



Report and Recommendation of the President to the Board of Directors

Project Number: 46924
January 2013

Proposed Senior Unsecured Loan Nations Trust Bank Small and Medium-Sized Enterprises Finance Project (Sri Lanka)

This is an abbreviated version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communication Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 December 2012)

Currency unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.0077
\$1.00	=	SLRs130.25

ABBREVIATIONS

ADB	–	Asian Development Bank
CAGR	–	compound annual growth rate
CBSL	–	Central Bank of Sri Lanka
CFC	–	Central Finance Limited
GDP	–	gross domestic product
IFC	–	International Finance Corporation
IFI	–	international financial institution
JKH	–	John Keells Holdings Limited
NTB	–	Nations Trust Bank
NPL	–	nonperforming loan
SMEs	–	small and medium-sized enterprises

NOTES

- (i) The fiscal year (FY) of the Nations Trust Bank ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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PROJECT AT A GLANCE

1. Project Name: Small and Medium-Sized Enterprises Finance Project		2. Project Number: 46924	
3. Country: Sri Lanka		4. Department/Division: Private Sector Operations Department Private Sector Financial Institutions Division	
5. Sector Classification:			
Sectors		Primary	Subsectors
Finance		√	Banking systems, small and medium-sized enterprises finance and leasing
6. Thematic Classification:			
Themes		Primary	Subthemes
Economic growth		√	Promoting economic efficiency and enabling business environment, widening access to markets and economic opportunities
Private sector development		√	Private sector investment
6a. Climate Change Impact:		6b. Gender Mainstreaming:	
Adaptation		Gender equity theme	
Mitigation		Effective gender mainstreaming	
Not applicable	√	Some gender elements	√
		No gender benefits	
7. Targeting Classification:		8. Location Impact:	
General Intervention	Targeted Intervention		
	Geographic Dimensions of Inclusive Growth	Millennium Development Goals	Income Poverty at Household Level
√			
9. Nonsovereign Operation Risk Rating : 10			
10. Safeguard Categorization:			
Environment		FI (treated as C)	
Involuntary resettlement		FI (treated as C)	
Indigenous peoples		FI (treated as C)	
11. ADB Financing:			
Sovereign/Nonsovereign	Modality	Source	Amount (\$ million)
Nonsovereign	Loan	Ordinary capital resources	\$15.0
12. Cofinancing: None			
13. Counterpart Financing: Not applicable			
14. Aid Effectiveness: Not applicable			

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed senior unsecured loan of \$15,000,000 to the Nations Trust Bank (NTB) for the Small and Medium-Sized Enterprises Finance Project in Sri Lanka.¹

II. THE FINANCIAL INTERMEDIARY

A. Investment Identification and Description

2. Sri Lanka's economy is performing well. Its gross domestic product (GDP) growth rate ranged from 6% in 2008 to 8.3% in 2011.² Since the end of a civil war in 2009, income levels have risen by 16%, consumer sentiment has improved, and many Sri Lankans who left the country during the conflict have been returning.³ Poverty levels have declined due to economic growth and pro-poor, pro-rural policy actions by the government.⁴ The main support for economic growth has come from the services and tourism sectors. Many companies engaged in these sectors are small and medium-sized enterprises (SMEs), which are often described as the backbone of the Sri Lankan economy. They contribute about 70% of GDP and provide significant employment.⁵ The country's current critical challenges are to continue providing opportunities to foster equitable development while dealing with vulnerabilities facing the economy, including a growing government budget deficit and inflation.⁶

3. Economic recovery has steadily increased the demand by SMEs for finance. SMEs in the northern and eastern post-conflict provinces of the country and in the southern provinces affected by the 2004 tsunami are in particular need of funding to expand or start new businesses and help reduce current high levels of unemployment.⁷ Primarily due to low financial sector development, however, SMEs face difficulties accessing funding, particularly longer-term finance. An International Finance Corporation (IFC) survey in 2011 found that 30% of firms in Sri Lanka identified access to finance as a major constraint, compared with 25% of firms in South Asia overall.⁸ Additional obstacles to SME borrowing include the perception of heightened risk because many of potential SME customers are self-employed; the underdevelopment of specialized credit analysis techniques at banks; and the fact that SMEs cannot afford the loan terms now available at the lower end of the market. Women in South Asia have more difficulty obtaining finance than men do, due to both financial and nonfinancial barriers. This was highlighted by the IFC survey, which stated that the region had only 0.2 million women borrowers, compared with 5.3 million women borrowers in East Asia.⁹

¹ The design and monitoring framework is in Appendix 1.

