



**Sri Lanka
Crisis Response
Small Medium Enterprise
Development Facility-SMEDeF**

Social Management Framework (SMF)

**Ministry of Finance and Planning
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Abbreviations Used in this Report:-

AU	(Project) Administrative Unit
CBSL	Central Bank of Ceylon
CRW	Crisis Response Window
FIs	Financial Intermediaries
FIL	Financial Intermediary Loan
GFC	Global Financial Crisis
GOSL	Government of Sri Lanka
GRM	Grievance Redress Mechanism
IDA	International Development Association
IDP	Internally Displaced Person
IFC	International Finance Committee
MoFP	Ministry of Finance and Planning
NPL	Non Performing Loan
SMEDeF	Small and Medium Enterprise Development Facility
SME	Small and Medium Enterprise
PAD	Project Appraisal Document
PFI	Participating Financial Institutions
PIU	Project Implementation Unit
RERED	Renewable Energy for Rural Economic Development
SIA	Social Impact Assessment
SME	Small and Medium Enterprise
SLTDA	Sri Lanka Tourism Development Authority
UNCITRAL	United Nations Commission on International Trade Law

Executive Summary

This report is a Social Management Framework (SMF) for the Crisis Response SME Development Facility under the Ministry of Finance and Planning. It outlines the major impacts of the project on the different provinces and outlines mitigatory strategies for the identified impacts.

The project is the result of World Bank's response to a request from the Sri Lankan government to assist it in its developmental goals by providing financial assistance to Small and Medium Enterprises (SMEs) particularly hard hit by the Global Financial Crisis (GFC). The proposed loan is a three-year Financial Intermediary Loan (FIL) consisting of a credit line and a risk sharing facility available to both public and private participating financial institutions (PFIs). Selection would be based on clearly defined eligibility criteria that would ensure minimum performance and profitability of the PFIs and focus on SME lending.

SMEs have the capacity to play a vital role in the development of a country as has been the case in the tiger economies of South-East Asia. Following similar directions, the Sri Lankan government, under its *Mahinda Chinthanaya Idiridakma* has identified SME sector contribution as an important factor to the growth and development of the country in attaining its ultimate economic goal of becoming the Miracle of Asia and also to reach a per capita income of US \$ 4,000 from its current level of US \$ 2,000.

The project intends to provide financial assistance to all sectors but the main demand is anticipated to come from the sub sectors of apparel, tourism and agri-business. SMEs will be eligible for loans without discrimination as to region or sector. However, the sectors categorized in the Environmental Management Framework as negative list industries will not be eligible for receiving loans from this SME facility (refer <http://www.treasury.gov.lk>).

The project will reach out to all provinces of the country including North and East. GFC coupled with three decades of civil unrest in the country has mostly affected the provinces outside of the Western Province. Available statistics indicate that SMEs in the selected sectors are largely centered around the Western Province. One objective of the project is to reach out to the other provinces in order to provide access to finance for eligible SMEs in all provinces. In order to achieve this, the project will ensure maximum transparency and conduct awareness programs to eligible SMEs particularly out of the Western Province. Modalities of the awareness programs will be defined by the PIU at the beginning of project implementation.

Current market failures in Small and Medium (SME) banking in Sri Lanka includes:-

- i) lack of capacity of banks in lending to SMEs,
- ii) lack of confidence of banks in SMEs because of an unfavorable economic environment and
- iii) maturity mismatch preventing banks from providing medium or long term financing to SMEs. The proposed project attempts to help the 'almost neglected' SMEs with financial assistance by providing the banks with the necessary funds for providing loans for SMEs. The main aim of the planned Crisis Response Window (CRW) Small and Medium Enterprise Development Facility (SMEDeF) project will be to broaden and deepen the access of small and medium enterprises to finance, with a

view to ultimately contributing to an expansion of productive activities, investment, and job creation.

Under the proposed project, all SMEs will be eligible for financial support. Tourism, apparel and agro based industries among other sectors have been identified as sectors which have been highly affected by the GFC. In the tourism sector, significant numbers of enterprises are located in the Western, Southern and Central Provinces (See Appendix A). Colombo district records the highest percentage of SME tourism accommodation to the total available in the island which stands at 15.2%. In 2008, tourism sector employed 52,000 individuals in direct employment and 73,000 individuals in indirect employment. Given that the tourist arrivals have been on the increase, this number is expected to grow significantly from 2010. The apparel sector has reached a conspicuous position in the development debate of Sri Lanka since the late 1980s. The SMEs in the apparel sector make a major contribution to the country's economy (See Appendix A). Apparel sector has become a major source of employment particularly to young women in rural areas who hitherto were forced to out-migrate in search of paid employment. In 2007, the country had 2,063 establishments involved in the apparel industry with 391,932 employees. Likewise, the economic contribution made through agriculture related businesses is also impressive. Many SMEs in agri- business engage in growing spices, fruits and vegetables. The agricultural sector contributes 17.9% of GDP and 34.1% employment in the country¹. In 2007, there were 4,471 SMEs involved in the manufacturing of food products and beverages with 128,386 employees working in them. Major constraints felt by SMEs in agri businesses are lack of transportation, pack houses and packaging².

No major social safeguards issues are foreseen under the project. The Social Management Framework identifies the potential social risks associated with SMEs to be supported under the SME lending program by the participating banks and the need for ensuring compliance with the labour laws and regulations of the country and World Bank's social safeguard policies. By identifying potential risks of the project, this SMF spells out mitigatory procedures that are necessary for minimizing risks through improving access to finance and outreach in different provinces. The report also puts in place the procedures required for a periodic social audit of the intended and unintended social impacts of the project.

The project comprises the following two components.

Component 1: Financing and Risk Sharing Facility

1. A wholesale line of credit to increase the liquidity for SMEs.
2. Partial guarantee facility to reduce the risk of lending to SMEs

Component 2: Policy and Capacity Enhancement for SME Banking

1. Capacity enhancement for lending institutions and SMEs
2. Technical assistance to ease access to finance policy and Regulatory barriers
3. Implementation support for the PIU

¹ ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

² ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

Component 1: Potential Impacts and their Mitigation

The direct impacts of Component 1 are likely to be felt mostly by potential borrowers from state and commercial banks who would also be SME proprietors. As Component 1 may lead to the establishment of a new SME or the expansion/consolidation of an existing SME its impacts would also be felt by the local community where the SME is located and then larger Sri Lankan society at a secondary stage. Increased access to financial assistance for SMEs is the most significant positive impact of the project. Furthermore, competition between and among the state and private sector banks is also an expected outcome of the project. The banks that are likely to participate in the project have not been identified. However, one of the selection criteria will be a national branch network. It is expected that the banks will have branches in all provinces of the country enabling increased access to loan facilities for all eligible SMEs in all provinces. If a certain group or SME proprietor has grievances related to contractual agreements with the Participating Financial Institutions (PFI), they could make a complaint/ appeal to the financial ombudsman³ of Sri Lanka.

