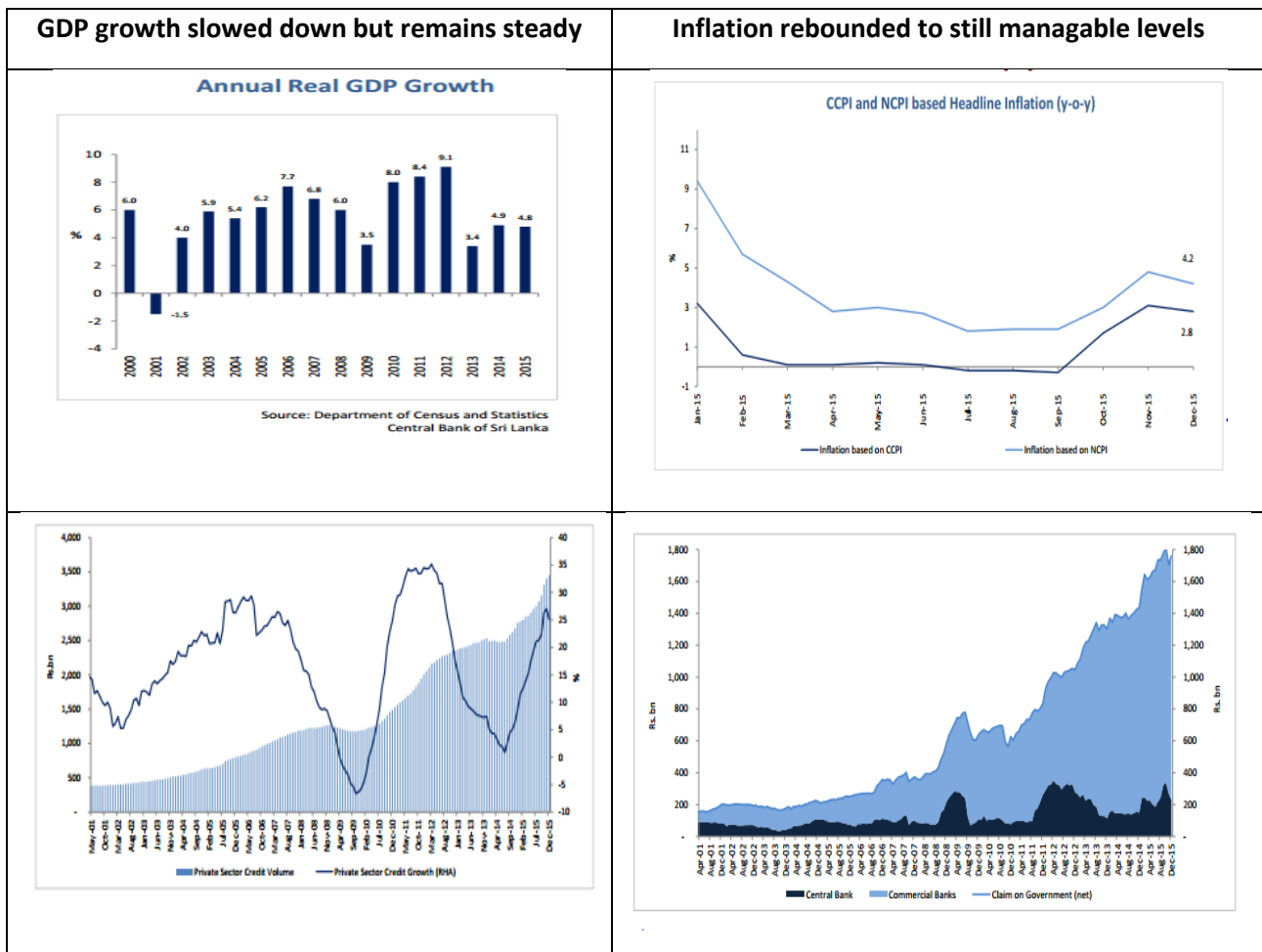
- 1. Sri Lanka aspires to reach the upper middle-income country (MIC) status, yet faces the risk of declining growth potential.** During 2011-2015, Sri Lanka's economy was one of the fastest growing among South Asian peers with an average growth of 6.1 percent. The reduction in poverty and improvements in household welfare since 2002 are noteworthy and place the country well on its way towards eradicating extreme poverty. Although poverty continued to decline between 2009/10 and 2012/13, inequality in both consumption and income has started to increase, as growth of per-capita consumption and income of the bottom 50 percent is slower than the ones of the top 50 percent. Sri Lanka is the only country in South Asia that experienced an increase in consumption inequality in the last decade. In turn, rising inequality tempered the poverty-reducing impact of growth.
- 2. The challenging global environment weakened macroeconomic stability which can hinder growth.** During 2014-2015, Sri Lanka experienced significant capital outflows, and reduced exports and remittances. These negative shocks resulted in the slowdown of economic growth to about 4.9 percent and contributed to heightened exchange rate pressures (Figure 1). To support and stabilize the economy, the authorities implemented expansionary monetary and fiscal policies which left the country with higher public debt and lower reserves. The accommodative monetary policy stance led to year-on-year expansion of credit to the private sector by 25 percent which supported growth, but also increased financial sector vulnerabilities. Increased real interest costs of government borrowing further restricted the government's ability to borrow at a sustainable level. Moreover, as the country nears the upper middle-income status, borrowing terms are becoming more commercial and could affect affordability. Finally, with low national savings compared to needed national investment, Sri Lanka must increase domestic savings mobilization and attract more foreign direct investment (FDI) to sustain high growth.
- 3. Sri Lanka needs a new growth model that requires investment to shift from the public to the private sector.** The need to shift investment activity from the public to private sector becomes increasingly important for Sri Lanka due to constrained fiscal space and inefficiencies in public investment. Even infrastructure investment, in which the Government of Sri Lanka (GoSL) has always played a central role, will require enhanced private sector participation because of the scale of infrastructure financing needed over the next decade. To this end, domestic capital markets must evolve