² Economist Intelligence Unit. 2012. *Country Report Sri Lanka*. London (May).

³ Lanka Business Online. 2011. *Income Measure*. <http://www.lankabusinessonline.com/fullstory.php?nid=337556589>

⁴ In 2010, 8.9% of the population lived below the poverty line. The poverty rate had declined to 7.7% in the rural sector and to 9.2% in the estate sector. Source: ADB. 2011. *Country Partnership Strategy: Sri Lanka, 2012–2016*. Manila; and ADB. 2012. *Asian Development Outlook 2012*. Manila.

⁵ Nations Trust Bank. 2012. *Nations Trust Bank PLC Annual Report 2011*. Colombo (February). SMEs account for 50% of private sector and 60% of government employment. <http://www.switch-asia.eu/?id=298>

⁶ Citibank. 2012. *Sri Lanka in a Flash—2013 Budget*. Hong Kong (9 November).

⁷ A 2010 survey published by the Hambantota District Chamber of Commerce in the country's south showed the rate of unemployment in the area to be around 9.3%, compared with the national level of 6.5%. <http://www.asiatuscanyetworkfordevelopment.org/project/i-paesi/sri-lanka>.

⁸ IFC. 2011. *Enterprise Surveys: Sri Lanka*. www.enterprisesurveys.org

⁹ IFC. 2011. *Strengthening Access to Finance for Women-Owned SMEs in Developing Countries*. Washington, DC; and McKinsey women SME mapping exercise 2011. McKinsey-IFC SME database; Enterprise Survey; International Labour Organization. 2011. *Human Development Report*. Washington; and team analysis.

4. The private commercial banking sector in Sri Lanka can play a more important role in supporting SMEs, overall economic growth, and financial inclusion.¹⁰ Although public sector banks make up more than half of banking sector assets, they tend to lend only to certain customers to the exclusion of others.¹¹ The banking sector's total loan portfolio was about 40% of GDP in 2011, an increase from 35% in 2010.¹² Domestic credit provided by the sector was 46% of GDP at the end of 2011,¹³ but this compared poorly with the ratios in Sri Lanka's lower-middle-income-country peer group (57%) and its South Asia peer group (68%).¹⁴ This means that, in terms of banking sector domestic credit provision, Sri Lanka's performance is close to that of a low-income nation, even though it is classified as a lower middle-income country. In addition, bank financing is predominantly short-term. This is due to prolonged political turmoil, the aftereffects of the 2008–2009 global financial crisis, and the country's underdeveloped financial sector. The domestic capital market, which is typically a source of long-term funding in many countries, is still limited.¹⁵ Compounding these issues is a high current account deficit and the need to bridge an external funding gap, which has led the government to encourage banks to seek overseas borrowings.¹⁶

