ASIAN INFRASTRUCTURE INVESTMENT BANK

PD000408-SL
February 25, 2021

**Project Document
of the Asian Infrastructure Investment Bank**

**Sovereign-backed Financings**

**The Democratic Socialist Republic of Sri Lanka**

**Sri Lanka COVID-19 Emergency and Crisis Response Facility**

**(Under the COVID-19 Crisis Recovery Facility)**

**Currency Equivalents**
(September 30, 2020)

Currency Unit – Sri Lankan Rupee (LKR)
USD 1.00 = LKR 184.95
LKR 1.00 = USD 0.0054

**Fiscal year**
1 January – 31 December

**Abbreviations**

| | |
|---|---|
| ADB | Asian Development Bank |
| AIIB | Asian Infrastructure Investment Bank (the “Bank”) |
| ALCO | Asset-Liability Committee |
| BOC | Bank of Ceylon |
| CBSL | Central Bank of Sri Lanka |
| COVID-19 | Coronavirus Disease 2019 |
| DGM | Deputy General Manager |
| DSA | Debt Sustainability Assessment |
| D-SIB | Domestic Systemically Important banks |
| ES | Environmental and Social |
| ESEL | Environmental and Social Exclusion List |
| ESF | Environmental and Social Framework |
| ESMS | Environmental and Social Management System |
| ESP | Environmental and Social Policy |
| ESS | Environmental and Social Standards |
| FI | Financial Intermediary |
| FX | Foreign Exchange |
| GDP | Gross Domestic Product |
| GoSL | Government of Sri Lanka |
| HLA | Higher Loss Absorbency |
| IIRMD | Independent Integrated Risk Management Division |
| IMF | International Monetary Fund |
| IRMC | Integrated Risk Management Committee |
| LCR | Liquidity Coverage Ratio |
| LKR | Sri Lankan Rupee |
| MDB | Multilateral Development Bank |
| NPL | Non-Performing Loan |
| OM | Operations Manual |
| PB | People’s Bank |
| PEP | Politically Exposed Person |
| PIU | Project Implementation Unit |
| PPM | Project-affected People’s Mechanism |
| SLFRS | Sri Lanka Accounting Standard |
| SME | Small and Medium-Sized Enterprise |
| SOE | State-owned Enterprises |

## CONTENTS

# 1. Summary Sheet
## The Democratic Socialist Republic of Sri Lanka
## Sri Lanka COVID-19 Emergency and Crisis Response Facility

| | |
|---|---|
| Project No. | PD000408-SL |
| Borrower/ Project Implementation Entity | • Bank of Ceylon (BOC); and<br>• People's Bank (PB) |
| Guarantor | The Democratic Socialist Republic of Sri Lanka |
| Sector / Subsector | Finance / Intermediary Financing |
| Project Objective | To provide financing support and increase the supply of liquidity to corporate and small and medium-sized private enterprises (SMEs) in Sri Lanka affected by the economic upheaval due to the coronavirus disease (COVID-19) pandemic |
| Project Description | The Project will provide sovereign-backed loans to the Borrowers, both of which are state-owned banks. The Project intends to address the urgent need for liquidity to provide credit to corporates and SMEs. These companies are facing short-term funding challenges due to the outbreak of the COVID-19 pandemic and the continued provision of credit is necessary to support the productive capacity of the country.<br><br>The Borrowers will on-lend the proceeds to corporates and SMEs in the form of short-term working capital loans.<br><br>At least 60 percent of the sub-loans on a value basis will be on-lent to SMEs.[1]<br><br>This Project will be processed under AIIB's COVID-19 Crisis Recovery Facility[2]. |
| Implementation Period | Start Date: March 2021<br>End Date: September 2022 |
| Expected Loan Closing Date | September 2022 |
| Cost and Financing Plan | Project cost: USD180 million<br><br>Financing Plan:<br>AIIB loans: USD180 million |
| Size and Terms of AIIB Loan | USD180 million; USD90 million each to BOC and PB. |

[1] Enterprises having annual turnover under LKR750 million (~USD4 million) or less than 300 employees if in manufacturing or 200 employees if in services.
[2] The Facility was approved by the Bank's board on April 16, 2020 (Link).

| | |
|---|---|
| | The loans will have a final maturity of 7 years, including a grace period of 2 years and 6 months, and will be made on standard Fixed Spread Loan terms for sovereign-backed loans with the corresponding average maturity. |
| Cofinancing | N/A |
| Environmental and Social Category | FI |
| Risk (Low/Medium/High) | High |
| Conditions of Effectiveness | • Adoption of the Operations Manual (OM) by each Borrower<br>• Alignment of existing Environment and Social Management System with AIIB's Environmental and Social Policy |
| Key Covenants | • Performance of Borrowers' respective obligations under the Project is in compliance with AIIB policies.<br>• Borrowers to carry out the Project in accordance with the OM.<br>• The aggregate amount of lending from each Borrower to SMEs should be equal to or more than 60 percent of total lending by each Borrower under the Project.<br>• Financial covenants with respect to capital, liquidity, and non-performing loans. |
| Policy Assurance | The Vice President, Policy and Strategy, confirms that AIIB is in compliance with the policies applicable to the Project. |

| | |
|---|---|
| President | Jin Liqun |
| Vice President | D.J. Pandian |
| Director General | Dongik (Don) Lee |
| Manager (acting) | Asim Rana, Principal Investment Officer |
| Project Team Leader | Neeraj Jain, Senior Investment Officer |
| Team Members | Abhijit Sen Gupta, Senior Economist<br>Amy Chua, Environmental Specialist<br>Giacomo Ottolini, Procurement Specialist (Consultant)<br>Liu Yang, Counsel<br>Marcin Sasin, Senior Economist<br>Matthew Bleiman, Investment Associate<br>Susrutha Goonasekera, Senior Social Specialist<br>Yogesh Malla, Financial Management Specialist |

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## 2. The Project Description

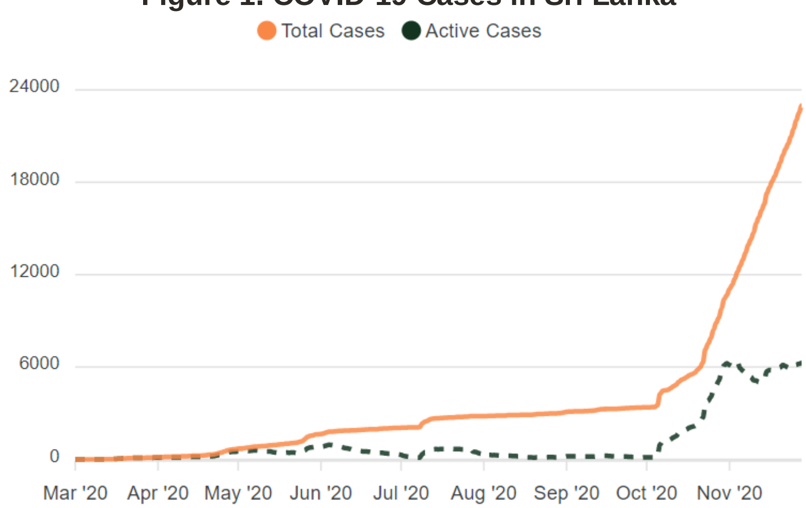
### A. Project fit under the COVID-19 Crisis Recovery Facility

1. **Background.** COVID-19 was declared a Public Health Emergency of International Concern by the World Health Organization on January 30, 2020, and it was declared a pandemic on March 11. COVID-19 has precipitated a global economic and financial market crisis. On March 27, 2020 the International Monetary Fund (IMF) announced a global recession, which is likely to be worse than the 2008 financial crisis. According to IMF's World Economic Outlook (June 2020), world output is expected to contract by 4.9 percent in 2020 with economic activity in advanced economies declining by 8.0 percent and emerging and developing economies experiencing a contraction of 3.0 percent.

2. **Crisis impact on the country.** The spread of COVID-19 has had significant socio-economic impacts on Sri Lanka. After an outbreak of cases by mid-March 2020, the government of Sri Lanka (GoSL) imposed travel restrictions and introduced aggressive containment measures. The measures, while helping to contain the virus' spread, have led to the slowdown of economic activity and a loss of income and livelihoods for large segments of the population. Asian Development Bank estimated that a serious outbreak would have resulted in 700,000 job losses and deepened poverty. The strain is particularly severe for workers in the informal sector, who account for a larger share of the workforce, and daily wage earners. The worsening labor market conditions could raise the poverty rate (measured at USD5.50 a day) to 41.7 percent in 2020 from 40.4 percent in 2016.

3. **While the government response kept the initial outbreak to 3,000 cases, a second wave began in October 2020 and cases continue to rise**, exceeding 60,000 by end-January 2021. Unlike the first mass lockdown in March 2020, the authorities have taken a more targeted approach, with localized lockdowns being preferred when required, to mitigate the disruptions to the economy, thereby facilitating the sustenance of livelihoods.

**Figure 1. COVID-19 Cases in Sri Lanka[3]**




[3] Sri Lanka Health Promotion Bureau. November 30, 2020. https://hpb.health.gov.lk/covid19-dashboard/.

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4. The Sri Lankan economy, which was expected to grow by 3.5 percent in 2020 according to pre-COVID-19 estimates is now estimated to shrink by some 4.6 percent according to the IMF (as of October 2020). However, assuming that mitigation measures continue successfully, and as the economy stabilizes on the back of the implemented stimulus policies, the IMF forecasts 2021 gross domestic product (GDP) growth at 5.3 percent, above pre-COVID-19 estimates of 4.3 percent.

5. **Most affected sectors**. After recording a healthy growth rate of 6.5 percent on average between 2010 and 2015, growth has slowed since 2016 due to drought, political uncertainty and the Easter Sunday terrorist attacks of 2019. The COVID-19 pandemic has now added further stress, derailing economic activity due to the loss of tourism and export earnings, supply chain disruptions, weak consumption as well as uncertainty and risk aversion impacting investment. SMEs, which account for over 90 percent of the total enterprises, 45 percent of total employment, and make a significant contribution to country's GDP, are particularly vulnerable to economic downturns and the impact of COVID-19.[4] SMEs in Sri Lanka, similar to their counterparts globally, have weaker balance sheets, are less diversified, and have fewer financing options. The COVID-19 pandemic has impacted sectors critical to Sri Lanka's economy.

(i) The tourism sector, which contributed 5 percent of Sri Lanka's GDP in 2018, was already impacted by the Easter Sunday terrorist attacks, which killed many civilians including tourists. Tourist arrivals declined by 18 percent to 1.9 million in 2019.[5] The subsequent closing of Sri Lanka's borders to tourists in mid-March has resulted in a complete shutdown of the sector in 2020. The outlook for the sector will be largely driven by the speed of containment of COVID-19 in Sri Lanka and the pace of recovery in key source markets. As of January 2021, Sri Lanka has opened its borders and has readied itself for the resumption of international tourism.

(ii) The apparel and textile sector accounts for nearly 50 percent of export revenues (2019 data) and helps sustain nearly a million workers. It is one of the sectors potentially most exposed to the pandemic. Early in the pandemic, with the lack of demand across major export destinations, significant orders have been reportedly cancelled, which led to layoffs and working capital shortages. It was estimated that revenue losses could have amounted to as much as USD1.5 billion between March to September 2020.[6] The sector has been adapting, including by supplying protective gear in place of the normal apparel orders, so the total textile and garment export in 2020 is estimated to have declined by no more than 15-20 percent compared with the pre-COVID-19 levels of 2019.

[4] Data from Government of Sri Lanka, Ministry of Industry and Commerce, National Policy Framework for Small Medium Enterprise Development, Colombo, 2016.

[5] KPMG. Impact of COVID-19 on the Sri Lankan Economy. April 8, 2020. https://assets.kpmg/content/dam/kpmg/lk/pdf/kpmg-covid-19-economic-impact.

[6] PWC. COVID-19 Outbreak- Impact on Sri Lanka and Recommendations. April 8, 2020. https://www.pwc.com/lk/en/assets/COVID-19-Impact-on-Sri-Lanka-PwC.pdf.

Nonetheless, the longer-term recovery of the sector is contingent on economic revival in destination countries.

(iii) The construction sector suffered due to delays in the procurement of raw materials and the unavailability of domestic and foreign workers due to containment measures and curfews. Major construction projects will not resume until the 2021 budget goes into implementation. Still, the sector benefitted in the second half of 2020 from the lifting of the curfew as well as recent political consolidation (discussed in paragraph 12 below).

6. The substantial impact on the real economy has also affected the banking sector, which is impacted by a debt moratorium across many sectors (see 12. Government response to COVID-19) and asset quality deterioration caused by the economic downturn. Fitch Ratings has assigned a negative outlook to Sri Lanka's banking sector for 2020.

7. GoSL has introduced financial measures to increase bank lending capacity, such as allowing banks to draw down their capital conservation buffers, relaxation of certain non-performing loan (NPL) classification rules and a two year deferral of the requirement to enhance minimum capital. The Central Bank of Sri Lanka (CBSL) has announced policy measures to ensure liquidity and credit do not dry up. Such measures are designed to soften the impact on private sectors and individuals.

8. **Fiscal response to COVID-19**. The National Operation Centre for Prevention of the COVID-19 Outbreak was set up to coordinate the preventive and management measures, while ensuring adequate provision of healthcare and other services. The Presidential Task Force on Economic Revival and Poverty Eradication coordinates the delivery of essential services. The government allocated up to 0.1 percent of GDP for containment measures while cash payments amounting to 0.25 percent of GDP were allocated for vulnerable groups. GoSL announced tax exemptions for key medical equipment and relaxed payment terms for income tax. GoSL also imposed price ceilings on essential food items and announced concessional loans and food allowances for the poor. The 'Saubhagya COVID-19 Renaissance Facility', an LKR50 billion (USD270 million) concessionary refinance program, was introduced to provide working capital for adversely affected businesses to revive their activities. Such economic stimulus package programs aim to ease the burden on businesses and individuals due to the pandemic and imposed restrictions on mobility. However, these efforts have negatively impacted Sri Lanka's fiscal balance, with the IMF projecting a government deficit of 9.6 percent of GDP for 202, and 8.1 percent of GDP for 2021 (Fitch expects an 11.5 percent of GDP deficit for 2021 and 2022).

9. **Monetary response to COVID-19**. Monetary measures to support continued lending and liquidity include policy rates cuts totaling 200 basis points since March 2020, a 3 percentage point cut in the required reserve ratio on domestic currency deposits of commercial banks, reductions in liquidity coverage ratio and net stable funding ratio requirements, and allowing banks to draw on their capital conservation buffers and reschedule NPLs.

