ADB

# Validation Report

Reference Number: PVR-267
Project Number: 36357-01/03
Loan Numbers: 2138 and 2139
November 2013

# Sri Lanka: Financial Markets Program for Private Sector Development

Independent Evaluation Department

Asian Development Bank

## ABBREVIATIONS

| | | |
|---|---|---|
| ADB | – | Asian Development Bank |
| CBSL | – | Central Bank of Sri Lanka |
| CSE | – | Colombo Stock Exchange |
| CSP | – | Country Strategy and Program |
| IBSL | – | Insurance Board of Sri Lanka |
| IED | – | Independent Evaluation Department |
| MOFP | – | Ministry of Finance and Planning |
| M&E | – | monitoring and evaluation |
| PBank | – | People's Bank |
| PCR | – | program completion report |
| PSDP | – | Private Sector Development Program |
| RRP | – | report and recommendation of the President |
| SEC | – | Securities and Exchange Commission |
| SEMA | – | Strategic Enterprise Management Agency |
| SMEs | – | small and medium-sized enterprises |
| SOCB | – | state-owned commercial bank |
| TA | – | technical assistance |

## NOTE

In this report, "$" refers to US dollars.

**Key Words**

asian development bank, finance, financial market program, private sector development, public enterprise reform, sri lanka

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## PROGRAM BASIC DATA

| | | | | |
|---|---|---|---|---|
| **Project Number:** | 36357-01/03 | **PCR Circulation Date:** | Oct 2011 | |
| **Loan Numbers:** | 2138 and 2139 | **PCR Validation Date:** | Nov 2013 | |
| **Project Name:** | **Financial Markets Program for Private Sector Development** | | | |
| **Country:** | Sri Lanka | | **Approved** ($ million) | **Actual** ($ million) |
| **Sector:** | Finance | **Total Project Costs:** | | |
| | | 2138 (program) | 90.000 | 90.000 |
| | | 2139 (project) | 5.000 | 0.453 |
| **ADB Financing:** ($ million) | **ADF:** 60.000 | **Loan:** | | |
| | | 2138 | 60.000 | 60.000 |
| | | 2139 | 5.000 | 0.453 |
| | | (SDR equivalent, million) | 3.318 | 0.312 |
| | | **Borrower:** | 0.000 | 0.000 |
| | **OCR:** 5.000 | **Beneficiaries:** | 0.000 | 0.000 |
| | | **Others:** | 30.000 | 30.000 |
| **Cofinancier:** | | **Total Cofinancing:** | 0.000 | 0.000 |
| **Approval Date:** | 15 Dec 2004 | **Effectiveness Date:** | 20 Mar 2005 | 20 Mar 2005 |
| **Signing Date:** | 20 Dec 2004 | **Closing Date:** | | |
| | | 2138 | 31 Dec 2007 | 28 Oct 2010 |
| | | 2139 | 1 Dec 2007 | 13 Sep 2011 |
| **Project Officers:** | | **Location:** | **From:** | **To:** |
| | B. Ericsson | ADB headquarters | Mar 2005 | Apr 2006 |
| | S. N. Oh | ADB headquarters | May 2006 | Oct 2006 |
| | R. Hartel | ADB headquarters | Nov 2006 | Dec 2007 |
| | S. Shah | ADB headquarters | Jan 2008 | Aug 2011 |
| | A. Huang | ADB headquarters | Aug 2011 | Sep 2011 |
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ADB = Asian Development Bank, ADF = Asian Development Fund, IED2 = Independent Evaluation Department (Division 2), PCR = program completion report, OCR = ordinary capital resources, SDR = special drawing rights.

# I. PROJECT DESCRIPTION

## A. Rationale

1. Sri Lanka committed to achieve its millennium development goals (MDGs) of reducing unemployment, raising living standards, promoting human development, and reducing poverty. To realize these goals, the government needed to promote private sector participation, including small and medium-sized enterprises (SMEs) in Sri Lanka's economy, by developing a market environment conducive for investment. The private sector was envisioned to take a lead role in generating employment, boosting economic growth, and raising income levels.

