Sri Lanka: DFCC IV – Promotion of the Private Sector

Ex-post evaluation report

OECD sector	24030 / Formal sector financial intermediaries	
BMZ project ID	2001 65 605 (Sample 2008)	
Project executing agency	DFCC Bank	
Consultant	----	
Year of ex-post evaluation report	**2008**	
	Project appraisal (planned)	**Ex post evaluation (actual)**
Start of implementation	Q3 2005	Q3 2006
Period of implementation	36 months	12 months
Investment costs	EUR 30.1 million (m)	EUR 20.1 million (m)
Counterpart contribution	---	---
Financing, of which FC funds	Market funds: EUR 25.1 m FC funds: EUR 5.1 m	Market funds: EUR 15.1 m FC funds: EUR 5.1 m
Other institutions/donors involved	none	none
Performance rating	2	
Relevance	2	
Effectiveness	2	
Efficiency	2	
Overarching developmental impact	3	
Sustainability	3	

Brief description, overall objective and project objectives with indicators

The project involved providing a credit line in the amount of EUR 20.1 million (composite financing), consisting of a EUR 5.1 million Financial Cooperation (FC) loan and EUR 15.0 million in market funds – the latter amount reduced since project appraisal - for the DFCC Bank, continuing the DFCC III credit line subjected to ex-post evaluation in 2003. The funds were primarily intended for financing sub-loans to private firms to cover the foreign exchange costs of their capital investments.

The objective of the programme was the efficient, sustainable provision, in line with demand, of medium and long-term investment loans by the DFCC Bank (project objective). This was to contribute to creating and safeguarding jobs and additional sources of income in the private sector (overall objective).

The KfW financing proposal set the following indicators:

Overall objective indicator:	Two years after full disbursement of the FC development loan, at least 3,600 jobs have been created or secured in the long term.
Programme objective indicator:	Two years after full disbursement of the FC development loan, the portfolio-at-risk (arrears in interest or redemption payments > 90 days) amounted to a maximum 12% of the refinanced loan portfolio of the DFCC Bank.

Project design / major deviations from the original project planning and their main causes

Since the late 1990s, Sri Lanka has no longer been regarded as a low-income but as a middle-income country. The economic crisis in Southeast Asia, which reached a climax in Sri Lanka in 2001, accelerated implementation of the economic reforms agreed under the poverty reduction programme. Since then, Sri Lanka's economy has developed favourably, albeit constrained by major deficits in infrastructure, in the regulatory setting, and in development policy. In 2003 the HDI Index was 0.731, and in 2007/2008 0.743; for a number of years now, Sri Lanka has accordingly ranked 99^{th} among 177 countries.

At the time of project appraisal, the financial sector was characterised by:

- strong government influence in the banking and insurance sector
- very high public sector financing requirements
- a markedly underdeveloped capital market (minimal importance of the stock exchange)
- poor portfolio quality of the entire banking system combined with high reserve and bad debt provision requirements
- a high interest margin due to high operative costs and poor portfolio quality.

As a result of these deficits, access to long-term financing was limited and expensive for the private sector, and longer-term refinancing was possible only through foreign capital markets and especially via bilateral and multilateral donors. The refinancing of DFCC Bank loans tackles this fundamental problem. No changes were made to the design in the course of the programme apart from a reduction in market funds. The Sri Lankan Government passed on the FC development loan (composite financing) to the DFCC Bank as a loan. The foreign exchange risk was to be borne by the Government.

<u>Economic development</u>

Since the time of project appraisal, the Sri Lankan economy has shown itself to be astonishingly robust in the face of external shocks like the tsunami disaster, escalation of the internal conflict with the Liberation Tigers of Tamil Eelam (LTTE) and the financial market crisis. In 2004, GDP growth rates were between 5% and 6%, growth being very strongly driven by internal demand, which particularly benefited the industrial and services sectors. Internal consumer demand was fostered particularly by the high return flow of funds from Sri Lankans working abroad. Despite marked growth, Sir Lanka has high budgetary and balance of payments deficits, which in recent years have varied between 7% - 9% and 3% - 4% respectively.