Access to the loan facility for all eligible SMEs is a key objective of the project. However, as stated above most SMEs are concentrated in and around the Western Province. Several economic and social factors such as the establishment of free trade zones, proximity to the air port and the harbour and better market possibilities in the Western Province enhance the prevalence of this concentration. Therefore, it may be inevitable that SMEs in the Western Province may gain more and easier access to loans under the facility. To extend beyond the Western Province the project will include island-wide awareness programs designed and planned by the PIU discussed above.

Outcomes of the project need to be monitored in order to ensure that the project objectives are met through project activities and to promote equal access to SMEs in all provinces without discrimination. A Social Impact Assessment (SIA) at the end of the first year of project implementation is an in-built feature of the project. The SIA would have to gather data on the identified economic and social indicators.

The project will have other broader impacts on the provinces and wider society once the loan applications are approved. This broader category of impact includes impacts of tourism on local culture, compliance with labour laws etc. Mitigation of these impacts is beyond the purview of the project. However, a similar SMF has been compiled for a tourism project under the Sri Lanka Tourism Development Authority (SLTDA) which discusses the mitigation of such negative impacts of tourism. Likewise, MoFP can alert the Ministry of Labour, Child Protection Authority and other relevant authorities of labour law violations if brought to the attention of MoFP. Such issues may be raised during the SIAs.

Component 2: Potential Impacts and their Mitigation

Two main activities have been proposed under Component 2, namely capacity enhancement of lending institutions and SMEs and legal and regulatory assistance to amend existing regulatory frameworks and/or to develop new regulatory frameworks. Most SMEs are family businesses managed by the head of the family. These managers are often weak in the areas of financial and human resource management. The main positive impact of Component 2 would be the provision of training in these areas for SMEs. A mandatory training will also be

³ <http://www.financialombudsman.lk/>

provided to all participating banks in the areas of providing loans and the relevant administrative rules and regulations that apply to such loans. This training will benefit the banks and SMEs in terms of enhancing their capacity. No negative social impacts are foreseen for Component 2.

Sri Lanka Crisis Response SME Development Facility Social Management Framework (SMF)

1.0 Introduction and Background: Development Objectives and Rationale

The proposed project is a result of a request from Government of Sri Lanka (GOSL) extended to the World Bank (WB) to broaden and deepen the access of Small and Medium Enterprises⁴ (SMEs) to medium and long-term finance, with a view to ultimately contributing to an expansion of productive activities, investment, and job creation. The proposed project, among others, would improve access to finance (including term finance) for SMEs particularly affected by the Global Financial Crisis (GFC) in Sri Lanka.

The GOSL announced in its National Strategy for SME Sector Development a significant array of programs aimed at making SMEs more competitive, more efficient by applying modern technology to improve production processes, and more effective exporters. One of the major priority areas for SME policies has been broader access to medium-term finance. Moreover, the World Bank 2009-2012 Country Assistance Strategy builds on the Government's vision for economic development laid out in the *Mahinda Chinthana Idiridekma*⁵, calling for expanding economic opportunities in lagging regions and improving the investment climate and competitiveness, in an economy driven by SMEs.

One of the major obstacles to growth and poverty reduction has been lack of economic growth in areas outside the Western Province (WP); inadequate infrastructure, particularly in rural areas; the stagnant agricultural sector; the decades-old civil conflict; a large fiscal deficit; access to credit and a lack of advanced skills in the labor force, and inflexibility in the labor market. The impact of the GFC adds to the strains felt in the Sri Lankan economy in recent years by the armed civil unrest and by the tsunami. Civil unrest in the North intensified during 2008, and peaked during the first half of 2009, just when the GFC was most severely felt. The end of civil unrest has put strains on public finances due to the need for rapid reconstruction efforts in the war-affected areas and the need to provide assistance to a large number of newly internally displaced persons. The room for maneuver on the fiscal side has been further reduced by a significant drop in tax revenues, in particular from import duties and Value Added Tax (VAT) as trade declined. In this backdrop, the GOSL sees the SMEs as an area with great potential for helping the country's development process.

Current market failures in SME banking in Sri Lanka include i) lack of capacity of banks in lending to SMEs, ii) lack of confidence of banks in SMEs because of an unfavorable economic environment and iii) maturity mismatch preventing banks to provide long term financing to SMEs. The proposed project attempts to help the 'almost neglected' SMEs with financial assistance by providing the banks with the necessary tools for expanding credit to SMEs⁶.

⁴ A discussion on the project components requires an understanding about what constitutes a SME and this seems to be an area for debate. However, for the purpose of this project, SMEs will be classified using a combination of two indicators; i) Small Enterprise: Rupees 10 million to 100 million asset value, inclusive of land, ii) Medium Enterprise: Rupees 100 million to 400 million asset value, inclusive of land, where the land extent would be less than 04 acres.

⁵ The last two National Development Plans of Sri Lanka, the Mahinda Chinthana 2005 and 2010, both recognize that SME sector as the engine of growth for the national economy.

⁶ The proposed World Bank credit line will complement existing credit facilities provided by the World Bank and other international organizations. The proposed lending operation seeks to build on the success of the

The World Bank is uniquely positioned to provide access to medium to long term funds to Sri Lankan banks, which could in turn on-lend to SMEs. The rationale for World Bank involvement stems from its access to long term funds at favorable terms and from its in-depth world-wide experience in proving credit lines. The proposed project will help reduce existing market failures that are currently constraining Sri Lankan banks from providing long to medium term finance to SMEs in local currency. In the long run, Sri Lankan banks are expected to expand term lending business to SMEs, including outside the Western Province, a critical element in the development and growth of SMEs.

1.1 Overall Objective of the SMEDeF Project

The main aim of the planned Crisis Response Window (CRW) Micro, Small and Medium Enterprise Development Facility (SMEDeF) project will be to broaden and deepen the access of small and medium enterprises to medium and long-term finance, with a view to ultimately contributing to an expansion of productive activities, investment, and job creation. It is expected that the project will also provide credit to SMEs throughout Sri Lanka in urban and rural areas and in regions with low credit activities (i.e., the North and East).

The project will reach out to all provinces of the country, particularly the North and East. GFC coupled with three decades of civil unrest in the country has mostly affected the provinces outside of the Western Province. Available statistics indicate that SMEs in the selected sectors are largely centered around the Western Province (See Appendix A). To achieve increased outreach the project will ensure maximum transparency and conduct awareness programs to all eligible SMEs particularly out of the Western Province. The modalities of these awareness programs may include a series of awareness seminars to be undertaken by panel of experts. The panel may comprise the District Agent, regional Bank Managers/Heads, representative from the company registrar, representative from regional chambers, experts on SME entrepreneur skills, social sector specialist and environmental specialist will take part in the awareness programs. The MoFP/PIU will not interfere in any of the banks' evaluation processes under any circumstances.

1.2 Objectives of this Report

The current report, which puts forward the social management framework for the above project identifies the potential social impacts of the project. The report will put forward strategies for mitigating any negative impacts identified.