to be in a position to play a key role in the financing of large investments. In a report prepared for the Colombo Stock Exchange in 2012, Mckinsey & Company estimated that to sustain the 8.0 percent target growth rate, the government needs to mobilize at least US\$300 billion targeting infrastructure over the next eight years.

4. The investment shift can help create the next one million jobs and micro, small and medium enterprises (MSMEs), in particular, could be the hinge for the new growth model to emerge. Most private enterprises in Sri Lanka are small, which have profound implications for productivity. The 2014 Economic Census conducted by the Department of Census and Statistics, Sri Lanka found that 93 percent of private economic establishments had fewer than five employees. Around 99.5 percent of all enterprises in Sri Lanka are MSMEs. They contribute over 52 percent to the Gross Domestic Production (GDP) and 69.5 percent of the total employment in the country. These statistics reveal an immense potential to boost the MSMEs' level of contribution to the economy when compared with the GDP and employment contributions in other countries.

Figure 1. Selected Macroeconomic Indicators





<b>Financial depth is low compared with peer countries and credit provision remains volatile</b>	<b>Net credit to GoSL has been rising rapidly with possible crowding out effects</b>
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Source: Central Bank of Sri Lanka

Sectoral and Institutional Context

Financial Sector Background

**5. The financial system in Sri Lanka is dominated by banks and state ownership.** In 2015, the banking sector comprised 25 Licensed Commercial Banks (LCB) and seven Licensed Specialized Banks (LSB) that accounted for 59 percent of the total financial system assets, of which the state-owned banks contributed to more than 44 percent. Further, the nonbank financial sector is made up of 46 financial companies and seven specialized leasing companies that account for only seven percent of total financial system assets. The large number of Microfinance Institutions (MFIs), which contribute to expanding financial inclusion are still outside the perimeter of the regulated financial system. The insurance and capital markets sector account for a relatively small share of the sector’s total assets. The 28 insurance companies represent 3.3 percent of the financial sector, while the capital markets sector, comprising 294 companies, accounts for only 0.9 percent. Sri Lanka has a sectoral supervisory structure with the Central Bank of Sri Lanka (CBSL) covering banking, finance companies, leasing and microfinance; Securities and Exchange Commission of Sri Lanka (SEC) covering capital markets; and the Insurance Board of Sri Lanka (IBSL) covering insurance.

**6. The development of the financial sector has not been commensurate with the development of real economy as reflected in its low depth relative to peers.** Despite having a per capita income of 2.5 times and 3 times higher than that of India and Bangladesh respectively, Sri Lanka’s credit to GDP ratio at 40.73 percent is lower than India (52.6 percent) and Bangladesh (43.9 percent), and is a fraction of that of China, Vietnam and Thailand (Figure 2). It is also below the South Asia regional average (47.59) and the MIC average (97.03). Relative to regional peers, Sri Lanka’s financial sector has room to grow in terms of the size of total assets, credit intermediation (Table 1), in depth and diversification.

Table 1: Indicators of Banking Activities for selected countries (2015)

Country	Broad Money (M2)/GDP	Bank Domestic Credit/GDP
China	205.7	153.3
Vietnam	137.6	111.9
Thailand	129.7	151.3
India	79.2	52.6
Bangladesh	64.5	43.9