5. The Asian Development Bank (ADB) met with several banks in 2011 to identify a suitable financial institution for support through long-term funding that would increase private commercial bank lending to SMEs and underserved customer segments. NTB, a medium-sized bank and a participant in ADB's Trade Finance Facilitation Program, was selected as a partner bank for the project for several reasons.¹⁷ First, NTB is the first commercial bank in Sri Lanka to emphasize SME lending with a goal of promoting more equitable inclusive growth across the country and, in particular, in post-conflict regions.¹⁸ NTB has a strong SME platform and has been receiving technical advisory services from the IFC since 2004 for credit risk assessment and customer capacity building.¹⁹ The bank's retail and SME division is its largest single business. Second, NTB's large 53-branch network includes 18 outside of the capital, Colombo, 6 of which are in northern and eastern post-conflict regions of Sri Lanka. This will help it access and serve the areas hardest hit by the civil war, as well as underserved customers outside the main urban areas.²⁰ All of NTB's branches support SME lending. Third, NTB's credit is sound and its credit rating is close to those of some larger commercial banks in the country, despite its ranking as sixth in size based on assets (\$775.5 million).²¹ In January 2012, Fitch Sri Lanka gave NTB a stable A rating, which was one notch higher than Seylan Bank's and one notch lower than those accorded to Hatton Bank and Sampath Bank (footnote 11).

¹⁰ This refers to the access and use by SMEs of financial services, as reflected in deposit and loan accounts, use of credit services, and specialized finance products. SMEs represent a key target segment for financial inclusion.

¹¹ Fitch Ratings. 2012. *The Sri Lankan Banking Sector: Special Report*. Colombo (January).

¹² Central Bank of Sri Lanka (CBSL). 2011 *Annual Report December 2011*. Colombo (Table 8.4, December).

¹³ World Bank (<http://data.worldbank.org/indicator/FS.AST.DOMS.GD.ZS>). Extracted May 2012.

¹⁴ World Bank. 2012. *World Bank List of Economies*. Washington, DC (April).

¹⁵ CBSL. 2011. *Monthly Bulletin December 2011*. Colombo (Table 69B, December).

¹⁶ Citibank. 2012. *Sri Lanka Macro View*. Colombo (20 February).

¹⁷ ADB. 2003. *Report and Recommendation of the President to the Board of Directors: Proposed Trade Finance Facilitation Program*. Manila.

¹⁸ The public sector has been involved in SME financing for the following: ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Loans, Partial Guarantee, and Technical Assistance to the Democratic Socialist Republic of Sri Lanka: Small and Medium Enterprise Sector Development Program*. Manila; ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loan Democratic Socialist Republic of Sri Lanka: Small and Medium Enterprise Regional Development Project*. Manila; and ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loans Democratic Socialist Republic of Sri Lanka: People's Leasing Company Limited and Commercial Leasing Company Limited*. Manila. However, these were all carried out before the civil war ended.

¹⁹ IFC was a shareholder of NTB until 2004 and continues to provide technical advisory services to the bank.

²⁰ NTB. 2012. *Nations Trust Bank PLC Annual Report 2011*. Colombo; and NTB management.

²¹ Comparison between private commercial banks in Sri Lanka by NTB in June 2012. Total assets as of end 2011. Using the exchange rate of \$1 = SLRs130 as of 1 September 2012.

6. **Project description.** The project entails a \$15 million, 5-year ADB loan to NTB for onlending to SME borrowers. The project will help meet rising demand for financing by SMEs and give them better access to funding. It will also support the growth of Sri Lanka's banking sector by providing longer-term financing. To promote inclusive financial development, the project will include geographic targets for NTB onlending in post-conflict areas, as well gender lending targets to support women involved in SMEs.

B. Business Overview and Strategy

7. NTB was founded in 1999 as a licensed commercial bank.²² NTB's principal activities are retail, corporate, and SME lending. Product lines include credit cards, deposits and loans, leasing, factoring, remittances, trade finance, and treasury services. NTB is the sole franchisee of American Express credit cards in Sri Lanka. The bank has a large network of branches, including a presence in the northern and eastern provinces of the country (para. 5). As of June 2012, NTB had 61 ATMs, one leasing center, seven personal banking centers, and 1,984 employees (footnote 20). NTB also has four wholly owned subsidiaries: (i) Waldock Mackenzie (fixed income trading); (ii) Allied Properties (commercial property); (iii) Mercantile Leasing (operating leases); and (iv) Nations Insurance Brokers (insurance brokerage).²³

8. **Small and medium-sized enterprises.** NTB began lending to SMEs in 2003. The bank established a separate SME unit in 2010 and began implementing a stronger strategic approach to SME lending in 2011. NTB plans to grow its SME business through its branch network expansion and by offering new products to provide working capital and finance trade and capital expenditures. The bank will also provide valuable nonfinancial services to SMEs to help strengthen their capacity.

