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Sri Lanka: NDB IV (Promotion of the private sector)

Ex post evaluation

OECD sector	24030 - Financial institutions of the formal financial sector	
BMZ project ID	1999 65 062	
Project executing agency	National Development Bank (NDB)	
Consultant	Not applicable	
Year of ex post evaluation	**2006**	
	Project appraisal (planned)	**Ex post evaluation (actual)**
Start of implementation	01/1999	01/1999
Period of implementation	3 years	6 years
Investment costs	No information available	No information available
Counterpart contribution	No information available	No information available
Financing, of which Financial Cooperation (FC) funds	EUR 30.7 million	EUR 30.7 million
Other institutions/donors involved	None	None
Performance (overall rating)	2	
• Significance / relevance (sub-rating)	2	
• Effectiveness (sub-rating)	2	
• Efficiency (sub-rating)	2	

Brief description, overall objective and project objectives with indicators

The project comprised a credit line to the National Development Bank (NDB) in the amount of EUR 30,677,512.87 (an FC loan of EUR 7,669,378.22 plus market funds of EUR 23,008,134.65) to refinance (on the basis of market conditions) the foreign exchange costs of durable capital goods incurred by industrial and service companies in the private sector in Sri Lanka. The maximum total amount of the sub-loans extended was fixed at EUR 2.6 million. The objective pursued with the credit line was to create income and employment in the private sector and at the same time to further strengthen the efficiency of NDB.

The overall objective of the project was to create and safeguard jobs and additional income in the private sector. According to the indicator defined this objective is considered as achieved if the return on investment produced by sub-borrowers has reached a satisfactory level (of 6% in real terms) on a long-term basis. The aim of the project was the provision of efficient, needs-related, long-term supplies of loans by NDB to refinance the purchase of durable capital goods by the target group (Sri Lankan private-sector industrial and service companies).

The programme goal is considered achieved when

- less than 20% of the loan portfolio of NDB is in default;
- ultimate loan losses do not exceed 5% of the loan portfolio.

From today's perspective we consider the indicators for the portfolio quality not as very ambitious.

The target group were private Sri Lankan enterprises.

Programme design / major deviations from the original programme planning and their main causes

The project executing agency was NDB. NDB was set up in 1979 as a state development bank. Its headquarter is in Colombo. The primary business objective until the privatisation of the bank in 2005 was the promotion of the economic development of Sri Lanka by providing medium and long-term loans and the mobilisation of domestic and foreign capital to finance development projects. Export-oriented projects, which create employment, were given priority. In 1996, through its subsidiary NDB-Bank, NDB started to build up a branch network targeting private customers (in addition to the existing network for corporate customers), thus diversifying its funding basis, which had up to then been largely dependent on donor financing. In 2001 NDB-Bank entirely took over the shares in the branch of the Dutch ABN AMRO Bank and by the time of the merger of NDB Bank and NDB in 2005 had expanded its branch network to 14 offices. At the same time the internet activities were also expanded. Thus, the prerequisites have been created for transferring NDB into a universal bank doing bulk business in the retail banking market.

The project NDB IV comprised a credit line in the amount of EUR 30,677,512.87 (an FC loan of EUR 7,669,378.22 plus market funds of EUR 23,008,134.65) to refinance investments in durable capital goods by industrial and service companies in the private sector in Sri Lanka at market-based interest rates. The maximum total amount of the sub-loans extended was fixed at EUR 2.6 million.

The loan funds were on-lent to private entrepreneurs in domestic currency and had maturities of 3-5 years. The reference interest rate was the Average Weighted Deposit Rate (AWDR), which is published once a week by the central bank. The maximum interest margin for NDB stipulated in the loan agreement was 3% p.a. (for large enterprises) to 4% p.a. (for small and medium-sized enterprises), depending on the risk assessment made by NDB. In cases where a higher interest rate was requested because of a higher risk the related funds were used, as contractually stipulated and confirmed by an internationally active auditing firm, as interest differential funds for training measures for NDB staff. Interest differential funds accruing with the Sri Lankan Finance Ministry were used to hedge the currency risk resulting from the fact that the loan funds denominated in Euro were on-lent by the Finance Ministry to NDB in LKR. In accordance with the loan agreement the Sri Lankan Finance Ministry does not have to report about the use of the interest differential funds.

The random checks of loan files and visits to the borrowers showed that the above-mentioned conditions and lending criteria were observed. The on-site review of the books to check how the funds were used provided no indication of improper use of funds.