The report will firstly provide an introduction to the project focusing on the potential impacts the project can have on the broader Sri Lankan society. The report focuses on issues such as equitable access to loans for all eligible SMEs, particularly in the fields of tourism, agri-business and apparel industry. The project is not expected to trigger any World Bank social safeguard policies related to OP 4.10 and OP 4.12, and no land acquisition will be funded under the project. Implementation of the project would be guided by the Sri Lankan labor and other laws (See section 1.5 for details). Abiding by the country's labour and other laws would be essential for receiving and for continued financial assistance through the project for eligible SMEs. Following these introductory sections the report will begin its main discussion

current Renewable Energy for Rural Economic Development (RERED), a Specific Investment Loan with a large financial intermediation loan (FIL) component, which was approved by the Bank in May 2002.

on impacts and strategies for their mitigation. The two project components, from 1 to 2, will be taken up for discussion in that sequence. The impacts of each component will be discussed first followed by mitigating strategies that would have to be put in place in order to avoid/minimize the negative impacts.

1.3 Components of the Project

The lending instrument proposed is a Financial Intermediary Loan (FIL), financed by an IDA credit of the Crisis Response Window (CRW) facility.

The Project Development Objective is to improve access to finance (including term finance) for SMEs affected by the GFC in Sri Lanka. Credit would be extended on market terms. Targeted end beneficiaries will include new SMEs and existing SMEs in need of financing whose businesses suffered from the effect of the crises (including the GFC and the conflict), as a way to support SME growth in economic recovery.

The development and implementation results will be monitored through several indicators: (i) number of loans and volume of finance to SMEs supported by the facility, (ii) number of loans and volume of finance that has original maturity greater than 3 years, (iii) improved portfolio quality of PFIs as measured by decreased non-performing loans (NPL) in their SME portfolios. In addition development indicators such as (i) lending rates to enterprises, (ii) employment and annual turnover by participating SMEs, (iii) number and value of SME loans by province, (iv) borrowers' gender background, (v) SME perceptions of access to finance through the project. Data related to all the above economic and social indicators will be gathered through the Social Impact Assessment (SIA) planned after the first year of project implementation. In the case of grievances against PFIs, the SMEs could approach the Financial Ombudsman of Sri Lanka.

The proposed loan is a three-year Financial Intermediary Loan consisting of a credit line and a risk sharing facility available to both public and private participating financial institutions (PFIs). Selection would be based on clearly defined eligibility criteria that would ensure minimum performance and profitability of the PFIs and focus on SME lending. Specific support to SMEs is justified by the fact that SMEs face market failures that need to be addressed to avoid increasing the gap between access to finance by the SMEs and larger firms. SMEs: (i) are more affected by regulation and transaction burdens than larger firms (*business environment constraints*), (ii) have less access to credit (*finance constraints*), (iii) less access to collaterals and (iv) have limited access to information, advisory services, technology and innovation (*knowledge constraints*). On the basis of these constraints, the project proposes to reduce the access to finance constraints by providing a credit line specifically targeting SMEs.

The island has been well covered in terms of availability of banking facilities. Even during the heights of civil unrest the two state banks have been operational in North and East with all the banking activities. Sri Lanka has 8 state banks, 2 domestic commercial banks, and 6 specialized banks which can be further sub-divided as 4 state owned development banks (6 regional development banks are now one bank) and 2 state owned savings banks. 9 domestic private commercial banks and 3 domestic private specialized banks are in operation in the country. In total there are 31 banks currently in operation. The distribution of bank branches throughout the island is highlighted in Appendix C. However, the banking sector has not been very active in lending to the SME sector.

1.3.1 Component 1: Financing and Risk Sharing Facility

1. **A wholesale line of credit to increase the liquidity for SMEs:** Based on established demand, the World Bank would provide a credit line to participating commercial banks for SMEs. Access, modalities and pricing would include features such as competitive interest rates and maturities in line with on-going commercial practices and OP 8.30, so that no market distortions are created.
2. **Partial guarantee facility to reduce the risk of lending to SMEs:** The purpose of the guarantee facility would be to backstop commercial lenders losses in case of default. This well tested instrument would provide an additional incentive for commercial banks to engage in short to medium term lending to SMEs. The guarantees would be issued on a portfolio basis, and the loan portfolios eligible for guarantees would include commercial banks' loans to new SME borrowers. GoSL/IDA would provide a limited first loss guarantee. In addition, the IFC has expressed interest in acting as a second loss partner in selected private banks on a sector portfolio basis, in renewable energy, agribusiness and possibly tourism. By sharing the credit risk with PFIs, the guarantee would leverage lending from banks to SMEs of up to ten times the amounts committed by GoSL/IDA.

1.3.2 Component 2: Policy and Capacity Enhancement for SME Banking

3. **Capacity enhancement for lending institutions and SMEs (US\$7 million):**

In partnership with the IFC and other development agencies, the project would provide technical assistance to the commercial banks benefitting from the credit line, in order to help build capacity in lending services to SMEs and to ensure that SMEs have the capacity to effectively utilize loans from the banks for the growth of their businesses. The project will include capacity enhancement and technical assistance on SME banking at the PFIs' branch level.

4. **Assessment of the Policy and Regulatory enabling environment for SME Banking (US\$1 million):**

The project would provide technical assistance to (i) carry out an assessment to identify the legal and regulatory issues that constraint funding and the rehabilitation and exit mechanisms for SMEs; and (ii) improve creditors' rights and insolvency regime of the country.

1.4 Profile of Industrial Sectors likely to Receive Financial Assistance through the Project

The geographical distribution of industrial/manufacturing SMEs is currently concentrated in the Western Province of Sri Lanka. Due to historical and organic growth path of the development trajectory the country has taken most commercial activities are concentrated in the Colombo district and its periphery. Tables 1 and 2 below gives the principle activities and geographic distribution of the industries⁷ in Sri Lanka. Map 2 in Appendix A provides the geographical distribution of SMEs in the tourism sector.

⁷ Industries as classified under UN definition. The data in Investment Map is adapted from Revision 3.0 of the International Standard Industrial Classification of all Economic Activities (ISIC). ISIC is defined by the United

When looked at from three criteria, namely percentage of annual output, number of employees and establishments, the Western Province by far accounts for a higher proportion than all other provinces in terms of SMEs (Industry Survey, 2008).

Furthermore, when looking at the geographical distribution of SMEs in terms of

- 1) industrial SMEs in a given district to total industries,
- 2) persons engaged in industrial SMEs in a given district to total labour force engaged in the industry
- 3) output of industrial SMEs in a given district to total output of the industrial sector, the Western province stands out with the highest prevalence of SMEs (See Appendix A).

The highest number of SMEs in the country, i.e. over 40% is established in the Western Province while the second highest percentage of over 20% is in the North Western Province. All the remaining provinces have less 10% of the country's SMEs (See Graph 1). This unequal distribution is undoubtedly a result of unequal distribution of resources, particularly financial resources, available for SMEs in the island.

The prominence of the Western Province in the geographical distribution of SMEs seems to be the result of many socio-economic factors. Firstly, the export processing zones established in the 1970s by the then government were largely established in the Western Province, namely in Biyagama and Katunayake. Likewise there are several industrial estates such as Sithawaka, Kaluthara and Rathmalana situated in the Western Province. The establishment of these industrial zones has partly been a result of the better infrastructural facilities in the region. The proximity to the Colombo harbour and the air port may also have been contributing factors for the high concentration of export oriented industries. In addition, the country has been experiencing persistent fiscal deficit which constrained capital investments in infrastructure. Therefore, SMEs outside the Western Province seem to suffer from poor infrastructural facilities⁸. The same SMEs have been particularly hard hit by three decades of civil unrest. Furthermore, the best market for these goods and services seem to be concentrated in the Western Province which also encourages concentration of the SMEs into the same province. Table 3 indicates the high density of SMEs in the Western Province.

