Public Disclosure Authorized

Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 14-Mar-2023 | Report No: PIDC35826

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Parent Project ID (if any)	Project Name
Sri Lanka	P180861		Sri Lanka Financial Sector Safety Net Strengthening Project (P180861)
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
SOUTH ASIA	May 05, 2023	Jul 06, 2023	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Democratic Socialist Republic of Sri Lanka	Central Bank of Sri Lanka	

Proposed Development Objective(s)

To strengthen the financial and institutional capacity of Sri Lankan financial sector safety net, with the focus on Deposit Insurance Scheme.

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	150.00
Total Financing	150.00
of which IBRD/IDA	150.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	150.00
IDA Credit	150.00

Environmental and Social Risk Classification	Concept Review Decision
Low	Track II-The review did authorize the preparation to continue

B. Introduction and Context

Country Context

1. **Sri Lanka's longstanding structural weaknesses, which were elevated by several exogenous shocks and ill-timed tax cuts, plunged the country into a severe economic crisis.** A restrictive trade regime, weak investment climate, episodes of loose monetary policy and an administered exchange rate, and poor governance contributed to macroeconomic imbalances in the last two decades. The fiscal indiscipline, coupled with low revenue collections, led to high fiscal deficits and large gross financing needs. The country experienced a political crisis in 2018 and the Easter bombings in 2019, followed by a 3.5 percent economic contraction amid the COVID-19 pandemic. In 2020, Sri Lanka lost access to international financial markets in the face of significant external debt services, following credit rating downgrades. Amid depleted reserves, Sri Lanka announced an external debt service suspension in April 2022. As a result, the economy contracted by 7.1 percent in the first nine months of 2022. Inflation peaked at 69.8 percent in September 2022 and the LKR has depreciated close to 80 percent against the US$ since Central Bank of Sri Lanka (CBSL) floated the currency on March 7, 2022. Effects of severe foreign exchange liquidity constraints have been felt across the economy, causing severe shortages of essential household items and inputs needed for economic activity. Existing inequalities rapidly sharpened and, between 2021 and 2022, the poverty rate doubled from 13.1 to 25.6 percent. Around 75 percent of households are estimated to have had their incomes reduced and 37 percent of households were facing acute food insecurity in November 2022.

2. **In response to the deepening crisis, the new Government of Sri Lanka (GoSL) and CBSL leadership sought support from the International Monetary Fund (IMF) and other International Financial Institutions (IFIs) in Spring 2022 and announced several important structural reforms.** The IMF and Sri Lankan authorities reached a staff-level agreement for a 48-month Extended Fund Facility (EFF) program of US$2.9 billion in September 2022. The EFF intends to restore macroeconomic stability and debt sustainability, while safeguarding financial stability and protecting vulnerable people. The EFF also aims to tackle corruption and unlock growth potential through structural reforms. The authorities implemented several structural reforms, including adopting new revenue measures, cost-reflective pricing of utilities, and enhancing competitiveness. To secure IMF Board approval, financing assurances from official creditors must be provided, progress must be made on a collaborative agreement with private creditors, and prior actions must be completed.

Sectoral and Institutional Context

3. **Sri Lanka's bank-dominated financial sector has been growing rapidly prior to the crisis.** Financial sector assets reached Rs 23,704 billion, or 141 percent of Gross Domestic Product (GDP), in 2021. The banking sector dominates the financial sector, accounting for 71.4 percent of the total assets. The banking sector consists of 30 banks, including 24 licensed commercial banks (LCB) and six licensed specialized banks (LSB). State-owned banks (SOBs) account for around 49.4 percent in total banking assets, with local private and foreign banks accounting for 43.5 percent and 7.1 percent, respectively. In addition, non-bank deposit-taking lenders (primarily, 37 licensed finance companies (LFCs)) and contractual savings institutions (insurance and state provident funds) account for sizeable portions of financial sector assets (6.9 and 20.1 percent, respectively).

4. **The steady growth in financial intermediation has decelerated in recent years.** Private credit nearly doubled

from 27.6 percent of GDP in 2009 to 55.6 percent of GDP by the end of 2021. The growth has largely been funded by domestic deposits, accounting for 75 percent of total bank liabilities as of end-2021. Yet private credit growth started decelerating after the 2019 Easter attacks and during the pandemic, being increasingly crowded out by credit to the sovereign and state-owned enterprises (SOEs) that reached 32 percent of financial sector assets in 2021. The credit growth has turned negative in the aftermath of partial sovereign debt default in April 2022, on the back of rising interest rates, macroeconomic uncertainty and mounting liquidity and solvency pressures.