Pakistan	53.5	15.4
<b>Sri Lanka</b>	<b>40.8</b>	<b>40.73</b>

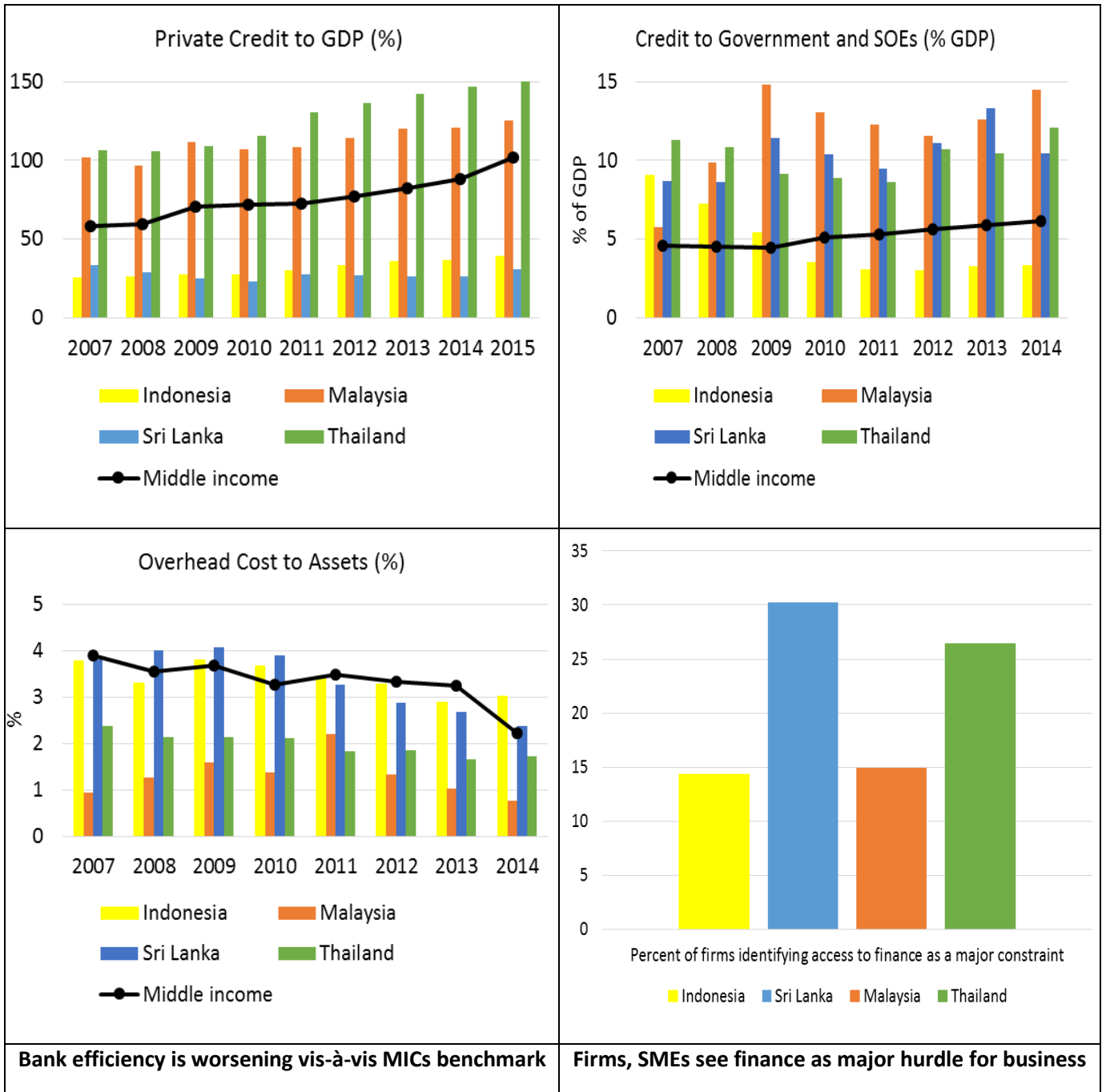
Source: World Development Indicators

**7. The absence of a competitive, diversified, and a well-regulated financial market limits the access to investment finance for MSMEs and economic opportunities for the financially under-served.**

MSMEs continue to get crowded out (Figure 2) from the banking sector by larger corporate clients, state owned enterprises (SOEs) and government debt financing as banks and other financial institutions consider them to be high credit risks. Capital markets – which could have provided an avenue for funding especially for larger corporates including SOEs – are underdeveloped leading to their over-reliance on the banking system for funding which happens at the expense of smaller firms. But credit institutions have also not developed adequate internal capacity for serving MSMEs mainly due to insufficient competition, resulting in low incentives to modernize and innovate to serve this segment. While the depth of the credit market, as measured by the credit-to-GDP ratio, has been stagnating around 30 percent, lending to government and SOEs has been increasing without any major improvement in bank efficiency (Figure 2). As a result, MSMEs perceive access to finance as a major constraint to investment and growth, more so than in peer countries (Figure 2) and for example, over 50 percent of the enterprises have reported that their working capital came from their own resources.

