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Report No. 6795

PROJECT COMPLETION REPORT

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRIES PROJECT (SMI I)
(CREDIT 942-CE)

May 22, 1987

IDF Division
South Asia Projects Department

ABBREVIATIONS

ADB	-	Asian Development Bank
BOC	-	Bank of Ceylon
BRI	-	Building Research Institute
BTT	-	Business Turnover Tax
CBOC	-	Commercial Bank of Ceylon
CBSL	-	Central Bank of Sri Lanka
CISIR	-	Ceylon Institute for Scientific and Industrial Research
DFCC	-	Development Finance Corporation of Ceylon
DSI	-	Department of Small Industries
EPR	-	Effective Protection Rates
FIAC	-	Foreign Investment Advisory Committee
GCEC	-	Greater Colombo Economic Commission
GOSL	-	Government of Sri Lanka
HNB	-	Hatton National Bank
ICICI	-	Industrial Credit & Investment Corporation of India
IDB	-	Industrial Development Board
IPZ	-	Investment Promotion Zone
MISA	-	Ministry of Industry and Scientific Affairs
MRI	-	Ministry of Rural Industrial Development
MTI	-	Ministry of Textile Industries
NAB	-	National Apprenticeship Board
NDB	-	National Development Bank of Sri Lanka
NERD	-	National Engineering Research Department
NIBM	-	National Institute of Business Management
NIM	-	National Institute of Management
NSB	-	National Savings Bank
PCI	-	Participating Credit Institution
PMB	-	Paddy Marketing Board
RRI	-	Rubber Research Institute
SMI	-	Small and Medium Industries
UNDP	-	United Nations Development Programme

FISCAL YEARS

Government of Sri Lanka	-	January 1 to December 31
Commercial Banks	-	January 1 to December 31
NDB	-	January 1 to December 31
DFCC	-	April 1 to March 31

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

Office of Director-General
Operations Evaluation

May 22, 1987

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Project Completion Report on Sri Lanka - First Small and Medium Industries Project (SMI I) (Credit 942-CE)

Attached, for information, is a copy of a report entitled "Project Completion Report on Sri Lanka - First Small and Medium Industries Project (SMI I) (Credit 942-CE)" prepared by the South Asia Projects Department. Under the modified system for project performance auditing further evaluation of this project by the Operations Evaluation Department has not been made.

Yves Rovani

By Ram K. Chopra

Attachment

CURRENCY EQUIVALENTS

Currency Unit - Sri Lanka Rupee

Sri Lanka has a floating exchange rate. Since 1980 the annual average rate has been:

1980 - US$1 = Rs 16.5; 1981 - US$1 = Rs 19.3;
1982 - US$1 = Rs 20.8; 1983 - US$1 = Rs 23.5; and
1984 - US$1 = Rs 25.5.

As of December 31, 1984, US$1 = Rs 26.3

As of December 31, 1985, US$1 = Rs 27.4

The following rate is used in this report:

US$1	=	Rs 27.4
Rs 1	=	US$0.036
Rs 1 Million	=	US$36,000

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PROJECT COMPLETION REPORT

SRI LANKA - FIRST SMALL AND MEDIUM INDUSTRY PROJECT (SMI I)

CREDIT 942-CE

PREFACE

1. Starting in 1979, the development of Small and Medium Industry (SMI) in Sri Lanka has been supported by two SMI projects. The first SMI I (Cr. 942-CE) was appraised in March 1979 and became effective on October 23, 1979. The original closing date of the Project was June 30, 1984 but this was subsequently extended to June 30, 1985 to allow for disbursement of unutilized funds which was completed by December 31, 1985. The Second SMI Project (Cr. 1182-CE) was appraised in February 1981 and became effective in May 1982. The original closing date was December 31, 1986 but this has subsequently been extended to December 31, 1987. In December 1985, US$2.4 million and US$1.3 million of eligible project and technical assistance expenditure under SMI II (Cr. 1182-CE) was transferred to SMI I to utilize available funds. However, due to delays in recruiting suitable consultants it was necessary to cancel a total balance of $922,000.

2. SMI I was committed more rapidly than expected and to meet credit demand SMI II was appraised and became effective before any real lessons could be learned from the implementation of SMI I. While this report is the PCR for SMI I, given the close interrelationship between the two projects, the common objectives and institutions, this report has treated the two projects as one in order to draw conclusions as to the effectiveness of IDA assisted SMI development.

3. Apart from providing credit to finance SMI investment, the major objective of the SMI Projects was to address the constraints hindering the rapid growth and productivity improvement of SMIs particularly in the areas of agro-industry, construction and building materials, garment production and the development of rubber products. This Report focusses on achievements under the SMI Projects until December 31, 1985 and the relationship of the Bank Group with the various implementing agencies.

4. The report was written by staff of the South Asia IDF Division, and was updated following a supervision mission to Sri Lanka in August 1986. Staff of the SMI Fund within NDB provided data for incorporation in the Report. The Report is, however, the sole responsibility of IDA staff based upon information provided by NDB, the Participating Credit Institutions (PCIs), technical assistance agencies and GOSL officials. A draft of the PCR was submitted to NDB and GOSL for review in early 1987 and both indicated that they had no detailed commentss. A file index of source material, which is part of the Project Implementation File, is held in the South Asia Information Center.

This project has not been audited by the Operations Evaluation Department.

PROJECT COMPLETION REPORT

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRIES PROJECT (SMI I)
(Credit 942-CE)

BASIC DATA SHEET
(US$ Million)

KEY PROJECT DATA

Item	US$ Million
Credit Amount	16.0
Disbursed	15.1
Canceled	0.9
Planned Commitment	FY84
% Actual Commitment	77
Actual Commitment	FY86
% Actual Commitment	94
Economic Rate of Return (Subprojects)	15%-55% (estimated)
Fiancial Performance (")	15%-30% (estimated)
Institutional Performance (PCIs)	Improved
Impact of TA	Mixed

OTHER PROJECT DATA

	Original	Actual
Project Preparation		06-00-78
Negotiation		05-23-77
Board Approval		06-26-79
Credit Agreement		07-24-79
Effectiveness		10-23-79
Final Subproject Submission	12-31-83	12-31-84
Closing Date	06-30-84	12-31-85

Borrower	Democratic Socialist Republic of Sri Lanka
Executing Agencies	National Development Bank (NDB), Ministry of Industries and Scientific Affairs (MISA)

Mission Data

		Date	No. of Week	No. of Year	Staff Weeks	Report Date
Preparation	1	05-78	3	2	6	06 -78
Preparation	2	12-78	4	7	28	2- 6-79
Appraisal		03-79	3	6	18	06- 8-79
Supervision	1	06-79	2	1	2	08- 8-79
	2	08-79	2	2	4	09-26-79
	3	11-79	1	1	1	02-19-80
	4	04-80	1	1	1	04-28-80
	5 1/	02-81	4	3	12	03-26-81
	6 1/	11-81	3	4	12	01-14-82
	7 1/	04-82	3	2	6	04-17-82
	8 1/	08-82	1	1	1	08-07-82
	9 1/	11-82	1	1	1	11-13-82
	10 1/	03-83	2	1	2	04-19-83
	11 1/	10-83	2	1	2	19-28-83
	12 1/	05-84	1	2	2	05-14-84
	13 1/	07-84	2	3	6	09-10-84
	14 1/	05-85	2	2	4	06-14-85
	15	11-85	2	1	2	12-26-85

1/ Joint supervision SMI I (Cr. 942-CE and SMI II-Cr. 1182-CE).
2/ Cr.942-CE was also supervised during the appraisal of the First and Second Industrial Development Project (Cr. 1401-CE and Cr. 1612-CE).

Staff Input

(S.W.)

	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	Total
Preparation	7.5	-	-	-	-	-	-	-	-	7.5
Appraisal	36.0	8.0	-	-	-	-	-	-	-	44.0
Negotiations	-	6.0	-	-	-	-	-	-	-	6.0
Supervision 1/	-	-	25.7	16.0	5.7	4.8	5.2	8.8	6.1	72.3
	43.5	14.0	25.7	16.0	5.7	4.8	5.2	8.8	6.1	129.8

1/ From FY82 onwards this project was supervised in conjunction with Cr. 1182-CE--SMI II.

Follow-on Projects

Following the rapid commitment of SMI I, SMI II-(Cr. 1182-CE) for US$30.0 million was approved in September 1981 and became effective in May 1982. NDB and the Development Finance Corporation of Ceylon (DFCC), which participated in both SMI projects also participated in Cr. 1401-CE for US$25.0 million approved in June 1983 and will participate in Cr. 1692-CE for US$20.0 million approved in May 1986.

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FIRST SMALL AND MEDIUM INDUSTRIES PROJECT (SMI I)
(Credit 942-CE)

HIGHLIGHTS

1. Until 1979, Bank Group support for the industrial sector in Sri Lanka had comprised three loans and three credits to the Development Finance Corporation of Ceylon (DFCC), IFC equity in DFCC and an IFC loan to the Bank of Ceylon (BOC). ADB Funding had also been provided to DFCC. These projects had been designed primarily to meet the needs of medium to large private industry units, although 25% of the IFC loan to the BOC was allocated to firms defined as small scale. SMI I provided an opportunity to foster the development of small scale industry which was seen as a key element in the industrial development of Sri Lanka and to focus on a number of policy and procedural constraints to the growth of SMI operations (paras. 5.02 and 5.09).

2. The principal objectives of SMI I were to address constraints hindering the rapid growth and productivity improvement of SMIs in order to increase their contribution to efficient and low cost employment generation, export expansion and economic growth. The credit provided US$16 million; US$12 million for partial refinance of term loans made to SMIs, and US$4 million to finance (a) services to SMIs in selected subsectors, (b) training and advisors to build capabilities of credit and SMI technical service institutions, and (c) policy studies on issues affecting expansion, export and efficiency prospects of SMIs. The project had major institution-building objectives. To increase viable SMIs' access to credit, an SMI Fund was established within the newly-created National Development Bank (NDB); five major credit institutions were to develop or expand the SMI units at headquarters and in key branches with trained, specialized staff in SMI project appraisal and supervision; and high spreads and a modified credit guarantee scheme were provided to increase incentives for credit institutions to expand SMI lending activity. Under the project, selected technical service agencies were to focus on providing effective technical, marketing and management services to SMIs in subsectors with expansion potential. Of these the Industrial Development Board (IDB) was to upgrade its regional extension network, start a subcontracting exchange to link small

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1/ Given the overlap of Cr. 942-CE and Cr. 1182-CE the findings and conclusions in the report draw on implementation experience under both projects.

manufacturers with public procurement and private contracts, and build subsector-specific schemes, staff and technical facilities in three major SMI subsectors. Three other technical service agencies were to implement discrete subsector-specific components and provide management training (paras. 1.02, 3.03 and 3.04).