Key results of the impact analysis and performance rating

In the context of a sample check of 15 sub-loans it was found that over a period of several years more than 92% of the sub-borrowers showed a return on investment of over 6%, which is a sustainable rate. In over 80% of all cases this rate even increased further after the investment had been made. There are only two exceptions: These are a fishery enterprise and a tourism enterprise, which are both directly or indirectly affected by the Tsunami that occurred in December 2004. The share of loans at risk of default (defaulting payments > 30 days) in the outstanding loan portfolio was 3.0% in September 2006. In 2005 ultimate loan losses – after realisation of securities – amounted to approx. 1% of the loan portfolio (2001: 3.6%) with a further declining trend. We rate the portfolio quality as satisfactory.

Besides the two indicators for the project objective, the indicator defined for the overall objective during project appraisal can also be considered as sufficiently achieved because most of the enterprises reached the requested return on investment and the two enterprises that did not, did so because of an unforeseeable natural catastrophe.

Though this aspect had been envisaged in the appraisal report neither for the overall objective nor for the project objectives, it appears desirable and appropriate from today's perspective to include a positive development of the indicators in the course of the project implementation (i.e. for the indicator of the overall objective: a positive development after the implementation of the investment refinanced) in the target system. Overall, such a positive development can be stated for all indicators, which means that even from this more differentiated viewpoint the indicators can be regarded as fulfilled. Moreover, the quality of the total NDB portfolio is much better than that of its competitors and the central bank requirements regarding loan loss provisions are observed. This is also attributable to the comfortable financial endowment and the positive profit situation of NDB. One overall objective not mentioned in the appraisal report but important from today's perspective is the contribution rendered by the project to the development of the financial system. From an ex post perspective, this contribution is rendered through of the improvement of the provision of long-term loans and the successful privatisation and transformation of the former development bank NDB into a universal bank, which was indirectly supported though the project. Overall, on the basis of the modified and complemented indicators the project objective and the overall objective are considered sufficiently fulfilled.

The number of loans extended under NDV IV until the time of the ex post evaluation was 490 with a total loan volume of LKR 3 billion (LKR 500 million have already been used on a revolving basis). The financed investment volume of over EUR 90 million was three times higher than the volume of FC funds of approx. EUR 30.7 million. The majority of loans extended (almost 79%) had an amount of less than EUR 10,000 and can thus be classified as loans to medium-sized enterprises in Sri Lanka. Most of the loans have maturities between 3 and 5 years. Sectoral priorities of the loans are food processing with 19 % of the loans, followed by the service sector (12%) and textiles (11%). As regards the regional distribution the Colombo region (due to its economic strength) accounts for most of the lending. No loans were extended to the region dominated by the Tamil separatists. Overall, according to the NDB the project helped to create or safeguard approx. 6.552 jobs.

In the course of the project NDB obtained interest differential funds of LKR 16,315,836 (at the time of the ex post evaluation the amount was EUR 119.588), which were used as contractually agreed for internal and external training measures for NDB staff.

Nevertheless, though the provision of loans was expanded the lack of access to long-term funds continues to be the most important obstacle to enterprise growth in Sri Lanka. The FC loans were used to finance 490 enterprises, most of which work profitably and, according to sample checks, produce a sustainable return on investment of 6%. Given the relatively high number of 6.552 jobs created or safeguarded, it can be assumed that the project has positive impacts on poor sections of the population. Gender equality was not a project goal. In principle, however, the project had a certain potential to contribute to gender equality. Loans were extended without regard for gender. Unfortunately, it was not possible to precisely determine the share of female borrowers because a very high percentage of borrowers were legal entities. Environmental aspects, and in particular compliance with environmental approval requirements, were generally taken into account in the credit appraisal. Given the low volume of the individual investments and the sectors supported we assume that no significant environmental effects were produced. The programme did not focus on participatory development or good governance.

The three main risks detected during project appraisal did not have any negative impacts on the project. No deterioration of the macroeconomic conditions in Sri Lanka, which might adversely affect the ability and willingness of the sub-borrowers to repay their loans, occurred. The enterprises did not suffer from any internal or external bottlenecks, which might have prevented the outflow of the loan funds. Due to the fact that NDB is expanding its branch network and in parallel is building up the deposit-taking business with corporate and retail customers it avoids the risk of becoming dependent on donor funds in the longer term.

In a summarised assessment of the above impacts and risks we have arrived at the following rating of the developmental effectiveness of project NDB VI:

<u>Effectiveness</u>

The aim of the project was the provision of efficient, needs-related, long-term supplies of loans to refinance durable capital goods by NDB to the target group (Sri Lankan private-sector industrial and service companies). Based on the in indicators formulated (less than 20% of NDB's loan portfolio is in default / ultimate loan losses per annum do not exceed 5% of the loan portfolio) the project objective was satisfactorily achieved: The share of loans at risk of default (defaulting payments > 30 days) in the outstanding loan portfolio was 3.0% in September 2006. In 2005 ultimate loan losses – after realisation of securities – amounted to approx. 1% of the loan portfolio (2001: 3.6 %) with a further declining trend. As regards the fulfilment of the indicators in the course of the project implementation, a positive development trend can also be stated. In the course of the project implementation until the time of the ex post evaluation altogether 490 loans worth a total of LKR 3 billion were extended. The reflows were used on a revolving basis. The investment volume of over EUR 90 million financed in the first round of lending was three times higher than the volume of FC funds of approx. EUR 30.7 million. 70% of the loans extended had an amount of less than EUR 10,000 and can thus be classified as loans to medium-sized enterprises in Sri Lanka. Most of the loans have maturities between 3 and 5 years. Sectoral priorities of the loans are food processing with 19 % of the loans, followed by the service sector (12%) and textiles (11%). NDB is planning to further expand its activities in the business segment of the FC project. In addition, SMEs are to be serviced more intensively. Overall, we classify the **effectiveness** of the project as **satisfactory (sub-rating 2**).

<u>Significance / Relevance</u>

The overall objective of the project was to create and safeguard jobs and additional income in the private sector. According to the indicator defined this objective is considered as achieved if the return on investment produced by sub-borrowers has reached a satisfactory level (of 6% in real terms) on a long-term basis. In the context of a sample check of 15 sub-loans made during the ex post evaluation it was found that over a period of several years more than 92% of the sub-borrowers showed a return on investment of over 6%, which is a sustainable rate. In over 80% of all cases this rate even increased further after the investment had been made. Overall, according to NDB the project helped to create or safeguard approx. 6.552 jobs in the first round of lending. From today’s perspective, the overall objective of the project would have to be complemented by the objective of making a contribution to the development of the financial system. From an ex post perspective the project contributed to sustainably strengthening the provision of long-term loans for private enterprises. Overall, the project contributed to the creation of income and employment. Overall, we assess the achievement of the overall objective of the project as satisfactory because it contributed to the development of the financial system and positively supported the privatisation of NDB. Therefore, we classify the significance / relevance of the project as satisfactory (<u>**sub-rating: 2**</u>).

<u>Efficiency</u>

Measured by the relation of operative expenses to the loan portfolio and to the total capital, NDB’s operative efficiency improved by 7.3% and 3.9%, respectively in 2005 over the previous year (6.6% and 3.5%) and remains at a good level. The cost/income ratio was reduced from 58% (2004) to 54% (2005), which is low by Sri Lankan standards. In connection with the satisfactory portfolio quality we assess the production efficiency of NDB also as satisfactory. NDB hands out the loans at market-based interest rates. We rate the allocation efficiency as satisfactory. We equally rate the **efficiency** of the project to be satisfactory. (**sub-rating 2**).

In a summarised assessment of the above impacts and risks we rate the project as having satisfactory developmental effectiveness **(overall evaluation: rating 2)**.

General conclusions and recommendations

In the context of the project subject to ex post evaluation here it has to be stated that the FC loan funds provided to the Sri Lankan Ministry of Finance and Planning, which had a maturity until 2039 were not on-lent with equal maturity (the funds on-lend to NDB have to be repaid by 2014). With a view to improving the use of funds it should be considered in the event of future projects to press for a stronger adjustment of the maturity of the FC loan and the maturity of the funds on-lent by the borrower to the project executing agency.

Legend

Developmentally successful: Ratings 1 to 3	
Rating 1	Very high or high degree of developmental effectiveness
Rating 2	Satisfactory developmental effectiveness
Rating 3	Overall sufficient degree of developmental effectiveness
Developmental failures: Ratings 4 to 6	
Rating 4	Overall slightly insufficient degree of developmental effectiveness
Rating 5	Clearly insufficient degree of developmental effectiveness
Rating 6	The project is a total failure

Criteria for the Evaluation of Project Success

The evaluation of the "developmental effectiveness" of a project and its classification during the ex-post evaluation into one of the various levels of success described in more detail below concentrate on the following fundamental questions:

- Are the **project objectives** reached to a sufficient degree (aspect of project **effectiveness**)?
- Does the project generate sufficient significant **developmental effects** (project **relevance** and **significance** measured by the achievement of the overall development-policy objective defined beforehand and its effects in political, institutional, socio-economic and socio-cultural as well as ecological terms)?
- Are the **funds/expenses** that were and are being **employed/incurred** to reach the objectives appropriate and how can the project's microeconomic and macroeconomic impact be measured (aspect of **efficiency** of the project conception)?
- To the extent that undesired **(side) effects** occur, are these tolerable?

We do not treat **sustainability**, a key aspect to consider for project evaluation, as a separate category of evaluation but instead as a cross-cutting element of all four fundamental questions on project success. A project is sustainable if the project-executing agency and/or the target group are able to continue to use the project facilities that have been built for a period of time that is, overall, adequate in economic terms, or to carry on with the project activities on their own and generate positive results after the financial, organizational and/or technical support has come to an end.