The economy of the country has increasingly diversified in recent years. This has been a result of increased economic strength, due not least to the high volume of transfers from people employed abroad. Furthermore, the financial sector has contributed substantially to GDP.

So far, rural population groups, especially outside the western provinces close to the capital have not benefited from economic growth. The gap between rural development and development in the urban areas close to the capital has been widened by resurgence of the conflict with the LTTE. As a result, the living conditions of the population in the rural northern and eastern parts of Sri Lanka have deteriorated considerably.

The current situation in Sri Lanka is marked above all by increased government efforts to find a military solution to the conflict with the LTTE. This entails higher financial requirements for military spending.

Development of the corporate sector

Since the 1990s, the private corporate sector in Sri Lanka has grown steadily in importance, primarily in industry but also to a more limited extent in services (telecommunications), contributing considerably to the rise in economic growth rates. The private sector generates some 27.9% of GDP, thus contributing much more to investment in Sri Lanka than the public sector, whose share of GDP is only about 5.4%. The private sector is also very important as an employer.

At the end of 2007, 96% of manufacturing was in the hands of private enterprise, including such highly profitable sectors as food production and processing, rubber products, and the textile industry. Other segments of the economy to experience major growth in recent years have been those heavily privatised in the 1990s, like telecommunications and transport.

As far as the size of enterprises is concerned, Sri Lanka has traditionally had a very high proportion of micro, small and medium-sized enterprises (MSMEs), a category to which some 80% of all registered businesses in Sri Lanka belong. To these must be added unregistered micro enterprises, which constitute a high proportion of businesses. Small and medium-sized enterprises (SMEs) operate in all sectors of the economy, but are particularly strongly represented in manufacturing, where they have a 95% share of businesses, 34% of the workforce, and 25% of production. Micro enterprises are mainly to be found in the tertiary sector. Some 75% of MSMEs are located in rural areas, where about 70% of the population live.

The Sri Lankan political agenda has taken account of the importance of the private sector for economic growth. The figures in the World Bank's Doing Business Report on starting a business, on getting credit (public registry coverage), on protecting investors, and on trading across borders have improved in 2007 over the previous years. Still problematic for business development is the uncertain legal situation in property and contract matters, and inefficient and inconsistently implemented tax collection. Moreover, in recent years the Sri Lankan Government has failed to pursue a coherent economic policy based on clear market-economy principles. For example, changes in the statutory conditions for the realisation of security have produced additional legal uncertainties, which tend to hamper lending. Other major obstacles to the further development of the private sector are the inadequate energy supply and poor transport infrastructure.

Development of the financial sector

With the support of the World Bank and the IMF, legal supervision of the financial sector was reformed. The supervisory capacity of the central bank was enhanced and international standards were increasingly implemented in the regulatory environment.

The financial sector is dominated by the banking sector. Some 68% of assets in the Sri Lankan banking sector are held by licensed commercial banks, almost half of them state banks, and some 13% are held by licensed special banks, which engage solely in development business and are not permitted to accept deposits. 19% of assets in the banking sector are held by the central bank.

The key performance indicators of the banking system improved as a whole between 2004 and 2007 since project appraisal. Total lendings increased markedly between 2004 and 2007. However, this was primarily owing to the government budget deficit and the strong demand for consumer loans. The total assets of licensed commercial and special banks rose over the implementation period from LKR 1,161.4 billion (of which LKR 317 billion held by special banks) in 2004 to LKR 3,069 billion (of which LKR 407 billion held by special banks) in 2007. The ratio of non-performing loans (NPLs) to the loan portfolio fell over the same period from 9.3% to 4.9% for commercial banks and from 10.4% to 6.8% for special banks. Compared with 2004 (63.8%), the ratio of bad debt provision to NPL in the banking sector improved as a whole (64.3%), but in the course of the financial crisis had fallen to 60.5% by March 2008. Average capital adequacy is sufficient; total capital adequacy ratio in 2007 was 13.8%. Although the share of net interest income in total income declined considerably over the period 2004 to 2007, this resulted in a fall in the return-on-assets (RoA) only for special banks, from 2.7% to 1.9%, while commercial banks were able to increase their income slightly.