In recent years with the end of the three decade long civil unrest, the potential for promoting SMEs beyond the Western Province has been recognized by the government. Despite the intensity of the unrest, the government focused on improving connectivity through improved infrastructure, particularly the roads network, telecommunication and the Internet. In addition, the economic activities in the North and East have boosted by the demand for goods and service in those areas. Tourism which had been severely affected due the security situation and the GFC has been revived including in the North and the East. If access to financial assistance which has been a major obstacle for SMEs particularly in the rural and remote areas, can be partially addressed through this project, the project is expected to play an important role in promoting SMEs throughout the island. Given that the SMEs are more labour intensive, it will also provide increased employment opportunities to semi- and

Nations Statistics Division and is a standard classification of economic activities (including both merchandise and services) arranged so that entities can be classified according to the activity they carry out. The classification was approved in 1948 and is based on four levels. For a list of the classification see:

http://www.investmentmap.org/invmapp/en/industry_classification.aspx?prg=1

⁸ ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

unskilled workers, thus contributing to improved economic conditions for the lower income strata.

Under the proposed project, SMEs from all sectors and regions will be eligible to receive loans. SMEs in the sectors of tourism, agri-business, apparel and footwear among other sectors are likely to have a large number of loan applicants. Though these have been identified as sectors more affected by the GFC, loans will be provided to any eligible SME. SMEs in the tourism industry are also primarily constricted to the Western Province but with significant numbers also available in the Southern and Central Provinces (See Appendix A). Colombo district records the highest percentage of SME tourism accommodation to the total available in the island which stands at 15.2%. In 2008, tourism sector employed 52,000 individuals in direct employment and 73,000 individuals in indirect employment. There is also a large portion of informal and seasonal labour involved in the Sri Lankan tourism industry. Given that the tourist arrivals have been on the increase, this number is expected to grow significantly from 2010. The apparel sector has reached a conspicuous position in the development debate of Sri Lanka since the late 1980s. The apparel sector plays a key role in the contribution made by industrial SMEs (See Appendix A). Apparel sector has become a major source of employment particularly to young women in rural areas who hitherto were forced to out-migrate in search of lucrative work. In 2007, the country has had 2,063 establishments involved in the apparel industry with 391,932 employees. Likewise, the economic contribution made through agriculture related businesses is also impressive. Many SMEs in agro business engage in growing tea, spices, fruits and vegetables. The agricultural sector contributes to 17.9% of GDP and 34.1% employment in the country⁹. In 2007, there has been 4,471 SMEs involved in the manufacturing of food products and beverages with 128,386 employees working in them. Major constraints felt by SMEs in agri-businesses are lack of transportation, pack houses and packaging¹⁰. See Table 3 below for details of SME distribution throughout the island.

Table 3 shows that the all districts in the island except Gampaha, Kaluthara (Western Province), Kurunegala and Puttalam (Northwestern Province) have less than 5 SMEs per bank branch in the district. This indicates that availability of banks for eligible SMEs throughout the island is reasonably well established.

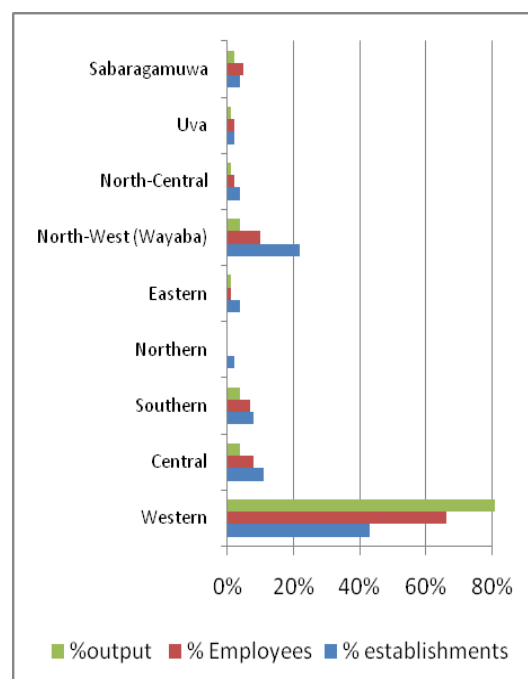
⁹ ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

¹⁰ ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

Table 1: SME data for Main Industries (Manufacturing, Mining and Electricity, Gas and Water – 2007

		SME TOTAL
No. of establishments	Number/Value (Rs.)	16,505
	% to Industry Division	91%
Persons engaged (No.)	Number/Value (Rs.)	263,127
	% to Industry Division	26%
Employees (No.)	Number/Value (Rs.)	238,538
	% to Industry Division	24%
Salaries & Wages (Rs.)	Number/Value (Rs.)	26,384,635,685
	% to Industry Division	16%
Value of output (Rs.)	Number/Value (Rs.)	367,223,271,475
	% to Industry Division	17%
Value of input (Rs.)	Number/Value (Rs.)	216,520,808,534
	% to Industry Division	17%
Value added (Rs.)	Number/Value (Rs.)	150,702,462,942
	% to Industry Division	17%
Gross additions to fixed assets (Rs.)	Number/Value (Rs.)	19,673,106,592
	% to Industry Division	10%

Graph 2: Geographical distribution of SMEs by provinces (manufacturing only)



Source : Industrial Survey 2008 – Department of Census and Statistics. Note: Only includes establishments with 5 or more employees

Sector-wise impacts of the project are anticipated largely depending on the nature of work/jobs involved in the different SMEs. In the tourism sector, labour is largely divided as organized and casual/ informal. There is the possibility of engaging children in casual labour in tourism. Likewise, the apparel sector has got the division of skilled and unskilled labour involved with a majority of the employees being women. Furthermore, trade unions in the apparel sector are not common and the few unions that exist are stated to be ineffective. Agri-business sector encounters different kinds of issues depending on the variety of products and therefore it is difficult to generalize their issues. For example, employees of small holding tea estates that would belong under the category of SMEs would face an issue of something similar to bonded labour. That is, unlike other employees in other sectors, the estate workers lose not only their livelihood but their entire social setting if they opt to leave the job as they live and work in the same estate space. The labour laws of the country apply to all sectors and provide specific guidelines for dealing with scenarios similar to the above and more. Certain

potential negative impacts, such as discrimination of employees, salary discrepancies, EPF/ETF/ gratuity payment, minimum wage as per Wages Board Ordinance (Rs. 5750 for a unskilled labourer) and other cases of labour law violations that are discussed below (see section 1.5) are beyond the purview of the project and their mitigation requires strict adherence to the labour laws of the country by the SMEs. The AU can be responsible for alerting the relevant authorities of such labour law violations. For example, the issue of child labour, if existent, would have to be reported to the Ministry of Labour and resolved with the assistance of the Ministry of Child Development and Women's Empowerment. Compliance to labour laws is monitored by the Labour Department. Violation of labour laws can be reported to regional labour department officers in the Divisional Secretariat Divisions and in the last resort to the labour commissioner in the labour department. Furthermore, under the companies act, directors of companies are held personally liable for the payment of EPF/ETF. Therefore, legal provisions for the protection of SME employees are already in place in the country.