3. The resource transfer was achieved more rapidly than was anticipated, notwithstanding later withdrawals from the project. The subprojects approved were mainly in traditional subsectors - rice milling, coconut processing, building materials, wood products and light engineering/metal products - and the project did not - contrary to expectations - finance any significant numbers of non-traditional subprojects in the agro-industry, construction or export oriented subsectors. This reflects more a misreading of the level of pent up demand for project financing in traditional products than in any inappropriate selection process on the part of the PCIs. On project completion, 1746 subprojects had been financed with mixed results. Long implementation delays with consequent cost overruns and lower than expected operating results plagued many of the projects financed. Major factors influencing implementation were both internal and external. Internally many projects were hampered by poor preparation and sponsor inexperience. Externally the effects of local and international economic developments were misjudged at the time of PCI appraisal. A major disrupting influence on many projects were the ethnic disturbances which wracked Sri Lanka from July 1983 onwards. Paradoxically, rapid commitment of the project, coupled with the internal/external implementation difficulties resulted in a significant level of arrears which affected the financial viability of the PCI SMI portfolios. However, steps have been taken to address these concerns and to ensure that arrears and infected loans are adequately provided for. These actions have resulted in a gradual reduction in arrears (paras. 4.01-4.03, 5.02-5.09, 5.16, and 5.17).

4. The institutional objectives of the project were achieved satisfactorily. A well staffed and managed SMI fund was established to administer SMI refinancing operations, and with GOSL support NDB and the PCIs became an effective group of SMI financing institutions. Within the PCIs, SMI financing units have been established and the standards of appraisal have been gradually improved. However, staffing of PCI operations has been erratic and a cause of much of the increase in portfolio infection. Training/staffing programs have been initiated to address this issue and SMI staff levels have stabilized. Notwithstanding the poor repayment performance of many of the subprojects, PCI participation in the project has been encouraging and PCIs are now seeking to diversify their SMI clientele. (paras. 5.10-5.15).

5. Achievement of the objectives of the technical assistance component, which focussed on upgrading technical, marketing and management support for SMI operations, was less than satisfactory. It was expected that implementation of the various TA programs would take a considerable time to complete, but delays in recruiting appropriate advisors and local staff,

finding suitable sites for service centers and constructing facilities went far beyond the lag expected. Thus although the project became effective in October 1979 and was initially fully committed within two years it was not until late 1982/early 1983 that the various service centers were in a position to provide any tangible support to SMI. Even after establishment of the service centers and initiation of the Industrial Development Board (IDB) and Export Development Board (EDB) assistance programs, the impact on SMI operation was limited due to the considerable difficulties of both organizations in retaining trained staff. Of the service centers, the Clothing Industry Training Institute performed well and established a sound institutional and physical structure which should ensure its survival (paras. 4.04, 5.18-5.21, 7.11 and 7.12).

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SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRIES PROJECT (SMI I)
(Credit 942-CE)

I. INTRODUCTION

1.01 Until March 1979 the Bank Group's involvement in industrial development had been limited to the provision of four lines of credit/loans totalling US$24.5 million to DFCC for medium and large scale industrial project financing. However, by 1978 GOSL's policy reforms and increased emphasis on expanding the private sector had created a climate in which the prospects for efficient SMI development could be exploited. Reviews of the main SMI subsectors and institutions supported this assessment of potential and in November 1978, an IDA project preparation mission reached understandings with relevant ministries and potential implementing agencies on the design and organization of an SMI project which would address the major constraint affecting the development of SMI. Negotiations for the project were completed in May 1979 and the project became effective in October 1979.

1.02 Under the project, US$12.0 million was provided for partial refinancing of SMI term loans, while US$4 million was provided to finance (a) services to SMIs in selected subsectors, (b) training and advisors to upgrade PCIs and technical service institutions, and (c) reviews of GOSL policy affecting expansion, export and efficiency prospects of SMIs. The project also had major institution-building objectives. To increase availability of credit, an SMI fund was established within the newly-created National Development Bank (NDB) to recycle the repayments from short-term lending under the project. Five major credit institutions with SMI activities were selected to participate in the Project subject to developing or expanding their SMI units at headquarters and in key branches with staff specialized in SMI project appraisal and supervision. Large spreads and a generous credit guarantee scheme were provided as incentives for the PCIs to expand this SMI lending activities. Under the project, the associated technical service agencies focussed on providing effective technical, marketing and management services to SMIs in subsectors with expansion potential. The IDB, a key technical service and development agency, was to upgrade its regional extension network, start a subcontracting exchange to link small manufacturers with public procurement and private contracts, and develop and staff subsector-specific service centers relating to three major SMI subsectors. Three other technical service agencies were to implement discrete subsector-specific components and provide management training to SMI Entrepreneurs. Since success of the project depended upon the capabilities

and motivation of key personnel in the credit and technical service organizations UNDP allocated US$175,000 from its Multi-Sectoral Facility to fund short term training of selected staff prior to the implementation of the Project.

1.03 This PCR reviews the experience of IDA and NDB, through the SMI Fund, in the implementation of the Project. It focuses on the impact of the subprojects financed under Cr. 942-CE and on the institution building activities initiated under the project and supported through the technical assistance component of the Credit.

II. THE SECTORAL ENVIRONMENT

A. Economic Setting 1/

2.01 Real GDP in Sri Lanka grew by 2.7% p.a. during 1970-1976, due to a combination of a policy framework unconducive to growth or efficiency, poor weather conditions which affected agricultural growth adversely and the sharp rise in the cost of fuel. In late 1977, the newly elected Government initiated a liberalization strategy with the objective of increasing the growth rate of production and employment, savings and investment and exports. 2/ To achieve these objectives, the Government introduced policies which included exchange rate unification and depreciation, import trade liberalization, interest rate increases to encourage savings, full cost pricing for most imported commodities and the establishment of a free trade zone to attract export oriented foreign private investment. The economy reacted vigorously to these changes at the beginning, with real GDP growth accelerating to an average of 7.3% p.a. during FY77-79, but it slowed down to 5% in FY81-85. The main areas of growth have been agriculture, services, garment exports and construction, all of which benefited from liberalization, the increased level of investment and other incentives. With assistance from foreign donors, fixed investment has risen from about 15% of GDP in the early 1970s to 26% in FY84.

1/ For a comprehensive analysis of the Sri Lankan economy, see Report No. 6176-CE - Sri Lanka: Current Economic Situtation and Outlook dated May 13, 1986.

2/ This program of reform was introduced in agreement with the IMF in support of a standby facility and subsequently, in January 1979, an Extended Fund Facility.

2.02 Some of the policies which made these achievements possible, however, also led to serious financial imbalances. As the public investment program gained momentum, it grew beyond the country's resource availabilities, contributing to unsustainable budgetary and balance of payments deficits and to undesirable levels of foreign commercial borrowing. More importantly, the imbalance in the budget and in the balance of payments were aggravated by an inadequate resource mobilization effort by the public sector and by the existence of a policy environment which was not conducive to exports due to a lack of adjustment in the exchange rate and high protection which created a bias toward import substitution. With significant increases in public sector investment and a disappointing revenue effort, the budget deficit increased from 11% of GDP in FY77 to 23% in FY80, declining to 14% in FY83, fell temporarily to 10% in FY84 but increased to 13% in FY85. Due to this budgetary deficit, external developments and an incentive structure biased against exports, the current account deficit increased to 19.8% of GDP in FY80, declining to 12.4% in FY83 and to 3.7% in FY84. After several years of precarious financial conditions, FY84 saw a significant reduction both in the external and internal deficits. While these achievements were partly the result of Government policy, including the adoption of restrictive credit policies towards the private sector, the introduction of new revenue raising measures and the containment of public spending, the dominant factor in explaining these developments was the growth in Government and export earnings from tea, which contributed to an increase in net international reserves of US$305 million in FY84. The sudden decline of tea prices in 1985-86 and the increasing level of ethnic disturbances, with their consequent impact on budgetary resources, underscored the continued vulnerability of the Sri Lankan economy and the need for diversification.

B. Industrial Structure and Performance

2.03 Although Sri Lanka has a limited industrial base, the manufacturing sector accounts for about 14% of GDP and 45% of exports. The structure of the sector has remained relatively unchanged over the past decade. Large enterprises, mainly public sector corporations, are concentrated in textiles, sugar, cement, ceramics, chemicals, petroleum, steel and wood products. Currently, the manufacturing sector consists of 20 medium- to large-sale corporations under the control of MISA; about 50 corporations supervised by other Ministries; about 400 large-scale registered private factories mainly in Colombo; 5,000 small and medium registered private factories; and about 25,000 dispersed unregistered small and cottage units concentrated in handicrafts and services. Additionally, there are about 100,000 small scale industrial units employing less than five people. The private sector employs 90% of industrial workers and accounts for about 60% of manufactured value added.

2.04 Government policy has had a significant impact on industrial performance. Liberalization of trade and industrial policies in 1977, the lifting of foreign exchange restrictions and growing commitment to the private sector as a basis for industrial development contributed to strong industrial growth of about 8% p.a. in FY78. However, after this initial improvement, the rate of real growth in industry slowed to an annual average

real rate of 4.6% in FY79-85. The appreciation of the exchange rate after FY78 adversely affected the production of traded goods. Furthermore, import tariffs were maintained to provide significant levels of tariff protection for manufacturers vis-a-vis other sectors. However, the growth opportunities created by this policy were limited due to the small size of the local market. While overall growth in industrial output from FY79 to FY85 increased to 4.6% per annum in constant prices, output of the Public Manufacturing Enterprises (PMEs) essentially stagnated with a growth rate of about 1%-2%. Private sector companies dominate production of food, beverages, tobacco, chemicals, rubber and plastic products for the domestic market, and textiles and garments for export which increased from US$12 million in FY77 to more than US$320 million in FY85. Despite the growth of the private sector, PMES remain important, accounting for about 50% of industrial investment and contributing about 40% of value added in the non-petroleum manufacturing sector.

C. Characteristics and Role of SMIs

2.05 Definition. For the purpose of fiscal incentives, GOSL originally defined SMIs as enterprises with less than Rs 1 million (US$46,000) in plant, equipment, land and buildings, valued at original costs. GOSL through MISA subsequently changed this definition to Rs 1 million (US$46,000) excluding investment in land and buildings. This increase was considered justified and provided a sound definition for the SMI target group of the proposed project 1/ since: (a) cumulative inflation over the past years made a definition of Rs 1 million in total fixed assets too restrictive for efficient operations in some SMI product groups; (b) expansion of existing SMIs would be encouraged; and (c) SMIs with up to Rs 1 million in plant and equipment were judged to be those for which simplified appraisal techniques and outside technical services were relevant. Based on this new definition, the SMI sector includes some 90% of registered private firms and all unregistered firms and accounts for about three-quarters of industrial employment in Sri Lanka and contributed over one-half of industrial value added. The same definition was also appropriate for SMIs in construction contracting and quarrying, which are not covered by fiscal incentives.

2.06 Geographical Distribution. At the outset of the project, about 70% of the registered SMIs were in and around Colombo, with secondary concentrations in the Kalutara, Kandy, Matara, Jaffna, Galle and Kurunegala districts. Unregistered small and cottage industries were more widely

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1/ For the purposes of Cr. 942-CE, SMIs included those in manufacturing, quarrying, construction. agroprocessing, cottage industries and certain industrial services. SMIs eligible for subloans were those with original cost of plant and equipment below Rs 2 million. This limit was subsequently increased to Rs 4 million.

dispersed among small towns and villages, with the Colombo district representing about 30% of the total. Regional industrial dispersal is one of the prime objectives of the present Government. However, the potential for SMI development in rural areas is limited largely to agro-industries, construction, and some cottage industries; the potential in secondary towns was considered greater if access to institutional finance and technical and marketing services could be increased.

