



Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Concept Stage | Date Prepared/Updated: 30-Aug-2016 | Report No: PIDISDSC18089



BASIC INFORMATION

A. Basic Project Data

Country Sri Lanka	Project ID P159303	Parent Project ID (if any)	Project Name Sri Lanka Financial Sector Modernization Project (P159303)
Region SOUTH ASIA	Estimated Appraisal Date Oct 31, 2016	Estimated Board Date Dec 21, 2016	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	

Financing (in USD Million)

Financing Source	Amount
International Development Association (IDA)	75.00
Total Project Cost	75.00

Environmental Assessment Category

C-Not Required

Concept Review Decision

Track II-The review did authorize the preparation to continue

Other Decision (as needed)

Safeguards are not triggered for this project.

B. Introduction and Context

Country Context

Macroeconomic Environment

1. Sri Lanka is focusing on long-term strategic and structural development challenges as it strives to transition to an upper middle income country. The country has experienced fast growth over the past decade but the growth has slowed down recently. 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 noteworthy¹ 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 started to increase, as growth of per capita consumption and income of the bottom half was slower than the growth of the top half². Sri Lanka is the only country in the region that experienced an increase in consumption inequality in the last decade. In effect, rising inequality tempered the poverty-reducing impact of growth.

2. The challenging global environment took a toll on the economy with significant capital outflows, reduced exports and remittances during 2014-2015, where economic growth slowed down to around 4.9 percent. On the government side, the expansionary monetary and fiscal policy supported the growth but left the country with higher public debt and lower reserves. Increased real interest costs further restricted the government's ability to borrow at a sustainable level. Meanwhile, capital outflows from the government securities market fueled by tight global financial conditions and scheduled external debt obligations contributed to heightened exchange rate pressures³. The recent downgrading of global growth forecast due to sluggish growth in advanced economies, low commodity prices, weak global trade, and diminishing capital flows can have further impact on the economy.

3. Sri Lanka's credit rating was downgraded by Fitch and put on a negative outlook by S&P in early 2016, due to growing external and fiscal vulnerabilities. Fitch Ratings downgraded Sri Lanka's long-term credit rating by one notch to B+ from BB- with a negative outlook on February 29, 2016. The key drivers of the downgrade are the increasing refinancing risks, significant debt maturities, weaker public finances, a decline in foreign exchange reserves and a high foreign-currency debt portion in the portfolio. At the same time, favorable economic growth, human development indicators, a clean debt service record and a smooth transition of power are identified as positive factors⁴. Meanwhile, S&P kept Sri Lanka's long-term sovereign credit rating at B+, but changed the outlook to negative from stable for similar reasons on March 3, 2016. The recent rating actions can heighten the refinancing and interest rate risks mentioned above.

4. Growth is expected to continue with manageable inflation in the medium term. Growth is expected to remain at 5.3 percent in the medium term, driven mainly by capital expenditure and non-tradable sectors. Gross external financing needs are projected to be substantial, especially in 2016 and 2019, but manageable provided FDI increases. Continuation of fiscal consolidation efforts will be critical. Increasing revenues is of primary concern, but maximizing the effectiveness of expenditures, particularly investment in human capital, will also be important for fiscal consolidation.

Table 1: Key macroeconomic indicators and outlook

¹ The headcount ratio of national poverty declined from 22.7 to 6.7 percent between 2002 and 2012.

² The increase in inequality holds after removing the top 0.5 percent of households in the income distribution.

³ The International Monetary Fund's (IMF) executive board has approved a three-year \$1.5 billion loan to support Sri Lanka's economic reform agenda - <http://www.dailymirror.lk/110455/IMF-approves-blk-loan-to-back-SL-s-economic-reforms#sthash.M7d259nq.dpuf>

⁴ <https://www.fitchratings.com/site/fitch-home/pressrelease?id=1000143>.