10. **Financial measures to COVID-19**. Sri Lanka has focused on encouraging the banking sector to continue providing credit to the private sector. CBSL implemented a six-month bank loan repayment moratorium for affected sectors which has since been extended another six months. Affected businesses are also eligible to receive working capital and refinance loans at

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concessional rates, partially supported by a CBSL guarantee. More information on the impact of these policies to the banking sector is presented in Section 3. Project Assessment, A. Industry Context.

11. Since May 2020, GoSL relaxed containment measures, including ending the initial lockdown and lifting a nation-wide curfew. Public transport restarted, businesses began operating and schools are currently in session with social distancing measures in place. CBSL has cited the resultant pickup in economic activity as a key driver of renewed GDP growth in the second half of the year. Data on remittances is also encouraging, as the large inflows (some 7 percent of GDP) faltered only temporarily and ended the year with a 5.8 percent increase compared with 2019, representing a diversified source of income for the country. Continued economic revival will depend on whether new measures implemented manage to contain the second wave while being sensitive to the state of the economy.

12. **August 2020 parliamentary elections.** GoSL response to the COVID-19 pandemic took place without a fully operating government after President Rajapaksa dissolved the opposition-led parliament in early May. Following elections held in August, President Rajapaksa's Sri Lanka Podujana Peramuna party gained a two-thirds super-majority through 2025. The change in the political landscape was expected to facilitate the economic recovery and promote business environment stability.

13. However, negotiations with the IMF on an emergency loan have not been conclusive so far, somewhat against market expectations. That development, combined with the second wave of COVID-19 infections and a sovereign rating downgrade, led to a renewed sell-off in Sri Lankan sovereign debt.

14. **Debt Sustainability Analysis.** Sri Lanka's public debt at the end of 2019, was 86.8 percent of GDP. It has grown by 17 percentage points of GDP since 2012—on the back of large debt-financed infrastructure investment program, decelerating growth as well as external and domestic shocks—and remains high compared with peers, with one of the largest gross financing needs ratios among emerging economies. Foreign currency debt constitutes slightly below 50 percent of the total. The pre-pandemic IMF assessment described risks to debt sustainability as high, with the typical safety thresholds exceeded under the baseline scenario. That said, fiscal consolidation envisaged under the now-expired IMF program was to steadily reduce debt levels and risks in the medium run, thus ensuring sustainability—however, Sri Lanka missed its 2019 fiscal deficit target by a wide margin, while prospects for fiscal consolidation were pushed back by the pandemic.

15. The pandemic exacerbated the situation. As of January 2021, Sri Lanka continues to experience external liquidity stress, as reflected by the increase in yields from 6.5 to over 20 percent (for the 2025 maturity bond). According to the IMF, Sri Lanka's public debt will rise to 98.3 percent of GDP in 2020 (or 105 percent of GDP including guarantees) and then stabilize at these levels. Gross financing needs will stay above 20 percent of GDP for some time. Debt risks are now higher than before, given higher debt and the general uncertainty. In these circumstances, debt sustainability is predicated on (i) official creditors continuing their exposures, in a coordinated manner, to shore up Sri Lanka through the market stress; as well as (ii) credible commitments from the authorities to implement the earlier-envisaged fiscal consolidation after the pandemic

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recedes. The country's ability to attract non debt creating foreign currency inflows including an improvement in both exports and foreign direct investments will also be important. It will also be instrumental to continue financing projects that have demonstrably high economic benefits and those that contribute directly to debt sustainability by preventing the destruction of economic capital of otherwise viable businesses. Between September and December 2020, all three major rating agencies downgraded Sri Lanka's Long-Term Foreign Currency Issuer Default Rating to the CCC range (Moody's: Caa1, Fitch: CCC, S&P: CCC+), citing an increasingly challenging external-debt repayment situation and a deteriorated fiscal position expected over the medium term.

16. **Alignment with AIIB's COVID-19 Crisis Recovery Facility.** The Project is aligned with the Decision to Support AIIB's COVID-19 Crisis Recovery Facility, as approved by the Board on April 16, 2020, specifically in respect to the scope of financing in paragraphs 14.3 on "financings to address liquidity constraints for clients in infrastructure and other productive sectors" and instrument of financing in 15.1 on sovereign-backed and non-sovereign-backed financing for regular investment projects ("lines of credit to financial intermediaries with focus on working capital and liquidity support to borrowing banks' clients"). This Project will support two state-owned banks in their efforts to maintain the availability and accessibility of short-term financing to the country's affected sectors. In the absence of AIIB's support, this financing may be curtailed, delayed or suspended.

17. **Alignment with the country's priorities.** The Ministry of Finance of Sri Lanka reached out to AIIB requesting financing support. The on-going COVID-19 pandemic has driven GoSL to take unprecedented measures to circumvent the direct and indirect impact of this global crisis on private sectors. Certain measures have been taken through the banking system to assist private enterprises. This in turn has necessitated the infusion of liquidity into the banking system to provide further and sustainable financing support to private sector entities. The Project is consistent with the emergency response policies and measures of GoSL and the CBSL.

18. GoSL has also made supporting SMEs a priority. In 2017, they adopted the National Policy Framework for SME development and have established various government institutions to support SME development. The current government's policy manifesto highlights the role of SMEs in critical sectors across the economy and emphasizes the need for the banking sector to develop to support affordable lending to SMEs.[7] Additionally, the Project is aligned with CBSL efforts to enhance the access of SMEs to the banking sector and financial inclusion, including urging banks to increase credit expansion to targeted segments including SMEs and directing banks to open new branches to enhance physical access.[8]

19. **Lessons learned from previous projects**. This will be the Bank's first Financial Intermediary project in Sri Lanka. The Bank will build on knowledge and experience of similar projects financed by other multilateral development banks (MDBs) in Sri Lanka and the Borrowers'

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[7] Gotabaya Rajapaksa. Gotabaya presents to you a Reconstructed Country with a Future. https://gota.lk/sri-lanka-podujana-peramuna-manifesto-english.pdf.

[8] ADB. Small and Medium-Sized Enterprises Line of Credit Project - Third Additional Financing: Report and Recommendation of the President – Financial Analysis. November 2020. https://www.adb.org/projects/documents/sri-49273-004-rrp.

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experience of prior financings with MDBs. For example, the Asian Development Bank (ADB) has successfully carried out the “Small and Medium-Sized Enterprises Line of Credit Project” since 2016, on-lending via GoSL to participating financial institutions, including BOC and PB. Discussion with ADB personnel highlighted that the SME Line of Credit Project has worked well. In particular, the technical capacity of the Borrowers addressing environmental and social (ES) matters has improved through ADB’s capacity building program.

20. On November 23, 2020, ADB’s board approved an additional USD165 million commitment with a 10-year tenor to their existing SME project. The approval highlights the good performance of the ongoing original project and ADB’s confidence in the financial health of Sri Lanka’s banking sector.

21. **Economic impact of the proposed investment.** Under the proposed investment, AIIB will partner with two state-owned commercial banks to provide much-needed funds to some of the sectors that have been most impacted by the COVID-19 pandemic including (a) tourism, (b) textiles and apparel, (c) construction, (d) wholesale and retail trade, (f) manufacturing, (e) agriculture exports, (f) health care, etc. (see Annex 3 for a full list of eligible sectors). The proposed investment is expected to have a strong economic impact with the above-mentioned sectors being major generators of employment. For example, the textiles and apparel, tourism, and construction sectors accounted for more than 37 percent of non-agricultural employment in 2018.[9] These sectors witnessed a significant decline in economic activity due to (a) disruptions in supply of input, (b) the reduction in domestic and external demand due to fall in income and rising uncertainty and (c) lack of access to finance due to tight credit conditions. As noted above, the problem is more acute for SMEs. Thus, to maximize impact, at least 60 percent of on-lent amounts will be allocated to SMEs.

22. The provision of liquidity support through the proposed investment will help in abating job losses and preserving productive capital as the availability of funds will enable the firms to fulfill their working capital needs, including wages and other statutory payments, and to repair supply chains that have been disrupted due to lack of capital. The focus on sectors that have high employment potential and strong value chain linkages with the rest of the economy will help Sri Lanka rehabilitate the economy.

## B. Project Objective and Expected Results

23. **Project objective.** The objective of the Project is to provide financing support and increase the supply of liquidity to corporates and SMEs in Sri Lanka affected by the economic upheaval due to COVID-19.

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[9] Government of Sri Lanka, Department of Census and Statistics. Quarterly Report of the Sri Lanka Labour Force Survey Quarterly Report – 2019 Fourth Quarter Available at http://www.statistics.gov.lk/samplesurvey/2019Q4report.pdf.
Employment in construction is inclusive of employment in electricity, gas and water supply.

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24. **Expected results.**

*Direct Results*

(i) Amount of financing provided to the sub-borrowers.
(ii) Amount of financing provided to SMEs.
(iii) Amount of financing provided to women led enterprises.
(iv) Number of sub-borrowers reached.
(v) Number of SMEs reached.

25. **Expected beneficiaries.** The Project is expected to benefit several key stakeholders:

(i) Direct beneficiaries

- The Borrowers, who will receive liquidity financing at an affordable rate.
- Sri Lankan corporates and SMEs involved in the affected sectors, who face liquidity and working capital challenges under the current economic upheaval due to the pandemic.

## C. Description and Components

26. **Overview of the Project**. The Project is supported by two 7-year term loans, for an amount of USD90 million each, to BOC and PB. The term loans will be guaranteed by Sri Lanka. This financing will be on-lent to provide working capital loans to the clients of the Borrowers, who are facing liquidity shortages due to the outbreak of the pandemic. At least 60 percent of the sub-loans on a value basis will be on-lent to SMEs, defined as enterprises having annual turnover under LKR750 million (~USD4 million) or less than 300 employees if in manufacturing or 200 employees if in services.

27. The Borrowers will be wholly responsible for the implementation of the Project, in accordance with local law and AIIB's operational policies and procedures[10]. Implementation of the Project will be guided by an OM, which will state the eligibility criteria for sub-loans, sub-borrowers, including compliance with AIIB's ES policies, standards and monitoring requirements, among other criteria, as well as AIIB's Procurement Policy. The Borrowers will be responsible for the selection, appraisal, approval and monitoring of sub-loans and take the full credit risk of the sub-borrowers.

28. **Description of the Borrowers**

29. **Bank of Ceylon.** Established in 1939, BOC is the first state-owned commercial bank in Sri Lanka. The bank is solely owned by GoSL and is the largest licensed commercial bank in the country, making it a Domestic Systemically Important Bank (D-SIB). BOC was incorporated under the Bank of Ceylon Ordinance No. 53 of 1938. BOC has 581 local branches and 1,033 ATMs as

[10] AIIB's operational policies include AIIB's Operational Policy on Financing, Environmental and Social Policy, Procurement Policy, Policy on Prohibited Practices and any other applicable AIIB policies to the activities supported by the AIIB Financing.

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well as overseas branches in Maldives, Chennai and Seychelles. Its branch in London was upgraded to a full-fledged bank and now operates as a subsidiary of BOC. The BOC group has 10 subsidiaries and 4 associate companies that are involved in non-banking financial institution operations, property development and leisure. BOC had a customer penetration ratio of over 62 percent and a staff strength of 8,503 employees as of end-2019.

30. Fitch has rated BOC's Long-Term Foreign and Local-Currency Issuer Default Ratings at B- and National Long-Term rating at AA+ Ika. The outlook on the Issuer Default Ratings and National Long-Term rating is Negative, which is aligned with the outlook on Sri Lanka's sovereign rating prior to the recent downgrade. On September 29, Moody's downgraded BOC from B3 to Caa1 in line with a sovereign downgrade.

31. **People's Bank.** Established in 1961, PB is a majority state-owned commercial bank (92 percent stake), with the remainder of the shares being held by Corporative Societies. As the second largest licensed bank in the country (in terms of asset base), it is also classified as a D-SIB. The bank has a 75 percent stake in one of the country's largest non-banking financial institutions, Peoples Leasing and Finance PLC, as well as a 50 percent stake in People's Merchant Finance. PB has a network of 739 branches and 755 ATMs, with a workforce of 7,836 employees servicing over 10 million customers island wide.

32. Fitch has rated PB's National Long-Term rating at AA+ Ika with Negative outlook.

33. A more detailed description of each Borrower is provided in Section 3. Project Assessment B. Counterparty Analysis. The Borrowers are well-suited to reach SMEs. PB has a dedicated SME business segment and BOC reaches SMEs through a development banking unit within its retail business segment. With their extensive branch networks, both have access to SMEs across the country and approximately 10 percent of each bank's private sector loan book is to SMEs by value. Both participate in the ADB SME credit facility line program.

## D. Cost and Financing Plan

34. **Amount.**

(i) **AIIB Loans (AIIB to Borrowers).** The total financing amount of this sovereign-backed project is USD180 million to be equally allocated in separate loans to BOC and PB. The Project Team has confirmed with both Borrowers that they have pipeline capacity to deploy the total amount of funds and that there is sufficient demand given the strong growing demand of their existing clients for short-term liquidity due to the outbreak of COVID-19. Disbursements will be tranched and disbursements subsequent to the initial disbursement will be contingent upon utilization of previously disbursed amounts.

**Table 1. AIIB Loan Amount per Borrower**

| Borrower | Percentage of Total | Amount (USD million) |
|---|---|---|
| Bank of Ceylon | 50% | USD90 million |
| People's Bank | 50% | USD90 million |

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(ii) **Sub-loans (Borrower to sub-borrowers).** Each sub-loan will have a maximum size of USD2 million. Each sub-borrower will only be allowed to take a sub-loan one time.

35. **Maturity**.

(i) **AIIB Loan (AIIB to Borrower).** The AIIB Loans will be structured as a 7-year term loan, including a grace period of 2.5 years.

(ii) **Sub-loans (Borrower to sub-borrowers).** The maturity of the sub-loans will have a maximum duration of 36 months, which is in line with the average maturity of working capital loans at both BOC and PB and market practice in Sri Lanka for such facilities.

36. **Pricing.**

(i) **AIIB Loan (AIIB to the Borrower).** The loans will follow the AIIB's General Conditions for Sovereign-backed Loans and will be made on standard Fixed Spread Loan terms for Sovereign-backed Loans with the corresponding average maturity.[11]

(ii) **Sub-loans (Borrower to Sub-borrowers).** The Borrower will have the discretion to determine each sub-loan's pricing based on the assessment of the creditworthiness of each sub-borrowers and in line with market practice; the all-in interest rate will be the sum of the cost of funding of each Borrower and risk-adjusted credit spread of the underlying sub-borrowers.