Overall, the income situation of banks can be described as stable in recent years, even though in late 2007 and early 2008 stagnation set in owing to the worldwide financial crisis.

Lending to the private sector in relation to gross domestic product is about 35%, and is thus still to be considered very low. The high share of the public sector in the economy and the financial requirements of the state resulting from the budget deficit have meant that the public sector has siphoned off a high proportion of the limited long-term capital market funds, tending to crowd out private investment. This, together with once again rising prices (in 2007 the inflation rate was 17.5%), has led to relatively high interest rates on the lending market.

Key results of impact analysis and performance rating

According to the project executing agency, the status of the agreed goal indicators in late 2007 was as follows:

- 3,931 jobs were created or safeguarded, so that the goal of creating and securing at least 3,600 jobs was attained.

- The rate of overdue loans, 6.4% of the outstanding loan portfolio, is much better than the target of a maximum of 12%.

It should be noted that the informative value of the overall objective indicator is very limited due to the uncertainties involved in data collection. Moreover, the creation and safeguarding of jobs are subject to very complex economic considerations and conditions. The economic strengthening of private enterprise does not necessarily maintain or increase the number of jobs. Measuring the overall objective in terms of the number of jobs therefore appears to be too one-dimensional.

With regard to the level of loans in default it should be taken into account that the 12% aspiration level had been set very low and had already been exceeded by the DFCC in 2002, albeit only once.

The refinancing line was completely earmarked and disbursed within a few months. A total of 343 financings (loans and leasings) in an average amount of about LKR 7.2 million, i.e., some EUR 50,000, were granted on market terms. Three loans were in excess of EUR 2.0 million. The amount financed by DFCC was EUR 24.6 million, of which EUR 20.1 were financed from FC funds. According to the DFCC, the investment costs financed amounted to EUR 39.4 million. Of the 343 financings, 74 were loans. They constitute 80% of the volume and amount to EUR 260,000. 269 leasing financing contracts were concluded for an average amount of EUR 19,000. The average term for loans was approx. 5.5 years, and for leasing financings 4 years. About 200 clients already had loans from the DFCC Bank.

Some 40% of loans were granted in Colombo or the Colombo region. Loans are relatively evenly distributed among sectors. Of the bank's total portfolio, 15% of assets are assigned to the food industry, 12% to paper and printing, 11% to hotels and restaurants, 10% to agriculture, and 10% to rubber. The rest is distributed among textiles and apparel, plastic products and non-metallic mineral products, electricity, building, transport, and finances.

The DFCC Bank, founded in 1955, is unique in that its establishment and business purpose are determined by the state through the executive branch, whereas the majority of shares in the bank are held by private sector companies. This ensures that management is profit- and risk-orientated while development policy goals are entrenched. The bank’s operating principles are therefore based on established and professional procedures for loan review, collateralisation, and supervision, which, according to the bank, are continuously updated and meet the usual standards. The conditions of the DFFC are market-based, and customer focus is on the private sector. The World Bank, which had provided advice when the DFFC was being set up, has undertaken regular, thorough analyses of the impact of the DFFC on the private sector, and in 2007 stressed the exemplary nature of the institution as a development bank for private enterprise.[1]

As a special bank, the DFFC has successfully specialised in medium- and long-term investment financing through loans and leasing and in development financing. Some 69% of the loan portfolio has a term of over one year. This business is mainly refinanced by means of long-term ODA funds, and 28% of liabilities have terms of over 5 years. As far as maturities are concerned, there is an excess of long-term receivables over long-term liabilities, but owing to ensured profitability, the DFCC Bank has always been in a position to refinance itself at reasonable conditions.

Until 2007, the development of bank business was characterised by a considerable rise in customer receivables, which grew by 20% in both 2006 and 2007. In the financial year 2007/2008 (year-end financial statements as at 31 March), customer receivables fell by a total of 0.5% owing to the global financial crisis.

The portfolio quality of the DFCC had improved in recent years, and in the financial year 2006/2007 non-performing loans (NPLs) constituted 4.6% of the loan portfolio. In the financial year 2007/2008, the proportion rose to 5%, yet still at a much better level than at the time of project appraisal.