	Actual 2014	Projections					
		2015	2016	2017	2018	2019	2020
Macroeconomic Indicators							
Real sector							
GDP, (current, LKR million)	10,448	11,183	12,335	13,541	14,856	16,346	17,927
GDP per capita, (current, US\$)	3,853	3,924	4,012	4,207	4,411	4,639	4,866
Real GDP growth (%)	4.9	4.8	5.3	5.3	5.3	5.3	5.3
CCPI inflation (%)	3.3	0.9	4.5	4.2	4.2	4.2	4.2
Overall fiscal balance	-5.7	-6.3	-5.7	-5.2	-5.1	-5.1	-4.8
Public debt	70.7	75.2	75.1	75.0	75.0	74.8	74.7
Savings ⁵	24	22.6	26.9	26.0	26.2	25.9	25.7
	Percent of GDP, unless otherwise indicated						
External sector							
Exports of goods	13.9	12.8	12.5	12.4	12.2	12.0	12.0
Imports of goods	24.3	23.0	21.2	21.7	21.9	22.1	22.3
Trade balance	-10.4	-10.2	-8.7	-9.3	-9.7	-10.1	-10.3
Remittances	8.8	8.5	8.4	8.2	8.1	7.9	7.8
External Current Account	-2.5	-2.4	-0.7	-1.5	-2.0	-2.5	-2.7
FDI inflows	1.0	0.8	1.2	1.2	1.3	1.3	1.4
Official reserves (months of imports of goods and services)	4.3	3.8	4.5	4.7	4.9	4.9	4.9
Exchange rate (end period, LKR/USD)	131.1	144.1					

Source: SL CPF FY17-FY20, CBSL, WB MFM, Ministry of Finance.

Sectoral and Institutional Context

Financial Sector Background

5. Sri Lanka has a sectoral supervisory structure, with different supervisory agencies overseeing different subsectors of the financial sector (Appendix 1A). There are three main supervisory agencies: (1) the Central Bank of Sri Lanka (CBSL) that supervises licensed banks (commercial and specialized), registered finance companies, primary dealers, and specialized leasing companies. With the passage of Microfinance Law imminent⁶, deposit-taking microfinance institutions will also be supervised by CBSL; (2) the Securities and Exchange Commission of Sri Lanka (SEC) that functions under the Ministry of Policy Planning, Economic Affairs, Child, Youth and Cultural Affairs; and (3) the Insurance Board of Sri Lanka (IBSL), which functions under the Ministry of Finance and Treasury.

⁵ Savings/GDP IMF estimates

⁶ Passed in Parliament. Speaker to signoff and Gazette notification to be issued



6. **Sri Lanka was the first country in the South Asia Region to initiate financial sector reforms about three decades ago.** Supported by the IMF and the World Bank, these reforms were mainly directed towards the banking sector and have brought substantial changes to the money market, capital market, banking activities and payment systems; and banks have become more efficient and competitive. Rapid financial sector development resulting from these early reforms have contributed positively to growth in employment and GDP⁷. However, gaps remain in the financial markets and Sri Lanka needs to further improve financial market efficiency to successfully address the growing demand and continue to contribute positively to economic growth.

7. **Structurally, the modernization and development of the financial sector, while improving over time, has not evolved with the growth of the economy in recent times.** Inadequate financial sector development is a hindrance to broader economic development and for Sri Lanka to meet its future goals, this anomaly needs to be addressed (Appendix II & III). Sri Lanka's credit to GDP ratio is lower than India and Bangladesh, and is a fraction of that of China, Vietnam and Thailand (Table 2) and below the South Asia regional average and Middle Income Country average (Figure A1: Appendix III). Banking sector is relatively stable with average capital adequacy ratios remaining above Basel III's minimum requirement and non-performing loans declining in 2015; however off balance sheet exposures have increased significantly. Comparative to regional peers Sri Lanka has room to grow in terms of assets and credit intermediation (Table 2).