Table 3: - Industrial Small Medium Enterprise Density

Province	District	No. of establishments	Population '000 (2009)	SME/Pop. Density ('000)	Pop. % in District to total pop.	No of Bank Branches and outlets	SMEs per Bank branch
Western	Colombo	3180	2,521	0.79	12.30%	860	3.70
	Gampaha	2856	2,165	0.76	10.60%	432	6.61
	Kalutara	904	1,128	1.25	5.50%	175	5.17
Central	Kandy	1300	1,415	1.09	6.90%	321	4.05
	Matale	266	490	1.84	2.40%	149	1.79
	Nuwara-Eliya	291	755	2.59	3.70%	145	2.01
South	Galle	784	1,074	1.37	5.30%	282	2.78
	Matara	359	831	2.31	4.10%	193	1.86
	Hambantota	147	565	3.84	2.80%	150	0.98
Northern	Jaffna	221	607	2.75	3.00%	190	1.16
	Mannar	41	103	2.51	0.50%	25	1.64
	Vavuniya	41	169	4.12	0.80%	42	0.98
Eastern	Batticaloa	197	537	2.73	2.60%	82	2.40
	Ampara	420	634	1.51	3.10%	192	2.19
	Trincomalee	82	368	4.49	1.80%	85	0.96
Nor. Western	Kurunegala	2095	1,550	0.74	7.60%	299	7.01
	Puttalam	1289	770	0.60	3.80%	155	8.32
Nor Central	Anuradhapura	420	820	1.95	4.00%	259	1.62
	Polonnaruwa	308	405	1.31	2.00%	126	2.44
Uva	Badulla	241	874	3.63	4.30%	214	1.13
	Moneragala	137	435	3.18	2.10%	107	1.28
Sabaragamuwa	Ratnapura	614	1,113	1.81	5.40%	231	2.66
	Kegalle	248	813	3.28	4.00%	195	1.27
	Total	16443	20,450	1	100.00%	4909	3.35

Sources: Industry Survey 2008;CBSL Annual Report-2009;www.cbsl.lk-CBSL Statistics

1.5 World Bank Safeguard Policies

No major social safeguards issues are foreseen under the project. The Social Management Framework identifies the potential social risks associated with SMEs to be supported under the SME lending program. The participating banks need to ensure compliance with the labour laws and regulations of the country and World Bank's social safeguard policies.

By identifying potential risks of the project, this SMF spells out mitigatory procedures that are necessary for minimizing the impacts of the risks through improving the possibilities of access to finance and outreach in different provinces. The report also puts in place the procedures required for a periodic social audit of the intended and unintended social impacts of the project.

However, the protection of SME employees would have to be ensured through strict adherence to the Sri Lankan labour law. Sri Lankan labour law does not have provisions for any salary discriminations in terms of gender, ethnicity, region and/ or religion. Therefore, 'equal pay for equal work' is ensured in principle. There are several labour laws that apply to SMEs that involve recruitment of individuals. They are as follows:-

- **Shop and Office Employees Act¹¹**- work hours, remuneration, employees' health and comfort, maternity benefits fall under the purview of this act.
- **Employees Provident Fund (EPF) Act¹²**- establishment and membership of the EPF, administration of such funds, covered employments and contributions fall under the EPF act.
- **Employees Trust Fund (ETF) ¹³**- provides enhanced retirement benefits to the working class. Its provisions with regard to coverage of employers are similar to those of the EPF Act. However, unlike in the case of EPF, it is a non-contributory benefit for employees.
- **Employment of Women, Young Persons and Children Act¹⁴**- employment of women for work at night in any industrial undertaking, employment of children in industrial undertakings and at sea and the employment of young persons fall under the purview of this act.
- **Maternity Benefits Ordinance¹⁵**- provisions for the payment of maternity benefits to women and other matters related to the employment of such women come under the purview of this act.
- **Trade Union Ordinance¹⁶**- deals with the registration and control of Trade Unions in Sri Lanka.
- **Wages Boards Ordinance¹⁷**- regulation of wages for employees in any trade is dealt with by this act. The Sri Lanka Gazette no 1556 of 30.05.2008 stipulates the minimum wage for an unskilled labourer as Rs. 5,750.

¹¹ <http://www.labourdept.gov.lk/Legislations/Shop%20&%20Office%20Employees.pdf>

¹² <http://www.labourdept.gov.lk/Legislations/Employment%20Provident%20Fund..pdf>

¹³ <http://www.labourdept.gov.lk/Legislations/Employment%20Trust%20Fund.pdf>

¹⁴ <http://www.labourdept.gov.lk/Legislations/Empl%20WomYouPersonsChi.pdf>

¹⁵ <http://www.labourdept.gov.lk/Legislations/Maternity%20Benefits%20ord.pdf>

¹⁶ <http://www.labourdept.gov.lk/Legislations/Trade%20Unions.pdf>

¹⁷ <http://www.labourdept.gov.lk/Legislations/Wages%20Boards%20Ordinance.pdf>

- **Workmen’s Compensation Ordinance¹⁸**- payment of compensation for employees who suffer from accidents during work and other occupational diseases fall under the purview of this act.
- **Employment of Trainees (Private Sector) Act¹⁹**- terms and conditions that apply to the training of individuals and the assurance of a job after concluding the training comes under the purview of this act.
- **Sexual Harassment in Offices and other work places under Section 345 of Act No 22 of 1995**
- **Companies Act of Sri Lanka No 07, 2007**

The borrowing SMEs will be required to comply with these laws, which protect the interest of the labour force employed in the SMEs. These laws are compatible with the expectations of WB social safeguards policies. For example, provisions for equal treatment of both genders and restriction of child labour are covered by these laws.

Situations where the violation of certain labour laws occur is heard of in the Sri Lankan job market scenario. For example, non-compliance to the EPF and ETF laws and avoidance of gratuity payments are two such possible employee complaints. Resolving these macro social issues is beyond the purview of the project, but violation of the national labour laws by borrowing SMEs would be a significant reputational risk for the project. However, the MoFP can ensure that such issues are identified and brought to the attention of relevant authorities through the SIA that will be conducted after the first year of project implementation, and which will assess the broader social impact of the project. Compliance to labour laws is monitored by the Labour Department through the regional labour offices in the Divisional Secretariats. Non-complying entities will be brought under the legal framework of the country and prosecuted. For example, if an organization has not paid EPF and ETF the regional labour department office will issue a red notice for non submission of the monthly EPF and ETF contributions. If the organization complies at this stage the matter will be closed. However, if it fails to comply, the Regional Labour Department will prosecute the Organization and its Directors. Likewise, issues of sexual harassment will be dealt by the Department of Police.

WB Policy on Forced Labour and Child Labour must also be adhered to by the SMEs. Here too, the local legislation that protects children is binding.