2.07 Subsectoral Distribution. The principal SMI subsectors, which together accounted for 88% of employment and 84% of investment in registered SMIs, were textiles and garments, light engineering, paper products, rubber and chemical products, food manufacturing and wood products. Subsector distribution of unregistered small and cottage industries was similar although their products are simpler, e.g. handloom textiles, jaggery, bricks, pottery, wood and coir items. SMIs presently account for about 80% of employment and 70% of investment in private construction contracting.

2.08 Performance and Efficiency. In 1977, SMIs made gross earnings equivalent to 34% of total sales and 40% of total investment. In the principal subsectors, SMIs compared well with larger private and public firms in terms of efficient use of capital and labor with lower capital/labor ratios and higher value added per unit of labor and capital. In the area of exporting SMIs also performed well; while non-traditional industrial exports in 1978 accounted for 9% of the total value of exports an increase from the 6% in 1977; the share of SMIs increased from 7% in 1977 to 10% in 1978. However, while many SMIs produced goods which could be internationally competitive, they found it difficult to establish direct contacts with foreign buyers and to obtain adequate information on direct/indirect export market requirements. Nevertheless, many SMIs needed to upgrade productivity, product quality and capacity utilization to operate profitably in the liberalized environment. For this purpose, SMI required better access to credit for inputs and fixed investments; and technical assistance to plan investments, improve production methods and take advantage of domestic market opportunities.

2.09 Expansion and Export Potential. Based on export demand assessments and increased domestic demand for consumer goods and construction materials, significant expansion opportunities existed for SMIs in most subsectors. With the anticipated higher rates of economic expansion, prospects in several SMI subsectors with growth potential were linked closely with other sectors of the economy. Thus, potential for significant expansion of agro-processing activity was linked to increased paddy production and availability of coconut husks and seafood. Similarly, the extensive public investment in agriculture was expected to generate additional demand for tools, spares, repair services and construction contracting. Subcontracting between SMI firms and larger private and public sector enterprises, which is less developed, also had considerable potential.

D. Financing SMIs

2.10 Following import liberalization, demand for credit by all sectors of the economy increased rapidly. During FY78, total credit by the banking system rose by 44%, whereas total deposits increased by only 30%. In addition to the sharp increase in the financing needs for trade and imports of raw materials and intermediate goods, delays in disbursements from the Central Bank of Sri Lanka (CBSL) refinancing scheme and the contractionary effect of government operations contributed to a significant liquidity squeeze in the second half of FY78. As a result, the banks' loan/deposit ratio increased from 0.85 at the end of FY77 to 0.94 at the end of FY78 with most banks exceeding their credit ceilings with the CBC. In FY78, industrial credit expanded sharply and accounted for 27% of total credit. However, due to heavy bank lending to PMEs, lending to private industry decreased from 55% of total industrial credit in FY77 to 45% in FY78.

2.11 Of the institutional finance in Sri Lanka, about 85% of industrial lending was provided by commercial banks, and 15% by DFCC and the smaller finance companies. Of the 11 commercial banks operating in Sri Lanka, 4 are domestic and 7 are foreign. 1/ The two state-owned commercial banks, Bank of Ceylon (BOC) and People's Bank (PB) have extensive branch networks and account for more than 90% of industrial credit by the banking system. The two principally private domestic banks, Hatton National Bank (HNB) and Commercial Bank of Ceylon (CBOC), are smaller but expanding. Most of the industrial credit was in the form of short-term loans and overdrafts, with medium and long-term lending accounting for 20% of the total.

2.12 With respect to SMI lending, there had been the usual problem of limited access to institutional credit. To remedy this, from FY76 BOC and PB participated, with varying degrees of investment, in a Joint Credit Scheme for SMI lending with the Industrial Development Board (IDB). Under this scheme, IDB formulated and appraised SMI projects, and recommended them for bank financing. While the scheme helped to improve access to credit by a number of SMIs, it was not satisfactory. Since they carried the risk on the loans, the banks were critical of the lack of objectivity and thoroughness of IDB's appraisals. Most commercial bank lending to SMIs was independent of the IDB Joint Scheme. In their own lending decisions, the commercial banks used fairly conservative lending criteria based more on collateral than on project evaluation. As a result, SMIs had difficulties in securing credit. Due to its limited rupee resources and lack of a branch network, DFCC concentrated mainly on lending foreign exchange resources to the larger firms although DFCC had been increasing its SMI lending activities. The scheme was terminated with the initiation of SMI I.

1/ The foreign banks concentrate mainly on foreign trade financing.

2.13 In FY78, GOSL established the National Development Bank of Sri Lanka (NDB) to (i) evaluate PME project proposals and where appropriate provide project financing, (ii) promote SMI lending, and (iii) review appraisals and provide refinance for SMI loans by the PCIs. The Chairman and General Manager had been appointed and were working on organization, staffing and operational policies and on selecting key managerial and technical staff. The proposed project was designed to assist NDB in developing its SMI refinancing activities and overall operations.

2.14 In response to the liberalized investment environment, credit to SMIs, which accounted for about 7% of lending to private industry, increased by some 50% in FY78, mainly for working capital. An estimate of potential demand for financing by SMIs was made based on conservative assumptions regarding the rate of growth of the sector (6.5% p.a.), the incremental capital/output ratio (ICOR) and permanent working capital requirements. Total investment requirements by SMIs for FY79-83 was estimated at Rs 2.8 billion. Taking into account anticipated levels of international and domestic inflation, credit demand by SMIs was estimated at US$12 million per year in current prices. However based on prior year transactions, credit institutions would provide only about 35% of this financing requirement, with a traditionally high percentage of the remaining requirements funded through self-finance.

2.15 In FY78, the commercial banks and DFCC lent about US$4.5 million in term credit to SMIs. However, the banking system's resource constraints and increased requirements for other purposes limited its ability to sustain a significantly higher level of SMI lending in the medium-term, particularly since it would take time to change conservative banking attitudes and increase SMI project appraisal capabilities. On the basis that the banking system would maintain its existing level of financing in real terms from its own resources, the projected financing gap was about US$7.5 million per year, or US$22.5 million over FY80-FY82. The project provided US$12 million to cover part of this potential financing gap until the banks built up their confidence and capacity to finance a higher level of SMI operations. Subsector analysis indicated that most demand for credit would be generated in construction and building materials, metal and rubber products, and agro-industrial SMIs.

2.16 Interest Rates and Inflation. As part of GOSLs FY77 policy reforms, interest rates were raised substantially to prevent possible capital outflow after the liberalization of foreign exchange controls, to reflect the higher rates of inflation expected during the transition to a more open economy and to stimulate medium-term private savings. Commercial banks paid 7.0% on savings deposits and 8.5% to 15% on time deposits. Due to liquidity problems and rising cost of funds, most banks increased their effective lending rates during FY78, to 13%-18% on industrial term loans, including loans to SMIs.

2.17 Based on the CBSL index, between December 1977 and December 1978 the inflation rate was 14%, mainly reflecting the reduction in food subsidies, relaxation of domestic price controls, and increased cost of some imports following the devaluation of the rupee. With further price adjustments on the producer and consumer levels and subsidy reductions planned by the Government for FY80-FY87, it was expected that the annual rate of inflation would decline gradually to international levels by FY81. At the projected rates of inflation, the on-lending interest rates of the major credit institutions would remain positive in real terms.

E. Technical Service Agencies

2.18 Although Sri Lanka had a number of public sector institutions providing managerial, technical, and training assistance to SMIs, the effectiveness of these agencies was constrained by unclear assignment of responsibilities, shortages of trained personnel, and inadequate operating facilities. The IDB, 1/ an agency of the MISA, was the principal SMI development institution responsible for promoting and assisting all SMI subsectors other than textiles and cottage industry. IDB was a long-established agency, but needed to strengthen its promotional activities and subsector services at headquarters and key districts, moving from a focus on loan-related activities to promotion. The Department of Small Industries (DSI), an agency of the MRI, was responsible for cottage industry development. However it needed to improve its impact by providing services to craftsmen rather than limiting its efforts to DSI-owned production facilities. The Ministry of Textile Industries (MTI) was responsible for formulating policy and implementing programs in the textile and garment subsector. Under its control the Department of Textile Industries (DTI) was responsible for developing the handloom industry and for increasing collaborative arrangements with private exporters although little had been done in this area. Training programs were concentrated in two main agencies: the National Institute of Business Management (NIBM), under MISA, providing production and financial management courses; and the National Apprenticeship Board (NAB), under the Ministry of Youth Affairs and Employment, arranging supervised, paid apprenticeships with private industry in a range of trades. However the effectiveness of all these agencies was poor and considerable upgrading was considered necessary before they could provide support to SMI.

1/ IDB has since been transferred to the Ministry of Rural Industrial Development (MRI).

III. THE PROJECT OBJECTIVES AND STRUCTURE

A. Evolution of the Project

3.01 Prior to the mid-1970s the Bank Group had an ongoing involvement in the industrial sector through a number of operation involving DFCC and BOC. The Bank has made two loans and two credits totalling US$24.5 million to DFCC, while IFC had provided a US$2.0 million line of credit to BOC. Additionally, IFC had an equity participation in DFCC and nominated a Board representative. In each case, the lending operation was for the financing of medium-large scale enterprises. Parallel to the Bank operations, the Asian Development Bank (ADB) and other bilateral agencies also provided funding to DFCC for medium-large scale industrial investment. However, the policy reforms enacted by GOSL in FY77 changed the economic climate that had previously prevailed. Increased emphasis was given to the role of the private sector and to the development of efficient SMI operations. The potential for industrial development through SMI activities was confirmed by Bank Group missions in FY78 and FY79 and the Bank assisted GOSL in the preparation of the Project. Development of the Project provided the Bank Group with the opportunity to broaden its industrial financing operations to cover the whole of the industrial sector and to become involved with more institutions in the financial sector through initial steps to strengthen their term lending operations. Specialist consultants in light engineering, agro-industries, and building materials were hired for preparation and appraisal missions. An expert in rubber products, working for UNDP in Sri Lanka, was borrowed for full-time participation in preparation and appraisal mission. Strong secondary information was used in garments. The Project development also provided the Bank with the opportunity to initiate the basic analytical work necessary to support needed changes in the trade and industrial policy regime.

B. Objectives, Scope and Institutional Arrangements

3.02 The principal objectives of the project were to address constraints hindering rapid growth and productivity improvement of SMIs, particularly in the key subsectors of agroindustry, construction and building materials, garments, and rubber products; and increase their contribution to efficient and low cost employment generation, export expansion, and economic growth. To meet these objectives, the project had two major components, an IDA Credit of US$12.0 million for term financing and US$4.0 million for technical services.

3.03 Credit Component. Under the credit component, responsibility for subproject appraisal, on-lending and supervision was delegated to five participating credit institutions (PCIs): two public commercial banks, BOC and PB; two locally controlled private commercial banks, HNB and CBOC; and DFCC. Under the project, their SMI activities were to be encouraged and supported by:

(a) providing of US$12 million to help fill the gap between projected SMI term lending requirements and available resources;

(b) creating a separately managed SMI Refinancing Fund within NDB to review subprojects, and providing partial refinancing of subloans made to SMIs which met financial and economic eligibility criteria;

(c) improving the capabilities of project lending institutions to do appraisal-based lending by: assigning SMI specialists to headquarters and key branches; providing SMI specialists and management with training in simplified SMI appraisal and supervision; and introducing systems and tools to facilitate this work; and

(d) providing inducements to increase financing of viable SMIs, through provision of attractive spreads, a credit guarantee scheme and a special capital facility for entrepreneurs unable to meet the normal equity requirements but with subprojects of strong economic merit.