9. NTB tailors its relationship management approach and product offering to SMEs according to customer segments. It defines SMEs as firms with an annual turnover of up to SLRs600 million. NTB has added a dedicated SME desk to all of its branches. In 2011, NTB had four regional SME centers outside Colombo (Anuradhapura, Batticaloa, Galle, and Kurunegala) where the potential for acquiring SME customers is high. Each center is a one-stop shop for SME customers and offers SME advisory services on top of the full range of corporate banking products and services. Through these centers, NTB can implement its structured customer acquisition process, maximize cross-sale opportunities, and position NTB as a provider of total solutions to SMEs.

Ownership, Management, and Governance

10. **Ownership.** NTB was established in 1999 by John Keells Holdings (JKH), Central Finance (CFC), and the IFC. NTB shares are currently held by JKH (29.9%), CFC (20%), Development Finance Corporation of Ceylon Bank (9.9%), Hong Kong and Shanghai Banking Corporation (7.9%), and the public (32.3%). JKH is one of the largest listed conglomerates in Sri Lanka, with interests in retail, financial services, leisure, plantations, services, property, and transportation. Its assets totaled SLRs133.9 billion at the end of March 2012. CFC is a publicly listed financial services company that offers leases, hire purchase financing, and consumer credit in Sri Lanka. Its total assets were SLRs53.5 billion as of 31 March 2012. NTB was listed on the

²² CBSL issues banking licenses for two categories of banks: licensed commercial banks and licensed specialized banks. The main difference is that, unlike licensed specialized banks, licensed commercial banks are permitted to accept demand deposits from the public and can act as authorized dealers in foreign exchange, which entitles them to engage in a wide range of foreign exchange transactions.

²³ ADB. 2012. *ADB TFP: Sri Lanka Country Report and Annual Reviews for Eight Sri Lankan Banks*. Manila.

Colombo Stock Exchange in 1999. JKH and CFC may reduce their shareholdings to 15% due to regulatory requirements.²⁴

11. **Management.** NTB's senior management team comprises seasoned banking executives with extensive banking experience in Sri Lanka. The chief executive officer, R. Fernando, has been with NTB in 2001. The chief financial officer joined the bank 2 years ago and together with the chief executive officer, they bring a total of 47 years of international and domestic banking and finance experience to NTB.²⁵ NTB has four management committees: (i) an assets and liabilities committee, which meets monthly or every 2 weeks as needed; (ii) a head office credit committee, which is responsible for credit risk management; (iii) an information technology steering committee; and (iv) a customer service steering committee.

12. **Governance structure.** NTB's board of directors comprises 12 members who bring extensive international banking and other professional experience to NTB. The board includes five independent non-executive directors, five non-executive directors, and two executive directors. The positions of the board chair and chief executive officer are separate. The board is chaired by J. Peiris, who is a director of JKH and has more than 40 years of finance and general management experience. The board approves and monitors the implementation of NTB's strategic plan and key policies through six board committees and the key management personnel it appoints. The board has a (i) supervisory committee, (ii) an audit review committee, (iii) an integrated risk management committee, (iv) a nominations committee, (v) a human resources and remuneration committee, and (vi) a credit committee.