37. **Currency.**

(i) **AIIB Loans (AIIB to the Borrowers).** USD

(ii) **Sub-loans (Borrower to sub-borrowers).** LKR or USD

38. **Sub-borrower eligibility.** Sub-borrowers will be private entities domiciled in Sri Lanka in compliance with local laws. Sub-borrowers must be economically and financially viable and meet the Borrower's criteria in terms of creditworthiness, foreign exchange (FX) position, ES risk profile, procurement and know your customer requirements. The sub-borrowers may not be related parties of the Borrower or the senior management of the Borrower. The criteria are presented in Annex 3.

39. **Sub-loan eligibility criteria**. Each Sub-loan must meet eligibility requirements including (a) be made only to an eligible sub-borrower to be used for working capital, (b) be made only to an Eligible Sector, (c) be in LKR or USD, (d) have maximum tenor of 36 months, and (e) loan proceeds may not be used for activities excluded under the ES requirements (e.g., Category A and other higher risk activities) or under AIIB's Environmental and Social Exclusion List (ESEL). The full criteria are presented in Annex 3.

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[11] Sovereign-backed Loan and Guarantee Pricing (December 2019). Link.

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## E. Implementation Arrangements

40. **Implementation period.** March 2021 to September 2022

41. **Implementation management.** The Borrowers will be responsible for the implementation of the Project. Each Borrower will establish a Project Implementation Unit (PIU) as a dedicated internal team, which will be responsible for the project implementation, management, monitoring, record keeping and reporting to the Bank. The PIU will mobilize staff from other departments and/or branches in support of the Project. The key functions of each PIU will be to administer, operate, monitor and track the day-to-day implementation of the Project on an on-going basis, and to be the direct point of contact for AIIB to monitor the Project with each Borrower. The PIU will also be responsible for preparing disbursement projections and send withdrawal applications to AIIB in accordance with AIIB requirements. Each PIU will also monitor the respective Borrower's compliance with applicable law, as well as with AIIB's fiduciary and ES requirements under the Environmental and Social Policy (ESP),[12] the Procurement Policy,[13] and Policy on Prohibited Practices.[14]

42. Both Borrowers already have experience managing MDB financing due to their participation in the ADB SME credit line and the design of both banks' PIUs for the Project will build on their experience in implementing the ADB project.

43. Operations Manuals. Each Borrower will be guided by an OM, to be agreed upon with AIIB. The OM will include the eligibility criteria for sub-borrowers and sub-loans and terms and conditions of sub-loans, including ES undertakings (see Annex 3). The OM will also describe the disbursement and funds flow process and the required reporting to AIIB for project monitoring. Each PIU will be responsible for managing the implementation of the OM. Finalization and adoption of each OM will be a condition of effectiveness in the Loan Agreements.

44. Agreements. The Project will be implemented through the following agreements: 1) Loan Agreement between AIIB and each Borrower; 2) Sub-loan Agreements between Borrower and sub-borrowers and 3) Guarantee Agreement between AIIB and the Democratic Socialist Republic of Sri Lanka.

45. **Financial management implementation.** Each Borrower will be responsible for the overall financial management of its Loan. The planning/budgeting, accounting, funds flow, internal control and audit arrangements will be aligned with the existing systems of the Borrowers. Each Borrower's PIU will provide technical and administrative support and is organized interface with appropriate staff to maintain adequate project financial management. The PIUs will prepare project accounts in accordance with the acceptable accounting standards. PIUs shall prepare and submit Interim Un-Audited Financial Reports to AIIB within 45 days of the end of each calendar semester. The external audit reports for each year of Project implementation will be submitted as

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[12] Environmental and Social Policy (February 2016, amended February 2019). Link.
[13] Procurement Policy (January 2016). Link.
[14] Policy on Prohibited Practices (December 2018). Link.

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follows: (i) the Project audited financial statements within 6 months from the fiscal year-end and (ii) Borrowers' entity audited financial statements within 1 month from approval by their respective Boards, but no later than 1 year from end of the fiscal year. The audited financial statements for each such period shall also include the management letter(s) issued by the auditors. An independent auditor will conduct annual project audits in accordance with applicable standards and terms of reference acceptable to AIIB. The detailed project financial management arrangements including planning/budgeting, funds flow, accounting, internal control, internal audit, disbursement, eligibility of sub-borrowers, reporting, external audits, etc. will be stated in the OM.

46. **Funds Flow and Disbursement.** Each borrower will be required to maintain following accounts: (1) the USD Nostro Account, (2) the Designated USD Control Account, and (3) the Designated LKR Control Account. The facility will adopt an advance method for disbursement. Under this method, AIIB will disburse funds based on the six-month estimated expenditure (as specified in the Disbursement Letter), to the existing USD Nostro Account denominated in USD opened by the Borrowers at a foreign bank. Subsequent disbursements will be made on submission of withdrawal application and statement of expenditures for eligible expenditures when the advance amount up to the percentage specified in the Disbursement Letter has been disbursed to the sub-borrowers. On the receipt of the funds in the existing USD Nostro Account, the borrowers will transfer funds to the designated USD Control Account. Thereafter, the funds will be used for on-lending USD sub-loans or will be transferred to the designated local currency (LKR) control account on a regular interval based on their requirements for on-lending to sub-borrowers in LKR. Loans provided in local currency will be accounted in the designated LKR control account after the disbursement made by their branches. Each Borrower will receive, maintain and monitor loan proceeds using their own financial management systems. The Borrowers shall prepare and maintain funds utilization statements of these accounts on periodic basis.

47. **Recycling of repayment flows from sub-borrowers.** The principal portion of repayment from sub-loans will be credited in the Designated USD or LKR control accounts depending upon the currency of repayment. The repayment received will be used for subsequent lending to new eligible sub-borrowers in compliance with the OM or repayment to AIIB.

48. **Accounting.** A separate project profile account will be created in the accounting system and ledger of the Borrowers, in which the chart of accounts will be designed by sub-borrowers to ensure the accuracy and completeness of Project transactions and financial reports. The Project's transactions will be recorded and reported on using appropriate basis of accounting. All payments to and from eligible sub-borrowers will be recorded and tracked in sub-loan accounts to be maintained in accordance with policies and procedures satisfactory to AIIB.

49. **Monitoring and evaluation.** The Borrowers will be responsible for monitoring the progress of sub-loans at the sub-borrower level individually and collectively. The Borrower will be obliged to closely monitor the progress of the sub-loans through site visits and management interviews. The Borrower will ensure that the Project is implemented in compliance with AIIB's Prohibited Practices Policy and under the Loan Agreement, the Bank will reserve the right to investigate any suspected violation of the Policy.

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50. The Borrower will submit progress reports quarterly until the completion of the Project in a prescribed format to be agreed in the OM. AIIB will evaluate progress on the proposed indicators through regular reporting by the PIU and through implementation support visits. During the Project's implementation period, AIIB will retain the right to review all sub-loans and conduct supervisory visits, including visits to the Borrowers and sub-projects, at its discretion.

51. **AIIB's implementation support.** Subject to travel disruptions caused by the COVID-19 pandemic, AIIB will carry out a bi-annual monitoring visit to each of the Borrowers to oversee the implementation of the Project. No technical assistance is envisaged.

## 3. Project Assessment

52. The Project Team has analyzed the financial condition of both Borrowers and has confirmed they have sufficient financial health to support the Project. ADB has also concluded that the participating financial institutions, including BOC and PB, have good financial standing in terms of capital, asset quality, earnings, liquidity, and sensitivity.[15]

53. The Project Team has conducted a comprehensive due diligence on each Borrower's internal policies, procedures and structure in place and has concluded that the Borrowers have an adequate business model, organization, and framework and implementation of risk management. Each Borrower's loan assessment capability, ES monitoring, internal controls, compliance and audit functions are well in place and structured to implement the proposed Project.

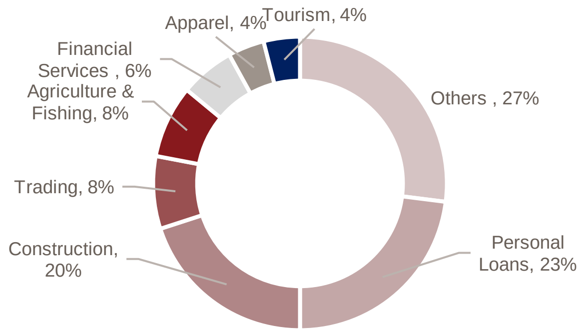
### A. Sector Context

54. At the end of 2019, the banking system consisted of 32 licensed banks – 26 licensed commercial banks (including 13 branches of foreign banks) and 6 licensed specialized banks. The sector continues to be concentrated with large banks with the four D-SIBs - BOC, PB, Commercial Bank of Ceylon and Hatton National Bank - accounting for 53.8 percent of industry assets (total banking industry assets of LKR12.5 trillion (USD68 billion)) as of end-2019. The annual growth of total assets declined sharply from 14.6 percent in 2018 to 6.2 percent in 2019, which mirrored the decrease in loan growth from 19.6 percent in 2018 to 5.6 percent in 2019.

55. The banking sector has exposure to vulnerable sectors of the real economy and over the past several years, due to a series of exogenous shocks, asset quality has been deteriorating, leading to increasing NPLs and decreasing returns. The gross NPL ratio has increased from 3.4 percent in December 2018 to 4.7 percent in December 2019.

**Figure 2. Sectoral Credit to Private Sector (June 2019)**

[15] ADB. Small and Medium-Sized Enterprises Line of Credit Project - Third Additional Financing: Report and Recommendation of the President – Financial Analysis. November 2020. https://www.adb.org/projects/documents/sri-49273-004-rrp.




*Source: KPMG – Impact of COVID-10 on the Sri Lanka*

56. CBSL has undertaken several important initiatives to strengthen the soundness of the banking sector, including the full implementation of Basel III and the adoption of International Financial Reporting Standards 9 via Sri Lanka Accounting Standard (SLFRS).[16] The forward-looking expected credit loss methodology of International Financial Reporting Standards 9 has helped strengthen the balance sheets of the Borrowers despite the previous years' challenges and has been particularly important during the ongoing moratorium period as both BOC and PB have continued to apply the expected credit loss approach to provisioning on their accounts regardless of regulatory forbearance on NPL recognition. Both BOC and PB have also adopted Basel III banking standards under the regulatory requirements of CBSL.

57. CBSL has developed a new supervisory rating model, the Bank Sustainability Rating Indicator, to facilitate risk-based supervision for licensed banks and enable early intervention and prompt corrective actions for licensed banks.

58. In response to weak economic activity CBSL eased its monetary policy stance since May 2019. CBSL cut both the Standing Deposit Facility Rate and Standing Lending Facility Rate by 100 basis points from May 2019 to January 2020 and imposed lending rate caps from September 2019 to March 2020.

59. In response to COVID-19's impacts on the economic CBSL took more aggressive monetary policy stance cutting Standing Deposit Facility Rate and Standing Lending Facility Rate further to 4.5 percent and 5.5 percent. The aggregate 200 basis point cuts in policy rates since COVID-19 has had a negative but small impact on interest margins as the lower interest revenue from largely floating rate asset books has been largely offset by the short duration nature of the deposit base. Additionally, CBSL has allowed D-SIBs to draw down their point capital conservation buffers by 100 basis points, reducing regulatory capital adequacy, and has lowered liquidity coverage requirements. This decision is indefinite subject to further assessment by CBSL as the situation unfolds.

**Table 2. Selected Sri Lankan Regulatory Requirements**
**Basel III Capital Requirement for D-SIBs**

[16] SLFRS was developed based on International Financial Reporting Standard 9.

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| | As of December 2019 | Current |
|---|---|---|
| **Common Equity Tier (CET) 1** | 7 percent+ HLA | 6 percent+ HLA |
| **Total Tier 1** | 8.5 percent+ HLA | 7.5 percent+ HLA |
| **Total Capital** | 12.5 percent+ HLA | 11.5 percent+ HLA |
| **Leverage Ratio** | 3 percent | 3 percent |
| **Liquidity Coverage Ratio** | 100 percent | 90 percent |
| **Net Stable Funding Ratio** | 100 percent | 90 percent |
| **HLA requirements for Licensed Banks Determined as D-SIBs** | | |
| **Bucket** | Licensed Banks | HLA Requirement |
| 2 | Bank of Ceylon | 1.5 |
| 1 | People's Bank | 1.0 |

60. In May 2019, CBSL requested licensed banks to grant a moratorium to borrowers in the tourism industry after the terrorist attack in 2019. Additionally, a six-month bank loan repayment moratorium on both principal and interested was implemented beginning in April 2020 for affected industries and individuals. The moratorium has since been formally extended for an additional six months through March 2021. Principal and interest during the moratorium period is to be structured into a term loan with a minimum tenor of 12 (for overdrafts) or 24 (for term loans) months beginning after the end of the moratorium, subject to a regulated interest rate.

61. Banks were also instructed to provide working capital loans at a regulated and subsidized interest rate with interest waivers for entities under moratorium. Along with government lending, such loans contributed to the Borrowers' loan book growth over the year.

62. CBSL regulatory guidance on lending rates (portfolio-wide rate reductions, caps on new loan rates, and policy rates for COVID-19 working capital loans) will make it more difficult for banks to effectively price risk.

63. As state-owned banks with positive public perception, both banks saw a large inflow of deposits since the COVID-19 outbreak. Additionally, both Borrowers have successfully raised capital (Additional Tier 1 and Tier 2) in the domestic capital markets, largely through issuances purchased by domestic pension funds associated with state-owned enterprises (SOEs). For example, on December 2 BOC raised LKR10 billion (USD54 million) of Additional Tier 1 capital bonds, after an initial issue of LKR3 billion was more than three times oversubscribed.

## B. Counterparty Analysis

**<u>Bank of Ceylon</u>**

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64. Business Profile and Strategy. Founded in 1939, BOC is the first state-owned commercial bank in Sri Lanka. The bank is solely owned by GoSL and is the largest bank in the country, identified as a D-SIB. As of Q3 2020, at the group level BOC has LKR2,863 billion (USD15.5 billion) in assets, of which LKR1,976 billion (USD10.7 billion) are net loans, and holds LKR2,324 billion (USD12.6 billion) in deposits.