2.0 Potential Impacts of the Project Components and Mitigation Strategies

Component 1 which deals with the credit line will provide improved access to financial resources for the SMEs throughout the island.

2.1 Impacts of Component 1

The direct impacts of Component 1 are likely to be felt mostly by potential borrowers from commercial banks who would also be SME proprietors. As Component 1 would lead to the establishment of a new SME or the expansion/consolidation of an existing SME its impacts

¹⁸ <http://www.labourdept.gov.lk/Legislations/Workmens%20Compensation.pdf>

¹⁹ <http://www.labourdept.gov.lk/Legislations/Employment%20of%20Trainees%20%28Private%20Sector%29.pdf>

would also be felt by the population in the given locality as who would be enjoying improved employment opportunities.

2.1.1 Increased Access to Financial Assistance for SMEs: Component 1 is likely to bring about many positive impacts for the SMEs which hitherto have experienced several financial obstacles that hindered their ability to develop to their full potential. Banks usually require collateral for providing financial assistance. Land is usually accepted as collateral by the banks for loans. However, for most SME proprietors this is difficult as they frequently do not possess secure titles to their land²⁰. Therefore, access to financial support is undoubtedly going to benefit potential investors establish new enterprises or for existing enterprises to improve its output. The staff in the lending banks may be trained to provide assistance to the SMEs in this respect. The risk sharing facility is also likely to encourage commercial banks to provide loans for such potential investors. The banks also find it difficult raise longer term funds and that will be addressed through this line of credit.

2.1.2 Improved Access to Financial Assistance for eligible SMEs in the Different Provinces: The line of credit is available for all state and private banks selected. The prevalence of SMEs in the Western Province is higher than the rest of the provinces. Therefore, it may be difficult to avoid the possibility of more loans being granted to those SMEs. Effective channels of communication would have to be used for reaching eligible SMEs throughout the country. Awareness programs should be organized with this purpose in mind especially through regional chambers.

Availability of banking facilities in the provinces is also a crucial issue in ensuring equal access to eligible SMEs. Availability of banks seems adequate throughout the island (See Appendix C).

2.1.3 Monitoring the Project Outcomes: Several criteria for assessing the effectiveness of the project have already been developed, namely, (i) number of loans and volume of finance to SMEs supported by the facility, (ii) number of loans and volume of finance that has original maturity greater than 3 years, (iii) improved portfolio quality of PFIs as measured by decreased non-performing loans (NPL) in their SME portfolios. In addition development indicators such as (i) lending rates to enterprises, and (ii) employment and annual turnover by participating SMEs. (iii) number and value of SME loans by province, (iv) borrowers' gender background, (v) SME perceptions of access to finance through the project. The project design includes annual independent Social Impact Assessments (SIAs) to ensure regular monitoring of these indicators (See Appendix B).

2.1.4 Lack of Knowledge about the Eligibility Criteria to Participate in SMEDeF: Eligibility criteria for commercial and specialized banks that can participate in SMEDeF and the same for SME proprietors who can apply for loans through commercial banks must be made widely known through clear and effective channels. Electronic media, published brochures and leaflets can be used for reaching eligible SMEs irrespective of their location. District-wise awareness programs will be organized by the MoFP for this purpose (See Section 1.1).

²⁰ ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

2.1.5 Competition among the Banks: Competition among private and state banks would lead to more efficient and appropriate interventions through SMEDeF. This competition is expected to improve access to financial assistance for SMEs. The exact banks that would channel the loans have not yet been identified. However, distribution of banks seems adequate to handle the number of eligible SMEs in the island (See Table 3 and Appendix C). One of the selection criteria will be a national branch network. It is expected that the banks will have branches in all provinces of the country enabling increased access to loan facilities for all eligible SMEs in all provinces.

2.1.6 Impacts on the Provinces and Wider Society if Applications are Approved: If loan applications are approved and provisions for establishing new SMEs or for expanding existing SMEs are made, it is expected to positively impact the region in which the SME is located and then the wider Sri Lankan society. A major positive impact would be the new avenues for employment for individuals. A negative impact of improved SME activities could be the impact it can have on local culture, particularly through industries related to tourism. Some of these potential impacts can be subtle impacts such as those on local attitudes, consumption patterns and fashion. Others may be the more obvious and serious impacts such as the abuse of drugs, changes in sexuality patterns that may pose threats of STDs such as HIV/AIDS²¹ and the use of child labor to improve profits.

Violation of labour laws that govern the employment market in Sri Lanka could be another indirect negative impact on the communities. The banks offering loans to the SMEs will add a clause to the loan application indicating the borrower's willingness to adhere to the labour laws of the country.

Most SMEs are labour intensive and provide on the job training for their employees or employ unskilled labour. However, when skilled labour is required, for example for the apparel industry such skills can be obtained through village level training outlets. In the case of tourism the sustainable tourism project funded by WB already has made provisions for skills training in tourism related jobs. It is likely that most of the industries eligible for financial assistance under the project would recruit unskilled labour and provide on the job training for individuals²². All in all, the project is expected to contribute to decreasing the unemployment rate in the country (which stands at 5.9% in 2010). It has been noted that GFC has resulted in an increase of the unemployment rate particularly since 2008²³. Gender bias in recruitments is also observed in some industries. For example, the apparel industry mostly recruits women as seamstresses. Industries with such bias would have to be sensitive to the employees' unique needs. An SME in the apparel sector would have to comply with regulations relating to maternity leave and other maternal health related issues. Dealing with the violation of these laws is beyond the purview of the project. However, alerting relevant authorities of such violations will be the responsibility of the MoFP (See Section 1.5).

²¹ Social Management Framework (SMF) for a Sustainable Tourism Project in Sri Lanka funded by the World Bank is already in place. The framework is currently available in the Sri Lanka Tourism Development Authority website.

²² ADB Technical Assistance Consultant's Report (July 2007), Sri Lanka: Preparing Small and Medium Enterprises Sector Development Program II

²³ Abeyratne, S. (2009) The Economic and Social Impact of the Global Financial Crisis in Sri Lanka, United Nations Development Program, Regional Centre, Colombo.

2.2 Mitigation Strategy and Guidelines: Component 1

Potential impacts of Component 1 outlined above are mainly related to improved access, submission, review and approval of loan applications, and the impacts of SMEs on the regions and then on wider society, if loans are granted. Therefore, most mitigation strategies suggested here are related to creating awareness among potential borrowers, ensuring improved access to finance.

2.2.1 Awareness and Transparency: The project can help potential loan applicants improve their capacity to succeed in receiving loans through enhancing the transparency of the process and through providing information required to succeed. For example, providing relevant information on the Ministry of Finance and Planning (MoFP) website, the respective bank's website and the publication of leaflets in English, Sinhala and Tamil languages will improve access to information. Private sector chambers can also be used as a channel of communication. Applicants should be informed about the criteria that would be taken into account when selecting proposals for the award of loans.

2.2.2 Independent Social Impact Assessment (SIA): A SIA after one year of project implementation is an inbuilt mechanism already in place in the project to assess the broader social impacts of the project. The SIAs must be planned in a manner that it takes into account the identified assessment criteria (See section 2.1.3) using stakeholder consultations with representatives from private sector chambers, other borrowers and employees of SMEs and will review project outcomes on a sample basis (See Appendix B).