3.04 Technical Assistance. Under the TA component funds were provided to employ local/expatriate advisors to:

(a) assist GOSL to carry out general policy studies on aspects of export incentives and the tariff system, which affect industrial efficiency, expansion, and export prospects;

(b) reinforce IDB's promotion and technical service programs for SMIs by improving it's regional extension network, starting a subcontracting exchange, and establishing staff training and technical facilities for rubber products, building materials, foundries and light engineering subsectors;

(c) improve the focus and effectiveness of other SMI technical service agencies by providing finance for (i) programs in garment training; (ii) extension programs in white coir extraction and processing; and (iii) an export organization for handloom products; and

(d) assist NDB and the PCIs to improve their SMI and general lending operations.

IV. UTILIZATION OF PROJECT PROCEEDS

Resource Transfer

4.01 The Credit Component. Initial commitment of the credit component was rapid. By December 1981, the credit component had been fully committed and there was a significant number of subproject application lodged with the PCIs for which no financing was available. However, because of exchange rate changes and withdrawals of approved subprojects from the project, previously committed funds were released for new commitment and these were not fully utilized until December 1984. In total, 1746 subprojects 1/ were approved by the Project closing date.

4.02 While commitment of the project was rapid, disbursement of subproject loans proceeded slowly. 2/ Full disbursement had been projected for the third quarter of 1983 (Annex 1), but this was not achieved until eighteen months after the original project closing date. Several factors led to the slowdown. Elections in the early part of 1982 with the possibilities of violence and a change in Government caused many sponsors to delay implementation of their projects. With the passing of the election, sponsors resumed implementation; however, the ethnic disturbances in 1983 halted the momentum of disbursement; from March 1983 to September 1983 only US$200,000 was disbursed. Lack of infrastructural facilities also delayed implementation and disbursement as did the lack of equity resources. The impact of these delays was such that, as of December 31, 1985, only US$9.0 million of the US$12.0 million component had been disbursed. To reduce the level of possible cancellation, US$2.4 million of subproject disbursements were transferred from SMI II (Cr. 1182-CE). The balance of US$0.6 million was cancelled.

4.03 The pattern of SMI lending by the PCIs was roughly in line with the levels forecast at the time of appraisal (Annex 2). As expected BOC and the PB accounted for 77% of project lending. However, CBOC was more active than anticipated and utilized 13% of the Credit vs 9% at appraisal. Because of the lack of a branch network to generate projects, DFCC was able to utilize only 1% vs 11% expected at the time of appraisal.

4.04 Utilization Technical Assistance. The technical assistance component which had been seen as a key factor in increasing the role of SMI in industrial development had considerable implementation problems which affected significantly the rate of disbursement. By the original closing date of June 30, 1984, only US$1.7 million (or 43%) of the original allocation of US$4.0 million had been disbursed. By December 31, 1985,

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1/ The final number of subprojects under the project was 1741 as five subprojects were withdrawn on closure.

2/ As of December 31, 1986, Rs 293 million had been committed. With cancellations actual Rupee disbursement was Rs 229.5 million.

through prepayment and expansion of service eligibility, disbursements were increased to US$3.1 million. To minimize cancellation of funds, US$586,000 of TA disbursements under SMI II (Cr. 1182-CE) were transferred to SMI I bringing total disbursement to US$3.6 million; the balance of US$0.4 million was cancelled on February 4, 1986.

V. PROJECT IMPLEMENTATION

A. Sub-Projects

General

5.01 Although there were subsequent cancellations, the rapid commitment of the credit component reflected (i) the existence of a considerable pent-up demand for SMI term financing, (ii) the relative attractiveness to sponsors of the 20% equity financing requirement, (iii) the simplified procedures developed for processing subproject applications, and (iv) initial competition by the PCIs to use the line of credit to expand their activity in the area of medium term foreign currency credit, integrating the activity with their short term working capital operations. While the availability of credit under the project met some of the initial credit demand, the uncertainties of elections and the disrupting effects of the ethnic disturbances in 1982 and 1983 respectively led to a slowdown of credit demand.

5.02 By supporting 1,746 sub-projects with a total investment cost in excess of US$30 million, the project contributed about 60% to the cost of SMI fixed assets during the period of implementation. In turn, actual disbursements under the credit refinanced about 80% of the foreign and local exchange needs of the sub-projects during the same period. About 10% of the output of the SMIs financed is expected to be exported helping to generate needed foreign exchange and consolidate Sri Lanka's presence in foreign markets in such sectors as garments and ceramics goods. Preparation and implementation of the project increased GOSLs awareness and understanding of SMI development problems as well as stimulated and streamlined the activity of the Sri Lankan financial institutions in the sector. An important contribution of the project was the positive impact it had in stimulating the mobilization of additional resources for SMI financing. Although actual utilization of the funds has been hampered by the country's economic downturn, the increasing interest shown by foreign collaborations in SMI development particularly in the garment sector is bound to have a lasting impact on the future of the sector.

5.03 Subsectoral Distribution. Annex 3 details subproject distribution. Major subproject concentrations were in food processing (27%), construction materials (16%), metal products (12%), wood products (10%) and agro-industries (7%). The balance was spread over a larger number of miscellaneous subsectors. This pattern has continued under SMI II and

follows the pattern of raw material availability and the structure of existing SMI operations in the country. Little investment has taken place in subsectors which could be regarded as non-traditional or significantly export oriented.

5.04 Geographical Distribution. The wide branch networks of the NCBs used under the projects has been particularly effective in achieving a geographical dispersion, albeit that there has been a tendency for the larger SMI projects to be located in the major urban areas. Under SMI I 50% of the subprojects were located in the major urban connurbations within the Colombo, Galle, Gampaha and Kurunegala districts. Under SMI II this concentration has increased to 58% (Annex 4). The balance of subprojects, which tend to be the smaller subloans, are decentralized over the remaining 21 districts of the country. The poor performance in channeling resources for industrial investment away from the urban area of Colombo is mitigated by the sub-projects contribution to the absorption of Colombo's growing labor force. Also, although conspicuous, the number of subprojects financed in Colombo was proportionally less than the share of SMIs already located in the area with respect to the rest of the country, thus at least indicating a decentralization trend. In retrospect the attempt to achieve regional development objectives under the project was too ambitious. These objectives could be more effectively pursued through other government actions such as industrial incentive legislation and provision of infrastructure and services.

5.05 Size of Subproject and Subloan (Annex 5). Of the subprojects approved under the Credit, 92% were for less than Rs 500,000 (US$200,000) with the average subloan being Rs 168,000 (US$67,200). Of the subloans approved under the Credit, 1608 (or 92%) were below the free limit of Rs 750,000; 138 subloans which were above the free limit were reviewed by the SMI Fund and by IDA. At the time of appraisal it was estimated that about 150 subprojects would be subject to a detailed review by the SMI Fund and IDA. With the increase in the limits of subproject eligibility under SMI II to Rs 4.0 million there has been a considerable change in the dispersion of subloans; under the project, 65% have been for subloans below Rs 500,000.

Sub-Project Implementation

5.06 To determine the effectiveness of project implementation, the PCIs surveyed a 7.5% sample (133) of the portfolio. This indicates that about 82% of the subprojects had been completed and were still operational although many had suffered from implementation delays. The main causes reported by project sponsors were (i) administrative constraints e.g. processing of construction permits, utility connections, (ii) procurement e.g., price changes, adjusted delivery schedule, change in suppliers, (iii) institutional e.g. requirements for disbursing the credit proceeds and providing additional credit to finance cost overruns, and (iv) personal e.g. limited time to follow-up the project or participates in project operations. Analysis of PCI supervision records indicates that delays in the implementation of subprojects could have been limited by more detailed project preparation

and more frequent site supervision. Projects under disbursement were frequently not properly supervised and release of funds were not always made to coincide with the phasing of implementation. In several cases, funds were released directly to the subborrowers and not to the building contractors or equipment suppliers.

5.07 Cost Estimates. Of the projects surveyed and completed, 44% were implemented with cost overruns, 29% were implemented within the original cost estimates and 9% were completed with some savings. The actual position could not ascertained for the balance. The range of cost overruns is broad, with overruns of from 1% to more than 200% of the original project cost estimates. The overruns originate mainly from construction costs (including site preparation), underestimated procurement costs and installation charges and, most frequently, underestimation of working capital needs. Cost overruns correlated closely with delayed implementation caused largely by insufficient/inexperienced project preparation and follow-up. Units in the metal products, wood products, food processing and miscellaneous subsectors were most affected by cost overruns.

5.08 Subproject Viability. Analysis of the subprojects in operation shows a very mixed performance with few subprojects achieving results in line with those anticipated at the time of appraisal. Subproject performance was affected significantly by a number of factors ranging from changes in the economy and political disturbances to inadequate project implementation. The elections of 1982 and the ethnic disturbances in 1983 created uncertainty in the minds of many sponsors, causing them to halt implementation and delaying further investment in their projects. The adverse developments in the international economy in the early 1980s added to the already difficult economic problems within Sri Lanka increasing the costs of foreign inputs and affecting the availability of domestic resources for equity/working capital financing. Other factors adversely affecting project performance included sponsors inexperience and sponsors indifference and the impact of GOSL's trade and industrial policy liberalization which lowered tariff barriers on imports. With regard to sponsor attitudes, many inexperienced sponsors found it difficult to adapt to the changing economic environment and this in turn led to sponsor indifference. Internal financial rates of return for larger subprojects were estimated by the PCIs at the time of appraisal and ranged from 15% to 50% with an average rate of 30% (Annex 4). Poor account recording by sponsors has limited the ability to determine accurate ex-post financial ratios and IFRR. NDB and the PCIs have subsequently implemented a project monitoring system to provide this data. However, based on analysis by NDB staff ex-post IFRRs have ranged from 15% to 30%; with the higher rates achieved in BMR and expansion projects.

5.09 Economic Impact. Excluding the cost of land included in the sponsor's contribution to project costs, the 1,746 subprojects financed under the Credit generated about 17,500 jobs at a job cost/ratio of about US$1,000. 1/ Supervision reports for projects in operation indicate that the average incremental employment is 7 in the case of subloan under Rs 100,000, 17 for subloans under Rs 500,000, and about 22 for projects above this amount. As expected at the time of appraisal, most of the projects are located in the Colombo area and in the secondary urban areas helping to relieve the employment problem in these areas. But the Project has not contributed significantly to the development of industry (particularly agro-industries) in the rural and less developed areas. Given the size of the subprojects, ERRs were not computed. An objective of the credit was to foster exports. In this regard, the project has had limited success. Only 20% of the credit funds were used for subprojects which were directly or indirectly export oriented. No significant data is available on actual export sales and productivity.

B. Institutional Aspects

The National Development Bank/SMI Fund 1/

5.10 As the coordinating agency for SMI term lending under the Project, NDB has developed into a sound financial institution with a wide range of activities. In 1979, when NDB was created, there were expressed concerns as to its role and its eventual contribution to industrial development. In seven years it has established itself as a well-respected, although somewhat bureaucratic, institution which has not only contributed to industrial development, but has also played a key role in the training of staff from other institutions. In close collaboration with IDA, NDB has become significantly involved in the discussion and analysis of policy issues affecting the development of SMI. NDB's efforts in this area have resulted in a number of changes in instruments and control affecting SMI operations. In defining the role of SMI in the economy, NDB has been less successful and needs to strengthen considerably its in-house sector work and improve the coordination between its research and operational staff.