65. BOC has a staff strength of 8,503 employees and customer penetration of 63 percent, with a network of 1,880 customer contact points (including 581 local branches and 1,033 ATMs) and has expanded overseas with 3 branches in Maldives, Chennai and Seychelles. Its branch in London was upgraded to a full-fledged bank and a subsidiary of BOC. The Bank's subsidiaries also include Merchant Bank of Sri Lanka and Finance, a Licensed Finance Company and Property Development PLC. This reach enables BOC to directly contribute to the development of individuals, entrepreneurs, SMEs and corporates. Debentures of the Bank are listed on the Colombo Stock Exchange.

66. BOC has identified four strategic priorities: (i) Excellence in customer service, (ii) Leading the digital adoption, (iii) Retaining market leadership, and (iv) Best in sustainable banking. The strategy is designed to play on their strengths as the market leader with a strong brand and deep branch reach, while improving appeal to younger demographics and upgrading technological systems to modern standards that can compete with younger banks and fintechs. BOC also views climate change as a threat and has elevated sustainable business practices to a strategic priority.

67. BOC's key business segments are:

(i) Retail banking. Through the retail segment the Bank provides a range of investment, lending and transactional banking solutions to individuals, start-ups ventures and SMEs. The credit portfolio mainly comprises of personal loans, housing loans, commercial/development loans, leasing, overdrafts and pawning. The retail cluster is also the main deposit mobiliser for the bank. The retail banking segment has contributed 52 percent and 29 percent to the bank's operating income and assets respectively in 2020. Prior to the COVID-19 situation, where profits have declined 32 percent through Q3 2020, the segment had achieved profit growth of 14 percent during 2019. The priority for 2020 in the retail banking sector has been to provide ongoing support for the SMEs in line with GoSL's development agenda.

(ii) Corporate and offshore banking. The segment provides financing solutions to the government, large-scale projects, SOEs and large-cap private companies. It has contributed 24 percent to the bank's operating income and 39 percent to assets in 2020. While the segment achieved a net interest income expansion of 37 percent in 2019, impairment charges of loans and advances have affected profitability, which declined 2 percent in 2019 and has declined 75 percent in 2020. The segment has seen the largest increase of assets, rising 41 percent, in 2020, reflecting the focus of credit growth to the government and SOEs.

(iii) International, Treasury, Investment and Overseas operations. The International division engages in foreign currency related transactions, facilitating remittances, issuing foreign currency travel cards and offering foreign currency deposit products. The Treasury division manages the bank's liquidity and asset-liability positions. The Investment division provides portfolio management services, trustee and custodian services and is involved in the structuring of investments such as debentures and securitized papers. The Overseas division manages the bank's overseas branches. This segment has been the most profitable for BOC during 2020 due to asset growth of 8 percent and limited impairments, driving profit growth of 48 percent.

(iv) Sustainable business. BOC emphasizes the significant role it can play in addressing income inequalities and climate change impacts. In 2019, the bank made LKR 77.8 billion (USD421 million) in disbursements to the SME and micro-financing sectors and LKR70.8 million (USD383,000) in investments in solar projects. The bank's approach to sustainability is outlined in the Sustainable Policy, which is reviewed annually, focusing on 3 main dimensions of economic, environmental and social sustainability. The bank introduced a comprehensive Environmental and Social Management System (ESMS) in 2018, and it has been screening all development lending via the ADB special credit line based on ESMS guidelines. As of end-2019, 681 officers are trained on ESMS criteria and LKR673.5 (USD3.6 million) has been disbursed after screening under the ESMS.

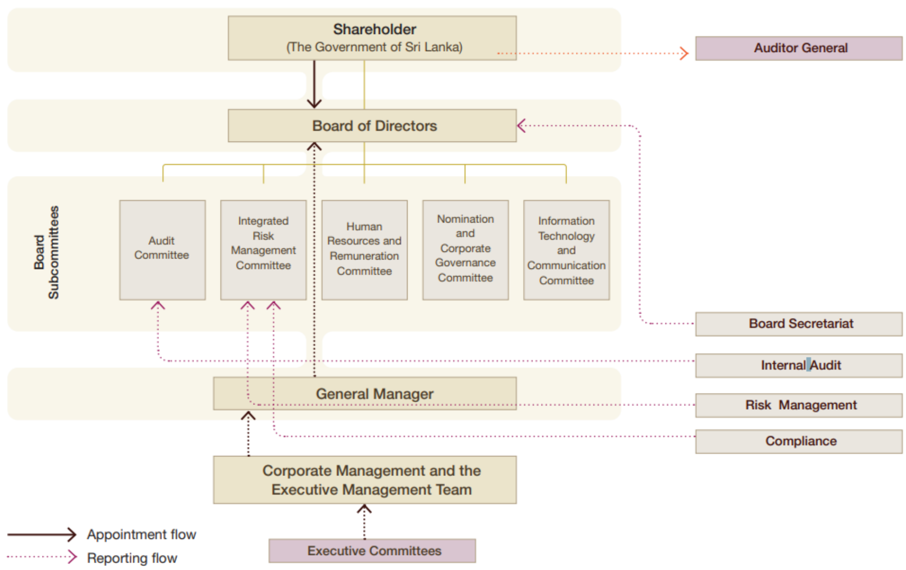
68. Governance. BOC has a well-defined governance structure comprising multi-level governance bodies, specific roles and responsibilities and clear reporting lines. The Board of Directors serves as the highest governing authority and is empowered to delegate the oversight responsibilities of specific functions to subcommittees as appropriate. A new board was appointed in January 2020, following a change in the political landscape, with directors combining a diverse range of public and private sector experience, industry insights and skills. There are currently five non-executive directors from the private sector representing senior corporate management, legal, finance and accounting and banking backgrounds. As a state-owned bank, all directors are appointed by the Minister of Finance and are approved by CBSL if the requirements are met. A representative of the Ministry also holds an ex officio position on the board – the current director has also served as an Alternate Executive Director to AIIB.

69. The Board holds apex responsibility for setting strategic direction, establishing robust governance and risk management practices, ensuring regulatory compliance, safeguarding the bank's reputation and presenting a balanced and fair assessment of the bank's financial performance and position. The Board has delegated specific responsibilities to five sub-committees: the Board Audit Committee, the Integrated Risk and Management Committee (IRMC), the Human Resources and Remuneration Committee, the Nomination and Corporate Governance Committee and the Board Information and Communication Technology Committee. The committee chairpersons are responsible for the effective functioning of the committees and to report and make recommendations to the board on the respective activities.

70. Day to day management is led by the Chief Executive Officer (referred to as the General Manager) and the senior management team, which is comprised of the Chief Financial Officer, Chief Legal Officer, Chief Marketing Officer, Chief Internal Auditor, Chief Information Officer, nine Deputy General Managers (DGMs) in charge of various business units, and the secretary to the board. Under the senior management sits 40 Assistant General Managers across the business. While BOC seeks to align its strategic direction with the country's policy objectives and GoSL can

influence oversite of BOC through board appointments and shareholder rights, the board and management are independent and are tasked with maintaining a fully commercial, profit-seeking organization. The internal audit function is discussed in Section 3. Project Assessment D. Fiduciary Governance.

**Figure 3. BOC's Governance Structure**




71. Risk Management. BOC applies the three lines of defense framework for risk management: 1) Business units, 2) the Independent Integrated Risk Management Division (IIRMD), and 3) audit/assurance. The first line of defense and the primary responsibility for credit risk management lies with the business units, supported by independent review by the Credit Risk Unit of the IIRMD. IIRMD is headed by the Chief Risk Officer, who directly reports to the IRMC. IIRMD is composed of two units, risk management and information security. IIRMD is responsible for determining the risk appetite, regular stress testing, preparation of the comprehensive International Capital Adequacy Assessment Process and supporting the first line of defense in risk identification, monitoring and reporting. BOC maintains a suite of risk management policies to implement the risk management framework throughout the organization. Key risks to BOC's business include:

(i) Credit risk: This is the largest risk for BOC, accounting for 92 percent of risk-weighted assets. BOC has a board-approved Credit Risk Management Policy which clearly sets out the principles under which credit risk is to be assumed, ensuring the consistent identification, management and reporting of credit risk across the bank. The credit risk policy framework includes segregation of duties, comprehensive credit appraisal mechanisms, delegated approval authority limits and prudential limits and is articulated through a set of comprehensive policies relating to risk rating, portfolio management and loan review, among others. The credit committee, headed by the General Manager, is responsible for the implementation of the credit risk management framework. Responsibilities of the credit committee include formulating reviewing and implementing credit risk appetite limits, approving credit up to authorized limits, and making recommendations to the board for credit beyond its authorized limits. For corporate clients, the bank utilizes risk rating models to evaluate exposures above thresholds in some sectors and irrespective of exposure in certain high-risk sectors. Each model weights a mix of risks (financial, business, management, industry, and transactional) with each being further broken down into quantitative or qualitative parameters. The output of the model maps to internal credit ratings, which are reviewed annually or at the time of granting a new loan. The ratings models were developed internally. Scorecards are used for retail clients. The credit team also monitors exposures by name, concentration, sector, collateral, and cross-border, and manages collateral valuation. Stress tests are conducted on NPLs, currency movement, operational risk, net interest margin and collateral value. BOC's pricing mechanism ensures facilities are priced factoring individual rating and availability of collateral.

(ii) Market risk: BOC defines market risk as exposure to interest rate risk, FX, risk, and equity risk. However, market risk is limited due to the structure of the balance sheet, with exposure comprising less than 1 percent of risk-weighted assets. Market risk is managed at the executive level by the asset-liability committee (ALCO), which supports the board in setting risk limits. IIRMD monitors interest, foreign exchange and equity risk via typical tools such as value at risk, price value for basis point, duration, gap analysis/open positions, stress testing and sensitivity analyses, and reports to the ALCO monthly.

(iii) Funding and liquidity risk: The ALCO is responsible for managing liquidity risks within board-set parameters. BOC maintains a contingency funding plan with specific triggers and action plans in the case of liquidity stress.

(iv) Operational risk: IIRMD implements an organization-wide operational risk management framework, including 1) performance of risk and control self-assessments on all business units to identify operational risks and 2) analysis of other tools such as risk indicators, internal loss data, and root cause analyses. The bank seeks to minimize risks by a mix of policies, working with business units on vulnerabilities, developing business continuity plans, and obtaining insurance for uncontrollable risks. Building systems to prevent cyber risk is considered a key focus area as BOC develops its digitization.

72. <u>Credit Approval Process and Monitoring</u>. BOC has a segregation of duties pertaining to credit appraisal and post-sanction monitoring. There are clearly defined approval limits for new credit, extension of existing credit and material changes to any terms and conditions of a facility. All potential credit exposures of the bank are first evaluated by transaction originators using credit risk models who are the risk owners of the credit mechanism. Credit proposals exceeding a certain threshold are independently reviewed by the Chief Risk Officer. Restructurings also require approval and follow a similar delegated authority structure. The post-sanctioning review of large

credit exposures is carried out periodically by the Credit Quality Assurance Unit, which monitors loans, including adherence to covenants and other conditions for significant loans. The risk management team also monitors the portfolio on an on-going basis.

73. Compliance. The compliance policy is approved by the board annually, which provides guidance on how compliance risks are identified, monitored and managed. The dedicated compliance officer is responsible for ensuring that BOC is compliant with all relevant external regulations and internal guidelines. The DGM for compliance has a team of 20, including 7 anti-money laundering officers and 13 regulatory compliance officers. Branch managers and banking officers implement the policy across the company's branches. The DGM for compliance reports to the IRMC monthly.

74. BOC has a board-approved policy on Prevention of Money Laundering and Combating Financing Terrorism. The policy covers the standard customer acceptance policy (criteria for acceptance of customers), customer identification procedures, politically exposed persons (PEPs), transaction monitoring, risk categorization, reporting of suspicious transactions, documentation procedures and training. BOC conducts know your customer diligence during new client onboarding. They use the Dow Jones risk database, which is updated daily and integrated with their Clari5 software, to check for sanctions (entities are screened against United Nations, Office of Foreign Assets Control, European Union, and local sanctions list entities) and PEP, and they also monitor adverse news. Periodic review is conducted using a risk-based approach with high-risk clients being subjected to enhanced due diligence. PEPs are reviewed every six months, high-risk clients annually, medium-risk clients every three to five years, and low-risk clients every ten years. On-going customer due diligence or enhanced due diligence is performed as and when the situation warrants irrespective of minimum frequencies in case the customer or transaction poses a high risk of money laundering. There is also an automated system in place with triggers for suspicious scenarios that draw review from the central team, who will work with the relevant branch to address any triggered issues.

75. BOC has a zero-tolerance approach to bribery and corruption. The policy is clearly communicated to all employees during the induction programs and reinforced through regular training and awareness sessions. The compliance team also overseas bribery and fraud prevention.

**People's Bank**

76. Business Profile and Strategy. Founded in 1961 under an act of Parliament, PB is a majority state-owned commercial bank, classified as a D-SIB, and is the second largest commercial bank in the country. As of Q3 2020, at the group level PB has LKR2,271 billion (USD12.3 billion) in assets, of which LKR1,739 billion (USD9.4 billion) are net loans, and holds LKR1,807 billion (USD9.8 billion) in customer deposits. It accounts for 15.5 percent of sector assets, 17.9 percent of sector loans and 16.5 percent of sector deposits at end-March 2020. In 2014, PB became the second largest Sri Lankan bank in terms of asset base. PB is also the first and only bank in Sri Lanka to receive the highest international accreditation for information protection and security- ISO/ IEC 27001:2013 certification.

77. PB has a 75 percent stake in one of the country's largest non-banking financial institutions, Peoples Leasing and Finance PLC, as well as a 50 percent stake in People's Merchant Finance. PB has a network of 739 branches and 755 ATMs, with a workforce of 7,836 employees servicing over 10 million customers island-wide.

78. PB aims to provide financial services that contribute to the quality of life and enterprise development via affordable, accessible and efficient solutions. It aims to operate with integrity and accountability, responsiveness and flexibility to meet the needs of its clients by being innovative and redefining itself to embrace change.

79. PB has identified four key strategic objectives: (i) deliver innovative market-leading client experience, (ii) maintain steady growth momentum and build resilience, (iii) be operationally excellent, and (iv) always do business the right way.

80. Under the current three-year strategic planning window, the General Manager highlighted as specific focus areas strengthening digital delivery and focusing on regional costs/staffing with an aim to improve cost efficiency. This approach fits with PB's digitization strategy with a goal to be the most digitalized and technologically advanced bank in Sri Lanka.