C. Financial Performance

13. NTB experienced strong growth during 2007–2011. Total assets increased from SLRs49.0 billion at the end of 2007 to SLRs100.8 billion at the end of 2011, generating a CAGR of 15.5%. Gross customer loans grew from SLRs29.9 billion at the end of 2007 to SLRs60.8 billion at the end of 2011. Total customer deposits also grew robustly at a CAGR of 18.9% during 2007–2011, from SLRs28.0 billion to SLRs66.5 billion. The table below provides financial highlights of NTB's performance from the end of 2009 to the end of June 2012.²⁶

Nations Trust Bank Financial Highlights (SLRs million)

Item	2009	2010	2011	June 2012 (Unaudited)
Total assets	69,978,230	82,416,846	100,821,640	118,376,587
Gross customer loans	34,539,757	43,631,157	60,794,418	71,619,582
Total deposits from customers	44,218,855	48,348,306	66,497,627	81,420,875
Total shareholder's equity	4,186,187	6,131,519	7,774,970	8,116,297
Net income	501,801	1,001,937	1,370,928	1,651,204
Net interest margin (%)	5.85	6.27	4.97	4.62
Cost to income ratio (%)	64.09	67.86	72.59	66.93
Gross NPL ratio (>90 days) per NTB (%)	8.50	4.80	2.83	2.92
Return on average equity (%)	12.36	19.42	19.72	20.78
Return on average total assets (%)	0.74	1.31	1.50	1.51
Capital adequacy ratio (%)	15.14	14.91	16.62	13.57

²⁴ Lanka Business Online. 2012. *Time Please*. <http://www.lankabusinessonline.com/fullstory.php?nid=1573586845>. In 2007, the CBSL restricted the ownership of licensed commercial banks to 10% of shares with voting rights, although this can be raised to 15% with CBSL approval. JKH requested a waiver on this restriction from the CBSL, and JKH has not had to reduce its stake while an official CBSL decision on the matter is pending. No time frame has been set for this decision.

²⁵ For an overview of NTB's senior management team, see Ownership, Management, and Governance (accessible from the list of linked documents in Appendix 2).

²⁶ Financial Analysis (accessible from the list of linked documents in Appendix 2).

Item	2009	2010	2011	June 2012 (Unaudited)
Average exchange rate (SLRs per US dollar)	114.35	110.95	115.40	133.26

ADB = Asian Development Bank, NTB = Nations Trust Bank, NPL = nonperforming loan.

^aIncludes loans on non-accrual status for which full payment is doubtful based on the assessment of management, and restructured loans that would otherwise be past due or impaired.

Sources: NTB and ADB.

14. **Capitalization.** NTB is well capitalized with a Tier 1 capital adequacy ratio (CAR) of 12.5% (based on Basel II standards). Its total CAR was 16.6% at the end of 2011 and 13.57% in June 2012. NTB compares favorably with the average banking sector Tier 1 capital ratio of 12.7% and total CAR of 14.3% at the end of 2011. NTB also exceeds the local regulatory minimum ratios of 5% and 10% and the Bank of International Settlements standards of 4.5% and 8% for Tier 1 capital ratio and total CAR, respectively.²⁷ NTB's CAR improved by 1.7% in 2011 from 2010 due to a capital infusion through subordinated debentures of SLRs2 billion, retained earnings from net income of SLRs1.3 billion, and the conversion of SLRs733 million in warrants.

15. **Earnings.** NTB's net annual income grew steadily from SLRs500 million in 2009 to SLRs1.4 billion in 2011 and to SLRs 1.6 billion in the 6 months to the end of June 2012 supported by both interest and non-interest income. Net income grew 36.8% in 2011 and 20.5% in the 6 months to the end of June 2012. This growth was helped by improved debt recovery. Although operational costs increased due to branch network expansion, recruitment of additional staff, and continuous upgrading of management information systems, profits remained strong. This interest rate restriction and expenses from the bank's continued expansion could put profitability under pressure in the future.

16. **Funding and liquidity.** NTB has diversified sources of funding. Time deposits accounted for 77.4% of customer deposits at the end of June 2012, up from 71.0% in 2011. As of 30 June 2012, NTB's funding structure comprised customer deposits (68.7%), borrowings (19.0%), equity and retained earnings (6.8%), and others (5.5%).²⁸ NTB's loan-to-deposit ratio has been stable: 90.2% in 2010, 91.4% in 2011, and 87.9% in June 2012.