**Figure 2. Role of State in the Financial System**

<b>Credit deepening is stagnant and lags behind peers</b>	<b>GOSL &amp; SOES absorb large part of the credit market</b>
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Source: Finstat & GSD databases, World Bank

*The Challenge - Importance of Developing the Enabling Environment*



**8. To remain on its path to upper-MIC status, Sri Lanka must address financial sector challenges to build a more efficient, inclusive, and stable financial system that can support shared prosperity.**

Robust financial sector development can help Sri Lanka sustain its developmental returns. More efficient finance can boost the competitiveness of Sri Lankan firms and overall job creation. The deepening of capital, pension, and insurance markets can help manage some fiscal challenges such as deficit financing and contingent liabilities due to aging population, natural hazards, and the economic vulnerability of the poor. Greater financial inclusion can help increase spatial integration, access to opportunities, and contain costs of informality. Improved governance and transparency in the financial market can spill over to the rest of the economy. However, to make this happen, Sri Lankan authorities must effectively address several challenges in the financial sector. Amongst other actions, addressing gaps in financial sector infrastructure, legal framework and supervisory capacity are needed as key starting points (evidenced by the Financial Sector Assessment Program [FSAP], 2015, and the requests for technical assistance from financial sector supervisors).

**9. The low and decreasing efficiency of the banking and Non-Bank Financial Institutions (NBFI) sectors must be tackled head-on to boost overall competitiveness in the economy.**

The persistently high cost-to-income ratio in Sri Lanka's banks signal cost inefficiencies. Banks need to improve management of operational costs to catch up with peer countries. NBFIs may need to overhaul their operations, as analysis has revealed major inefficiencies in this subsector. Improving market entry and exit for banks and NBFIs can enhance overall market contestability. To create the conditions for a level playing field and increased competition, state-owned banks need to be fully subjected to the banking law and progressively commercialized just as the regulations for banks and NBFIs must be harmonized. Low market transparency can be improved by promoting clearer and more comprehensive disclosure of prices by banks and NBFIs and by scaling up the extent and quality of information released by the CBSL.

**10. Inadequate diversification of Sri Lanka's financial system hinders possible gains in financial efficiency, development of alternative channels for credit intermediation, and economic resilience.**

Underdeveloped capital, pension, and insurance markets, (where for instance insurance premium to GDP at around 1 percent is much lower than comparators), undermine the ability of Sri Lanka to meet the long-term financing needs of the economy. With a concessional interest rate regime and limited exposure to external capital flows and weak financial infrastructure for bond markets, debt markets are underdeveloped. Developed capital markets offer businesses better access to low-cost, long-term financing which is vital for expansion and growth of businesses. Weak governance, the lack of adequate pricing benchmarks, and low use of technology hamper the development of Sri Lanka's nascent capital market. Long term funding needs of larger firms and infrastructure projects need a well-functioning capital market to allow for advances in economic efficiency and risk management. The 2015 FSAP pointed to a number of gaps in financial sector infrastructure (such as the risk in settlement of corporate securities) as well as the legal framework and supervisory capacity (such as the SEC Act and enforcement powers of SEC and IBSL) to boost competition and efficiency in non-bank financial markets.

**11. The move towards a risk-based and consolidated supervision across all financial sub-sectors remains work in progress, even though it is well accepted by the country authorities. While the**





financial system is relatively stable, business inefficiencies and the missing culture of risk management can create vulnerabilities in an environment when interest rates and business margins continue a downward trend. Some small and midsize banks, specialized licensed banks, and NBFIs show already elevated levels of nonperforming loans despite an environment of regulatory forbearance. Such risks must be addressed in a consolidated and forward-looking manner. Furthermore, regulatory and supervisory loopholes that the market has been exploiting and the strong emergence of financial sector groups makes a functional consolidated supervision a necessity. This also creates a level playing field for institutions that do not belong to any financial groups and operate across banking, insurance, capital markets or leasing industries. Risk-based supervision, and consolidated supervision is not only important for assessing the financial soundness of institutions, but it can also stimulate greater market competition that is currently missing in the Sri Lankan market. However, inadequate capacity and resources (in terms of staff, expertise and tools) to meet their expanding responsibilities have led to effectiveness challenges for the three main regulators. Further, regulatory and supervisory frameworks for microfinance institutions, financial consumer protection and pensions have not yet been developed. Absence of well-defined standards and framework for financial consumer protection have led to considerable consumer detriment that span across different financial services—from insurance, to banking, to NBFIs and to the prudentially unregulated microfinance.

#### *The Change Process and Government Ownership*

**12. The need for financial sector reform is fully articulated in the GoSL's development directions as outlined in recent policy statements, and endorsed via the 2016 and 2017 Budgets.** The 2015 FSAP identified priority reforms in the financial sector. In line with its general pledge to stronger governance and reform, the GoSL too has expressed commitment to create the enabling business environment in which the financial sector can operate effectively and efficiently. The GoSL recognizes the need to reform the banking industry and stimulate competition within the sector, increase outreach to underserved areas and sectors and improve the supervisory capacity of CBSL to address systemic risks in the banking sector as well as regulate and oversee the NBFIs and microfinance sectors. While acknowledging the innovations and expansions of the banking sector that has extended banking to the door step of the customer, GoSL identifies the restrictive practices of collateral based lending that has become an impediment to the development of the MSME sector and the business startup culture in Sri Lanka. The GoSL also perceives capital markets to be an untapped resource and recognizes the weaknesses discussed above. Strengthening of insurance business, in particular the agri-insurance and provision of pension annuities are other areas of key importance highlighted in the budget. The GoSL and CBSL in particular recognize the area of financial stability and effective implementation of macroprudential policy as important. They work with the International Monetary Fund (IMF) on this area under the technical assistance that follows up on the 2012 Stability FSAP. The Asian Development Bank (ADB) is assisting in the areas of capital market development following the 2015 FSAP recommendations that complements the work of the World Bank.