81. Regarding growth in the loan book, there is currently an emphasis on developing the SME sector and import substitution industries in alignment with the government's strategy to strengthen its current account balance. Overall, PB expects to grow their loan book 12 to 15 percent per year. Exposure to government-related entities has increased from 35 to 40 percent of loans in 2018-19 to 51 percent of the loan book today. Fitch has previously noted that PB's loan growth fluctuates depending on demand from the state sector, while non-state lending growth has remained lower than peers.

82. PB's key business segments are:

(i) Retail banking. Retail banking accounts for over 88.7 percent of the bank's total deposits and 35.5 percent of the bank's total loans and advances at end-2019. The retail segment is mostly driven by housing loans, pawning advances (gold-backed loans) and vehicle finance through People's Leasing & Finance PLC (each accounting for around 10 percent of gross loans). PB is the market leader in gold-backed lending among domestic banks. The launch of the Retail Loan Originating System to automate the retail loan approval process is one of the bank's strategic priorities. In 2019, the system was launched in 37 branches and 667,349 new customers were acquired, driving the current and savings account portfolio to grew by more than 5 percent.

(ii) Enterprise banking (SMEs). Enterprise banking contributed 15 percent of loans and advances by end-2019. PB has a range of conventional lending products such as term loans, trade and working facilities, and cash margin loans with which it engages in lending to SMEs across Sri Lanka. During 2019, priority was given to empowering women by supporting women entrepreneurship. Under the ADB funded loan scheme, women-led enterprises were to receive grants for up to 35 percent of the loan value based on the location and other conditions.

(iii) Corporate banking. This segment accounts for larger private corporations and SOEs. Corporate banking contributed 42.4 percent to the bank's operating profit and 42 percent of total loans and advances by end-2019. While the NPL ratio edged up to 3.3 percent due to the adverse external environment, the ratio is still below the industry average. Sector-wise, government and SOEs represented 77 percent and private sector stood at 23 percent in 2019.

83. Governance. PB also has a well-defined governance structure comprising multi-level governance bodies, specific roles and responsibilities and clear reporting lines. The Board provides leadership, oversight, control and deliberates with the Executive Management about the bank's strategic direction, financial goals, resource allocation and risk appetite. Like BOC, as a state-owned bank the Board of Directors is appointed by the Minister of Finance and are approved by CBSL if the requirements are met. The Board of Directors was completely replaced by the new administration beginning in the end of 2019. The current board comprises of a chairman and seven non-executive directors, who are eminent professionals of the SOE and private sector including two chartered accountants, two lawyers, one IT specialist, one commercial banker, and a representative from the Ministry of Finance. All non-executive directors are independent of management and free from any business or other affiliations that could materially interfere with or could reasonably be perceived to materially interfere with the exercise of their unfettered and independent judgement. The Board has delegated specific responsibilities to eight sub-committees namely, Audit Committee, the IRMC, Human Resources and Remuneration Committee, Investment Banking Committee, Credit Committee, Nomination Committee, Strategic Plan Review Committee and IT Committee. The Board retains ultimate responsibility for determining PB's 'risk tolerance'. The Risk Management Report, which includes monitoring, controlling and reporting of identified risks and uncertainties, is reviewed by the Board. In addition, the Board reviews reports referred by the Chairman of the IRMC and Audit Committee pertaining to risk management. Day to day operations are managed by the General Manager, who is supported by a team of 16 DGMs and 30 Assistant General Managers. The internal audit function is discussed in Section 3. Project Assessment D. Fiduciary Governance.

84. GoSL's influence stems from its appointment of directors. However, the General Manager stated that GoSL cannot give a direct order to the bank – it only follows circulars from CBSL – and that the bank effectively operates independently from GoSL. The strategic direction of the bank is thus developed completely internally. It includes a goal of being aligned with GoSL and is intended to take a longer-term view, but PB operates independently with a profit objective. PB's dividend policy is set via negotiation with GoSL and management successfully negotiated reduced payouts to support internal capital generation and bolster capital adequacy.

**Figure 4. PB's Governance Structure**

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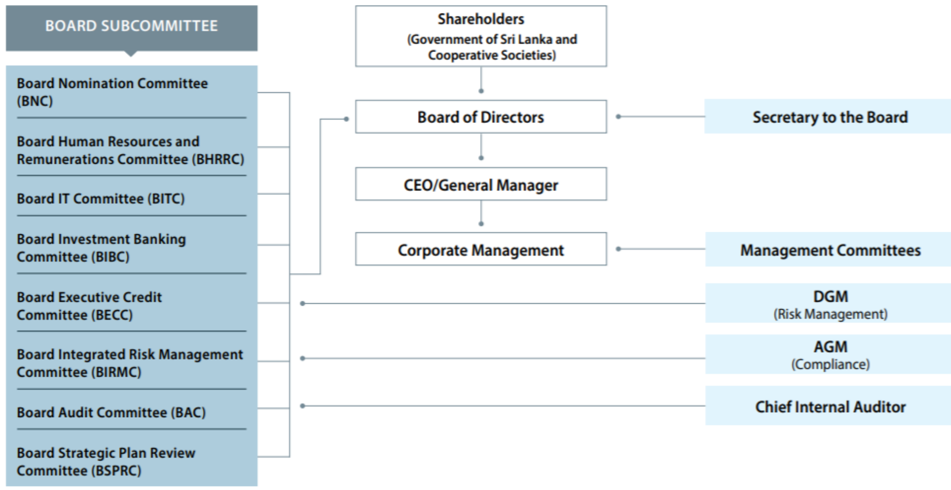



85. Risk Management. PB also uses the three lines of defense framework for risk management: 1) Business lines/corporate function; 2) risk management and controls; and 3) assurance. Risk is identified and managed as part of a group-wide risk management framework. The Board of Directors has ultimate responsibility for the oversight of risk, determining risk appetite levels, formulating risk policies and ensuring the effectiveness of the risk management processes and procedures in place. The risk management and credit control departments hold overall executive responsibility for PB's risk management functions. It is headed by the Chief Risk Officer (DGM-Risk Management) who reports directly to Board IRMC and operates independently of business units as well as profit and volume targets. Four separate units have been established under the risk management and credit control departments with specific responsibilities for handling credit, market, operational and information systems risks. Also reporting to the IRMC is PB's Chief Compliance Officer. Other board committees at the risk level include the Board Executive Credit Committee, which the General Manager reports to, and the Audit Committee, which the Chief Internal Auditor reports to. The senior management also oversees risk via management committees including the ALCO, Credit Risk Management Committee, Operational Risk Management Committee, and Information Security Steering Committee.

(i) Credit risk: This is the largest risk for PB, accounting for over 80 percent of the bank's risk-weighted assets. The primary responsibility for managing credit risk lies with the business units, complemented by independent review by the Credit Control Unit. The Credit Control Unit operates independently from the business lines and drives all credit risk management efforts. The responsibility for credit risk management sits with the board executive credit committee and includes formulating policies in consultation with the Board IRMC, establishing credit approval structures, conducting reviews of exposures, ensuring adequacy of provisioning, maintaining the risk rating systems and final approvals above the threshold. The General Manager reports to this committee and oversees implementation of the credit risk program throughout the organization. The credit policies include delegated approval authority at multiple levels, a comprehensive credit appraisal mechanism which includes well-defined credit criteria and prudential limits in line with the defined risk appetite among others. PB applies in-house assessment methodologies scorecards, and the bank's nine points rating scale to evaluate the creditworthiness and assign ratings to the borrowers. Tailor-made scorecards have been developed for assessing corporates, SME borrowers' financial institutions as well as retail borrowers. These rating scorecards are periodically reviewed and validated by the Board IRMC. The risk ratings for new transactions and for all material exposures are annually reviewed and deteriorating credit is reported to credit committees quarterly. PB seeks to manage default risk by focusing on concentration limits (by individual large exposure split by SOE/non-SOE, sector, product, and geography). Stress testing includes various shocks to NPLs, collateral value, and large borrower defaults.

(ii) Market risk: Market risk is managed via policies on asset-liability management, treasury management, foreign exchange risk and stress testing. Analyses include value at risk, duration gap, sensitivity analysis and stress testing. Key market risks include interest rate (repricing, basis, and yield curve), foreign exchange, equity price risk, gold collateral value and liquidity, all of which are continuously monitored and discussed monthly at the ALCO. The bank has a contingency funding plan in place with pre-defined triggers for activation to support liquidity requirements in stressed conditions but has not needed to activate the plan.

(iii) Operational risk: The risk management department works with the business units to identify and mitigate areas of operational risk. They maintain a database of events and near misses and quarterly reports reviewing events, risks and emerging issues are presented to Board IRMC. Other mitigants include recovery planning, segregation of duties, insurance and operation of the risk management system. External frauds, damage to physical property and execution and process management make up over 90 percent of the operational risks faced by PB. Overall loss has been reduced by a third over the past five years.

86. <u>Credit Approval Process</u>. PB uses delegated credit authority with approved limits requiring authorization at the branch, region, and at Assistant General Manager/DGM/GM level at the corporate office; all deals requiring at least DGM approval (LKR250 million (USD1.4 million) for term loans) go to a credit committee. Deals going to the credit committee are first reviewed by the credit risk management department and approved by the DGM for risk management.

87. Corporate loans are handled at the headquarters. Such loans are originated via a sales team and relationship managers who meet customers, evaluate proposals and do site visits for certain deals. For retail loans, guidance on new and updated products is distributed via circular to the branch level. On-going monitoring is performed by the credit officers of the relevant unit in close cooperation with the credit control department. Any post-disbursement material changes to a credit facility require additional approval.

88. Compliance. The Assistant General Manager for Compliance reports directly to the Board IRMC monthly. Compliance has implemented and oversees CBSL guidelines on know your customer and anti-money laundering. The dedicated Compliance Officer oversees the compliance status and regularly assesses the compliance and reports the status to the Board IRMC and Board of Directors. PB has a board-approved policy on Prevention of Money Laundering and Combating Financing Terrorism. The policy covers the standard customer acceptance policy (criteria for acceptance of customers), customer identification procedures, PEPs, transaction monitoring, risk categorization, reporting of suspicious transactions, documentation procedures and training. When new clients are onboarded, a know your customer diligence is completed during appraisal and if there are red flags, management decides whether to proceed. The process is in-house without utilizing third party reporting. Taking on a PEP requires approval from PB's executive leadership team and such clients are classified as high-risk. Ongoing monitoring is done on a risk-basis with high-risk clients reviewed annually, medium-risk biannually, and low risk less frequently. Compliance officers also conduct ongoing monitoring for adverse news. Anti-money laundering investigations can be triggered via alerts from the system or from branch staff and the compliance officers seek additional information from the branch staff as necessary. Suspicious transactions are analyzed, evaluated and reported to the Financial Intelligence Unit. PB has implemented the Accuity system and screen transactions against United Nations, Office of Foreign Assets Control, and European Union sanctions lists for both domestic and cross-border transactions. There is an annual regulatory audit on compliance systems.

## C. Financial Analysis

89. **Overall Assessment**. The Project Team has undertaken a thorough assessment of both banks' financial health and credit quality. The majority of both BOC's and PB's assets are government-related, aligning the credit risk with the sovereign. Both banks have been provisioning on a forward-looking basis in accordance with SLFRS. The Project Team also takes comfort with CBSL's robust capital adequacy standards and both banks' internal targets in excess of such standards, the banks' status within Sri Lanka, and their access to domestic institutional investors to raise additional capital to support their capital adequacy buffers. Access to such markets has been demonstrated in periods of stress including during the COVID-19 pandemic.

90. Both banks maintain healthy liquidity profiles in LKR and are largely funded by stable deposit bases. There are no regulatory requirements on foreign currency liquidity and there is some risk given the lack of high-quality liquid foreign currency assets.

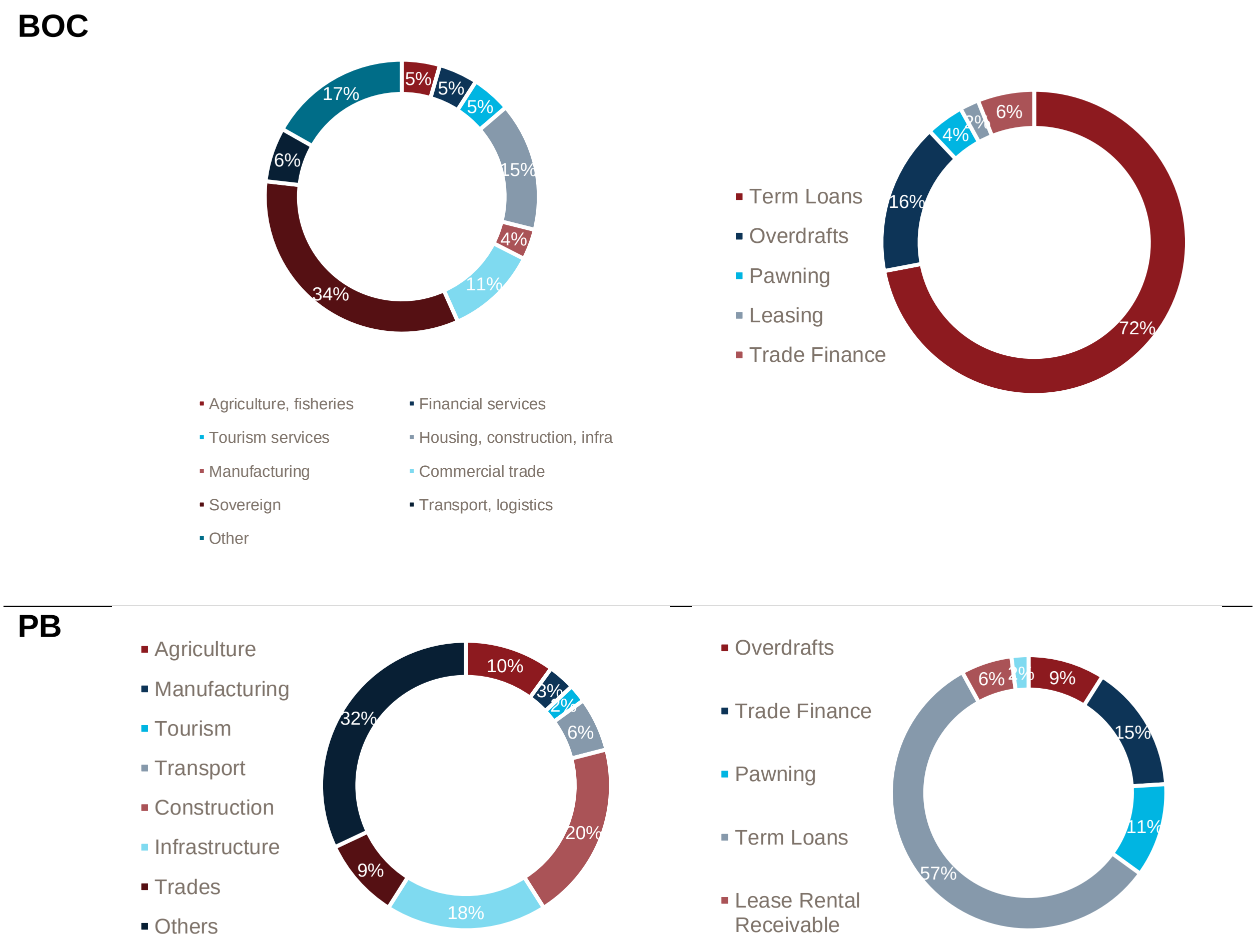
91. While the Project Team believes the level of credit risk in the Project is acceptable, given the uncertain future driven by on-going COVID-19 disruptions there remains risk of future shocks and degradation in credit quality, though this is mitigated by the high level of forward-looking provisioning to date.