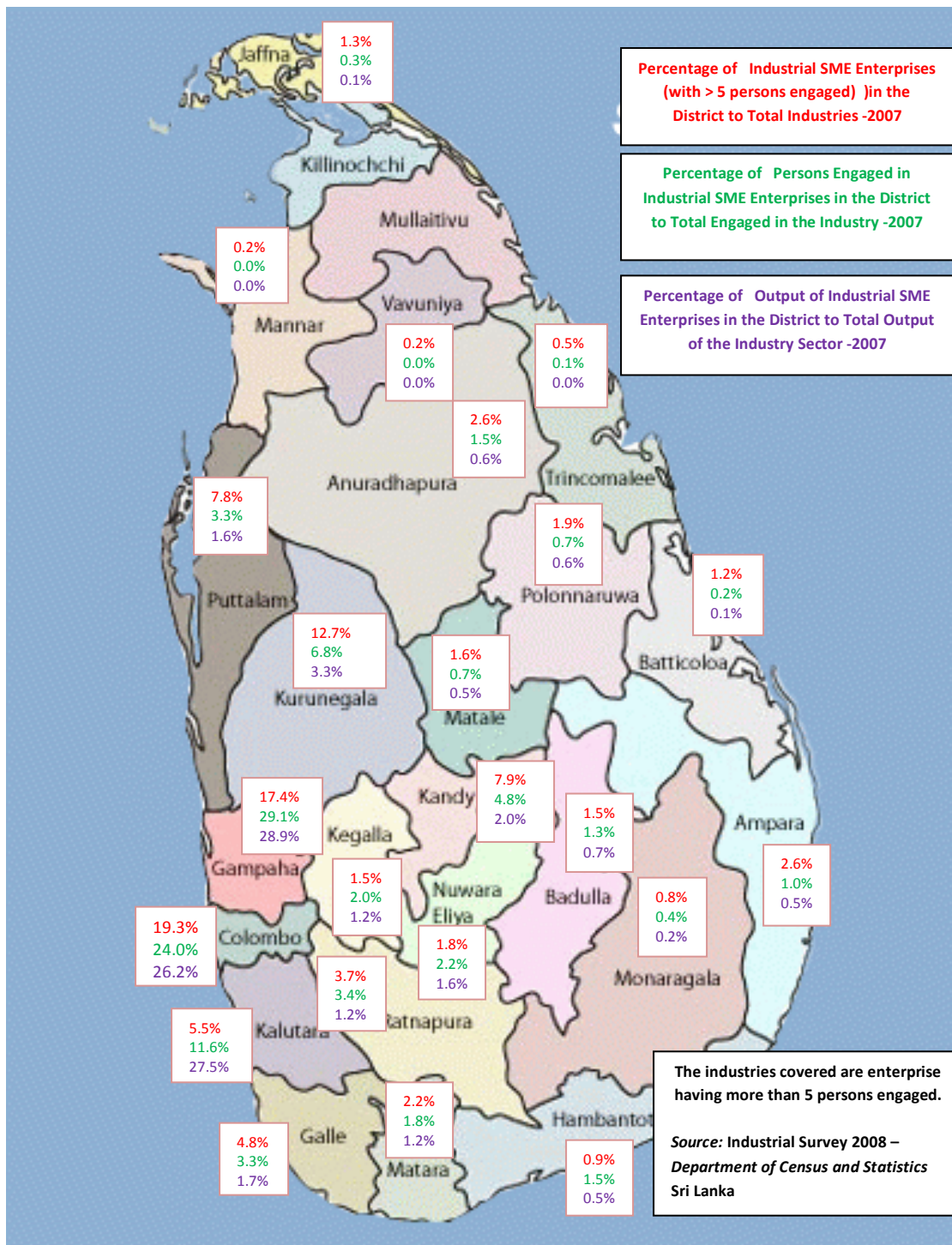
An NGO qualified in conducting social assessments or a relevant firm can be assigned through the MoFP for conducting these SIAs.

2.3 Impacts of Component 2

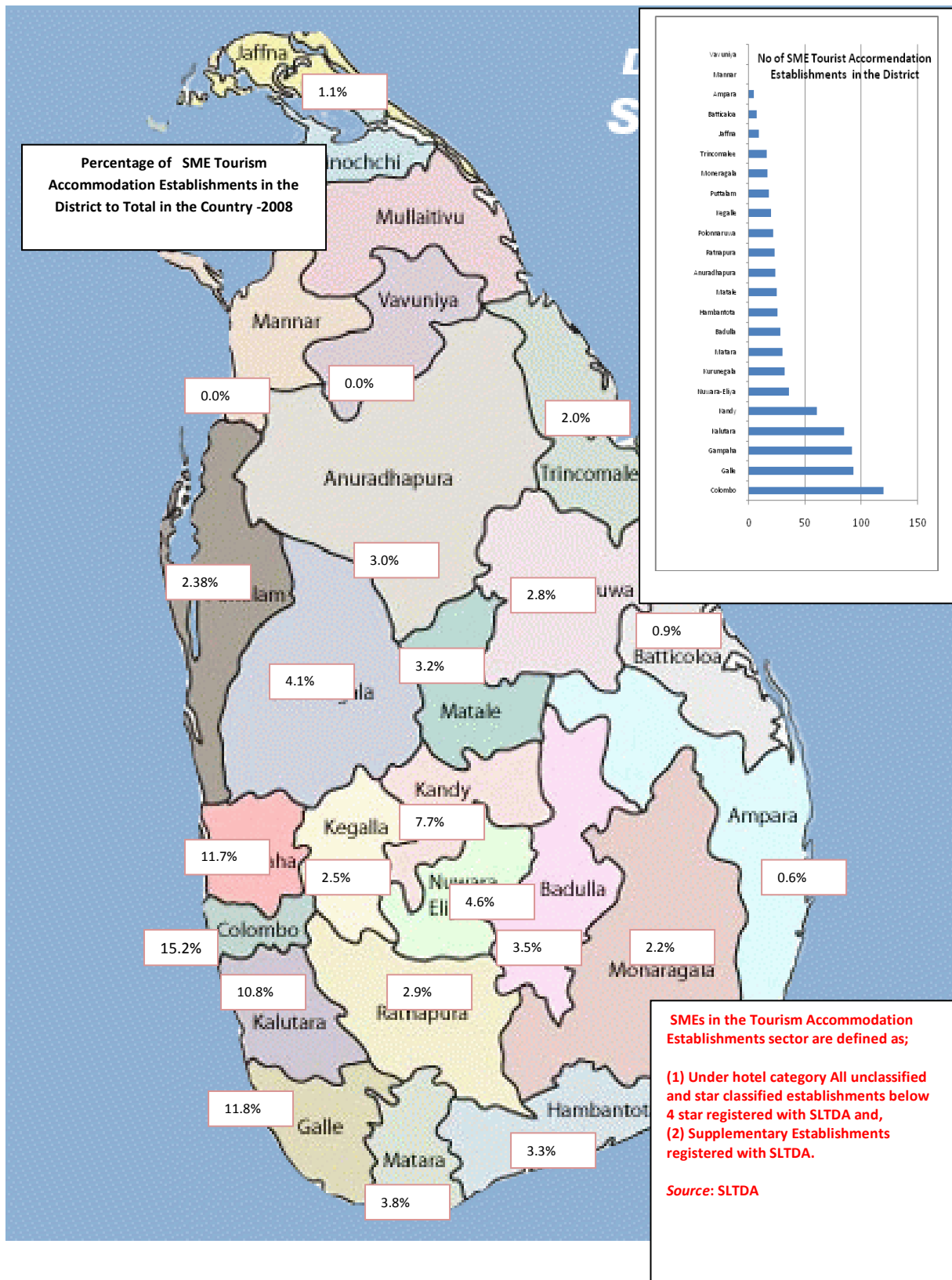
Two main activities have been proposed under Component 2, namely capacity enhancement of lending institutions and SMEs and legal and regulatory assistance to amend existing regulatory frameworks and/or to develop new regulatory frameworks. As noted above no negative social impacts are expected from this component.

