



1. Project Data :		Date Posted : 05/17/2000	
PROJ ID: P010419 OEDID: C2484		Appraisal	Actual
Project Name : Private finance development project	Project Costs (US\$M)	153.6	153
Country : Sri Lanka	Loan/Credit (US\$M)	60	57.7
Sector, Major Sect .: Financial Sector Development, Finance	Cofinancing (US\$M)	12	12
L/C Number : C2484			
	Board Approval (FY)		94
Partners involved :	Closing Date	06/30/1999	06/30/1999
Prepared by :	Reviewed by :	Group Manager :	Group :
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2. Project Objectives and Components

a. Objectives

The ICR and the Staff Appraisal Report (SAR) list four objectives:

- Improve efficiency of financial intermediation .
- Assist in domestic resource mobilization for long-term investment .
- Enable the private sector to respond to the changing economic environment .
- Help deepening the financial system and strengthening the key players in the financial sector, including the contractual savings institutions, the Central Bank, the Ministry of Finance, the Institute of Chartered Accountants of Sri Lanka and the participating credit institutions .

b. Components

To achieve the above objectives, the loan had three components :

1. **Policy framework** . The project was expected to support wide ranging reforms in the policy and regulatory environment in the financial sector, especially in areas affecting mobilization of domestic resources for investments through commercial channels.
2. **Investment credit** . This component was expected to: (a) provide funds to participating credit institutions for term loans to private enterprises, (b) increase their domestic resource mobilization capacity by financing 60% of the loan amount, and (c) create a Pollution Control and Abatement Fund to help industries comply with environmental standards. IDA lent \$57.5 million for this component.
3. **Technical assistance** . This component was expected to finance technical assistance in preparing and implementing policy reforms to: (a) establish a viable domestic bond market; (b) prepare the restructuring and capitalization of state-owned commercial banks; (c) implement new accounting and auditing standards and debt recovery legislation; (d) strengthen the bank supervision function of the Central Bank; (e) upgrade the capabilities of participating credit institutions; and (f) support implementation of environmental standards by entrepreneurs, credit institutions, and regulatory agencies . IDA lent \$2.5 million for this component. USAID provided assistance for capital market development (\$7 million) and the KfW funded the Pollution Control and Abatement Fund (\$5 million).

c. Comments on Project Cost, Financing and Dates

The ICR and the SAR do not explain how the components were related to each of the four stated objectives . Moreover, meeting or failing to meet the agreements on reforms did not seem to have bound the disbursement of the funds.

3. Achievement of Relevant Objectives :

The line of credit provided financing for long-term investment.

The technical assistance component helped to improve the management capacity of some of the participating credit institutions.

4. Significant Outcomes /Impacts:

The loan financed investments in the industrial sector worth \$ 137 million and the creation of about 12,000 new jobs. The two development finance institutions diversified their activities, maintained their focus on development finance and became premier financial institutions in the country; at the end of the project, both were operating as private

sector companies.

The project increased the awareness of industrialists to the need of using cleaner technologies in their production processes, and companies that received loans tended to improve their environmental management .

5. Significant Shortcomings (including non-compliance with safeguard policies):

The loan did not succeed in promoting some desired reforms because political support for them dwindled . The government failed to restructure the state banks and to improve their financial performance . State-owned financial institutions still dominate the financial sector, a dominance that raises serious concern about its long -term health and prospects.

The loan could hardly help improve the financial sector because it did not tackle the main cause of its poor performance: the fiscal deficit.

6. Ratings :	ICR	OED Review	Reason for Disagreement /Comments
Outcome :	Unsatisfactory	Unsatisfactory	
Institutional Dev .:	Substantial	Modest	First, the government issued only part of the legislation that it agreed to . Second, the diversification of the Employees Provident Fund has not started yet . Third, the project did not achieve one of its main objectives: downsizing and privatizing state banks.
Sustainability :	Likely	Likely	Actions taken are likely to be maintained, but the financial sector can grow well only if the government tackles the main cause of the problems: the fiscal deficit.
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Deficient	Unsatisfactory	
Quality of ICR :		Satisfactory	

7. Lessons of Broad Applicability :

IDA should support and encourage reforms when the government has a good diagnosis of the problems and a consistent policy framework to solve them . When the government lacks both the diagnosis and the framework, it tends to reform policies in an ad-hoc manner, without generating clear benefits to the country .

Long lists of actions and studies cannot substitute for the solution of the main problem that plagues the development of the financial sector. In Sri Lanka, the fundamental problem in the financial sector was a public sector deficit of 10 percent of GDP, which the government financed with forced loans from the financial institutions at below market rates of interest. The deficit, thus, had to be reduced so that the financial institutions could offer more attractive interest rates and have more resources to lend to the private sector .

Foreign loans granted to domestic institutions to onlend to entrepreneurs do not expand the supply of **domestic** savings if domestic policies discourage people and companies from savings, and discourage financial institutions from intermediating resources.

8. Audit Recommended? ● Yes ○ No

Why? IDA has supported 11 financial sector operations in Sri Lanka . That long involvement offers the opportunity to find out how much IDA has contributed to improve the quality of the sector . It would also help to draw important lessons for future financial sector operations in countries with similar problems . The ICR and SAR do not link explicitly the performance of the financial sector, the fiscal deficit and the obligation of financial institutions to buy government bonds; the audit should help explain why the project missed to point that out, and why it was not dealt with in the loan.

9. Comments on Quality of ICR :

The ICR evaluates the loan in a satisfactory manner .

Perhaps, the ICR provides more information than that needed to evaluate the loan . The ICR should have presented an initial summary page with the project's basic information (loan size, dates of appraisal, of Board presentation, etc.).

The ICR could have tried to separate the important conditions and achievements of the loan from the less important

ones, and to link actions taken and conditions met to outcomes and objectives met . The ICR follows the structure of the SAR, which pulls together the important and the superfluous and weighs them equally.

The ICR could have provided some indicators, or a little of more evidence, to support some of its claims about what the project achieved (for example, some of those mentioned in paragraph 4 of the main text).

The ICR makes inconsistent statements about the ownership of the reforms (see paragraphs 24, 83 and 89).

The ICR does not present information showing in a satisfactory manner that the government auctions treasury bills in a market-based manner.