5.11 NDB has made considerable efforts to establish a strong operational management, and to build-up a core of experienced officers through recruitment and training. It has also devoted considerable efforts, with the help of expatriate advisors, to provide private entrepreneurs with comprehensive project identification services. In the area of SMI

1/ On the basis of total project cost (i.e. land, buildings and equipment) the cost per job was about US$1,600.

1/ For a detailed analysis of NDB's operation see Annex 6.

operations, NDB's management has worked hard to establish the SMI Fund as a strong operational unit. The task has however been difficult due to the shortage of experienced staff in Sri Lanka and to the greater appeal of NDB (and PCI) term lending operations which have attracted the staff recruited and trained for SMI operations. The unexpectedly high volume of refinancing activities also created problems of morale in a situation of less than adequate staffing. To a large extent these problems have now been resolved. Additional staff have been recruited and the SMI Fund now operates as a sound, efficient unit within NDBs overall operations.

The Participating Credit Institutions (PCIs)

5.12 Institution building in the PCIs has been a major part of the SMI Fund activities. Through substantial and systematic efforts, the PCIs have established a satisfactory organizational framework for processing SMI subloans, and considerable progress has been made in improving appraisal standards and procedures. As of July 31, 1986 about 1,150 PCI officers had been trained in project appraisal and supervision techniques. However, this training has not been sufficient to staff adequately the headquarters/branch operations of the PCIs, particularly in the BOC and PB. While increasing volumes of SMI operations have contributed to the situation, promotion and the standard process of reassignment of officers within the PCIs as part of planned career progression have created some staffing problems and made continuous training programs necessary. Minimum staffing levels have been agreed with the PCIs for SMI operations and for the most part these levels have been achieved.

5.13 With assistance from IDA, the PCIs have developed and introduced a comprehensive quarterly reporting system which focusses on the main aspects of SMI operations. The reports provide data on key activities such as staffing, sectoral distribution of lending, project appraisal pipelines, and most importantly details of collections and arrears. However because of the large branch networks of the PCIs, collection and processing the data within the PCIs has been considerably delayed and has resulted in a significant time lapse between the actual transaction and the reporting. To overcome this situation, PCI branches submit their SMI data directly to the SMI Fund for collating and subsequent distribution to the PCI headquarter staff. This process is demanding for NDB/SMI Fund staff and was never expected in the project design. The process is also a financial burden on NDB which bears the full cost of data collection and processing with no interest spread on SMI operations. The need to maintain and improve the data flows is a major concern and is necessary to focus greater attention on project monitoring and implementation particularly where there is a need to improve collection performance.

5.14 The major achievement in institution building under the SMI projects has been the introduction of sound SMI project term lending by PCIs based on good project appraisals with little or no application of the collateral requirements of short term lending operations. Earlier weaknesses in estimating financing requirements, determining working capital needs,

reducing collateral requirements and setting grace periods have largely been addressed. However, there is a constant ebb and flow in improvements. The continuous training program strengthen the appraisal/supervision techniques of the PCI staff, the constant staff turnover and reassignments erode the gains.

5.15 While sound appraisal standard have been developed in the PCIs, only two of the five PCIs which participated in the SMI I credit program played a meaningful role in terms of number of SMI operations and volume of SMI lending. The same trend prevails under SMI II although DFCC has increased its participation. To encourage SMI operations the credit program was opened to all interested commercial banks to stimulate competition during the latter phase of project implementation and possibly increase the number and type of users of the credit facilities. However this approach hampered the achievement of a uniformly high standard of subproject appraisal and supervision because of the inability of the banks with low level activity to organize adequately for SMI lending. Limiting the participation to the credit program to the PCIs which can guarantee a significant level of lending and meet clearly stated eligibility requirements (i.e. staffing) would facilitate and improve future SMI operations and ensure greater compliance with policy objectives.

Portfolio Management

5.16 By December 31, 1982 the collections of principal and interest on the SMI portfolios had declined significantly. After the offset of collections against interest, remaining collections were only equal to 66% of principal due and 68% of all subloans were infected by arrears which represented 33% of the outstanding loans portfolio. Site visits for supervision indicated however that a substantial number of subprojects were operating profitably and were able to service their loans. Arrears due to wilful default were estimated at 30%, while tardy repayment by sponsors accounted for about 25%. The continued shortfall in collections exacerbated the level of arrears, which increased from 33% of the portfolio in FY82 to 75% in FY85 (Annex 7).

5.17 With the deterioration of the SMI portfolio and the implementation of SMI II in 1982, the PCIs and IDA adopted a two-phased program to control and reduce the level of arrears. Phase I consisted of visits by PCI headquarters staff to key branch/district officers to (i) analyze the arrears, (ii) identify causes, (iii) examine the standards and procedures in use, (iv) motivate managers/SMI staff, and (v) develop a detailed medium-term action program to address the causes of the deterioration. Phase II consisted of the implementation of the program and provided for specific action against wilful defaulters, more frequent follow-up, the imposition of penal interest rates to bring the SMI rates into line with prevailing commercial rates which were 4%-6% higher, rescheduling and further assistance to the SMI unit where necessary. This has resulted in a gradual increase in the collection rate from 66% in 1982 to 70% in 1985 under SMI I and an average collection rate of 73% under SMI II with current individual PCI collection levels of up to 88% (Annex 8). However because of the inherent

weaknesses in many of the earlier projects increases in the collection rate for SMI I have been achieved slowly and IDA has insisted on appropriate provisions for bad debts and these have been made by the PCIs.

C. Technical and Marketing Services

Background

5.18 Apart from the provision of credit for SMI operations, the major objective of the SMI Projects was to address specific technical, marketing and management problems of SMIs in subsectors with significant expansion potential and economic impact such as agroindustries, construction/building materials, garments and handlooms, and rubber products. Allied to these objectives, the projects aimed to improve the management of institutions serving SMI such as the IDB, EDB and MISA. To monitor and coordinate the action programs of the various implementing agencies an SMI Coordinating Committee chaired by the Secretary-MISA was established and scheduled to meet once a month. Under SMI I and II IDA financed equipment, advisors and training for public and private agencies to assist the selected subsectors through provision of service facilities, process and product development and general promotion and extension services.

5.19 As expected, the technical services component took a considerable time to implement and the SMI I components were still incomplete at the time of closure. Implementing agencies had to locate appropriate advisors and local staff, find suitable sites for the service centers and construct the facilities. In the case of the IDB, the various service centers did not become fully operational until 1983. The first light engineering extension service became operational in February 1982, but because of difficulties in locating a suitable site at Jaffna (and the subsequent ethnic disturbances) the establishment of the second center was significantly delayed. The establishment of a sub-contracting exchange was not completed until late October 1982. The Rubber Products Center became operational a year behind schedule and with considerable cost overruns for the operating equipment which was not commissioned until early in 1983. Having worked hard to establish the centers, IDB faced considerable difficulties to continue their operation due to the high turnover of staff. Action under SMI II addressed in part the causes of the high turnover, but IDB is still faced with a turnover problem as staff move to higher paid positions in the private sector after they have been trained.

5.20 As with the other TA components, difficulties in recruiting consultants and local staff to set up the Clothing Industry Training Institute (CITI) was a major cause of the delay in implementation and it was not until 1984 that CITI became fully operational. However, since its establishment, CITI has made significant progress and is now a major force in the training of staff for the industry and in developing international quality control standards. A significant part of the operating costs of the Institute are now met from fees and these should increase as the range of

technical assistance is expanded. A parallel program to establish a private sector company to foster the production and export of high quality handloom cloth did not achieve the same success. While both GOSL and the private sector exporters considered the idea sound, it could not be translated into reality as the exporters were reluctant to take up equity in a company which would then be in direct competition with their own operations. After a number of efforts by IDA and MTI to develop an alternative concept the component was dropped and the TA funds reallocated.

5.21 Coordination and Monitoring. The project achieved the main objectives of institutionalizing the Government's capability to deal with the SMI sector, providing technical assistance to SMIs and setting up an effective system to provide loan financing for their development. This achievement is evident in the creation and development within MISA of a permanent structure (the SMI Coordinating Committee) coordinating services and promoting the development of SMIs, the development within NDB of a well structured Fund specifically responsible for coordinating and monitoring overall SMI lending in Sri Lanka, and the organization within the PCIs of individualized operational structures to deal with SMI lending exclusively. However, considerable difficulties were encountered by the project in streamlining the policy making activity of MISA. These could have been limited and the results enhanced if project formulation had taken into account the unavoidable limitations of operating within a ministerial department (salary levels and organizational structure). In retrospect, it would have been preferable to entrust some of the technical functions expected from MISA/IDB (e.g. studies, promotional actions), to NDB and rely on its capability of transferring the results to MISA for final decision and action. This approach is presently being followed with regard to the implementation of SMI II.

VI. THE ROLE OF IDA

6.01 Since 1978 IDA has devoted a considerable amount of direct and indirect staff effort to the project; firstly in the form of an industrial subsector review and preparation mission and subsequently in the appraisal and supervision process. The involvement has been through provision of technical assistance, frequent supervision, and more recently in developing arrears recovery program to improve the level of collections under the project. IDA's efforts have had some success. NDB and the PCIs have developed into active promoters of SMI development, a situation which SMI II has continued to support.

6.02 As the economic downturn of the early 1980s, and the ongoing recent ethnic disturbances have affected the economy, the development of SMI operations has slowed and the weakness in many of the earlier SMI projects has become apparent, being manifested by declining capacity utilization/ profitability and increasing arrears. With the slowdown in use of SMI funds, IDA has taken more initiative to ensure implementation of TA components

designed to foster new SMI operations and to improve the efficiency of existing units. The initiative has met with some success, but more work is needed. With hindsight, IDA's impact could have been greater. By 1982-83, most of the TA components were significantly behind schedule and it is now obvious that IDA and GOSL should have ensured that key elements of the TA programs were in place prior to effectiveness or disbursement of the Credit.

VII. CONCLUSION AND LESSONS LEARNED

7.01 Performance under SMI I was mixed. While the project achieved its term financing objectives satisfactorily, most of its sectoral, institutional and operational objectives fell somewhat short of their objectives particularly in the case of the complex TA component. However, the project represented a major source of financing for SMI development, supporting the creation/expansion of relatively small and labor intensive enterprises in most of the industrial sectors. The project was very successful in creating employment, a primary objective of the loan. It also had a positive impact on the modernization of SMIs. In general, the project helped in upgrading Government capability to deliver technical assistance to SMI investors and operations; developing NDB into an effective apex institution geared to administer SMI term credit; inducing four commercial banks to promote, appraise and supervise SMI investment projects; and finally, increasing cooperation between the various government agencies responsible for the development of SMIs and the financial institutions lending to them.

7.02 The project had been less successful in promoting a government coordinated policy framework responsive to SMI needs and in ensuring a satisfactory quality and level of activity by all the commercial banks participating in the credit program. Other more specific areas in which the project did not meet its original expectations were: the achievement of a more balanced regional distribution of SMI investments, and the targeting of a larger part of the credit to more export oriented enterprises. The implementation of the credit component also presented a number of operational problems. Some of them were corrected during project implementation (e.g. documentation of subproject expenditures), while others were corrected under SMI II. Through frequent supervision IDA found that progress on implementation depends upon (i) a continued commitment by the Borrower to fulfill the component, (ii) the design of the component, (iii) the implementing capacity of the Agency, and (iv) the continuity of parties involved on the component. Of these factors (i), (ii) and (iv) have been key in influencing implementation progress under the Project and those which have occupied most of the supervision/technical assistance effort.