17. **Loan portfolio and asset quality.** NTB's loan portfolio grew by 39.3% in 2011, which was faster than the sector average of 31.9%.²⁹ The growth resulted from increases in the retail and SME lending, leasing, credit card, and corporate banking business lines. About 80% of the bank's business was being done in Colombo.³⁰ NTB's SME portfolio covers all these lines but is concentrated in the manufacturing, trading, and services sectors.

18. Better political and economic conditions and the government's recovery efforts have helped reduce NTB's nonperforming loan (NPL) rate to 2.8% at the end of 2011 and 2.9% in June 2012 from 4.8% at the end of 2010. This was lower than the sector average of 3.8% as of end of 2011. Despite the 39.3% loan growth in 2011, NPLs decreased by 19% to SLRs2.7 billion from SLRs3.3 billion in 2010. NTB's loan loss coverage ratio was 35.2% at the end of 2011, compared with the sector average of 57%, and stood at 32.9% at the end June 2012. This lower than sector average for loan loss coverage is because consumer and leasing loans form a larger portion of NPLs (60%) and the majority of this portfolio is collateralized (70%) by cash, land, government securities and vehicles and, as such, requires a lesser coverage.³¹ In addition to making

²⁷ CBSL. 2012. *Annual Report 2011*. Colombo (March, end-of-2011 figures are provisional).

²⁸ Nations Trust Bank. 2012. *Annual Report 2011*. Colombo (March and unaudited 6-month management financials).

²⁹ CBSL. 2012. *Annual Report 2011*. Colombo (March, end-2011 figures are provisional).

³⁰ SME loans are provided in most sectors. They are defined as SMEs if they have a turnover of below SLR600 million.

³¹ According to the CBSL, banks are exempted from maintaining a general provision in respect of credit facilities secured by cash deposits, gold, or government securities with the same bank.

provisions for NPLs, NTB maintains a general provision of 0.5% on all its performing loans, as required by the CBSL.

III. THE PROPOSED ADB ASSISTANCE

A. The Assistance

19. ADB proposes to provide a senior unsecured loan of \$15 million to NTB with a term of 5 years to support SME lending. The ADB proceeds will be onlent to SMEs that have an annual turnover not exceeding SLRs600 million. This definition of SLRs600 million is consistent with the CBSL definition.³² The project will aim to ensure that a minimum of 50% of ADB's facility in SLRs equivalent will be onlent to SMEs outside Colombo and that 30% of this 50% targeted will be onlent to SMEs in the northern, eastern, and southern provinces that were most affected by the civil war and tsunami and are in particular need of access to finance to expand or start new businesses and reduce high levels of unemployment (footnote 7). To promote access to finance for women, 20% of the ADB's facility in SLRs equivalent will be onlent to SMEs owned or controlled by women borrowers.³³

B. Implementation Arrangements

20. **Reporting arrangements.** NTB will be required to provide (i) unaudited semiannual financial statements; (ii) audited annual financial statements; (iii) semiannual compliance certificates for agreed-upon financial covenants; (iv) semiannual reports on the SME portfolio, which will include data on loans extended to women and to geographic areas; and (v) an annual environmental and social performance report, including a report on SME loans taken by women. Pursuant to ADB's *Operations Manual* governing nonsovereign operations, monitoring reports will be prepared on a regular basis and at least annually.³⁴ The first monitoring report will be prepared no later than 12 months after project approval by the ADB Board of Directors.

C. Value Added by ADB Assistance

21. ADB's value addition to the project is expected to be the following:
- (i) ADB will provide critically needed long-term funding to NTB, which will in turn give SMEs better access to financing, thereby overcoming one of the largest obstacles to their growth. With ADB's project loan, NTB will be able to extend the terms of SME financing to 5 years.
 - (ii) ADB's loan will improve financial inclusion in Sri Lanka by setting targets for (a) lending to SMEs in post-conflict and tsunami-affected regions, and (b) lending to female borrowers (footnote 41).
 - (iii) By supporting the growth of NTB and offering access to longer-term financing, ADB will help strengthen and expand private sector commercial banking in Sri Lanka. This will broaden the bank's ability to reach underserved customers.