92. **Loan Book**. Both banks have seen growth in their loan books over the past five years, with BOC's growing 69 percent and PB's 52 percent since end-2017. There has been large loan

growth in 2020 at 25 percent and 20 percent respectively, largely driven by additional lending to government-related entities.

93. Both banks are well diversified in industry exposure and single name exposure. Large exposures are to the construction, infrastructure and trade sectors. See a breakdown of the loan book in Figure 5.

**Figure 5. Customer Advances by Sector and Type (FY 2019)**




94. Both BOC's and PB's largest exposure is to government-related entities (GoSL and SOEs). The exposure is both LKR and USD-denominated and includes government bonds, direct government lending, and lending to SOEs. Both banks provision government exposures in foreign currency on a risk basis.

95. As of Q3 2020, 25 percent of each bank's loan book is in foreign currency, primarily USD. Both BOC and PB maintain a matched FX book. The foreign currency loan book is largely less than one year in maturity, limiting liquidity risk and exchange rate sensitivities.

96. During diligence, the Project Team has assessed both banks' loan books to understand the allocation of risk and potential sources of stress. Outside of government-related exposures, a large portion of the loan book is backed by high-quality collateral, including gold, property, and cashflow from individuals with government salaries. Total provisions are very healthy against the remaining portion of the loan book.

97. There is some uncertainty in loan performance due to regulatory forbearance, including the on-going moratorium on repayments across affected sectors. However, the Project Team takes comfort from the fact that due to the implementation of SLFRS, both banks are taking a forward-looking approach and provisioning against expected credit loss, including in the moratorium book. There is a clear risk that once the moratorium ends in March 2021 there will be an increase in NPLs, but both banks appear to be taking a prudent approach to closely watch the moratorium portfolio and set aside reserves against credit risk.

98. **Capital Adequacy**. BOC's capital adequacy ratio is 14.04 percent and PB's is 16.30 percent as of Q3 2020 (see Table 4). Subsequent to publishing the Q3 financials, on December 2 BOC issued an additional LKR10 billion (USD54 million) of Additional Tier 1-compliant instruments which has not yet been reflected in the numbers of this analysis.

99. Both banks' large exposure to the government, mostly risk-weighted at 0 percent, reduces the credit risk-weighted assets substantially under the Basel III framework, with BOC having 47 percent density and PB having 36 percent density. While market risk is low, both banks have an additional ~10 percent of risk-weighted assets for operational risk. In total, BOC had LKR1,264 billion (USD6.8 billion) and PB had LKR780 billion (USD4.2 billion) risk-weighted assets as of Q3 2020.

100. Against these risk-weighted assets, both banks currently hold sufficient capital to meet their regulatory requirements as shown in Table 4. Compared with 2019, BOC's common equity ratio has declining by 119 basis points and total capital ratio declining by 155 basis points. PB's common equity ratio declined by 73 basis points but their total capital ratio increased by 164 basis points after raising additional capital this year. Given CBSL regulatory relief to utilize 100 basis points of capital conservation buffer, both banks remain compliant against regulatory requirements with buffers in excess of 100 basis points. Given the already high capital ratio requirements imposed on the banks by CBSL, the Project Team is comfortable that BOC and PB both have sufficient capital.

**Table 4. Borrower Capital Ratios**

| | BOC | | PB | |
|---|---|---|---|---|
| | 2019 | Q3 2020 | 2019 | Q3 2020 |

| | | | | |
|---|---|---|---|---|
| Common Equity | 127,675 | 126,083 | 77,941 | 77,549 |
| Total Tier 1 | 127,675 | 131,083 | 77,941 | 77,549 |
| Total Capital | 178,244 | 177,601 | 106,972 | 127,100 |
| | | | | |
| Risk-weighted Assets | 1,144,041 | 1,264,624 | 729,785 | 779,387 |
| | | | | |
| Common Equity Capital Ratio | 11.16% | 9.97% | 10.68% | 9.95% |
| *Regulatory minimum* | *8.50%* | *7.50%* | *8.00%* | *7.00%* |
| Tier 1 Capital Ratio | 11.16% | 10.37% | 10.68% | 9.95% |
| *Regulatory minimum* | *10.00.%* | *9.00%* | *9.50%* | *8.50%* |
| Total Capital Ratio | 15.58% | 14.04% | 14.66% | 16.30% |
| *Regulatory minimum* | *14.00%* | *13.00%* | *13.50%* | *12.50%* |

101. As state-owned banks, both depend on the government to access common equity capital, and in anticipation of the absence of a capital infusion, they have retained more profit in 2019 and raised additional capital. BOC successfully issued LKR5 billion (USD27 million) of Additional Tier 1 capital and recent added an additional LKR10 billion (USD54 million). PB has issued LKR20 billion (USD108 million) in Tier 2 capital this year, having raised LKR10 billion (USD54 million) last year. Both banks have also reduced dividend payouts. The Project Team takes comfort in the successful execution of these other measures to keep capital buffers sufficient during the current period of stress.

102. **Liquidity**. BOC's loan-to-deposit ratio is 90 percent and PB's is 98 percent. BOC and PB are funded primarily through current and savings accounts and term deposits, which comprised 86 percent of BOC's and 85 percent of PB's liabilities in Q3 2020. Both banks have managed to grow their deposit bases in 2020 in both LKR and USD. Generally, the structure of the deposit base has remained the same over recent years.

103. A large portion of the deposit bases are sticky, attributable to long-term relationship clients in both local and foreign currency. The foreign currency deposit base – largely USD – is primarily supported by a combination of inward remittances and export industries.

104. Bank funding makes up 8 percent of BOC's and 9 percent of PB's liabilities. These borrowings are largely money market with less than one-year tenors, but include some longer-term financing, including China Development Bank facilities.

105. As of Q3 2020, BOC's all-currency Liquidity Coverage Ratio (LCR) is 119 percent and PB's is 100 percent. The liquid assets are largely treasury bonds and bills and Sri Lanka Development Bonds. The statutory liquid asset ratio for domestic banking is 29 percent for BOC and 26 percent for PB and the net stable funding ratio is 139 percent for BOC and 132 percent for PB. All ratios for both banks are above the CBSL regulatory requirements.

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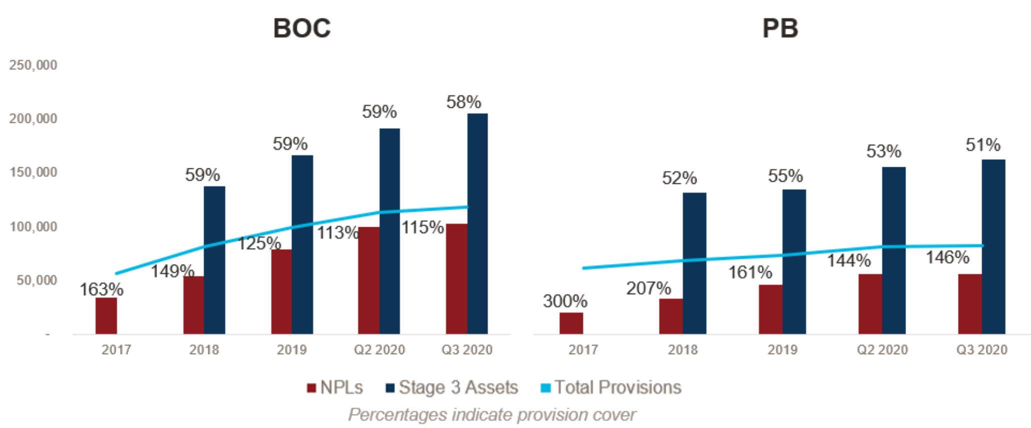
106. While there is no foreign currency LCR requirement, both BOC and PB run large foreign currency LCR shortfalls, driven by almost no high-quality liquid assets (only small amounts of cash) and regulatory outflows (a percentage of deposits and 100 percent of wholesale funding) substantially in excess of inflows from repayments. Foreign currency liquidity risk is mitigated by bank risk management policies in addition to contingency planning.

107. **Profitability**. Prior to 2020, while the Borrowers had been able to maintain stable net interest margins, they both saw a deteriorating bottom line due to increased provisioning associated with rising NPLs. In 2020, provisioning has continued to hurt the banks' profitability while net interest margins have also been compressed as CBSL cut rates. Despite these headwinds, both banks remain profitable through Q3 2020, with BOC registering LKR11.7 billion (USD63 million) (14 percent less than 2019) and PB LKR6.0 billion (USD32 million) (35 percent less than 2019). Most of this profit will be retained to buttress internal capital.

108. **NPLs and Provisioning**. The Borrowers have seen a steady increase in NPLs over the past several years in line with the industry, with BOC's rising from 2.9 percent in 2016 to 5.0 percent today and PB's from 1.7 percent in 2016 to 3.3 percent today. As noted above, the banks have implemented forward-looking SLFRS standards from an accounting perspective and both have classified roughly 10 percent of their loan books as Stage 3 assets.

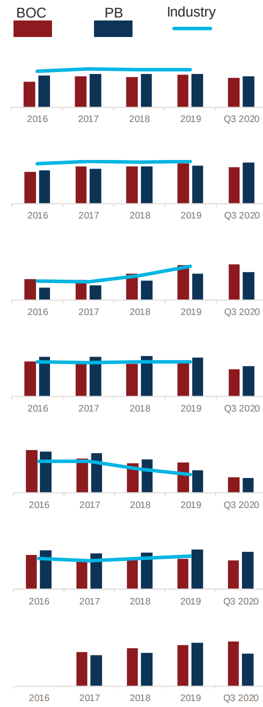
**Figure 9. Provision Coverage against NPLs and Stage 3 Assets**




109. Through Q3 2020, BOC has provisioned LKR20.6 billion (USD111 million) and PB has provisioned LKR8.3 billion (USD45 million), compared with full year 2019 provisioning of LKR18.5 billion (USD100 million) and LKR5.8 billion (USD31 million), respectively.

110. **Industry Comparison**.

| | 2016 | 2017 | 2018 | 2019 | Q3 2020 | Δ '16-19 | Δ '19- Q3 2020 |
|---|---|---|---|---|---|---|---|
| **Tier 1 Ratio** | | | | | | | |
| BOC | 8.8% | 10.9% | 10.4% | 11.4% | 10.3% | 2.6 pp | (1.1) pp |
| PB | 11.1% | 11.5% | 11.7% | 11.6% | 10.9% | 0.5 pp | (0.7) pp |
| Industry Average* | 12.6% | 13.4% | 13.1% | 13.0% | | 0.4 pp | |
| **Total Capital Ratio** | | | | | | | |
| BOC | 12.5% | 14.5% | 14.6% | 15.7% | 14.2% | 3.3 pp | (1.5) pp |
| PB | 13.0% | 13.7% | 14.5% | 14.9% | 16.1% | 1.9 pp | 1.3 pp |
| Industry Average | 15.6% | 16.4% | 16.2% | 16.5% | | 0.9 pp | |
| **NPLs to Loans** | | | | | | | |
| BOC | 2.9% | 2.9% | 3.6% | 4.8% | 5.0% | 1.9 pp | 0.2 pp |
| PB | 1.7% | 2.0% | 2.7% | 3.7% | 3.9% | 2.0 pp | 0.2 pp |
| Industry Average | 2.6% | 2.5% | 3.4% | 4.7% | | 2.1 pp | |
| **Net Interest Margin** | | | | | | | |
| BOC | 3.6% | 3.4% | 3.4% | 3.5% | 2.8% | (0.1) pp | (0.7) pp |
| PB | 4.1% | 4.1% | 4.2% | 4.0% | 3.2% | (0.1) pp | (0.9) pp |
| Industry Average | 3.6% | 3.5% | 3.6% | 3.6% | | 0.0 pp | |
| **ROAE** | | | | | | | |
| BOC | 23.5% | 19.1% | 16.2% | 16.8% | 8.8% | (6.7) pp | (8.1) pp |
| PB | 22.8% | 21.8% | 18.6% | 12.5% | 8.2% | (10.4) pp | (4.3) pp |
| Industry Average | 17.3% | 17.6% | 13.2% | 10.3% | | (7.0) pp | |
| **Cost-to-Income** | | | | | | | |
| BOC | 55.1% | 48.1% | 47.6% | 49.1% | 45.9% | (6.0) pp | (3.1) pp |
| PB | 62.6% | 57.7% | 59.4% | 63.7% | 60.0% | 1.0 pp | (3.7) pp |
| Industry Average | 49.2% | 45.7% | 50.0% | 52.7% | | 3.5 pp | |
| **Liquidity Coverage Ratio - All currency** | | | | | | | |
| BOC | n/a | 105.0% | 115.0% | 125.6% | 172.0% | n/a | 46.4 pp |
| PB | n/a | 95.1% | 100.4% | 132.2% | 99.5% | n/a | (32.7) pp |
| Industry Average | n/a | n/a | n/a | n/a | n/a | n/a | |




* Industry data from CBSL, Q3 2020 not yet available

## D. Fiduciary and Governance

111. **Financial management**. The financial management capacity of the Borrowers was assessed focusing on institutional capacity, staffing, planning/budgeting, funds flow, accounting, internal controls/audit, financial reporting and external audit systems based on desk reviews of documents and virtual meetings. Both have experience implementing projects funded by MDBs and have financial management systems to meet the accounting and financial reporting requirement of MDBs. Both have an adequate number of qualified and experienced finance staff to manage projects funded by MDBs. The required staff for the PIU will be deputed by the Borrowers.