#### *Financial Sector Modernization (FSM) Project*



**13. The project addresses some of the main constraints in the financial sector and is also key in generating demonstration effect for deeper engagement on high-level financial sector reforms.** The project is designed to address several of the key challenges confronting the development of the financial sector in Sri Lanka. In its investment component, this project aims to improve the financial market infrastructure, legal and regulatory framework for the financial system, and the institutional capacity of financial sector regulators all of which are essential actions for a stronger financial sector.

**14. The project focuses on addressing select technical and mid-level recommendations identified through the 2015 FSAP and aligns with on-going policy dialogue on sector reform priorities** (see Box 1). While the project does not focus on high-level policy recommendations, the Disbursement Linked Indicator (DLI) component of the project addresses several mid-level policy recommendations thus, facilitating a platform of engagement that enables downstream progress on high-level reforms. The DLI component targets developing more competitive markets by requiring a holistic supervisory approach; switch to forward looking supervisory perspective; and leveling of the playing field within and across financial subsectors. It also aims to improve the investment performance of the pension provident funds to secure adequate replacement income for retirees.

**Box 1: FSAP 2015 summary recommendations**

**The 2015 Development FSAP made recommendations at three levels to improve financial sector efficiency and financial inclusion in Sri Lanka, and boost inclusive growth and job creation as given below:**

- **High-level policy recommendations**—such as strengthening State Owned Financial Institutions (SOFI) governance, integrating the supervisory structure and improving supervisory governance, rationalizing and consolidating state financial support programs (credit lines and partial credit guarantee schemes);
- **Mid-level policy recommendations**—such as establishing an institutional and legal framework for financial consumer protection, improving investment management of pension provident funds, and removing the monopoly of state-owned insurance companies in insurance business with the government; and
- **Technical-level recommendations**—such as improving the financial sector infrastructure, upgrading the legal and regulatory framework, introducing risk-based and consolidated supervision, increasing the supervisory capacity to assess and monitor risks and enforce regulations across all financial subsectors.

*Higher Level Objectives to which the Project Contributes*

**15. The operation is fully aligned with the Country Partnership Framework (CPF) for Sri Lanka for FY17-20.** The project will contribute to the achievement of the first CPF pillar on improving macro-fiscal stability and competitiveness by enabling the country’s transition to become a more outward-oriented, competitive, globally-integrated economy. It will also help promote more and better-paying private sector jobs for the bottom 40 percent. Specifically, the planned activities will directly facilitate the achievement of Objective 1.4: Enhancing Financial Inclusion and Financial Sector Efficiency. Further, it is



envisaged that the proposed work on capital market development and pension investment will also complement the activities on public finance management (Objective 1.1) and social protection (pension) systems (Objective 2.2). The CPF identified that the future World Bank Group (WBG) initiatives will focus on activities including: (a) strengthening and enhancing regulatory, supervisory and governance structures in line with international standards; (b) expanding access to finance for MSMEs and underserved segments through working with banks and NBFIs by supporting the development of strategy, capacity as well as financing; (c) deepening the capital market through necessary legal, regulatory and market infrastructure while introducing new products, instruments and markets; and (d) developing the credit and financial infrastructure. The proposed project expects to invest in these areas.

**16. The project is also in line with the GoSL's development directions.** These were outlined in recent policy statements, and endorsed via the 2016 and 2017 Budgets, as well as the government's plan for MSME development for sustainable growth and job creation. The current project builds on the achievements and the development activities carried out by an earlier project (the IDA funded 2000/05 CBSL modernization project, the outcome of which was rated "highly satisfactory" by the Internal Evaluation Group's project completion review, having achieved its objective under each component).

**17. Overall, the project aims to level the playing field and align the incentives of the financial sector for greater support of inclusive growth in Sri Lanka.** The leveling of the playing field and aligning of incentives could be achieved through modernized financial infrastructure, legal and regulatory framework in line with good international standards, and greater capacity of regulators to conduct holistic and forward-looking supervision across all financial subsectors. The resulting greater market competition, financial sector efficiency and inclusion of firms and people in the use of needed financial tools is expected to follow. In turn, MSMEs will be able to exploit greater economic opportunities by investing, growing and creating new and better jobs. To sustain the expected gains in poverty reduction and shared prosperity, the project will also help enhance financial soundness of financial firms and thus contribute to overall financial and macroeconomic stability.