Lessons Learned

7.03 Experience in the implementation of SMI I and the ongoing implementation of SMI II which cover some 3100 subprojects have highlighted a number of aspects which should be reflected in any new SMI operation.

7.04 Eligibility and Subproject Size. The evidence seems to show that the flexible approach on eligibility limits adopted under SMI I and II helped in channelling subloans to those who have previously had difficulty in obtaining access to institutional finance rather than just to a particular size group. The eligibility limits took into account the efforts of lending institutions to minimize administrative costs and risks and were consistent with the aim of providing finance to as wide a group of small enterprises as possible. Flexibility in eligibility criteria helped also to reduce reluctance of dynamic SMI firms to expanding for fear of losing special benefits.

7.05 Analysis shows clearly that while the PCI were risk takers under SMI I, the high rate of default caused them to become very cautious in lending under SMI II where there is a considerable reduction in the number of projects established by new entrepreneurs and new enterprises were more often established by seasoned entrepreneurs. Under a new SMI Project special promotion efforts should be made to direct part of the project to first-time borrowers and to new entrepreneurs as well as new enterprises.

7.06 Subsectoral Distribution. Experience indicates that unless special stipulations are introduced into the project agreement (limits on the proportion of the Credit that can go to one or specified subsectors, or specification of priority subsectors), the Credit distribution tends to follow the pattern of the subsectoral breakdown of existing SMI enterprises in the country. In turn, stress on the geographical decentralization of subprojects appears to lead to an increase in the number of subprojects in the areas of services and basic consumer products (bakeries, food and agroprocessing, furniture, repair shops, printing, etc.).

7.07 Geographical Distribution. Under the two projects there is a tendency for major subprojects to be located in the larger urban centers. Thus the smaller a project's average subloan size, the greater the decentralization achieved, although this was somewhat limited. However a major factor in achieving significant geographical dispersion has been the choice and organizational structure of the intermediaries. The wide branch networks of the commercial banks have been particularly effective in this respect.

7.08 New Enterprises. The choice of intermediary has a significant influence on the type of subborrower and the purpose of a loan (start-up, expansion, or modernization). Where DFCC was used, there was a greater readiness to take risks, and the proportion of new enterprises was higher. The commercial banks were more cautious and tended to favor loans for expansion to subborrowers who already had manufacturing experience or track records as successful businessmen. In those cases where the NCBs were willing to lend to new enterprises, borrowers were either established traders setting up manufacturing enterprises or artisanal family businesses borrowing for the first time. There appears to be a close relationship between the arrears and default record of the lending institutions on the one hand and the proportion of loans going to new enterprises on the other. Under SMI I

about 50% of the loans were to new entrepreneurs which now have a high level of arrears. In this regard the NCBs now appear to be making reasonable judgment on risk and creditworthiness. We should therefore be cautious in encouraging them to increase the share of lending to new clients.

7.09 Financial Intermediaries. While the participation of the NCBs in refinanced lending for SMI is encouraging, these institutions have generally adopted a cautious approach that favors lending to applicants with collateral and, usually, previous business records. DFCC generally take more risks; in most, but not all cases, its actions lead to new enterprises being created. For successful SMI lending programs to be developed, special departments or divisions are needed in the lending institutions; these must be adequately staffed and capable of providing advice and limited nonfinancial assistance.

7.10 Within broad limits, the level of the interest rate alone is not a major factor inhibiting the demand for SMI subloans. The success of a scheme is usually based on a number of factors, including the interest rate, repayment and grace periods, collateral requirements and processing time. There is strong evidence that the availability of subloans at interest rates substantially lower than commercial rates encourages investment in underutilized equipment, produces a bias towards capital-intensive technologies, and introduces distortions in the use of available financial resources.

7.11 Technical Assistance. Under both SMI I and II, the technical assistance arrangements do not appear to have achieved any significant success or were not properly implemented. This inadequacy is probably reflected in other, less obvious features of the projects, such as the limited extent to which finance is available to entrepreneurs without previous business experience and the degree to which subprojects are confined to traditional SMI subsectors; in some cases the effect is seen in a high rate of arrears.

7.12 The use of public institutions as delivery systems under the two projects encountered the inherent problems of bureaucracy--low staff motivation and morale, inexperienced personnel, management and staff turnover, and political pressure--though not necessarily all at the same time. These are common and endemic, rather than just local, features. Not all of these problems will be resolved, but better results might have been achieved if smaller, independent, local or subsectoral organizations or units had been used, with the concentration being on outreach programs and closer formal and informal links with banks, industrialists, professional associations, technical institutes, local private consultants, and large industries--from the district wherever possible, but outside the region when referral is necessary. Despite the limited experience and professional skills available in Sri Lanka more could be done to hire personnel with effective industrial experience; if necessary on a part-time basis.

The Future

7.13 While SMI I defined the framework of an integrated approach to SMI development in Sri Lanka, the Second is testing its adaptability to changes in the economic environment (slowdown in industrial investment), in the financial sector (relative availability and cost of financial resources), and in government socio-economic priorities (public expenditure limitations due to budgetary constraints). The combined experience of the two projects indicates that:

(i) SMI development in Sri Lanka deserves priority support for it can generate substantial employment at very low cost and with limited government intervention and subsidies;

(ii) the institutional framework for SMI development established under the first project and further experimented under the second has not generated a significant level of new enterprise investment or technology transfer; and

(iii) the capability of private sector institutions concerned with SMI development should be enhanced.

7.14 The latter objective could be achieved by improving coordination among public and private sector institutions and by assigning to NDB and the Coordinating Committee a more important role in reviewing and proposing SMI development policies. In this respect, the areas which require most attention in view of the pending completion of SMI II are: (i) the development of a program to assist enterprises financed under the project to streamline their initial operations (thus avoiding the deterioration of the PCI portfolio); (ii) the development of a program to promote the use of SMI credit in the changed economic environment (extension and modernization of existing enterprises rather than the creation of new ones); and (iii) the study of measures to make SMI financing more attractive for the commercial banks (interest spread, more secure guarantees on bad loans, and enhanced technical assistance from the technical and marketing agencies). This would imply that the cost of finance is brought more into line with the commercial risks of lending to SMI.

October 1986
Revised: May 1987

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY PROJECT (SMI I)
(CREDIT 942-CE)

Estimated and Actual Disbursements

(US $ '000)

	Estimated		Actuals				
	Per Quarter	Cumulative	Refinance	TSC	Total	Cumulative Total	% of total loan
Year : 1979							
4th Quarter	180	180	5.8		5.8	5.8	0.03
Year : 1980							
1st Quarter	800	980	105.6	29.4	135.0	140.8	0.88
2nd Quarter	1000	1980	252.4	76.8	329.2	470.0	2.34
3rd Quarter	1200	5180	783.9	80.5	864.4	1334.4	8.34
4th Quarter	1200	4380	1404.0	57.4	1461.4	2795.8	17.47
Year : 1981							
1st Quarter	1500	5880	1155.6	88.3	1243.9	4039.7	25.25
2nd Quarter	1500	7380	1575.4	105.8	1681.2	5720.9	35.76
3rd Quarter	1500	8880	1245.6	128.0	1373.6	7094.5	44.34
4th Quarter	1500	10380	1357.9	129.1	1487.0	8581.5	53.63
Year : 1982							
1st Quarter	1400	11780	867.9	58.8	926.7	9508.2	59.43
2nd Quarter	1200	12980	708.9	64.9	773.8	10282.0	64.26
3rd Quarter	1100	14080	221.8	95.7	317.5	10599.5	66.25
4th Quarter	1100	15180	310.9	196.6	507.5	11107.0	69.42
Year : 1983							
1st Quarter	340	15520	329.3	57.3	386.6	11493.6	71.84
2nd Quarter	300	15820	116.4	17.9	134.3	11627.9	72.67
3rd Quarter	180	16000	227.8	68.9	296.7	11924.6	74.53
4th Quarter	-	-	225.2	101.6	326.8	12251.4	76.57
Year : 1984							
1st Quarter	-	-	165.8	28.7	194.5	12445.9	77.79
2nd Quarter	-	-	246.2	83.9	330.1	12776.0	79.85
3rd Quarter	-	-	63.0	27.8	90.8	12866.8	80.42
4th Quarter	-	-	84.0	221.8	305.8	13172.6	82.33
Year : 1985							
1st Quarter	-	-	139.2	146.5	285.7	13458.3	24.11
2nd Quarter	-	-	11.2	140.5	151.7	13610.0	85.06
3rd Quarter	-	-	8.4	177.1	185.5	13795.5	86.22
4th Quarter	-	-	-	941.2	941.2	14736.7	92.10
Un-utilized balance of SMI (I) Loan			388.0	875.3	1263.3	16000.0	100.00

PROJECTED AND ACTUAL LENDING OPERATIONS (RS. IN MILLION)

	1979		1980		1981		1982		1983		1984	
Subloan Approvals	Proj. Amt.	Actual Amt.	Proj. Amt.	Actual Amt.	Proj. Amt.	Actual Amt.	Proj. Amt.	Actual Amt.	Proj. Amt.	Actual Amt.	Proj. Amt.	Actual Amt.
Domestic Currency												
Loans	3.5	.8 (04)	86.3	146.1 (993)	143.2	127.4 (660)	124.6	-	23.8	22.4 (118)	-	-
Refinance Loan Commitments												
Domestic Currency												
Loans	2.8	.6	69.0	116.8	114.6	101.9	99.6	-	19.1	18.0	-	-
Refinance Disbursements												
Domestic Currency-Loans	-	-	-	43.4	-	101.8	-	43.6	-	22.0	-	14.0

ANNEX 2

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY (SMI) PROJECT

CR. 942-CE

Refinance Activities
(Rs millions)

PCI	Cr. 942-CE				Cr. 1182-CE			
	No.	%	Amount	%	No.	%	Amount	%
Bank of Ceylon	663	38	110	38	736	54	236	42
Comm Bank of Ceylon	115	7	38	13	48	3	27	4
DFCC	7	1	1	-	142	10	128	23
Hatton National	65	3	29	10	61	4	31	6
Peoples Bank	896	51	116	39	392	29	41	25
	1746	100	293	100	1379	100	563	100

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY (SMI) PROJECT

CR. 942-CE

Sectoral Distribution
(Rs Million)

	Cr. 942-CE				Cr. 1182-CE			
	No.	%	Amount	%	No.	%	Amount	%
Food Processing	473	27	71.6	24	370	27	166	29
Construction Material	273	16	54.8	19	95	7	42	7
Other Agro-Industries	120	7	13.0	4	98	7	39	7
Rubber products	29	2	8.8	3	46	3	27	5
Metal products	217	12	29.7	10	121	9	38	7
Construction Contracting	11	1	6.2	2	6	-	7	1
Wood products	177	10	25 7	9	101	7	24	4
Garments	89	5	12.0	4	87	6	26	5
Textiles	52	3	10.0	3	27	2	14	2
Repair workshop	51	3	5.1	2	71	5	18	3
Miscellaneous	254	14	56.2	20	145	11	71	13
Leather & Allied Products					15	1	5	1
Plastic products					22	2	16	3
Printing & Paper products					82	6	42	7
Other Comm. Transfer					93	7	28	6
	1746	100	293.1	100	1379	100	563	100