112. Based on the financial management assessment, financial management capacity is considered adequate and financial management risk as Medium due to some internal control weaknesses. The financial management risk is mitigated at the project level through adequate mitigation measures such as project-specific accounting, a specific terms of reference for the external auditor, the internal audit of the Project and specifying detail on financial management and reporting procedures in the OM.

113. Both Borrowers have a department of accounting and reporting, which is headed by the chief accountant. This department will be responsible for accounting and financial reporting in coordination with PIU staff. Both Borrowers have a sufficient number of finance personnel. Both Borrowers follow SLFRS for their accounting systems and CBSL guidelines relating to financing reporting. Both borrowers have the Chart of Accounts for accounting and financial reporting as

per requirement of SLFRS and CBSL. The accounts of both Borrowers are computerized with an accounting module and integrated to various software being used for various banking activities. Both Borrowers follow accrual basis of accounting and a similar basis of accounting will be used for the Project's accounting. CBSL rules requires three controls: initial, current and final controls for each accounting transaction. The initial control is done by the implementer, the current control is done by the chief accountant, and the final control is done after the transaction is completed and it is performed to verify whether it was done correctly.

114. Each Borrower's OM will include key internal control mechanisms in financial management, disbursement procedures, funds flow and financial reporting for the application and use of project funds. Both have an in-house internal audit department to conduct internal audit of the various activities and departments based on the audit policies, charters and audit plan approved by their Audit Committees. BOC has 176 internal audit staff while PB has 80 internal audit staff headed by the Chief Internal Auditor, who reports directly to the banks' Board Audit Committee. The internal audit departments of both borrowers review compliance with policies and procedures of the banks, directives of the central bank and the effectiveness of the internal control systems on periodical basis using samples of the transactions and report significant findings of non-compliance to the Board Audit Committee for review at their periodic meetings. The internal audit department of both Borrowers will conduct internal audit of project activities and submit a report to their Board Audit Committees. For the Project's specific internal audit, OM shall set out the terms of reference of internal audit, periodicity of the audit, and report-sharing arrangements with AIIB. The internal audit report of the Project shall be submitted semi-annually and shared with AIIB. Both Borrowers prepare a full set of financial statements compliant with Sri Lanka Accounting Standards (LKAS and SLFRS) as issued by the Institute of Chartered Accountants of Sri Lanka, which are compliant with International Financial Reporting Standards 9. Both banks are complying with external reporting requirements and statutory requirements that focus on requirements of CBSL, statistical needs and tax information.

115. The external auditors (National Audit Office) for both Borrowers have issued unqualified (clean) audit opinions for their respective annual financial statements for the last three years. In the case of BOC, the external auditors in FY2019 raised two key audit matters relating to the bank's complex information technology related to applications, controls and impact of those on the financial reporting process and impairment allowance for loans and advances.

116. **Procurement.** The Borrowers will be financing working capital loans through the facility. Short-term working capital facilities are not expected to be used to finance any capex expenditure projects. The sub-loans are not expected to finance contracts for goods or services. However, if they do, they are likely to be small contracts, in which case the provisions of paragraph 14.4 Financial Intermediaries under the Interim Operational Directive - Procurement Instructions for Recipients would apply, and the beneficiary will procure the items in accordance with the normal procurement practices of Private Entities provided they are acceptable to the Bank.

117. **Integrity.** The Project Team spoke with the Chief Compliance Officers and also performed integrity checks on both BOC and PB, their boards, and their senior managements through Thomson Reuters World Check and Nexis Diligence, which identified some findings. Overall, the

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Project Team believes the findings are not material and that the Borrowers' internal integrity is sound, and that the Project does not pose an unacceptable reputational risk to AIIB.

## E. Environmental and Social

118. **Environmental and Social policy, standards and categorization**. AIIB's ESP including the ESEL and relevant Environmental and Social Standards (ESSs) apply to this Project. The Project has been placed in Category FI and an ESMS, which is in place for an existing ADB-supported Project and will be updated to comply with the ESP, will be used as the Project's ES instrument. During due diligence, the Project Team confirmed that the ESMS is functioning at both banks and that both banks will update their respective ESMSs to align and comply with AIIB's ESP. The updated ESMS will be a condition of effectiveness of each Loan Agreement. Each bank will screen sub-loans in accordance with its updated ESMS, against the ESEL. The Loans will only finance working capital sub-loans covering the payment of operating expenses, short-term non-financial assets (inventories, trade receivables), and short-term non-financial liabilities. It will exclude from eligibility for AIIB financing refinancing of existing loans and sub-loans for modernization, rehabilitation or expansion of existing business or new initiatives. Coal mining, coal transportation or coal-fired power plants, as well as infrastructure exclusively dedicated to support any of these activities will be excluded. Also excluded are any Category A activities and other higher ES risk activities (i.e., activities that may potentially result in (i) land acquisition or involuntary resettlement, (ii) risk of adverse impacts on Indigenous Peoples and/or vulnerable groups, (iii) significant risks to or impacts on the environment, community health and safety, biodiversity, and cultural resources, (iv) significant retrenchment, and/or (iv) significant occupational health and safety risks). The Borrowers will be responsible for screening, selection and oversight of implementation by the sub-borrowers in accordance with the ESMS. More details on the eligibility criteria for sub-loans are included in Annex 3.

119. The environmental and social risks from the transactions are mostly expected to be Category C and readily addressed through standard mitigation measures and compliance with national laws. Social risks may arise from the Project's focus on large corporates and the challenge in of providing SMEs in rural areas with less connectivity with equal access to funding under the Project. The Borrowers' experience in applying their ESMS to working capital lending under the ADB-supported program should mitigate these risks. In addition, the Bank will undertake a prior review of two initial sub-loans made by each Borrower to confirm the Borrowers' capacity to implement the Bank's requirements.

120. **Environmental and Social management system and capacity.** The Borrowers each have an existing ESMS and have benefited from technical support under the ongoing ADB supported project. The Bank's due diligence included a review of the Borrowers' previous selection of sub-borrowers, their ES monitoring reports, any grievances that they have received from the sub-borrowers or from the public, and their gender focus. The due diligence assessed and confirmed the (i) equivalency of each Borrower's ESMS with AIIB's ESP (alignment to be completed prior to disbursements), (ii) performance of the Borrowers in implementing their ESMS and (iii) capacity of the Borrowers to implement their ESMS and training plans. In addition, an information dissemination campaign will be undertaken to accomplish effective outreach so that

potential beneficiaries are fully aware of the Project benefits and how to access them, and that stakeholders share a common understanding about the Project. The due diligence also confirmed that both Borrowers have well-established grievance mechanisms, that gender forms a part of both their official mandates and that the ADB experience has been instrumental in streamlining these processes into the Borrowers' strategy.

121. **Stakeholder Engagement and Consultation.** The borrowers recognize the need for an effective and inclusive engagement with all the relevant stakeholders and the SMEs at large. Meaningful consultations and disclosure of appropriate information are essential to ensure that the most deserving are indeed 'included'. However, given the COVID-19 situation, it may not be possible to hold large information campaigns and reaching out to entrepreneurs in the rural areas throughout the country will be a serious challenge. Similarly, the prevalence of big corporates and SMEs in the Western Province is higher than the rest of the country, and it may be difficult to avoid the possibility of more loans being granted to those sub-borrowers. Effective channels of communication would have to be used for reaching eligible sub-borrowers throughout the country and will require the Borrowers to make efforts to carry out information campaigns in Sinhala, Tamil and English, combining both electronic and standard methods, to solicit proposals from across all 9 provinces.

122. **Project-level grievance redress mechanisms**. Communities and individuals who believe that they are adversely affected as a result of this Project may submit complaints to the project-level (at head offices of BOC and PB) and sub-project level (at each of the participating bank branches) grievance redress mechanisms that have already been set up by the Borrowers under their enhanced ESMS. This information, together with the availability of the Bank's Project-affected People's Mechanism (PPM) will be disseminated by each Borrower through its website and information campaigns.

123. **AIIB independent accountability mechanism**. The Bank's Policy on the PPM applies to this Project. The PPM has been established by the Bank to provide an opportunity for an independent and impartial review of submissions from Project-affected people who believe they have been or are likely to be adversely affected by the Bank's failure to implement the ESP in situations when their concerns cannot be addressed satisfactorily through the project / sub-project level grievance redress mechanisms or the Bank's management processes. Information on the PPM is available at: https://www.aiib.org/en/policies-strategies/operational-policies/policy-on-the-project-affected-mechanism.html.

## F. Risks and Mitigation Measures

| Risk Description | Assessment | Mitigation Measures |
|---|---|---|

| | | |
|---|---|---|
| **Implementation capacity**<br>*Risk that the Borrower is unable to implement the Project as approved.* | *Low* | • Both Borrowers have experiences with MDBs. Due to previous lines of credit granted by ADB, an implementation structure is already established and both Borrowers have committed adequate financial resources and competent people to ensure smooth project implementation. |
| **Macroeconomic Risk**<br>*Risk of a severe macroeconomic downturn induced by the COVID-19 pandemic.* | *High* | • The government introduced several tax relief and stimulus packages to boost the local economy impacted by the outbreak of COVID-19. CBSL has undertaken policies to increase liquidity in the market and has allowed the banks to utilize their capital conservation buffer if needed.<br>• Sri Lanka's initial measures were highly successful at limiting the spread of COVID-19 and driving an economic rebound. GoSL's track record indicates they have the capability to manage the impacts of the second wave.<br>• The Borrowers have agreed to covenants on maintaining capital buffers. |
| **FX Risk (Market Risk)**<br>*Risks that the fair value of financial instruments fluctuate due to change in FX, interest rates, lead to potential losses.* | *Medium* | • AIIB loans are in USD while the sub-lending will occur in both USD and LKR. The Borrowers bear the FX risk, but intend to hedge their exposure.<br>• The transaction has been structured as long term with a grace period and amortized repayment profile, removing exposure to near-term FX liquidity challenges in Sri Lanka and spreading repayments over several years.<br>• Both Borrowers have 20-25 percent USD assets and liabilities, allowing for internal management of FX and sourcing of dollars.<br>• Both banks have well-established risk management functions with oversight over maintaining FX risk appetite limits. |
| **Asset Quality (Credit Risk)**<br>*Risk that banks will incur losses due to default on contractual obligation of* | *High* | • The majority of the Borrowers' asset books is exposure to GoSL or private entities supported by high quality collateral.<br>• The Borrowers have implemented SLFRS forward-looking impairment standards and have already provisioned their asset books using |

| | | |
|---|---|---|
| *counterparties, evidenced by deterioration of NPL ratio and other metrics.* | | updated probabilities of default, losses given default, and stressed economic factors.<br>• The Borrowers have agreed to covenants on maintaining capital buffers. |
| **Liquidity Risk**<br>*Risk that banks unable to meet payment obligations when due.* | *Medium* | • The Borrowers have diversified, sticky deposit bases with long-standing customer relationships and are trusted during periods of stress. Both have accessed MDB financing as well as capital markets to further diversify their liabilities.<br>• Both undertake regular monitoring of future cash flow and liquidity, which incorporates an assessment of availability of high-grade collateral that could be used to secure additional funding if required.<br>• The Borrowers have developed and incorporated internal control processes and contingency plans.<br>• Borrowers have accumulated liquidity and maintain LCRs above the minimum regulatory requirements.<br>• The Borrowers have agreed to a liquidity coverage covenant above the CBSL requirement. |
| **E&S Risk**<br>Minimal E&S risk as it is only on working capital loans. | Low | • The ESMS will require screening of sub-loans against the ESEL and to exclude all Category A activities as well as higher ES risk activities. AIIB will undertake prior review of initial sub-loans to confirm the application of its requirements.<br>• The Borrowers have specific experience applying their ESMS to working capital loans lending under the ADB program |
| **Financial Management Risk**<br>*Delay in the transfer of funds by Borrowers to the sub borrowers.*<br><br>*Delay in accounting of repaid principal* | *Medium* | • The risks shall be mitigated by clearly spelling out the timeline and service standards in the transfer of funds and timeline for submission of the project audit reports in the OM. |

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|---|---|---|
| *loan amounts to the respective designated bank accounts.*<br><br>*Delay in receipt of the project audit reports.* | | |
| **Disbursement risk** | *Low* | • BOC and PB both have consistently disbursed funds under the ADB SME credit line.<br>• The Borrowers will be required to provide a six-month indicative pipeline to make a first withdrawal and will have to utilize 80 percent of disbursed proceeds before making additional requests, which will also be accompanied by additional pipeline detail. |
| **SME reach risk** | *Low* | • BOC and PB's successful participation in the ADB SME credit line highlights their reach and ability to disburse to SMEs.<br>• Both banks have dedicated units to extend credit to SMEs and have the two largest branch networks in Sri Lanka with ability to reach SMEs throughout the country.<br>• Each sub-borrower can only take one sub-loan, ensuring follow-on working capital loans prior to AIIB Loan repayment will have a multiplier effect and reach a broader set of SMEs. |
| **Crowd out risk** | *Low* | • International Finance Corporation has identified a USD13.7 billion potential financing gap for SMEs in Sri Lanka, which has been further exacerbated by COVID-19. The Project, along with the expansion of the ADB credit line, together represent a small portion of this financing gap and will be critical to supporting the ability of SMEs to access financing. |

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## Annex 1. Results Monitoring Framework

| **Project Objective:** | To provide financing support and increase the supply of liquidity to corporate and small and medium-sized private enterprises (SMEs) in Sri Lanka affected by the economic upheaval due to the COVID-19 pandemic | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Indicator Name** | **Unit of measure** | **Base-line Data Year** | **Cumulative Target Values** | | | | | | **End Target** | **Frequency** | **Responsibility** |
| | | | **YR1** | **YR2** | **YR3** | **YR4** | **YR5** | **YRn** | | | |
| **Project Objective Indicators:** | | | | | | | | | | | |
| 1. Cumulative value of working capital loans provided to eligible sub-borrowers | USD | 0 | 180 | 220 | 290 | 340 | 340 | 340 | 340 | Annual | Borrowers |
| 2. Cumulative value of working capital loans provided to SMEs | USD | 0 | 108 | 132 | 174 | 204 | 204 | 204 | 204 | Annual | Borrowers |
| 3. Cumulative value of working capital loans provided to women led sub-borrowers[17] | USD | 0 | 18 | 22 | 29 | 34 | 34 | 34 | 34 | Annual | Borrowers |
| 4. Number of eligible sub-borrowers receiving financing | Number | 0 | 360 | 450 | 580 | 710 | 710 | 710 | 710 | Annual | Borrowers |
| 5. Number of SMEs receiving financing | Number | 0 | 320 | 400 | 520 | 630 | 630 | 630 | 630 | Annual | Borrowers |

[17] Women led is defined as: (i) 51% of enterprise ownership is controlled by women, or (ii)meets the below 3 criteria: (a) at least 20% of enterprise ownership is controlled by women; (b) a woman is either the chief executive officer (i.e., senior most manager) or chief operations officer (i.e., second most senior manager); and (c) 30% of board members are women, where a board exists

## Annex 2. Sovereign Credit Fact Sheet

### A. Recent Economic Developments

1. Sri Lanka is a lower middle-income country with a per capita GDP of USD3,853 and a population of 21.8 million. After growing at an average annual rate of 5.7 percent from 2008 to 2017, growth slowed to 3.3 percent in 2018, in the context of higher oil prices, volatile market conditions, and a domestic political impasse. Growth further declined to 2.3 percent in 2019 as the Easter terror attacks in April 2019 impacted tourism and other sectors. The outbreak of COVID-19 and the lockdown across several hotspots hampered the nascent recovery. The outbreak has significantly weakened economic activity due to disruptions in supply chains, reduced revenue from tourism due to closure of airports between April and September and their knock-on effects on the economy. Between September and December 2020, all three major rating agencies downgraded Sri Lanka's Long-Term Foreign Currency Issuer Default Rating to the CCC range (Moody's: Caa1, Fitch: CCC, S&P: CCC+), citing an increasingly challenging external-debt repayment situation and a deteriorated fiscal position expected over the medium term.