Table 2: Indicators of Banking Activities for selected countries (2014)

Country	Broad Money (M2)/GDP	Bank Domestic Credit/GDP
China	193.1	141.9
India	77.4	51.6
Pakistan	52.0	15.6
Vietnam	127.5	100.3
Bangladesh	63.2	42.4
Thailand	127.8	146.8
Sri Lanka	37.7	26.8

Source: World Development Indicators

8. **The financial system in Sri Lanka is dominated by banks and state ownership (Appendix 1B).** In 2015, the banking sector comprised 25 Licensed Commercial Banks (LCB) and 7 Licensed Specialized Banks (LSB) that accounted for 59 percent of the total financial system assets⁸, of which the state-owned banks⁹ contributed to more than 44 percent. Further, the nonbank financial sector is made up of 46 financial companies and 7 specialized leasing companies that account for only 7 percent of total financial system assets. The insurance and capital markets sector account for a relatively small share of the financial sector's total assets. The 28 insurance companies represent 3.3 percent of the total assets of the financial sector, while the capital markets sector, comprising 294 companies, accounts for only 0.9 percent.

7 Hemachandra, W., 2010. Competition and Financial Sector Development in Sri Lanka. Sri Lanka Journal of Advanced Social Studies, 2(1). Available at <http://www.sljol.info/index.php/SLJASS/article/download/5119/4091>

8 http://www.cbsl.gov.lk/pics_n_docs/10_pub/_docs/efr/annual_report/AR2015/English/12_Chapter_08.pdf.

9 The state sector banks consist of two commercial banks and six specialized banks



9. **With a financial market that is dominated by the banking sector, the under-developed capital market is ill equipped to support the growth momentum that the country aspires to.** The stock market capitalization stood at US\$2,459.9 billion as at end of 2013 accounting for only 30 percent of GDP, relatively smaller than comparators; Indonesia (49 percent of GDP), Thailand (77 percent of GDP) and Malaysia (160 percent of GDP) (Figure A1: Appendix III). To-date, a majority of the public domestic debt is used in government lending activities to support State-owned enterprises' (SOE) funding needs. For example, both Ceylon Electricity Board (CEB) and Sri Lanka Ports Authority (SPA) were the top recipients of government funding, constituted about 57.1 percent of total government lending activities. There is a structural imperative underpinning the need to develop the capital markets in Sri Lanka. Long-term projects increasingly require funding from the non-public sector, emerging middle classes and substantial needs in upgrading infrastructure and urbanization, which cannot all be met via fiscal spending only. The corporate sector in Sri Lanka is subject to multiple risks that include maturity risks and interest rate risks. The overall leverage ratio of the corporate sector is very low when compared to other major emerging market countries. Fundamental issues relating to limited issuer and investor base; inefficient benchmark yield curve for government securities; an inefficient intermediation structure; lack of liquidity and inadequate financial infrastructure in the capital market remain.

10. **While there has been rapid growth in the insurance sector, this is from a very small base, and overall the insurance sector is still a small component of the financial system.** Sri Lanka is a country that is exposed to a variety of risks; yet insurance penetration is particularly low. The total assets amounted to 3.3 percent of GDP while the penetration ratio, measured as the ratio of gross written premium to GDP was only 1.09 percent in 2015 even after having increased for the past five years. This is despite the fact that the insurance sector in Sri Lanka is made up of a large number of companies. Sri Lanka lags behind in the life market in all but one of its peer group countries (Table 3). Among the 28 life and non-life insurance companies operating in Sri Lanka in 2015 two are state-owned corporations – Sri Lanka Insurance Corporation (SLIC) and National Insurance Trust Fund (NITF) which have a better distribution network than the others. The vast majority of people in Sri Lanka across product segments (life and non-life) remain untapped by the insurance market. The low insurance penetration in Sri Lanka 1.1 percent in 2015, compares unfavorably with other South Asian countries. In 2010, the insurance premium in Sri Lanka was US\$33 per capita (1.2 percent of GDP). Although this had risen slightly to US\$40 per capita by 2015, this still represented only 1.1 percent of GDP (0.5 percent for life insurance and 0.7 percent for non-life). This compares poorly with 3.3 percent of GDP in India and 4.51 percent of GDP in Malaysia and 5.8 percent in Thailand.

11. **The supervisory and regulatory structures have also not kept pace with the evolution of the financial markets.** Inadequate capacity and resources (in terms of staff, expertise and tools) to meet their expanding responsibilities has led to challenges in developing supervisory effectiveness in areas of banking, non-bank financial institutions (NBFI), capital market and insurance. Regulatory and supervisory frameworks for microfinance institutions, financial consumer protection and pensions have not been developed as yet.