2. The Asian Development Bank (ADB) supported the Government of Sri Lanka through the Private Sector Development Program (PSDP) cluster.[1] The Financial Markets Program for Private Sector Development (the program) was the second of two subprograms (subprogram I and II) under the PSDP. It was to build on the results achieved by the PDSP subprogram I, especially in the development of financial markets and private sector's access to finance, and as support to the government's public enterprise reform program in the banking sector through the establishment of the Strategic Enterprise Management Agency (SEMA).[2]

3. Given the progress achieved under subprogram I, the program was re-focused toward broadening financial sector development by further facilitating private sector's access to finance, including the SMEs. In particular, it was aimed at supporting government reforms, including the restructuring and phased recapitalization of the People's Bank (PBank), a state-owned bank.

## B. Expected Impact

4. The program's expected impact was to facilitate private sector development by strengthening the financial markets, including the restructuring and recapitalization of PBank.[3] The envisaged impact indicators were increased economic growth rate (from the growth rate of 5% per year), increased private sector investment as a percentage of gross domestic product (GDP) (from 16.7% level), removal of government budgetary support to PBank, including dividend payments and other proceeds paid by PBank to the government by 2014, at least equal to phased-in recapitalization amount, and increased number of financially viable SMEs throughout the country.

## C. Objectives or Expected Outcome

5. The envisaged program outcomes, as indicated in the program framework at both appraisal and completion, were: (i) to develop financial markets and (ii) reduce public sector spending in PBank. The envisaged outcome indicators for outcome (i) were (a) strengthened competition, enforcement, and regulatory framework in the capital market; (b) increased turnover of the capital market (e.g., increased turnover to market capitalization ratio from 28%); (c) increased amount of available risk capital in the capital market (i.e., increase in stock market capitalization from SLRs263 billion); (d) increased number of listed companies on the Colombo Stock Exchange (CSE) from 244 companies; (e) increased products and services available in the financial markets (e.g., usage of publicly traded securitized bonds to be introduced in the market); (f) improved liquidity in the stock market (increase in daily average turnover from SLRs308 million) and debt markets (e.g., increase in the number of trades per year from 1,685); (g) reduction in interest rate spreads (from 4% average); and (h) increase in debt capital formation, with increased corporate debt market capitalization from SLRs9.7 billion.

6. For outcome (ii), performance targets were (a) reduction in government budget deficit as a result of the positive net contribution from PBank, (b) implemented restructuring plan of PBank, and (c) improved profitability of PBank, including improved financial and operational performance indicators (e.g., reduced cost/income ratio from 73.5%).

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[1] ADB. 2000. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Sri Lanka for the Private Sector Development Program.* Manila.

[2] ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans to the Democratic Republic of Sri Lanka for the Financial Markets Program for Private Sector Development.* Manila.

[3] ADB. 2011. *Completion Report: Financial Markets Program for Private Sector Development.* Manila.

## D. Components and Outputs

7. The program comprised a policy loan and a technical assistance (TA) loan. The policy loan had two main components. The first component included the development of financial markets by increasing the availability of financial products and services, enhancing corporate governance in the financial market, and improving insurance industry regulations. The second component involved strengthening the banking system by improving corporate governance of state-owned commercial banks (SOCBs), and restructuring the PBank. Increasing financial products and services was to be achieved by facilitating secured transaction, introducing publicly-traded securitized bonds, strengthening Central Bank of Sri Lanka (CBSL) regulations to include financial products for forward risk management, harmonizing taxation rule across financial instruments, and improving bond market performance.

8. Enhancing corporate governance in the financial market was to be achieved by making the Securities and Exchange Commission (SEC) a more effective regulator, improving corporate governance, regulation, and functioning of the capital market, increasing investor disclosure and protection safeguards for investors, and preventing money laundering. Improved insurance industry regulations were planned to be achieved by strengthening insurance supervision. On the other hand, improved corporate governance of SOCBs was envisioned to be attained by reducing government intervention in the day-to-day management of PBank and the Bank of Ceylon. Reforms for PBank were to involve implementation of a restructuring plan and recapitalization.

9. The TA loan was envisaged to provide capacity building and skills development of PBank, including strengthening of the insurance industry through capacity building of the Insurance Board of Sri Lanka (IBSL). It was also aimed at supporting the creation of a national computerized movable property registry through capacity building and provision of equipment. The TA loan was also designed to provide banking expertise to SEMA in order to improve its ability to manage the banks in its portfolio. Provision of legal and governance advisory for corporate securities, financial markets, commercial and banking law, and policy reforms were also envisaged under the TA loan.