2. Inflation has been in the range of 0 to 8 percent during the past five years. After declining moderately in the first half of 2020, prices inched up again in the second half, primarily due to renewed pressures from food prices, the revival of economic activity and the base effect. To support growth the central bank lowered the policy rate by 200 basis points since March 2020.

3. The fiscal deficit widened to 8.2 percent of GDP in 2019, due to slow growth arising from the Easter attacks, tax cuts introduced in 2019 and higher election related expenditure. Limited fiscal space hindered the government's ability to undertake fiscal measures to spur the economy during COVID-19. Fiscal accounts continued to deteriorate in the first half of 2020 as tax revenue fell short due to weak collection of value-added, income and import taxes while expenditure to contain the impact of the pandemic and support the vulnerable groups were ramped up.

**Table 8. Selected Macroeconomic Indicators**

| | 2017 | 2018 | 2019 | 2020* | 2021* |
|---|---|---|---|---|---|
| Real GDP growth (% change) | 3.6 | 3.3 | 2.3 | -4.6 | 5.3 |
| CPI Inflation (% change, average) | 6.6 | 4.3 | 4.3 | 4.6 | 4.7 |
| Current account balance (% of GDP) | -2.6 | -3.2 | -2.2 | -3.6 | -3.2 |
| General government overall balance (% of GDP) | -5.5 | -5.3 | -8.2 | -9.6 | -8.1 |
| Nominal gross public debt (% of GDP) | 77.9 | 83.8 | 86.8 | 98.3 | 98.3 |
| Public gross financing needs (% of GDP) 1/ | 18.3 | 19.6 | 20.9 | 23.3 | 23.3 |
| External debt (% of GDP) 1/ | 57.5 | 58.8 | 63.8 | 68.6 | 66.3 |
| Gross external financing need (% of GDP) 1/ | 14.6 | 15.5 | 14.0 | 15.4 | 14.0 |
| Gross official reserves (millions of USD) 2/ | 7,959 | 6,919 | 7,642 | 5,665 | --- |
| Exchange rate (LKR/USD, EOP) 2/ | 152.9 | 182.7 | 181.6 | 186.4 | --- |

Source: IMF World Economic Outlook Oct. 2020, IMF Country Report No. 19/335; '*' denotes estimates and projections
Notes: 1/ AIIB Staff estimates based on IMF data; 2/ data from the central bank

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4. The current account deficit declined slightly in 2019, to 2.2 percent of GDP, reflecting lower imports due to measures taken to curtail imports, subdued economic activity and the depreciated currency. Lower imports helped offset weak tourism receipts. The current account deficit further narrowed in the first half of 2020 with the reduction in imports driven, by import restrictions and lower oil prices, offsetting the decline in export and tourism receipts. Exports declined by 17 percent whereas imports declined by 20 percent during January-November of 2020. Official reserves remain low relative to short-term liabilities.

## B. Economic Outlook and Risks

5. The COVID-19 pandemic has exacerbated an already challenging economic situation. Sri Lanka's economy is expected to contract by 4.6 percent in 2020 as the necessary containment measures restricted household income, which has impacted private sector sales and investment. Public investment is remains subdued as the government prioritized healthcare and income support measures. Export demand has also been constrained due to low growth in major export destinations such as the United States and the European Union. Growth is expected pick up significantly in 2021 as economic activities normalize and tourism returns, unless stricter measures become necessary to curb the second wave which continues since October 2020.

6. While the IMF expects the current account deficit in 2020 to widen slightly, recent data point to a decline to around 1.5–2.0 percent of GDP, thanks to resilient remittances, restrained imports and lower oil prices, and despite muted export receipts and a collapse in tourist earnings. In 2021, as the pandemic subsides, a pick-up in the global economy and a cautious rebound of tourism despite the lingering restrictions is expected to help support the current account.

7. Higher expenditure on healthcare and income support measures and lower revenue are expected to have pushed the fiscal deficit to 9.6 percent of GDP in 2020. Large fiscal deficit will lead to higher government debt and external debt ratios.

8. Debt vulnerabilities have been significant already for some time. Public debt increased significantly in 2018 and 2019, to 86.8 percent of GDP, reflecting weak economic performance, the depreciation of the rupee, the impact of the 2019 terrorist attack and the weakening of the fiscal stance. The pandemic will add to the burden—with higher deficit and lower GDP debt is expected to further increase, to around 98 percent of GDP (or 105 percent including guarantees) and barely stabilize. Gross financing needs are high, at 25 percent of GDP. Since March 2020 Sri Lanka has been experiencing an external liquidity crunch and remains cut off from international markets (bond yields have increased from 6.5 to over 20 percent).

9. So far, Sri Lanka has been able to navigate through the events, thanks to normalizing economic activity, rebounding exports, contained imports, resilient remittances, robust disbursement from official creditors, new financing from China and India and a shift to domestic financing. Ultimately, Sri Lanka will need to regain market access, which would require a medium-term fiscal consolidation. The draft 2021 budget is the first step, albeit based on optimistic assumptions.

## Annex 3. Sub-loan and Sub-Borrower Eligibility Criteria

### A. Eligible Sectors

**Table 10. Eligible Sectors**

| NACE Rev. 2 | Category |
|---|---|
| Section A | Agriculture and fishing |
| Section C | Manufacturing |
| Section D | Electricity, gas steam, air conditioning |
| Section E | Water supply (sewerage, waste, remediation) |
| Section F | Construction |
| Section G | Wholesale and retail trade |
| Section H | Transport and storage |
| Section I | Accommodation |
| Section J | Information and communication |
| Section M | Professional, scientific and technical activities |
| Section N | Administrative and support service activities |
| Section P | Education |
| Section Q | Human health and social work activities |

**Table 11. Ineligible Sectors**

| NACE Rev.2 | Category |
|---|---|
| A2 | Forestry and logging |
| Section B | Mining and quarrying |
| C11.01 | Distilling, rectifying and blending of spirits |
| C12 | Manufacture of tobacco products |
| C19 | Manufacture of coke and refined petroleum products |
| C20.2 | Manufacture of pesticides and other agrochemical products |
| C24.46 | Processing of nuclear fuel |
| C25.4 | Manufacture of weapons and ammunition |
| C27.1 | Manufacture of transformers using PCBs |
| C28.25 | Manufacture of non-domestic cooling and ventilation equipment using ozone-depleting substances and types using banned compounds (e.g., CFCs). |
| C30 | Manufacture of military fighting vehicles |
| C30.11 | Building of ships and floating structures (warships) |
| C30.4 | Manufacture of military fighting vehicles, intercontinental ballistic missiles (ICBM) |
| C35.1 | Production of electricity (coal) |
| G46.21 | Unmanufactured tobacco |
| Section K | Financial and insurance activities |
| Section L | Real estate activities |
| Section O | Public Administration and defense, social security |
| Section R | Arts, entertainment and recreation |
| Section S | Other service activities |
| Section T | Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use |
| Section U | Activities of extraterritorial organisations and bodies, e.g. diplomatic and consular missions, international organisations, etc. |

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## B. Eligible Sub-borrowers

A sub-borrower must meet the following requirements to be eligible for a sub-loan:

**Eligibility.** The sub-borrower must be (i) a company, enterprise, firm, business, sole proprietor or other legal entity (including a commercially-operated state-owned enterprise) which is formed under the laws of Sri Lanka or (ii) an individual operating as an entrepreneur or engaged in economic activities in accordance with the laws of Sri Lanka and in each case (iii) operating primarily in Sri Lanka.

**Private entities.** Except in the case of an individual, the sub-borrower must be a private entity:

(i) which is carrying out or established for a business purpose and is operating on a commercial basis;

(ii) which has not more than 50 percent of its capital voting rights owned by the government;

(iii) which is financially autonomous from the government; and

(iv) whose day-to-day management is not controlled by the government.

**Borrower lending criteria.** The sub-borrower meets the Borrower's usual lending criteria in respect of creditworthiness, financial position, accounting and control capacity, foreign-exchange position, integrity checks, environmental and social risk profile and procurement practices.

**Sub-borrower capability.** The sub-borrower must have the technical, managerial, staffing and financial capability and resources needed to carry out its operations or other activity being financed and to repay the sub-loan. A sub-borrower will be ineligible for a sub-loan if either (i) the sub-borrower is in default under any of its existing loans, or (ii) the Borrower has rescheduled a loan to the sub-borrower more than once.

**Sub-borrower capacity.** The sub-borrower meets the Borrower's requirements in terms of its capacity to, *inter alia*: (i) ensure adequate and proper financial accounting of all incomes and expenditures, (ii) prepare financial statements relating to all its activities and the sub-activities to be financed through the Loan, (iii) manage its financial position in a prudent and effective manner, (iv) carry out adequate and satisfactory ES management, monitoring and reporting in accordance with the AIIB's ESP, and (vi) carry out proper procurement procedures in accordance with AIIB's Procurement Policy.

**Industry classification.** The sub-borrower is predominantly operating in an eligible sector as defined in Table 10 (*Eligible Sectors*) in accordance with the industry classification of the European Union NACE (Rev. 2)18 or equivalent in Sri Lanka.

**Approvals, consents.** The sub-borrower has obtained all necessary approvals, certifications and permits to carry out its activities.

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18 Source: Eurostat (Link). List of NACE.

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**Prohibited Practices.** Neither the sub-borrower nor any person acting on behalf of the sub-borrower has engaged in any Prohibited Practice within the meaning of AIIB's Prohibited Practices Policy in relation to the sub-loan being financed.

**Debarment.** The sub-borrower is not, at the time the proceeds of the sub-loan are advanced to it, included on AIIB's debarment list.

**Environmental and social requirements.** The sub-borrower is in compliance with all applicable environmental and social, and employment laws, regulations and standards in effect in Sri Lanka and will maintain such compliance during the tenor of the sub-loan.

**Environmental and social proceedings.** The sub-borrower is not, and is not likely to be, subject to any litigation, arbitration or administrative proceedings of or before any court, arbitral body or agency in relation to a material breach of any environmental and social requirements.

**Reputational risks.** The sub-borrower (i) is not subject to mainstream media or social media coverage in relation to a material failure to comply with good environmental and social practices, (ii) is not the subject of material complaints by stakeholders and (iii) is not the target of public opposition or labor movement disputes or industrial action.

**Related parties.** The sub-borrower must not be a related party of the Borrower's Board or senior management.

## C. Eligible Purposes

**Eligible purposes.** The proceeds of a sub-loan may only be applied as follows:

(i) Working Capital Loans, meaning loans provided for the purposes of financing short-term operational needs including the payment of operating expenses, short-term non-financial assets (inventories, trade receivables), and short-term non-financial liabilities.

**Ineligible purposes.** The proceeds of a sub-loan may not be used for any of the following purposes:

(i) *Excluded activities:* any activity listed in Table 11 (*Excluded Activities*);

(ii) *ESP exclusions:*

  a. any activity listed in the Environmental and Social Exclusion List included in and appended to the ESP; or

  b. any activity categorized as Category A under the ESP;

(iii) *UN sanctions:* any payment to a person or for any import of goods if such payment or import is prohibited by any measure decided by the United Nations Security Council under Chapter VII of the United Nations Charter;

(iv) *Speculative investment:* speculative investment in property or currencies or any other speculative investment activities;

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(v) *Securities:* investments in securities of any kind, including investments in share capital of other companies;

(vi) *Capex:* undertaking any capital expenditure investment or works not otherwise permitted in accordance with this Annex;

(vii) *Certain business activities:* refinancing or adjusting an existing loan or for balancing, modernization, rehabilitation or expansion of existing business or new initiatives;

(viii) Higher ES risk activities:

a. any activity that involves (a) land acquisition or involuntary resettlement, (b) risk of adverse impacts on Indigenous Peoples (as defined in the ESP) or vulnerable groups (as defined in the ESP), (c) significant risks to or impacts on the environment, community health and safety, biodiversity or cultural resources, (d) significant retrenchment, or (e) significant occupational health and safety risks;

b. any sub-loan categorized as Category A under the Borrower's ESMS;

c. any economic activity by any sub-borrower, client or recipient of financing from the Borrower that involves:

i. coal mining, coal transportation, coal-fired power plants;

ii. the construction or implementation of dam works; or

iii. infrastructure exclusively dedicated to support any of these activities; or

(ix) *Operational Policy on International Relations:* any activity that would trigger AIIB's Operational Policy on International Relations, including:

a. any activity involving an International Waterway (as defined in the Operational Policy on International Relations);

b. in a territorial area that is claimed by two or more countries; or

c. where a De Facto Government (as defined in AIIB's Operational Policy on International Relations) is in power in the country in which the sub-loan is made.

**Procurement.** If the proceeds of a sub-loan are intended to be used for the procurement of goods, works or services, then the Borrower must require the sub-borrower to demonstrate that the procurement is conducted in accordance with AIIB's Procurement Policy and Interim Operational Directive on Procurement Instructions for Recipients, as amended from time to time.