Table 3: Insurance Density for selected countries (2014)

Country	Density Non-Life	Density Life (USD)
Sri Lanka	\$19.74	\$15.93
Thailand	\$82.14	\$225.89
Vietnam	\$10.08	\$12.12
Philippines	\$13.63	\$35.52
Indonesia	\$14.52	\$30.78
India	\$7.89	\$41.13

Source: AXCO Global Insurance Statistics

12. **Low efficiency in the financial sector can hamper the competitiveness of Sri Lankan private firms and job creation, while exacerbating some of the country's fiscal challenges and impacting macroeconomic stability.** For example, the operational cost management seems inadequate as the proportion of overhead costs to total assets is above the ratios of SAR, Malaysia and Thailand (Figure A2: appendix III). Further, efficiency gains can be obtained also from reducing the relatively high share of credit extended to the government and SOEs (Figure A2: Appendix III). Enhanced access to and availability of appropriate financial products, particularly for micro, small and medium enterprises (MSMEs), farmers and agribusinesses, is needed to support innovation, productivity gains and growth in the private sector. However, access to finance to MSMEs has remained limited¹⁰ in spite of increased liquidity in the banking sector. Absence of well-regulated standards and framework for financial consumer protection have led to considerable consumer detriment that span across the sectors in the financial services industry, from insurance, banking, NBFIs to even the unregulated microfinance sector. The regulatory environment has weaknesses which hinder private sector development and encourages informality. Informality in turn tends to curtail access to finance, investment, uptake of technology, and ultimately productivity gains¹¹.

13. **Lack of competitive, diversified, and well-regulated financial markets limits access to investment finance for SMEs, corporates and economic opportunities for underserved segments of the population.** For example, the analysis of commercial bank credit shows that 55 percent of the credit had been with short term (one year) maturities¹². In the agriculture, services and consumer sectors, the share of the long-term (over 5 years) credit is much less. The major constraint identified by the business enterprises especially in the manufacturing sector during the World Bank Enterprise Survey (2011) is lack of access to finance (this constraint was much more severe in the provinces outside of Western Province). Since bank lending is collateral based, smaller enterprises are particularly more constrained in accessing credit. Over 50 percent of the enterprises reported that their working capital came from their own resources.

¹⁰ 82.7 percent of adults have an account at a financial institution though only 17.9 percent of loans originated from a regulated financial institution (FSAP, 2015)

¹¹ Sri Lanka CPF, 2016.

¹² CBSL annual report, 2015.



14. **Inadequate diversification of Sri Lanka's financial system impacts financial efficiency, limits options for credit intermediation needed for greater stability, and impairs economic resilience through limited financial services.** The underdevelopment of the capital, pension, and insurance markets undermines the ability of Sri Lanka to meet the long-term financing needs of the economy¹³. For example, the benchmark yield curve for Government Securities is not well developed despite issuance of 20 and 30-year bonds by the Government of Sri Lanka. Recent issues have been in predominantly shorter tenors. There is no clear strategy for comprehensive market reforms targeting the primary market (including issuance policy), secondary markets and market infrastructure for the bond markets. Consequently, the corporate bond market remains notably underdeveloped due mainly to the lack of appetite by corporate entities to use this instrument since they are able to raise funds from banks at prime interest rates. Without an alternative avenue of long term financing from the non-bank financial sector and capital markets, the corporate sector is vulnerable to potential risks including financing, maturity mismatch risks and interest rate risks. These impediments also affect the capacity to manage some of the fiscal challenges associated with the Government fiscal deficits and the contingent liabilities arising from an aging population, natural hazards, and the economic vulnerability of the poor. Low use of technology and lack of adequate benchmarks of good governance hamper the development of the nascent capital market. Long term funding needs of SMEs, long-term infrastructure projects, and corporates cannot all be met via fiscal spending only and need a well-functioning capital market. Hence, needed are a robust regulatory framework, enabling market infrastructure, improved market efficiency—starting with a reliable benchmark yield curve—and greater market transparency to expand the narrow investor base and provide the right funding instruments.