Appendix A

Geographical Distribution of Industrial SMEs Map 1- Prevalence of SMEs Across the Island



Map 2- Prevalence of Tourism Related SMEs



Appendix B

Guidelines and Draft TOR for Social Impact Assessment²⁴

Social Impact Assessment (SIA) involves the collection of data related to measurable change in human population, communities, and social relationships resulting from a development project or policy change; in this case a Crisis Response SME Development Facility.

Scope of work:

1. Gather data on all variables at least once a year. Mobilization of research assistants in this venture.
2. Design effective measurements for the identified assessment criteria, namely (i) number of loans and volume of finance to SMEs supported by the facility, (ii) number of loans and volume of finance that has original maturity greater than 3 years, (iii) improved portfolio quality of PFIs as measured by decreased non-performing loans (NPL) in their SME portfolios. In addition development indicators such as (i) lending rates to enterprises, and (ii) employment and annual turnover by participating SMEs. (iii) number and value of SME loans by province, (iv) borrowers' gender background, (v) SME perceptions of access to finance through the project. Development of these measurements will require expertise in the field of Economics and/or Banking and Sociology.
3. Use participatory tools in data gathering. Stakeholder consultation with representatives from the private sector chambers, borrowers and current employees. These stakeholder consultations will also gather data related to possible violations of the country's labour law. Discussions with other SMEs in the regions which have not obtained financing.
4. The following must also be captured in data collection: 1) possible avenues of employment revealed through the project, 2) availability of loans across regions and sectors, 3) difficulties encountered by SME proprietors in applying for loans, 4) nature and availability of support received to overcome such difficulties
5. SIAs must be conducted based on a sample. Selection of a sample can begin at the level of the lending bank. Information about loan grantees can be obtained through the bank and a sample of borrowers, including borrowers who have become non-performing. Representatives of private chambers must also be chosen into the sample. Village level government officers may also be included in the sample to find out about the overall impact of SMEs on the region, if relevant and appropriate.
6. Assess transparency and responsiveness of participating banks' operations. Identify any bias, inequities or unintended social consequences. Suggest mitigatory measures. Develop a mitigation plan.
7. Monitoring– Develop a monitoring program.

Expertise required:-

This may vary according to the components.

²⁴ These guidelines are based on the international SIA guidelines/ principles put forward by IAIA (International Association for Impact Assessment- USA) (2003) and on the guidelines by the Interorganizational Committee on Guidelines and Principles for Social Impact Assessment, USA (1994). The consultant/s undertaking each SIA must be encouraged, as much as possible, to follow the international guidelines specified by these organizations. However, certain adaptations may be required to suit the Sri Lankan social, economic and cultural scenario.

It is recommended that individuals with at least a Master's Degree in social science with experience in applied research techniques be recruited as chief researchers. An assistant with equal qualifications in the fields of Economics and/or Banking must also be recruited for developing the assessment measurements.

Several assistants who possess at least a BA degree should be recruited to support the chief researcher.

Deliverable:-

1. Interim reports to be submitted one month after the SIA for comments by MoFP.
2. Final report to be submitted two weeks after receiving comments.

Appendix C

Bank and Branch Network of Licensed Commercial Banks by District from 2006 - 2009 3rd Quarter

District	No. of Banks				Branches				Other Banking Outlets (a)				Total Branch & Banking			
	2006	2007	2008	2009 - III	2006	2007	2008	2009 - III	2006	2007	2008	2009 - III	2006	2007	2008	
1	AMPARA	6	6	6	6	28	29	29	29	93	143	155	163	121	172	184
2	ANURADHAPURA	8	9	10	10	47	47	49	49	135	167	194	210	182	214	243
3	BADULLA	8	10	10	10	47	49	50	50	110	135	155	164	157	184	205
4	BATTICOLOA	5	5	6	6	15	15	17	20	43	46	55	62	58	61	72
5	COLOMBO	23	23	22	22	315	339	393	398	313	380	436	462	628	719	829
6	GALLE	8	9	11	11	51	53	55	57	133	176	210	225	184	229	265
7	GAMPAHA	13	13	13	13	131	142	138	139	185	265	291	293	316	407	429
8	HAMBANTOTA	6	7	7	8	29	33	33	33	68	89	113	117	97	122	146
9	JAFFNA	5	5	5	6	34	34	34	36	89	129	142	154	123	163	176
10	KALUTARA	11	11	10	11	56	62	62	63	69	108	110	112	125	170	172
11	KANDY	13	13	13	13	57	68	68	68	174	219	236	253	231	287	304
12	KEGALLE	8	8	9	9	41	42	41	41	95	120	142	154	136	162	183
13	KILINOCHCHI	2	2	2	2	3	3	3	3	2	9	10	10	5	12	13
14	KURUNEGALA	13	13	13	13	65	74	74	74	138	195	212	225	203	269	286
15	MANNER	3	3	3	4	4	4	4	5	10	15	18	20	14	19	22
16	MATALE	7	8	8	8	26	27	30	30	86	106	119	119	112	133	149
17	MATARA	10	11	12	12	39	41	42	44	103	122	145	149	142	163	187
18	MONARAGALA	6	6	7	7	25	25	25	25	51	70	82	82	76	95	107
19	MULATIVU	2	2	2	2	4	4	4	4	0	6	7	7	4	10	11
20	NUWARA ELIYA	6	7	7	8	32	33	33	34	85	93	109	111	117	126	142
21	POLONNARUWA	7	8	8	8	23	23	25	25	64	85	98	101	87	108	123
22	PUTTALAM	8	9	10	10	33	35	41	42	77	98	112	113	110	133	153
23	RATNAPURA	9	10	10	10	48	53	53	55	127	161	176	176	175	214	229
24	TRINCOMALEE	6	6	6	6	16	16	16	16	47	60	64	69	63	76	80
25	VAVUNIYA	6	6	6	7	6	6	6	7	16	25	27	35	22	31	33
Total						1175	1257	1325	1347	2313	3022	3418	3586	3488	4279	4743

Source: Central Bank

(a) Banking units such as Extension Offices, Pawning Centers, Student Savings Units & Pay Offices