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[1] Fernando, Ranjit, The DFCC Bank – One Among The Successful Few, World Bank South Asia, Juli 2007

The net interest income of the bank in the financial year 2007/2008 increased over the previous year. The drastic rise in interest expenses in the context of the global financial crisis, which has affected the DFCC Bank as well, was balanced out by higher interest income.

In 2005 there was a 6% rise in profit before taxes over the previous year. At the end of 2007, profitability and equity capitalisation were satisfactory. Capital adequacy was much higher than the internationally recommended 8% and the Sri Lankan target of 10%. Although the figure is below the average capital adequacy of special banks, if the comparatively high proportion of loans to private businesses is taken into account, this is acceptable. Considering the critical developments in the worldwide financial sector and the concomitant increase in the cost of refinancing, the DFCC was well able to hold its own until March 2008.

Rating of the project in terms of the selected **DAC indicators** appears to be appropriate. We place the project in the category “extensive poverty reduction at macro and sectoral level” (**MSA**) The refinancing of investment projects indirectly allows poorer sections of the population to benefit from the programme. The project shows no special potential for gender impacts (**G0**) nor is it designed to produce any governance-related effects (**PD/GG0**). Environmental considerations are in principle taken into account in extending loans. However, lending is not specifically directed towards attaining environmental effects (**UR0**).

In sum, we assess the developmental effectiveness of the project as follows:

a) Relevance

In the aftermath of the economic crisis of 2001, the project tackled a major obstacle to development in Sri Lanka. By providing medium and long-term investment loans, the project gave the private sector access to financing, which had previously been severely limited by the high financing requirements of the government and the inadequate liquidity provided by the capital market.

The aim of the project was to ensure private sector investment in maintenance and expansion by providing sustainable access to long-term investment loans and other financial services and thus to help maintain competitiveness, encourage economic growth, and to create and safeguard jobs. This cause-and-effect chain as postulated for the project is still plausible.

The project is in keeping with the Sri Lankan development promotion programme adopted in the framework of medium-term strategic planning, is tailored to actual needs, and was consistent with the objectives of German Development Cooperation (DC) at the time of project appraisal. The ambiguous implementation of Sir Lankan development policy is to be considered a hindrance, which, while encouraging private sector investment had increasingly set interventionist disincentives in agriculture and in economic and budgetary policy. The structural problem of high government financing requirements has been exacerbated by high military spending.

With respect to the growing gap in economic development between the rural population and the urban population, especially around the capital, and the internal conflict with the LTTE, which has escalated since 2007, the focus of development cooperation set by Germany and other donors has meanwhile shifted to conflict prevention and the promotion of MSMEs. In the financial sector, the IMF, ADB, and JICA will in the future concentrate largely on promoting MSMEs. Although the project was not designed purely for MSME promotion, the bank nevertheless provides a considerable amount of financing for micro, small and medium-sized enterprises, so that the refinancing facility is also consistent with this new direction. The successor project, DFCC V (BMZ No 2003 65 270) is designed solely to refinance MSME loans.

Overall, we assess the **relevance** of the programme as **good** (**rating 2**).

b) Effectiveness

The project objective indicator was attained. Loans were extended without undue delay and have been well serviced by borrowers. The business of the DFCC Bank has developed respectably, the bank's portfolio quality has improved markedly, the level of non-performing loans has remained acceptable, and the economic situation is better than average for special banks in Sri Lanka.

The project has strengthened the DFCC Bank in its consistent focus on promoting the private sector. The structural design of the bank, with its business purpose being determined by government and its management under private control, has so far proved its worth, earning stable returns over the years with a well-established clientele. The interest of the private sector is evidenced by the rapid outflow of funds and by the total investment costs that businesses have been able to raise through the financing made available to them.

We assess the **effectiveness** of the project as **good** (**rating 2**).

c) Efficiency

In view of the still robust financial and operative efficiency of the DFCC and the rapid outflow of funds, we rate the production efficiency of the programme as good. Portfolio quality is much higher than the indicator target for the programme. The operative efficiency of the DFCC Bank is also to be considered very good in comparison with other banks serving a comparable business segment.