15. **The above challenges/gaps were well identified in the recently concluded FSAP Development Module¹⁴. Furthermore, the need to overcome these challenges is articulated in the Government of Sri Lanka's development directions as outlined in recent policy statements, and endorsed via the recent Budget.** Hence, in line with its commitment to good governance and reforms, the government expressed commitment to create the enabling environment in which the financial market can operate efficiently and effectively. The Government identified capital markets to be an untapped resource in Sri Lanka with limited use of technology and a lack of adequate benchmarks of good governance. Developed capital markets offer businesses better access to low cost long term financing which is vital for expansion and growth of businesses. Similarly, developing the SME sector as a vital sector with approximately 70 percent contribution to the GDP, micro finance sector as an important economic driver providing assistance to the micro level entrepreneur to be financially inclusive, agri insurance, and pensions are other areas of key importance highlighted in the budget¹⁵.

16. To address the constraints identified above, one set of key actions Sri Lanka needs to undertake is to strengthen financial sector market infrastructure, enhance regulatory capacity and deepen financial markets to support better development of longer term access to finance. **A strong regulatory and supervisory capacity is essential for maintaining the stability and efficiency of the financial system.** For the banking sector, the

13 In a report prepared for the Colombo Stock Exchange in 2012, McKinsey & Company estimated that in order to sustain the 8.0 percent growth rate, the government needs to mobilize at least US\$300 billion over the next 8 years.

14 Dominance of the commercial banking system and absence of a vibrant capital market were also identified as constraints in a number of previous reports; by ADB (2005), IMF/World Bank's FSAP (2007) World Bank study on "South Asian Bond Markets – Developing Long Term Financing For Growth" in 2008, the Financial Policy Note of the World Bank in 2012 and World bank study on "Unlocking Sri Lanka's Financial Resources: Role of Capital Markets in providing Long Term Financing" in 2015.

15 Sri Lanka Government Budget, 2015



capacity of CBSL (last supported under an IDA project in 2000/05), must be strengthened and updated to meet the growing complexity and evolution of financial markets. The capacity enhancement of CBSL will help the regulator to better supervise and monitor the banking and non-banking sectors thus mitigating risks to the sector stability and achievement of financial sector stability objective of CBSL. Similar support is required to develop Sri Lanka's underdeveloped insurance and capital market sectors through support to the IBSL and SEC. In Sri Lanka, despite the large number of insurance companies (28), the outreach of insurance remains very low. Globally, it is well understood that good regulation and supervision is a foundation for the development of effective insurance markets; the lack of which, can pose challenges for effective supervision resulting in regulatory arbitrage and gaps, which may have an impact on the stability of the financial system. At the same time, capital markets have the potential to be powerful engines of economic growth in developing nations. An efficient stock market provides the public with investment opportunities and mobilizes their savings, as well as international capital, for productive corporate financing. Thus, the capital market must provide convenient and uncomplicated access for all parties while assuring transparency and fairness throughout. 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 the international standards.

17. **Bond market development** is crucial given that the Sri Lankan capital market is an under-developed/untapped resource that could have provided long-term financing to help fill the gap in infrastructure investments. By providing an alternate avenue for financing of such projects, it would mitigate crowding out of financing of SMEs by banks. The planned bond market development activities would strengthen the government bond market as a reliable source of price reference for other financial and capital market products and contribute to reduced vulnerability to financial shocks and facilitate the development of a deeper, liquid and more stable capital market in Sri Lanka.

18. Sound macroeconomic policies, strong legal framework and institutional set-up alone are not sufficient for capital markets to flourish. They need to be complemented by **a well-developed financial market infrastructure to facilitate trading and the exchange of information**. In addition to trading platform and settlement systems, there is a need to establish online reporting system to process, evaluate, and validate the information being produced and used by capital markets, and surveillance systems to ensure that there is market abuse prevention. Similar online reporting systems are needed for the insurance sector. Strengthening of Central Bank infrastructure including the payment system would enable efficient and equitable island-wide provision of core central banking activities thereby support the flow of credit to underserved areas in a more equitable manner across all administrative districts; thus facilitating greater inclusion and support achievement of economic development objective of CBSL.