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY (SMI) PROJECT

CR. 942-CE

Geographical Distribution
(Rs Million)

Districts (by location of Project	Cr. 942-CE				Cr. 1182-CE			
	No.	%	Amount	%	No.	%	Amount	%
Colombo	402	23	108.2	36	391	29	194	35
Puttalam	147	8	19.8	6	84	6	28	6
Gampaha	217	12	38.4	16	174	14	82	15
Kandy	152	9	11.7	4	57	4	17	3
Kurunegala	178	10	16.4	5	85	6	38	7
Galle	76	4	9.6	3	153	11	46	8
Matale	53	3	5.9	2	14	1	5	1
Kegalle	29	2	5.6	2	71	5	23	4
Jaffna	51	3	15.3	5	7	-	5	1
Hambantota	37	2	5.6	2	30	2	8	1
Ampara	19	1	2.7	1	1	-	1	1
Badulla	68	4	6.1	2	24	2	5	-
Kalutara	67	4	9.4	3	42	3	26	1
Ratnapura	22	1	2.6	1	53	4	21	4
Matara	92	5	14.6	5	63	5	27	4
Polonnaruwa	36	2	4.8	2	30	2	8	5
Batticaloa	22	1	4.6	2	4	-	2	1
Trincomalee	08	1	2.6	1	2	-	1	-
Moneragala	03	-	0.2	-	18	1	3	-
Anuradhapura	46	3	4.7	2	59	4	18	-
Mullaitivu	03	-	0.4	-				3
Nuwara Eliya	09	1	0.8		16	1	4	
Vavuniya	06	1	1.1		1	-	1	1
Mannar	03	-	1.6					
TOTAL	1746	100	293.1	100	1379	100	563	100

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY (SMI) PROJECT

CR. 942-CE

Dispersion of Financial Assistance
(Rs Million)

	Cr. 942-CE				Cr. 1182-CE			
	No.	%	Amount	%	No.	%	Amount	%
Nature of Projects								
New	883	51	192.6	66	568	41	244	43
Existing	863	49	100.5	34	811	59	319	57
Total	1746	100	293.1	100	1379	100	563	100
Size of Loan								
Rs								
0 - 50,000	834	48	19.3	6	207	15	6	1
50,000 - 500,000	774	44	161.9	55	780	57	152	27
0.5 mln- 1.0 mln	138	8	111.9	39	225	16	147	26
1 mln - 2.0 mln	-	-	-	-	139	10	189	34
2 mln - 4.0 mln	-	-	-	-	28	2	69	12
Total	1746	100	293.1	100	1379		563	100
Repayment Period								
1 - 3 years	583	33	32.6	11	298	22		
3 - 5 years	999	57	192.3	66	330	24		
5 - 7 years	121	8	45.6	16	580	42		
7 - 10 years	43	2	22.6	7	171	12		
Total	1746	100	293.1	100	1379	100	563	100

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY PROJECT (SMI I)

(Credit 942-CE)

National Development Bank of Sri Lanka (NDB)

1. Background. NDB was established in January 1979, 1/ with the principal objectives of providing medium- and long-term credit to private and public industries and mobilizing internal and external resources, including stimulation of capital markets. NDB is empowered to offer a wide range of financial services, including direct lending, refinancing, underwriting and financing equity and debenture issues, providing guarantees, accepting deposits and issuing letters of credit. NDB's authorized share capital is Rs 2 billion (about US$73 million), of which Rs 600 million has been paid up. 2/ Although NDB's Act makes provision for issuing shares to the public, the initial issue was taken up by GOSL (67%), CBC (17%) and by People's Bank and the Bank of Ceylon (8% each). NDB enjoys the full support of GOSL, its major shareholder. In accordance with the NDB Act, GOSL bears the exchange risk on NDB's external borrowings, has granted NDB a tax holiday for the first ten years of operation and guarantees NDB's borrowings from internal and external sources. NDB is under the general supervision of the MOFP and, although its administrative budget is subject to the approval of the Minister of Finance and Planning, it has been given full autonomy for its operations.

2. Institutional Aspects. NDB's operations are controlled by its Board of six Directors, all of whom are appointed with the concurrence of the Minister of Finance and Planning. The Board presently comprises the Secretary MOFP (ex-officio), one director appointed by the Monetary Board, one director appointed by the Board of the People's Bank, one director appointed by the Bank of Ceylon and two directors nominated by the Minister of Finance and Planning. The Chairman of the Board is appointed by the Minister for a period of four years. The Board meets regularly to set NDB's overall operational policies and role in the financial sector as well as to approve all direct lending proposals. The Chairman also acts as Managing

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1/ Under the National Development Bank of Sri Lanka Act of 1979.

2/ Of this amount, Rs 450 million was in cash and Rs 150 million in promissory notes of the NCBs.

Director. Four Assistant General Managers for Operations, Administration and Finance report to the General Manager. The GM has been supported by expatriate advisors for Project Promotion, Operations and General Banking. As part of the process of developing an operational strategy for the next three years (1986-1988), NDB is reviewing its client services and area of possible product diversification, operational structure and staffing requirements.

3. As of December 31, 1985, NDB had 163 staff including 79 professionals. Staff turnover was low from 1980-1983 due to the opportunities for promotion in a new, growing institution and the strong reputation NDB built in its initial years of operation. However, during 1984 turnover rates for professionals rose from 11% to 15%, due largely to the GOSL controlled salary levels and the attractive benefits offered by private banks and industrial firms. With the sharp increase in staff turnover, the need for manpower planning, salary adjustment, and in-house training became acute. In October 1984, a Manpower Planning and Training Unit was established to reinforce NDB's use of internal and external training. Initially, the Manpower Planning Unit has focused on staff training for commercial bank officers participating in the SMI Refinancing Scheme. NDB has programmed staff participation in a number of local and overseas courses during 1986-1988.

4. Strategy, Policies and Procedures. NDB's Policy Statement, approved in April 1981, established clear guidelines for direct project financing, refinance and equity activities and specified prudent financial exposure limits for equity and term lending operations. Supplementing the Policy Statement is a detailed operational program for 1985-1986 which provides a basis for NDB's short term operations but does not give a longer term perspective of NDB's strategy, areas of diversification and priorities. Both NDB's Strategy and Operational Policy Statements are being revised by NDBs management to reflect strategic options for the medium term (1986-1988).

5. In the areas of operational standards and procedures, NDB's appraisals are sound, providing adequate coverage of technical, market and financial aspects. For all projects receiving direct assistance, NDB calculates the financial rate of return and for subloans of over US$400,000 equivalent computes the economic rate of return, based on the World Bank's guidelines for calculating economic rates of return and domestic resource costs (DRC). While most projects have higher economic rates of return, 15% is used as the normal minimum acceptance cutoff point. Appraisals and management review are completed in four to six months which is satisfactory for large-scale projects. With TA under Credit 1401-CE, NDB has strengthened its Project Identification and Promotion activities and has modified its appraisal format and procedures to accelerate processing of smaller equipment loans to become more competitive with leasing companies. During project implementation and end use operations, projects are visited every six months with more frequent visits to complex or problem projects. NDB's procurement standards are satisfactory with all foreign exchange related procurement for major projects made through international competition bidding (ICB) and international shopping for limited supply or spare part procurement in accordance with the World Bank's procurement guidelines. NDB's accounting procedures and standards are satisfactory and are subject to an adequate

annual audit by the auditor General or an independent auditor acting on his behalf.

6. Operational Performance and Impact. Since its establishment in 1979, NDB has supplemented its initial equity base (Rs 600 million) with the mobilization of Rs 1.3 billion, through borrowings from CBC, ADB and IDA of Rs 415 million (33%), internal cash generations Rs 401 million (31%), portfolio recoveries Rs 330 million (26%) and general funding Rs 123 million (10%). In turn these resources have been used to fund disbursements of Rs 1.4 billion (US$52 million) against NDB's net approvals of Rs 1.8 billion (US$67 million) to about 2,400 projects. Direct loans to 184 large scale projects accounted for Rs 1.7 billion (US$62 million), or 77% of NDB's total approvals; refinance for about 32% of the total large scale project costs. Metals and chemical units accounted for 25% of total approvals; other main areas were hotels (18%), industrial services (17%) and rubber products (10%). Average loan size on direct financing during 1980-1984 was about Rs 15 million (US$547,000), with the largest loan being US$43.3 million which was NDB's share of a syndication of US$25 million. About 60% of NDB's financing was for BMRE activities, with the major concentration in the Western region in and around Colombo. The weighted ex-ante average financial rate of return of projects approved for direct loans since 1980 is 18% with a range of 11% to 46%. Estimated ERRs of recent large projects range from 18% to 50%,with a weighted average of 32%. These investments are expected to earn or save about US$30 million in foreign exchange annually and are expected to create some 4,700 jobs. Average fixed asset costs per job are about US$21,000; this ratio reflects NDB's concentration in capital intensive investments in the chemical sector (e.g. Ceylon Oxygen) and hotels and the relatively high proportion of BMRE lending with low incremental job creation in NDB's portfolio. Since 1983, NDB has given greater attention to subsector analysis and project development. NDB has established a Project Identification and Development Unit, and with the assistance of an advisor funded under IDP I, has built up a network of contracts with the private sector, investment promotion agencies and the Government. NDB also has made good in slow use of a UNDP Project Development Facility of US$750,000 for consultancy services to carry out feasibility studies and to assist in project implementation. Investments of US$70 million (including US$35 million for the Colombo Dry Docks) have resulted from the 30 studies carried out.

7. Portfolio Management. As of December 31, 1985, NDB's portfolio had increased from Rs 260 million (1980) to Rs 1.3 billion; with light engineering loans accounting for 31%, hotels 24%, food and beverages 13%, textiles 8%, rubber products 8%, agro-industries 8% and miscellaneous 8%. From January 1979 to date, total arrears have increased from Rs 7 million to Rs 118 million, or 9% of the total portfolio with textiles and ready-made garment units accounting for the mounting arrears. In line with GOSL's policy NDB has rescheduled its hotel sector loans. With the increasing arrears, collections as a percentage of interest and principal falling due decreased from 90% (1982) to 69% (1983) and to 60% (1984) although with the rescheduling of hotel arrears and implementation of a portfolio arrears recovery program, NDB's collections have increased to an annual rate of 69%. To reduce the level of arrears and portfolio infection, NDB is implementing a detailed portfolio restructuring program for all projects (e.g. with cost and time overruns within the repayment grace period). NDB's loans are fully

secured by charges on the assets of projects and provisions, and capital and reserves of Rs 1.1 billion (US$40 million) are adequate to cover any potential write-offs.

8. Financial Performance. NDB's profitability has grown consistently, with net profits increasing from Rs 80 million in 1980 to Rs 112 million in 1985, or at an average annual rate of 7.5%. In 1983 and 1984, income from project operations accounted for 66% of revenue, with income from deposits and miscellaneous operations 34%, a reversal of the revenue mix in 1981 and 1982. Increased cost of funds has led to a decline in its earnings spread from 12.0% (1980) to 10.5% (1985). These patterns and an increasing level of NPAs have constrained NDB's profit growth although its profitability is still satisfactory. NDB is exempt from taxation until 1989 and has paid only a 6% dividend on share capital. Reserves and retained earnings, which are now Rs 536 million, have contributed substantially to NDB's total resources. NDB's total assets have grown from Rs 0.7 billion (1980) to Rs 2.0 billion (1985), or by 23% p.a. Initially, the asset mix was 75% deposits and 25% loans; now deposits are 40% and loans 60%. With the change mix in operations, the increasing level of NPAs and the fall in overall collections (paragraph 4.22), the return on assets (ROA) has dropped from 12% (1980) to 6% (1985). The overall ratio for 1985 has subsequently improved significantly following GOSL's refinancing and rescheduling of hotel loans. NDB's debt:equity ratio is 0.72:1 and its debt service coverage ratio is presently 4.5:1, both highly satisfactory.