With regard to allocation efficiency, it should be noted that some of the funding was made available for sectors of the economy (e.g., the hospitality trade, agriculture) whose contribution to economic growth is as a whole difficult to assess. However, the long-term focus of the DFCC Bank on promoting the private sector and the good servicing of loans compared with other special banks, gives no indication of any unsuitable allocation of FC funds.

We assess the **efficiency** of the project as **good** (**rating 2**).

d) Overarching developmental impact

By providing the financing facility for medium- and long-term investment, the project has in general made a substantial contribution to creating and safeguarding jobs and additional income in the private sector. This also counteracts the "crowding out" of the private sector.

The growing gap in the development of economic performance between the western provinces and the rest of the country, however, shows the need to focus lending more strongly to allow the population of the disadvantaged regions to benefit better from development policy. The follow-up financing programme DFCC V (BMZ No 2003 65 270) rightly concentrates more strongly on small and medium-sized enterprises in rural regions.

Recent developments on the financial markets, which have massively reduced the availability of refinancing via the capital market, mean that the positive effects of the project on Sir Lankan lending cannot at present be assessed. However, the rising share of the private sector in investment volume recorded up to 2007 and the development of bank business indicate that Sri Lankan commercial banks have recognised the potential of private sector financing and are focusing their activities increasingly on more market-economy oriented and venturesome lending.

We rate the **overarching developmental impact** of the project as **satisfactory** (**rating 3**).

e) Sustainability

The sustainability of the programme has so far been ensured by the good economic and financial situation of the DFCC Bank. Although the loan loss rate rose at the beginning of 2008 to over 5%, there is no sign to date that this has endangered the profitability of the bank.

The slight rise in the loan loss rate reflects the difficult economic conditions to which firms in Sri Lanka are currently subject. They have been brought about not only by the global financial crisis but also by the unfavourable national situation, which has caused a progressive deterioration for business in transport and energy infrastructure, legal certainty, and foreign trade figures.

The long-term business model of the DFCC Bank with its explicit focus on financing the private sector has, however, so far proved viable in previous economic crises.

Overall, we assess the **sustainability** of the project to be **satisfactory (rating 3**).

In a **summarised assessment** of all impacts and risks described above, we **rate the project's developmental effectiveness as good (rating 2).**

General conclusions

The project shows that developmental success and sustainable structural impacts on the financial sector depend strongly on the actual political conditions prevailing in the country. Particular note is to be taken of:

- The future role of government, especially in the financial sector
- The timely, differentiated examination of barriers to investment for various groups of enterprises and the possibilities for satisfying requirements in order to attract more new customers to the financial sector.

Notes on the methods used to evaluate project success (project rating)

Projects are evaluated on a six-point scale, the criteria being relevance, effectiveness (outcome), "overarching developmental impact" and efficiency. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

1	Very good rating that clearly exceeds expectations
2	Good rating fully in line with expectations and without any significant shortcomings
3	Satisfactory rating – project falls short of expectations but the positive results dominate
4	Unsatisfactory rating – significantly below expectations, with negative results dominating despite discernible positive results
5	Clearly inadequate rating – despite some positive partial results the negative results clearly dominate
6	The project has no positive results or the situation has actually deteriorated

A rating of 1 to 3 is a positive assessment and indicates a successful project while a rating of 4 to 6 is a negative assessment and indicates a project which has no sufficiently positive results.

Sustainability is evaluated according to the following four-point scale:

Sustainability level 1 (very good sustainability)

The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability)

The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected.)

Sustainability level 3 (satisfactory sustainability)

The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability)

The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and an improvement is very unlikely. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The overall rating on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. A rating of 1 to 3 indicates a “successful” project while a rating of 4 to 6 indicates an “unsuccessful” project. In using (with a project-specific weighting) the five key factors to form a overall rating, it should be noted that a project can generally only be considered developmentally “successful” if the achievement of the project objective (“effectiveness”), the impact on the overall objective (“overarching developmental impact”) and the sustainability are considered at least “satisfactory” (rating 3).