19. **The proposed project would complement other ongoing efforts to address constraints that can unleash the country's growth potential.** It would also complement other parallel and independent efforts of the government, the regulators and other development partners. Accordingly, the project aims to support modernizing the financial sector and addresses many of the constraints identified above. The requests from the three regulators for this project - endorsed by Department of External Resources (ERD) of the Ministry of Finance (MoF) - focuses mainly on strengthening the financial market regulations and infrastructure, capacity



of regulators/supervisors, and the development of the long term financing (debt and equity) markets to spur growth and investments.

Relationship to CPF

20. **The proposed operation is well grounded in the World Bank's Country Partnership Framework (which will be discussed by the Executive Directors on June 28, 2016) objective of private sector development; social and financial inclusion; and governance and security.** The work contributes 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 and the promotion of more and better-paying private sector jobs for the bottom 40 percent. Specifically, the planned activities will directly facilitate the achievement of Objective 1.3: *improving efficiency and inclusion in financial services*. Further it is envisaged that the proposed work on capital market development will also complement the activities on pension systems (Objective 2.2)¹⁶ and debt management (Objective 1.1)¹⁷. The CPF identified that the future WBG initiatives will focus on activities including: (a) strengthening and enhancing regulatory, supervisory and governance structures in line with international standards; (b) supporting access to finance for MSMEs as well as underserved segments through banks and NBFIs by developing strategy, capacity as well as provide financing; (c) deepening the capital market through necessary legal, regulatory and market infrastructure, and introducing new products, instruments and markets, and (d) developing the credit and financial infrastructure. The proposed project expects to cover each of these areas.

21. **Overall, the project will support building a stronger financial sector.** The planned parallel interventions with the three key regulators will contribute to macro-financial stability and facilitate improved financial intermediation, thus promoting inclusive growth and contributing to the World Bank Group's twin goals. This is expected to contribute to intensifying financial deepening and inclusion, expanding outreach of regulated financial services, and enabling more responsible financial services to all. Sri Lanka will need to develop a financial sector which is stable and capable of efficient financial intermediation to the productive sectors of the economy, allowing a boost to capital accumulation and investment to generate faster growth that will sustain its aspirations as a middle-income country (MIC).

¹⁶ Objective 2.2. Improving health and pension systems to address the challenges of the demographic transition (non-contributory civil service pension system)

¹⁷ Objective 1.1. Improving public sector capacity for enhanced efficiency, effectiveness and accountability



C. Proposed Development Objective(s)

The proposed project development objective is to strengthen institutional capacity of key financial sector regulators and market infrastructure to contribute to enhancing financial market stability, efficiency, inclusiveness, and depth

This will be achieved by assisting the Central Bank of Sri Lanka (CBSL), the Securities Exchange Commission of Sri Lanka (SEC) and the Insurance Board of Sri Lanka (IBSL) to (a) improve the delivery of their main functions efficiently in accordance with relevant international standards (b) adopt effective regulatory and institutional framework and infrastructure and (c) strengthen their institutional capacity in carrying out their operations. Through the modernization program the country can achieve: (a) a more stable and efficient financial system; (b) better access to finance in the society; (c) improved governance in the financial sector; and (d) smoother implementation of government debt management strategy. Weaknesses in the financial sector can significantly slowdown economic growth. Lack of competitive, diversified, and well-regulated financial markets limits the access to investment finance for SMEs, corporates and the society. Hence, it is expected that outcomes of this project would enhance efficiency and inclusion in the financial sector, which would play an important part in enabling sustainable and inclusive growth. A developed financial sector would support job creation and improve competitiveness, thus providing better economic opportunities to the underserved segments of the population in Sri Lanka.