### **C. Proposed Development Objective(s)**



**Note to Task Teams:** The PDO has been pre-populated from the datasheet for the first time for your convenience. Please keep it up to date whenever it is changed in the datasheet.

The project development objective (PDO) is “to contribute to increasing financial market efficiency and use of financial services among MSMEs and individuals”.

The project will achieve the PDO through modernizing financial market infrastructure, upgrading the legal and regulatory framework for the financial system, and strengthening the institutional capacity of financial sector regulators (CBSL, IBSL, and SEC). Because of its comprehensive approach to creating an enabling environment for robust financial development, the project is also expected to advance financial inclusion through: (i) increased financial efficiency and competition as well as (ii) the greater reach and financial connectivity of MSMEs and individuals that the new and more inclusive financial market infrastructure shall enable.

#### *Project Beneficiaries*

**18. The project beneficiaries are the financial sector regulators (CBSL, SEC, and IBSL).** The interventions planned with the regulators will also permeate to financial firms, MSMEs and individuals. Whilst the financial sector regulators and several providers of core financial sector infrastructure will benefit from the project directly, it is likely that MSMEs and individuals including women, and beneficiaries under the Employees’ Provident Fund (EPF) will also be positively impacted.

#### Key Results

### **D. Project Description**

Key Results (From PCN)

#### *PDO Level Results Indicators*

**19. The contribution to increasing financial market efficiency will be measured by:**

- i. Increased transactions of retail electronic payments on the modernized infrastructure (measured by the growth of cards issued under National Card System (NCS) in relation to total Debit Cards issued);
- ii. Increased trading in the secondary government bond market (measured by the growth of secondary market trades of Central Government Debt in value terms);
- iii. Increased share of private insurance companies in newly issued insurance policies (measured by the growth in insurance premiums to GDP);



- iv. Increased financial soundness of MFIs (measured by establishing and complying with the regulatory minimum capital requirement for the MFIs)

**20. The project will also track a set of additional intermediate monitoring and evaluation (M&E) indicators as part of its M&E framework.** Among others, these include gender disaggregated measures for the use of financial services (e.g. MFI and MSME lending) and citizen engagement indicator (i.e. percentage of project beneficiaries who agree that the project activities /results reflected their needs).

#### D. Concept Description

##### *Project Design and Rationale*

**21. To help increase financial efficiency and thereby financial inclusion, the project will modernize financial infrastructure, upgrade the relevant legal framework, and strengthen financial sector regulators' supervisory capacity.** Through supporting financial market infrastructure, the legal and regulatory framework and strengthening the institutional capacity of regulators, the project aims to contribute to addressing some of the key financial sector constraints discussed above. Importantly, the project's DLI (results based financing) component supports the project design through a set of mid-level reforms that are critical to achieving the project objectives. As discussed above, efficiency and inclusion in financial services are critical for boosting inclusive growth, in particular by enabling investment, growth, and job creation by MSMEs. The Government's policy statements and 2016 and 2017 budgets echo this potential. The project thus focuses on assisting the GoSL with its priority financial sector reforms. Moreover, it builds a platform for possible high level reforms of financial policy and institutions in the near future. The project aims to boost financial access for MSMEs through a market enabling approach rather than supporting direct interventions by the GoSL such as credit lines of partial credit guarantee schemes. As reported by the 2015 FSAP, such direct interventions have been ineffective, weakly governed and are introducing distortions to proper functioning of the financial system. The project design emphasizes the need for effective coordination across implementing entities (CBSL, SEC, and IBSL) by establishing the Financial Sector Oversight committee (FSOC) as the project steering committee (PSC) and a Ministry-level Central Project Coordination Unit (CPCU). The ongoing/planned complementary technical assistance (TA) activities supported by the Bank including the Financial Sector Reform and Strengthening (FIRST) Initiative trust funds are expected to further bolster the implementation arrangements and probability of achieving the project objectives (refer to the Lessons Learnt section below for details of these TA activities).



*Project Components*

**22. The proposed support will include the following three components<sup>1</sup>:**

- Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing
- Component 2: Strengthening Regulators' Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing Financial Market Infrastructure
- Component 3: Project Implementation and Monitoring

**Component 1: Supporting Selected Mid-Level Reforms through Results-Based Financing (IDA financing US\$15 million)**

**23. The implementation of selected mid-level reforms through DLIs enables corresponding Investment Project Financing (IPF) components and reinforces the overall positive impact of the Project.** The DLIs, as well as the IPF components, are based on the 2015 FSAP recommendations. The funds will be disbursed to the Ministries and financial sector regulators responsible for Disbursement Linked Results (DLRs) - Ministry of National Policies and Economic Affairs (MoNP&EA), CBSL, SEC and IBSL.