9. Prospects and Key Ratios. Given political stability, the investment climate and business prospects for NDB are satisfactory, although close attention will be needed to ensure viable operation of ongoing subprojects. During 1986-1990, NDB expects to increase its direct lending operations by 10% p.a., with total net approvals mostly to the private sector projected to be Rs 6.2 billion (US$226 million) in current prices during the period. Direct finance loans would account for 64%, SMI refinancing 28% and equipment financing and equity participation 8%. Foreign exchange loans are expected to account for 52% of annual lending with funding provided by IDA, ADB and Euro/Japanese Syndications. Net profits are projected to increase from Rs 115 million (1984) to Rs 219 million (1990). However, with the need for increased borrowings to service the projected level of operations and rising costs of funds, NDB's net interest spread is projected to fall from 6% (1985) to 3% (1990), a level which will require optimal collection and performing assets. With the increased profitability, ROA is projected to increase from 6% (1985) to 10% (1990), while NDB's DSCR is expected to decline from 4.5:1 (1985) to 2.7:1 (1990).

GROSS APPROVALS OF FINANCING FACILITIES BY SECTOR

Amounts in Rs Mn

	1980 Amount			1981 Amount			1982 Amount			1983 Amount			1984 Amount			1985 Amount			TOTAL Amount		
	Loan	Equity	%	Loan	Equity	%	Loan	Equity	%	Loan	Equity	%	Loan	Equity	%	Loan	Equity	%	Loan	Equity	%
1. Food Beverage and Tobacco							20.30		5.3	68.59	1.35	26.0	48.66		9.3	45.63		7.9	203.09	1.35	8.7
2. Agriculture Agro Business and Fishery				5.80		2.3	39.40		10.4	27.18	25.00	15.2	33.72		6.4	41.90		7.2	148.10	25.00	7.3
3. Textile and Wearing Apparel	14.00		4.9	66.85	6.20	29.3	29.80	3.00	8.7	5.48		1.6	44.42	0.55	8.6	73.50		12.6	234.05	9.75	10.3
4. Wood/Paper Products	8.00		2.8							5.20		1.5	18.95		3.6	7.11		1.2	39.26		1.7
5. Rubber and Leather Products	8.00		2.8	30.30	3.00	13.4	53.70	5.89	15.[illegible]	11.99	0.45	3.6	68.35	0.5	13.2	35.72	25.70	10.6	208.06	35.84	10.3
6. Metals and Chemicals and Petroleum and Engineering	107.70		37.6	41.80		16.8	124.80	3.89	3.9	54.45	7.31	17.9	111.68	1.23	21.5	81.23	5.91	15.0	521.66	18.34	22.8
7. Hotels	79.00	2.50	28.4	81.20	5.05	34.6	66.50	0.83	7.7	61.17	2.00	18.3	23.59		4.5	16.14		2.8	327.60	10.38	14.3
8. Service Industries	63.50	3.75	23.5				31.40		8.3	47.10		13.6	126.66	26.00	29.1	100.00		17.2	368.66	29.75	16.8
9. Miscellaneous				9.00		3.6				5.00	3.00	2.3	19.90		3.8	147.95		25.5	181.85	3.00	7.8
TOTAL	280.20	6.25	100	234.95	14.25	100	365.90	13.1	100	306.17	39.11	100	495.93	28.28	100	549.18	31.61	100	2232.33	133.11	100

SIZE OF APPROVALS

(Rs Million)

	1980		1981		1982		1983		1984		1985		TOTAL	
	No	Amount	No	Amount	No	Amount	No	Amount	No	Amount	No	Amount	No	Amount
Below Rs 10 Million	07	39.65	10	78.20	15	105.81	29	114.00	58	192.50	81	227.70	200	757.86
Between Rs 10-25 Million	06	83.80	08	131.00	14	215.70	09	181.28	13	213.46	13	168.02	63	993.26
Above Rs 25 Million	04	163.00	01	40.00	02	58.00	01	50.00	02	118.25	05	185.07	15	614.32
Total	17	286.45	19	249.20	31	379.51	39	345.28	73	524.21	99	580.79	278	2365.44

NATIONAL DEVELOPMENT BANK OF SRI LANKA

OWNERSHIP CLASSIFICATION OF DIRECT FINANCING APPROVALS

	1980		1981		1982		1983		1984		1985		TOTAL	
	No	Rs M	No	Rs M	No	Rs M	No	Rs M	No	Rs M	No	Rs M	No	Rs M
1. Quoted Public Ltd Companies														
Mixed Public & Private Sectors	-	-	1	9.00	1	14.00	6	61.10	3	108.95	2	15.00	13	208.05
Private Sector	3	40.25	5	82.25	7	107.57	8	212.91	16	116.35	14	148.08	53	616.41
2. Non Quoted Public Ltd Cos -														
Mixed Public & Private Sectors	-	-	-	-	1	5.40	-	-	1	12.00	-	-	2	17.40
Private Sector	1	12.00	5	60.35	-	-	2	3.74	6	31.81	4	33.99	18	141.89
3. Private Ltd Companies														
Mixed Public & Private Sectors	3	91.70	1	20.00	1	21.00	1	20.00	4	22.69	3	70.27	13	245.66
Private Sector	4	34.70	5	29.60	12	91.04	19	104.70	35	183.68	55	188.95	130	632.67
4. Partnership	1	2.00	-	-	-	-	1	5.00	4	12.75	9	24.41	15	44.16
5. Sole Proprietorship	-	-	-	-	1	4.30	-	-	1	5.00	5	11.73	7	21.03
6. Public Corporation	2	53.00	-	-	4	92.40	2	28.83	2	27.61	5	30.84	15	232.68
7. Government owned Business Undertaking	3	52.80	2	48.00	3	29.30	-	-	1	3.37	2	57.52	11	190.99
8. Others	-	-	-	-	1	14.50	-	-	-	-	-	-	1	14.50
TOTAL	17	286.45	19	249.20	31	379.51	39	345.28	73	524.21	99	580.79	278	2365.44

PERCENTAGES

	1980		1981		1982		1983		1984		1985		TOTAL	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
Public Sector (%)	29	36.9	10	19.3	23	32.1	5	8.3	4	5.9	7	15.2	9	17.9
Private Sector (%)	71	63.1	90	80.7	77	67.9	95	91.7	96	94.1	93	84.8	91	82.1

OPERATIONAL PROJECTIONS 1980 - 1988
(Rs Million)

	Actual 1985	PROJECTED 1986	1987	1988	Average Growth Rate 85-88 %
A. Local Currency					
Loans	335	458	613	673	34
Equity participation	32	22	24	26	-
Total	367	480	637	699	30
B. Foreign Currency					
Loans	207	241	312	343	22
SMI Refinance	273	325	350	375	12
Total	480	566	662	718	17
C. Combined (A+B)					
Loans	542	699	925	1,016	29
SMI Refinance	273	325	350	375	12
Equity participation	32	22	24	26	-
Total	847	1,046	1,299	1,417	22

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY PROJECT (SMI I)

(Credit 942-CE)

Analysis of Arrears

		Dec. 1982	Dec. 1983	Dec. 1984	Dec. 1985
Loans in arrears					
Total no. of loans in portfolio (released)		1,656	1,713	1,731	1,745
No. of loans in arrears under 3 months		398	289	197	102
As % of total loan portfolio		24	17	11	6
No. of loans in arrears over 3 months		724	750	698	638
As % of total loan portfolio		44	44	40	37
Total no. of loans in arrears		1,122	1,039	895	738
As % of total loan portfolio		68	61	51	43
Principal affected by arrears					
Total principal outstanding	(Rs. in M.)	209.4	184.8	149.8	123.2
Principal affected by arrears under 3 mths.	(Rs. in M.)	25.2	18.3	13.9	7.0
As % of principal outstanding		12	10	9	6
Principal affected by arrears of 3 to 12 mths.	(Rs. in M.)	40.3	30.7	23.8	13.5
As % of principal outstanding		19	17	16	11
Principal affected by arrears over 12 mths.	(Rs. in M.)	85.2	78.0	85.0	82.2
As % of principal outstanding		41	42	57	67
Total principal affected by arrears	(Rs. in M.)	150.8	127.0	122.7	102.7
As % of total principal outstanding		72	69	82	83
Actual amounts in arrears					
Arrears under 3 months	(Rs. in M.)	1.8	1.5	1.4	0.7
As % of principal outstanding		7	8	10	10
Arrears between 3 to 12 months	(Rs. in M.)	8.9	5.6	5.2	4.2
As % of principal outstanding		22	18	22	31
Arrears over 12 months	(Rs. in M.)	21.8	45.9	59.8	69.6
As % of principal outstanding		26	59	70	85
Total arrears	(Rs. in M.)	32.5	53.0	66.4	74.5
As % of total principal outstanding		16	29	44	60

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY (SMI) PROJECT

CR. 942-CE

PCI Collection Performance

PCIs	% Collection Ratio FY82	FY82	FY84	FY85	% Accruals FY85
BANK OF CEYLON					
SMI I	67	69	72	73	63
SMI II	-	71	67	78	3
Sub-total	67	71	72	74	17
PEOPLE'S BANK					
SMI I	60	59	60	65	67
SMI II	-	63	68	72	2
Sub-total	60	61	61	66	28
COMMERCIAL BANK					
SMI I	71	72	69	65	46
SMI II			32	43	11
Sub-total	71	72	56	63	31
HATTON NATIONAL BANK					
SMI I	-	88	84	81	43
SMI II	-	97	84	85	6
Sub-total	-	89	84	81	19
D F C C					
SMI I	48	41	40	27	62
SMI II			81	92	6
Sub-total	48	41	42	83	1
ALL PCIs					
SMI I	66	66	67	70	60
SMI II	-	74	68	76	3
GRAND TOTAL	66	66	67	71	19

SRI LANKA

FIRST SMALL AND MEDIUM INDUSTRY (SMI) PROJECT

CR. 942-CE

Collection Performance: FY82-FY85
(Rs Million)

	FY82	FY83	FY84	FY85
1. Balance B/F	14.2	32.4	52.9	66.4
2. Amounts Due CY	60.0	67.2	59.2	55.0
3. Total Due	74.2	99.6	112.1	121.4
4. Recoveries	41.8	46.7	45.7	47.0
5. Balance C/F	32.4	52.9	66.4	74.4
% Collections - 2	69.5	69.5	77.2	85.5
% Collections - 3	56.0	46.9	40.7	38.7

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THE NATIONAL DEVELOPMENT BANK OF SRI LANKA

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FOR : ALEXANDER NOWICKI
DIV CHIEF OPERATIONS EVALUATN DEPT

RE YR PCR FOR FIRST SMI PROJECT (CR 942 CE)
I HV NO COMMENTS TO MAKE THEREON.

RGDS, WICKRAMASINGHE GMNDB
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