## E. Provision of Inputs

10. The program included two loans–a policy (program) loan of $60 million from ADB's ordinary capital resources (OCR) and a TA loan of $5 million equivalent from ADB's Special Funds resources.The total adjustment cost of the program was estimated at $90 million, which consisted of $82 million for the recapitalization of PBank, $3 million for the drafting and submission of Acts to Parliament under the policy reform program, and the administrative costs for SEMA to manage PBank; and $5 million for the establishment and operation of the Public Debt Office.

11. The funds were released in 3 equal tranches of $20.0 million and were fully disbursed. The TA loan was to require about 112 person-months of international consulting services and 32 person-months of domestic consulting services. However, about $4.5 million out of the $5.0 million TA loan proceeds was cancelled because the government subsequently decided that it could undertake most of the TA loan activities from its own resources. As such, only two consultants were recruited. The project completion report (PCR) indicated that consultants' performances were generally satisfactory.

## F. Implementation Arrangements

12. The executing agency for both the program loan and the TA loan was the Ministry of Finance and Planning (MOFP), while the implementing agencies for the TA loan were the CBSL, Credit Information Bureau, CSE, IBSL, PBank, SEC, and SEMA. The planned implementation arrangements were not fully followed. The steering committee was established by MOFP, about 2.5 years after loan effectiveness, in view of significant time spent on building political consensus needed to guide program implementation.

13. The PCR noted that overall compliance to the loan and TA covenants was weak. Compliance with the covenants for the release of the second and third tranches was partially waived after the government promised to furnish all the required audited project accounts (APAs), audited project accounts (AFAs), and audit reports to ADB. However, at the time of the PCR completion, ADB had yet to receive the required reports. Also, the MOFP was not able to facilitate PBank's compliance with the loan covenants in terms of the submission of required monitoring reports. The partial compliance of the implementing agencies caused delays in ADB's review of the program and TA implementation. With the TA loan largely canceled by the government, there were few actions undertaken by the implementing agencies to meet the envisaged TA loan objectives.

# II. EVALUATION OF PERFORMANCE AND RATINGS

## A. Relevance of Design and Formulation

14. The PCR rated the program *relevant* as it was able to address the issues related to Sri Lanka's financial sector and was consistent with the government's development strategy and the Country Strategy and Program (CSP) 2004–2008 of ADB. The program's objectives were still valid after several years of implementation. The envisaged activities and outputs were generally consistent with the overall objective of the program. This validation has the same view as the PCR's assessment. However, the complex design of the program with reforms in several subsectors led to capacity constraints in key agencies. The program attempted to implement the reforms in a wide range of subsectors in finance through a clustered program, in which two subprograms were to support various reform measures for private sector development over a long period. Even so, the capacity constraints turned out to be more serious than it was envisaged at the time the program was designed, causing a significant delay in completing the whole reform package (para. 18). On the whole, the validation rates the program *relevant*.

## B. Effectiveness in Achieving Project Outcome

15. The PCR rated the program *effective* in achieving its outcomes. For the envisaged outcome of developing the financial market through increased financial products and services suitable for the capital markets, the Securitization Act was passed on 3 June 2009 and implemented. The new settlement system was established on 10 December 2007. A delivery-versus-payment system was installed in the debt securities trading system and market distortions were reduced. On enhanced corporate governance in financial markets, the capacity of the Public Debt Department was strengthened. A finance business bill was passed by the Parliament on 21 September 2011. The amended Securities and Exchange Commission of Sri Lanka Act No. 47 was approved in 2009 and the Amended Banking Act Direction No. 11 was enacted in 2007. The SEC's surveillance capacity was improved. Three legislations on anti–money laundering and combating the financing of terrorism were passed. CSE's market capitalization reached SLRs2,342 billion as compared to the target of SLRs263.00 billion. The

daily average turnover of SLRs2,940 million in CSE was greater than the target of SLRs308.00 million. The corporate debt market capitalization was SLRs30.6 billion, far greater than the target of SLRs9.7 billion.