D. Risks

22. **Market competition.** Since 2009, the SME market in Sri Lanka has become increasingly competitive, particularly in the areas of tea production, agriculture, and textiles. Large state-

³² CBSL. 2011. *Banking Act Direction No. 9 of 2011*. Colombo.

³³ SMEs classified as women borrowers must meet at least one of the following qualifications: (i) at least 50% of the enterprise is owned by women, (ii) at least 3 out of 5 of the most senior managers are women, (iii) at least 50% of the registered full-time employees of the enterprise are women, or (iv) a joint loan is made to an enterprise owned and/or managed by a husband and wife.

³⁴ ADB. 2013. *Nonsovereign Operations. Operations Manual*. OM D10/BP. Manila.

owned banks are active in SME lending and provide subsidized loans that give them an edge over private sector banks such as NTB, due to lower interest costs and better affordability.³⁵ Based on its strategy, performance to date, and reputation, NTB is positioned well to compete successfully in the SME market.

23. **Portfolio growth and risk management.** Despite strong growth in 2011, the expansion of NTB's portfolio is expected to slow in 2012. The Monetary Board has limited the credit growth of a licensed bank in 2012 to 18% of the total outstanding credit at the end of 2011. However, banks may lend up to 23% of this amount if the corresponding funds are raised from overseas sources. NTB has low levels of NPLs (2.9% as of the end of June 2012)³⁶ and has upgraded its credit underwriting and portfolio monitoring standards. This has included the use of credit scoring models. Some of these measures have been supported by international finance institutions (IFI) technical assistance projects. Portfolio growth deriving from ADB's loan will be managed by phased disbursements. ADB will monitor asset quality through reporting by NTB on its overall and SME portfolios.

IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impact, Outcome, and Outputs

24. **Impact.** The transaction will increase access to finance for SMEs in Sri Lanka and improve financial inclusion.

25. **Outcome.** The outcome from this project is expected to be the enhanced capacity of NTB to provide financial services to SMEs. This is expected to have a demonstration effect, i.e., encourage more banks to serve Sri Lanka's SMEs.

26. **Outputs.** The project's outputs will be (i) increased financing for SMEs both in terms of the number and volume of SME loans as well as loan tenor (ii), greater geographic and gender diversification in NTB's SME portfolio with an emphasis on service to SMEs in the Northern, Eastern, and Southern provinces and to women borrowers and (iii) compliance with ADB's Safeguards Policy Statement (2009).

B. Alignment with ADB Strategy and Operations

1. Consistency with Strategy 2020 and Country Strategy

27. Under Strategy 2020, ADB aims to strengthen its support to the financial sector at the regional and national levels by helping develop financial infrastructure, institutions, and products and services to promote inclusive growth.³⁷ Through such initiatives, ADB intends to help channel the region's savings into the most productive investments and to build the capacity of financial institutions by introducing international best practices. The project supports institutional and financial sector development and the deepening of the financial sector by increasing the ability of a mid-sized bank to expand lending to SMEs.

28. The project is consistent with the goals of ADB's 2012–2014 country operations business plan to catalyze private investment and promote inclusive growth in Sri Lanka.³⁸ The project is

³⁵ Shrimal Perera, Michael Skully, and My Nguyen. 2012. Market concentration and pricing behavior of Sri Lankan banks. *South Asian Journal of Global Business Research*, 1 (1). pp. 63–78.

³⁶ NPL ratio based on NTB calculations, per CBSL. NPL ratio is 3.9% per ADB definition, as of the end of June 2012.

³⁷ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

³⁸ ADB. 2011. *Country Operations Business Plan: Sri Lanka, 2012–2014*. Manila.

also aligned with the government's development policy framework for 2010–2016, which aims to accelerate economic growth, improve access to finance, and increase low private sector investment. ADB's 2012–2016 country partnership strategy for Sri Lanka is built on the government's development policy framework and Strategy 2020 and calls for ADB support for private sector development, including projects that accelerate the pace of private sector participation and promote financial sector development.³⁹ ADB's country partnership strategy notes that ADB's private sector operations should support banks with projects that have high development impact of the kind that this project is expected to deliver.