Key Results (From PCN)

22. The PDO is expected to be measured through the following tentative key performance indicators:

- a. **Market infrastructure:** the online reporting systems/data platforms of all three regulators relating to risk based supervision installed; payment & settlement infrastructure upgraded; trading platform, CCP and back office system established (Efficiency indicators - growth of financial accounts and automated transactions, increase usage of financial services by the public).
- b. **Regulatory and Supervisory Capacity Building:** Financial sector laws and prudential regulations consistent with international standards established, Adequate systems for risk based & proportionate off-site/on-site supervision established; (efficiency indicators - compliance to risk based capital/supervision requirements by intermediaries- fully compliant/partially compliant/non-compliant, liquid yield curve established, bond investor financing is maintained and increasing in volume).

D. Concept Description

23. The proposed Project will include the following four components: (i) Support to modernize and develop the CBSL and the Bond Market; (ii) Support to modernize and improve the capacity of the IBSL; (iii) Support to modernize the capacity of SEC; and (iv) Support for project coordination, implementation and monitoring.

Component 1: CBSL Modernization and Bond Market Development

24. **Strengthening regulatory and supervisory capacity of CBSL:** The proposed component will focus on effective implementation of regulatory and supervisory framework, and compliance with international best practice. The areas would include update and streamline of financial sector laws and regulations in line with the market and international best practice; implementation support and capacity building to establish



risk based supervision for banks and non-banks, establishment of institutional & regulatory framework for microfinance; establishment of institutional & regulatory framework for financial consumer protection; establish professional investment policy for the Employees Provident Fund (EPF) that would streamline and restructure the fund management practice; comprehensive diagnostic analysis and preparation of an action plan for the improvements needed for the national payment system; self-assessment of the LankaSecure and LankaClear systems based on the Principles for Financial Market Infrastructures using the assessment methodology as prescribed by CPMI-IOSCO; and assistance in implementation of ISO messaging standard20022 for payment systems and related systems.

25. **Bond market development¹⁸**: The proposed activities will focus on enabling institutional framework for government bond market development and issuance of related regulations/procedures and supervision; comprehensive diagnostic analysis and preparation of an action plan for the primary market and international benchmarking as well as design and implementation support for the issuance policy to support benchmark building; design and implementation support for a liability management (lm) program; analysis of auction data and procedures/rules, recommendations to address regulatory and tax framework bottlenecks for different types of non-government products, investor base - mapping of the current investor base and trends by different investor segments; action plan and implementation of measures to diversify the investor base; preparation of an action plan for the secondary market operations, international benchmarking; and debt market development workshops/trainings.

26. **Market infrastructure**: The market infrastructure development support will be considered for Large Value Payment System (LVPS) that may include upgrading of the existing system/components, multicurrency support and convertibility, participant monitoring system for regulatory purposes and to facilitate effective implementation of monetary policy; Retail Transaction System through support to develop the next phases of common payment switch (LankaClear); A standardized platform with a single database for EPF and clear data set of EPF members (presently housed in two different databases in CBSL and labor ministry); Strengthening of CBSL IT infrastructure to enable efficient and equitable island-wide provision of core central banking activities and services; and a bond trading platform for the government bond market including clearing and settlement infrastructure.

Component 2: IBSL Modernization

27. **Strengthening regulatory and supervisory capacity of IBSL**: The insurance industry has undergone changes with IBSL having revised the regulatory framework. With effect from 1st January, 2016, IBSL implemented Risk-Based Capital (RBC) framework and moved away from the conventional rule-based solvency framework. To be more efficient, the planned activities will facilitate the complete migration of

¹⁸ In terms of Section 113 of the Monetary Law Act No. 58 of 1949, CBSL is entrusted with carrying out the function of debt management on behalf of the Government of Sri Lanka. In complying with this legal obligation, the Public Debt Department of CBSL raises debt, both domestic and foreign commercial debt, through various debt instruments in the domestic and international markets, services both foreign and domestic debt, ensures the smooth functioning of the Government securities market and manages risks in the domestic debt portfolio.



IBSL to a Risk Based Supervision (RBS) framework; setting up of an early warning system under the RBS regime, thereby evolving the supervisory process towards one that is more anticipatory; improving insurance penetration via the development of a dedicated Micro Insurance (MI) regulatory and supervisory framework along with advice on restructuring existing products and distribution system with related capacity building and assistance in product development; review of compulsory motor third party liability insurance legal framework and market practice; and review of the legal framework and market practices (considering improvements in data collection, premium and reserve calculation). The modernization component will aim at strengthening the capacity of IBSL to regulate and supervise the insurance/reinsurance pension sector. Enhancing the capacity of IBSL is meant to address the skills constraints and data needs for the market as well as to set up sound legal, regulatory and supervisory frameworks to improve supervision combined with strong infrastructure which are essential for ensuring a secured and resilient insurance sector.