16. As regards improved regulations of the insurance industry, the Regulation of Insurance Industries Act (amendment) was enacted in 2011. Similarly, on arrangements to improve the corporate governance of SOCBs, independent boards and corporate management teams were established on 23 April 2008 The capital and the financial performances of PBank were improved, based on the five operating benchmarks set for 2007.

17. However, up to October 2011, the central registry had not been established. The market share of the mutual fund net asset value declined. A securitized bonds market was not established as expected under the program. The companies listed on the CSE were 252 in June 2011, with marginal increase from the target of 244. In 2010, the total market turnover was 26% of market capitalization, lower than the target of 28%. On the outcome of reducing the public spending on PBank, the bank had reached a capital adequacy ratio of 10% since 2008, higher than the capital adequacy ratio requirement. Hence, there was no need for additional government contribution for the recapitalization as PBank submitted SLRs5.9 billion to the government's Treasury in the form of a special levy from 2004 to 2010. Overall, some outputs of the program were eventually realized although the indicators of several outputs were below the targets. The validation rates the program *effective*.

## C. Efficiency of Resource Use in Achieving Outcome and Outputs

18. The PCR rated the program *less efficient* in achieving outcomes and outputs. The program was originally designed to be implemented in 3 years—from December 2004 to December 2007. However, the program was delayed by 3 years as tranches II and III were delayed and released only in October 2010. The PCR indicated that the delay was due to factors such as change of government, the initial resistance from PBank's labor union, the escalation of military activities, and external factors such as tsunami and global financial crisis. The closing of the program was rescheduled three times, from December 2007 to December 2008, December 2009, and December 2010. Furthermore, the executing and implementing agencies were not able to release financial statements on time. Finally, the executing agency canceled the TA loan that was needed to strengthen the capacities of both executing and implementing agencies. The validation rates the program *less than efficient*.

## D. Preliminary Assessment of Sustainability

19. The PCR rated the program *likely to be sustainable*. The benefits derived from the program supported by ADB included the Securitization Act, the settlement system for equity transactions, the delivery-versus-payment system in the debt securities trading system, the strengthened capacity of CBSL's public debt department, the finance business bill, the amended Securities and Exchange Commission of Sri Lanka, the Amended Banking Act Direction No. 11, the SEC surveillance capacity, the three legislations on anti-money laundering, the Regulation of Insurance Industries Act (amendment) (2011), the independent boards and corporate management teams, and the improved capacity of PBank. These were likely to be sustainable. By the end of program period, the national capacity component had been developed enough that ADB was able to plan disengagement from various program initiatives in which it had been involved. Since the benefits are likely to be sustainable and the national capacity has been developed enough, the validation also assesses the program *likely to be sustainable*.

## D. Impact

20. The PCR did not rate the program impact. The poverty, institutional, economic, environmental, social, and financial impacts were not assessed under the program in the PCR. Some indicators for monitoring and evaluation (M&E) were listed in Appendix 1 in the PCR. Total CSE market capitalization increased substantially and the vast majority of the equity shares listed on the CSE were from private businesses. The percentage of gross credit to the private sector to the broad money increased gradually from an annual average of 75.7% between 2001 and 2005 to 80.6% between 2006 and 2010. The share of private sector industrial production to GDP (both calculated at 2001 constant price level) increased gradually from an annual average of 1.12% to 1.21% during 2006–2010. However, increase in the number of financially viable SMEs throughout the country was not measured. The validation concludes that the program had a *significant* impact on private sector development.

# III. OTHER PERFORMANCE ASSESSMENTS

## A. Performance of the Borrower and Executing Agency

21. The PCR rated the performance of the borrower and executing agency *satisfactory*. MOFP cancelled the TA loan in 2008 as the implementing agencies preferred to attain the TA loan objectives by utilizing their own resources instead of the TA loan facility. The second and third tranches were released in October 2010. Also, due to lack of institutional capacities, the implementing agencies had difficulties meeting the covenants, particularly in separating the program accounts and timely submitting the financial and audit statements. Nonetheless, the PCR indicated that key program outputs were delivered and program outcome was largely satisfactory. The performance of the borrower and the executing agency varied among different components but considering that they managed to produce satisfactory results of the program, the validation has a similar rating to that of the PCR.