2. Consistency with Sector Strategy

29. Supporting financial sector development is a key focus of ADB's development assistance. ADB's enhanced poverty reduction strategy seeks to promote sound, efficient banking systems and capital markets, which are essential for macroeconomic stability, mobilizing savings, and ensuring availability of long-term financing to foster pro-poor growth.⁴⁰ ADB's Private Sector Development Strategy seeks to strengthen the financial sector. This includes increasing SME access to finance.⁴¹ The 2010–2012 business plan and priorities of the Capital Markets and Financial Sectors Division of ADB's Private Sector Operations Department seek to help SMEs gain better access to finance and consider this integral to a healthy financial sector.⁴² ADB's financial sector operational plan also aims to support SME access to finance as part of financial sector development.⁴³ The project is consistent with ADB's overall financial sector strategy because it will help increase lending to SMEs, which is a critical component of Sri Lanka's financial sector that needs expansion.

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

30. The investment is classified category FI (treated as C) for impacts on the environment, involuntary resettlement, and indigenous peoples. NTB will use the facility exclusively for onlending to SMEs involved in business activities that have minimal or no adverse environmental impacts and are unlikely to entail impacts on involuntary resettlement and indigenous peoples. NTB will apply ADB's prohibited investment activities list, exclude all projects that will have adverse environment and social safeguards impacts, ensure that investments using ADB funds abide by applicable national laws and regulations and comply with ADB's Safeguard Policy Statement. NTB will confirm this in its periodic reports to ADB and NTB will achieve this by screening and reviewing subloan applications.⁴⁴

B. Anticorruption Policy

31. NTB was advised of ADB's Anticorruption Policy (1998, as amended to date) and policy relating to the Combating of Money Laundering and Financing of Terrorism (2003).⁴⁵ Consistent

³⁹ ADB. 2011. *Country Partnership Strategy: Sri Lanka, 2012–2016*. Manila.

⁴⁰ ADB. 2004. *Enhancing the Fight Against Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

⁴¹ ADB. 2000. *Private Sector Development Strategy*. Manila.

⁴² ADB. 2010. *PSCM Business Plan and Priorities: 2010–2012*. Manila.

⁴³ ADB. 2011. *Financial Sector Operational Plan*. Manila.

⁴⁴ Summary Poverty Reduction and Social Strategy; Safeguards and Social Dimensions Summary (accessible from the list of linked documents in Appendix 2).

⁴⁵ Sri Lanka is classified by the Financial Action Task Force (FATF) as a strategically deficient jurisdiction in relation to anti- money laundering and countering the financing of terrorism. The project team was mindful of this when conducting its integrity due diligence. The results of such integrity due diligence did not disclose any significant integrity risk.

with its commitment to good governance, accountability, and transparency, ADB requires NTB to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption and money laundering activities and the financing of terrorism; and to covenant with ADB to refrain from engaging in such activities.

C. Investment Limitations

32. The proposed senior unsecured loan is within the medium-term country, industry, group, and single investment exposure limits for nonsovereign investments.

D. Assurances

33. Consistent with the Agreement Establishing the Asian Development Bank (the Charter), the Government of Sri Lanka will be requested to confirm that it has no objection to the proposed assistance to NTB. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.⁴⁶

VI. RECOMMENDATION

34. I am satisfied that the proposed senior unsecured loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$15,000,000 to the Nations Trust Bank for the Small and Medium-Sized Enterprises Finance Project in Sri Lanka, from ADB's ordinary capital resources, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

15 January 2013

⁴⁶ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RFPs/?id=46924-01-4>

1. Sector Overview
2. Ownership, Management, and Governance
3. Financial Analysis
4. Country Economic Indicators
5. Summary Poverty Reduction and Social Strategy
6. Safeguards and Social Dimensions Summary