28. **Market infrastructure:** This component will include implementation of a stable and secured ICT, including cybersecurity infrastructure. An IT system for online filing of returns to facilitate better supervision that includes developing/procuring a risk based supervision diagnostic tool and scoring system including RBS risk scoring system (including quantitative modeling).

Component 3: Modernization of SEC

29. **Strengthening regulatory and supervisory capacity of SEC:** Developed capital markets offer businesses better access to low-cost long-term financing which is vital for expansion and growth of businesses. The limited use of technology and a lack of adequate benchmarks for good governance have hindered the reforms process thus far. Against this backdrop, SEC is keen to create a fair and efficient environment that is conducive to all market participants which would ultimately support the aspirational economic growth targets of the country. The proposed activities include implementation of Risk Based Supervision and Risk Based Capital Structure for market intermediaries; training and capacity building of SEC to implement the RBS approach; advisory support on establishment of the Central Counterparty system (based on the initial evaluation); enabling XBRL reporting in the market, and developing legal, regulatory and operational framework for market intermediaries.

30. **Market infrastructure:** This component will include establishment of online market surveillance system, online reporting system to streamline regulatory filing, enabling XBRL format reporting, Central Counterparty and common back office system.

Component 4: Project implementation and monitoring:

31. This component will support the regulators' capacity in project implementation and in developing a strong monitoring and evaluation mechanism. It will include costs for project management, M&E, capacity building as well as Governance and Accountability Action Plan (GAAP) implementation. GAAP would focus on non-fiduciary governance issues, such as eligibility criteria, compliance, and citizen feedback, as well as other governance issues relevant to the project. The Project Implementation Units (PIUs) if required, will engage/train additional staff, including recruitment of consultants to manage and monitor project



activities.

SAFEGUARDS

A. 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.

B. Borrower's Institutional Capacity for Safeguard Policies

A comprehensive policy and regulatory framework for the conservation of natural resources and environmental management is in existence Sri Lanka. The Central Environmental Authority (CEA) is the key regulatory body that is mandated by the National Environmental Act (NEA) to implement all regulatory provisions outlined in its statutes. The CEA has the mandate on implementing regulatory provisions on Pollution management and the Ministry of Mahaweli Development and Environment (MoMDE) is the policy making body which ensures the management of E-Waste. In Sri Lanka the Hazardous Waste (Scheduled Waste) Management rules were first announced under the National Environmental Act in 2008 under the Gazette Extraordinary 1534/18. As per this regulation E – Waste has been categorized as a scheduled waste and every generator, collector, store, transporter, recover, recycler and disposer need to obtain a license from the CEA. In addition the MoMDE national policy on e-waste management has already been drafted and plenty of public private partnerships have been established between the CEA and private companies to manage e-waste in a sound manner. The Electronic Waste Management Project, implemented under the purview of the CEA has signed 14 MOUs with large scale private companies in an effort to manage the e-waste. According to the CEA directive on E – Waste management, E-waste can only be disposed via this list of published authorized collectors, certified by the CEA. In addition the CEA conducts collection drives in collaboration with these organizations targeting government institutions as well.

C. Environmental and Social Safeguards Specialists on the Team

Mohamed Ghani Razaak, Mokshana Nerandika Wijeyeratne

D. 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 Manuel 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.

E. Safeguard Preparation Plan

Tentative target date for preparing the Appraisal Stage PID/ISDS

Sep 19, 2016

Time frame for launching and completing the safeguard-related studies that may be needed. The specific studies and their timing should be specified in the Appraisal Stage PID/ISDS

No other safeguards assessments envisaged. It is proposed in Section D that the guidelines on the waste management as per the national regulations will be included in the project Operations Manual.

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APPROVAL

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