**24. Disbursement of funds under the component will be subject to the achievement of the following DLIs:**

- i. DLI 1: Adoption of a consolidated risk-based approach to supervision of financial institutions.
- ii. DLI 2: Establishment of the Financial Consumer Protection Authority across all financial services under an independent authority or an authority under CBSL.
- iii. DLI 3: Establish an information system for holistic management of EPF's assets (investment) and liabilities (collections), and adopt a diversified investment strategy.
- iv. DLI 4: Establishment of Delivery-versus-Payment (DvP) mode of settlement for corporate securities to minimize possible risks to financial stability.
- v. DLI 5: Restructuring of the National Insurance Trust Fund (NITF) by separating the underwriting and reinsurance businesses.

**Component 2: Strengthening Regulators' Institutional Capacity, Upgrading the Legal and Regulatory Framework and Modernizing of Financial Market Infrastructure (IDA financing US\$59 million)**

**25. The component aims at strengthening the institutional capacity of the financial sector regulators.** This component is expected to enhance proactive enforcement of market discipline, financial soundness, business conduct, and market competition due to increased supervisory powers,

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<sup>1</sup> As mentioned in paragraph 15 above, the project addresses select mid-level (Component 1) and technical level recommendations (Component 2).



legal and regulatory framework aligned with good international practice, market data access, as well as data management and analytical skills of the supervisors. This component will include implementation of several key Information and Communication Technology (ICT) systems with related cybersecurity components. It will finance goods and equipment, non-consulting as well as consulting services, trainings and workshops. A strong regulatory and supervisory capacity is essential for maintaining the stability and efficiency of the financial system, especially relevant in the context of the progressively complex evolution of the financial sector. The component, through strengthening the regulators, also contributes to enabling them to facilitate better financial intermediation and outreach in the banking sector, capital markets and the insurance sector.

- **Component 2a. Strengthening the capacity of CBSL for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US\$ 31 million).** This sub-component includes activities focused around supporting core central banking functions and developing market infrastructure. The sub-component will support strengthening of the regulators' capacity to meet the growing complexity and evolution of financial markets. It will facilitate strengthening of legal and regulatory framework and supervisory capacity that are in line with international best practice in areas of microfinance, financial consumer protection, non-bank financial institutions, bank supervision and establishing comprehensive consolidated risk-based supervision framework. The project would further support modernizing key financial infrastructure through technology investments in hardware and software for the national payment system, EPF Information Technology (IT) platform/database, settlement and clearing infrastructure for the government securities market as well as the foreign exchange market monitoring mechanism. Training and capacity building will be provided under most activities. The expected result is a strengthened legal, regulatory and supervisory framework as well as supervisory expertise and powers of the CBSL including in the areas of microfinance and financial consumer protection; and modernized financial infrastructure, with a focus on payment systems, EPF investment management, and central Government bond market development.
- **Component 2b. Strengthening the capacity of SEC for supervision and regulation, and modernizing relevant financial infrastructure (IDA financing US\$ 19 million).** This sub-component lays the foundation needed to stimulate capital market development through addressing the existing regulatory, infrastructure and capacity gaps identified. The upgrading of the regulatory and supervisory capacities of SEC will enable it to fully meet its current and future regulatory and market development function, in line with international standards, while streamlined market infrastructure will enable better risk management and enhance supervisory capacities, thus increasing efficiency. Training and capacity building will be provided under most activities. The expected result is strengthened legal, regulatory and supervisory framework including the framework for supervision of corporate bond market, expertise in risk based supervision, and powers of the SEC; and modernized IT infrastructure, with a focus on the Central Counter Party (CCP) system, market surveillance system, eXtensible Business Reporting Language (XBRL) reporting, and management information systems.
- **Component 2c. Strengthening the capacity of IBSL for supervision and regulation and modernizing relevant financial infrastructure (IDA financing US\$ 9 million).** This sub-



component aims to support IBSL to better supervise and monitor the insurance sector. Enhancing the regulatory and supervisory framework and related IT infrastructure would enable sound and prudent management and oversight of the insurer's business as well as protection of the interest of policyholders. Training and capacity building will be provided under most activities. The expected result is strengthened legal, regulatory and supervisory frameworks as well as enhanced supervisory expertise and powers of the IBSL with a focus on developing micro insurance, restructuring of motor third party liability insurance, strengthening reinsurance arrangements, and modernizing the IT infrastructure to enable risk based supervision.

### **Component 3: Project Implementation and Monitoring (IDA financing US\$ 1 million)**

**26. This component aims to provide support to the FSOC and CPCU to manage and coordinate technical operations, financial management, procurement, social and environmental issues as well as monitoring and evaluation under the project.** It will include costs for project management, M&E, training and capacity building. To coordinate the activities among the three regulators and thus assist the FSOC, the MoNP&EA will house a CPCU. The three regulators have identified staff who would form the project implementation teams within each institution. Periodic monitoring reports and supporting research will provide accountability of program results.