## B. Performance of the Asian Development Bank

22. The PCR rated ADB's performance *satisfactory*. The validation confirms this rating since the approvals and disbursements of loans were prompt, the program monitoring was regularly conducted, and the review missions from ADB headquarters supported by the resident mission were timely arranged.

## C. Others

23. There were no resettlement, environmental, and other safeguard issues identified in the PCR. Overall compliance to the program loan and TA covenants was poor according to the PCR, partly due to lack of experience in managing donor-funded programs.

# IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

## A. Overall Assessment and Ratings

24. The PCR and validation ratings had no difference. The program is rated relevant as it was able to address financial sector issues. It is rated *effective* since outcome performance targets were generally achieved. However, the program is *less than efficient* largely in view of implementation delays. The program is rated *likely to be sustainable* in view of improved

capacity to sustain the gains realized under the program. Overall, the validation has a similar rating to that of the PCR (see table).

**Overall Ratings**

| Criteria | PCR | IED Review | Reason for Disagreement and/or Comments |
|---|---|---|---|
| Relevance | Relevant | Relevant | |
| Effectiveness in achieving outcome | Effective | Effective | |
| Efficiency in achieving outcome and outputs | Less efficient | Less than efficient | |
| Preliminary assessment of sustainability | Likely to be sustainable | Likely to be sustainable | |
| **Overall assessment** | **Successful** | **Successful** | |
| Borrower and executing agency | Satisfactory | Satisfactory | |
| Performance of ADB | Satisfactory | Satisfactory | |
| Impact | not rated | Significant | |
| Quality of PCR | | Satisfactory | |

ADB = Asian Development Bank, IED = Independent Evaluation Department, PCR = program completion report.
Note: From May 2012, IED views the PCR's rating terminology of "*partly*" or "*less*" as equivalent to "*less than*" and uses this terminology for its own rating categories to improve clarity.

## B. Lessons

25. The PCR identified three lessons, pertaining to the timing of a program, minimizing the number of legislative actions, and providing incentives on institutional strengthening. Specifically, it is vital that ADB should be aware of potential changes in a country's political environment that could affect program implementation. Also, minimizing the number of legislative initiatives could minimize implementation. During the program design stage, providing appropriate incentives for institutional strengthening and ownership could help improve operational management of concerned entities. The validation generally agrees with these lessons.

## C. Recommendations for Follow-Up

26. The program helped establish the basis for developing the financial markets to promote private sector participation in developing Sri Lanka's economy. However, to build further the economy, more work needs to be done by monitoring the SOCBs' performance, developing the capital markets, and developing the private sector. Further progress can be made through facilitating the development of a bond market, demutualizing CSE, establishing a commodities exchange, developing the regulatory framework for domestic rating agencies, and developing qualification framework of financial industry professionals; and by ensuring compliance with the covenants. The validation supports the PCR's recommendations.

# V. OTHER CONSIDERATIONS AND FOLLOW-UP

## A. Monitoring and Evaluation Design, Implementation, and Utilization

27. The program was generally well designed to carry out an appropriate M&E of its activities. To ensure the conduct of an M&E, a program framework and core outputs and outcomes were attached to the report and recommendation of the President (RRP) (Appendixes

1 and 2, respectively) and were used as checklists. The covenants in the loan agreements among ADB, the Government of Sri Lanka, PBank, and IBSL were also used for the monitoring and review of program implementation and the subsequent assessment of the achievement against the output targets. However, the program framework presented minimal quantifiable indicators, and in areas where it did, the benchmark indicators and targets were not always included. The program framework did not fully capture some of the outputs and outcome indicators indicated in the main body of the RRP.

## B. Comments on Project Completion Report Quality

28. The PCR was generally complete and logically structured. It included information on the evaluation, context, the program, methodology, findings, conclusions, recommendations, and lessons learned. The tables and other data were in order and relevant annexes such as program framework and other information were included. However, it should have attempted to assess or comment on the benefits, especially economic and institutional benefits, contributed by the program. This validation assesses the overall quality of the PCR *satisfactory*.

## C. Data Sources for Validation

29. The main data sources consist of the RRP, PCR, and selected program administration documents.

## D. Recommendation for Independent Evaluation Department Follow-Up

30. The IED may consider conducting a performance evaluation by combining the first and second subprograms, if this is deemed necessary.