## **E. Implementation**

### **Institutional and Implementation Arrangements**

**27. The Financial Sector Oversight Committee (FSOC - an existing body comprising heads of all three regulators), as the project steering committee, will be mandated to carry out the function of inter-regulatory coordination.** The three regulators have agreed on this arrangement. The FSOC will: (a) serve as project steering committee to ensure effective coordination and communication between the three regulators as well as the MoF; (b) provide overall policy guidance and support to the three regulators and MoF in the implementation of the project; (c) mobilize and ensure coordination with other relevant stakeholders. The FSOC will be chaired by the Governor of the CBSL with the respective Chairmen and Director Generals of the SEC and IBSL, and the Deputy Governor, CBSL as other members.

**28. To assist the FSOC in the implementation and coordination of the project, a ministry-level Central Project Coordination Unit (CPCU) will be formed** which will be housed at the MoNP&EA. CPCU will be responsible for facilitating and coordination of procurements, all monitoring and evaluation activities, project reporting and managing the project level grievance and complaints procedures.

**29. The project implementing entities (CBSL, SEC, and IBSL) will form their respective project implementation teams.** Each implementing team will be headed by a Project Director and include staff for handling fiduciary and other functions who will be the focal point for all project activities, including handling internal and external implementation coordination. Since implementing entities (CBSL, SEC and





IBSL) are separate legal entities, all funds for project activities will flow through the Government (MoF) who will grant funds to CBSL, SEC and IBSL. Hence, there will be individual Project Agreements between the Bank and the three implementing entities.

**Note to Task Teams:** The following sections are system generated and can only be edited online in the Portal.

**F. Project location and Salient physical characteristics relevant to the safeguard analysis (if known)**

There are no alternative locations under consideration, the project will be implemented in Colombo in the Headquarters of the three regulators. The procurement will be limited to IT hardware/software for online systems.

**G. Environmental and Social Safeguards Specialists on the Team**

Mohamed Ghani Razaak, Mokshana Nerandika Wijeyeratne

**SAFEGUARD POLICIES THAT MIGHT APPLY**

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	No physical interventions are envisioned as per the proposed project. However it is expected that due to project activities there is the possibility that e-waste will be generated via the upgrading of computer hardware under Component 1-3 as old units may be replaced. Thus as a due diligence measure to ensure that any e-waste generated are handled accordingly, the project Operations Manual will include a set of guidelines on the management of e-waste as per the national regulations which meet bank safeguard requirements.
Natural Habitats OP/BP 4.04	No	Project interventions are not expected to have any significant impacts on the natural habitats in relation to the project location thus the policy is not triggered.
Forests OP/BP 4.36	No	No impacts due to the proposed project are envisioned on forests.
Pest Management OP 4.09	No	Not Applicable as no project interventions are made where significant use of pesticides and other such substances are utilized.
Physical Cultural Resources OP/BP 4.11	No	Project interventions do not involve any physical interventions, thus there are not impacts expected



any physical cultural resources.

Indigenous Peoples OP/BP 4.10	No	The project will not affect any indigenous groups.
Involuntary Resettlement OP/BP 4.12	No	Project activities are not expected to involve any resettlement.
Safety of Dams OP/BP 4.37	No	No dams will be affected via project interventions.
Projects on International Waterways OP/BP 7.50	No	The proposed project activities do not have any impacts to the international waterways and therefore this policy is not triggered.
Projects in Disputed Areas OP/BP 7.60	No	There are no disputed areas where project interventions are undertaken and therefore this policy is not triggered.

**KEY SAFEGUARD POLICY ISSUES AND THEIR MANAGEMENT**

**A. Summary of Key Safeguard Issues**

1. Describe any safeguard issues and impacts associated with the proposed project. Identify and describe any potential large scale, significant and/or irreversible impacts:
2. Describe any potential indirect and/or long term impacts due to anticipated future activities in the project area:
3. Describe any project alternatives (if relevant) considered to help avoid or minimize adverse impacts.
4. Describe measures taken by the borrower to address safeguard policy issues. Provide an assessment of borrower capacity to plan and implement the measures described.
5. Identify the key stakeholders and describe the mechanisms for consultation and disclosure on safeguard policies, with an emphasis on potentially affected people.

**B. Disclosure Requirements**

**C. Compliance Monitoring Indicators at the Corporate Level (to be filled in when the ISDS is finalized by the project decision meeting)**



### The World Bank Policy on Disclosure of Information

Have relevant safeguard policies documents been sent to the World Bank's Infoshop?

No

Have relevant documents been disclosed in-country in a public place in a form and language that are understandable and accessible to project-affected groups and local NGOs?

No

### All Safeguard Policies

Have satisfactory calendar, budget and clear institutional responsibilities been prepared for the implementation of measures related to safeguard policies?

Have costs related to safeguard policy measures been included in the project cost?

Does the Monitoring and Evaluation system of the project include the monitoring of safeguard impacts and measures related to safeguard policies?

Have satisfactory implementation arrangements been agreed with the borrower and the same been adequately reflected in the project legal documents?

## CONTACT POINT

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**APPROVAL**

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**Approved By**

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**Note to Task Teams:** End of system generated content, document is editable from here.



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Sri Lanka Financial Sector Modernization Project (P159303)

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