5. **Banks' financial soundness indicators point out to growing stability risks.** Official non-performing loans (NPLs, Stage 3 loans) have reached 10.9 percent in Q3-2022 (up from 7.6 percent at end 2021), despite continued regulatory forbearance. Bank capital adequacy was reported at 15.3 percent in Q3-2022 (down from 16.2 percent a year ago). Increasing deposit rates are driving up banks' cost of funding and eating into their profits (and ultimately capital buffers). As of Q3-2022, banks were reporting decreasing profitability, with return on assets and returns on equity dropping to 8.5 percent and 0.7 percent respectively as compared to 14.5 percent and 1.2 percent in 2021. Local currency deposit growth decelerated rapidly (up by 7.5 percent y-o-y at end September 2022, compared to a growth of 15.9 percent y-o-y in September 2021). Foreign exchange deposits recorded a contraction of 7.7 per cent y-o-y over the same period of time. Although liquidity ratios remain within regulatory limits, domestic banks, and in particular SOBs, had to rely heavily on the CBSL liquidity facilities to fulfill their funding needs as interbank market remains moribund.

6. **Deposit-taking non-bank financial institutions (NBFIs) are facing similar challenges.** NPLs stood at 16.8 percent in Q3-2022 (up from 12.8 percent a year ago). Provisioning of NPLs remains low, covering only around 30 percent of NPLs in Q3-2022. Capitalization reached 21.7 percent in Q3-2022, mainly due to infusion of new capital to meet CBSL's tightened regulatory requirements following the failure of several LFCs in 2020/2021.

7. **To alleviate the immediate pressures on the financial sector, CBSL reintroduced debt moratoria for all sectors in July 2022 and adopted several other forbearance measures**. Apart from restricting discretionary payments (cash dividends and repatriation of profits), the CBSL allowed banks to drawdown the countercyclical capital buffers, extended deadline for enhancement of capital requirements to end-2023, allowed the delayed recognition of losses on government securities, and relaxed liquidity requirements. In the short term, authorities are focusing on the urgent measures to boost the financial sector safety net/crisis management frameworks.

8. **Currently, the Sri Lanka Deposit Insurance Scheme (SLDIS) is one of the weakest pillars of the financial sector safety net.** The scheme has been collecting premiums from member institutions since its establishment under CBSL auspices in 2010, and it conducted several payouts for failed LFCs in recent years. However, as established by the World Bank's recent assessment of SLDIS against the Core Principles of International Association of Deposit Insurers (IADI CPs), to effectively fulfill its mandate, the deposit insurance system must be strengthened institutionally and financially, and its systems and procedures should be urgently enhanced.

Relationship to CPF

9. **The proposed activities are aligned with the new Country Partnership Framework (FY23-26) under preparation.** The activities will support *Objective 2: Increase the Resilience and Efficiency of the Financial Sector*, aiming to safeguard stability and restart healthy financial intermediation. The operation will also be related to a cross-cutting topic of inclusion, insofar as the operation will support the strengthening of institutional capacity of deposit insurance scheme which protects the savings of smaller/retail depositors, including women and rural population. The project is aligned with Global Crisis Response Framework (GCRF), specifically *Pillar 2 - Protecting People and Preserving Jobs* and *Pillar 4 - Strengthening Policies, Institutions and Investments for Rebuilding Better*. Strengthening of the deposit insurance scheme will be an essential part of the financial sector safety net and will help build up confidence in the financial system, thus reducing the

likelihood of a financial sector crisis and improving functioning of the sector as a financial intermediary in the medium term.

C. Proposed Development Objective(s)

10. To strengthen the financial and institutional capacity of Sri Lankan financial sector safety net, with the focus on Deposit Insurance Scheme.

Key Results (From PCN)

11. The project is expected to lead to improvements in the financial and institutional capacity of SLDIS in the direction of greater compliance with IADI CPs, with the results expected in two areas:

- Ensuring adequate financial inflows into the SLDIS during the course of the project, in order to achieve a targeted funding ratio in the absence of payouts (e.g., at least double the current level);
- Improving the institutional capacity of the SLDIS to perform its legally mandated functions (deposit payout and contributing to resolution), as evidenced, inter alia, by the reduction in time required for reimbursement.

D. Concept Description

12. The proposed US$150 million operation will finance increase in SLDIS's capitalization and strengthen its institutional capacity. The proposed instrument is an Investment Project Financing (IPF) with result-based Performance-Based Conditions (PBCs) and technical assistance (TA) components, drawing on experience from successful World Bank projects supporting deposit insurance schemes in other Emerging Markets and Developing Economies over the past decade.

Component 1: Capitalization of Deposit Insurance Scheme

13. The first component will finance the quick build-up of SLDIS reserves towards a more prudent funding ratio against achievement of PBCs. The current fund size is inadequate to protect against existing financial system vulnerabilities, and the build-up of reserves in the near term is essential to bolster the confidence of retail depositors and enable SLDIS to deal with potential bank and LFC failures, as necessary. According to preliminary World Bank (WB) estimates, with the WB financing the funding ratio[1] is projected to increase to 2 percent in 2026, adequately protecting depositors in all small and medium-sized banks and LFCs. This should provide a strong positive signal to depositors, reducing the risk of system-wide loss of confidence.

14. Putting in place the adequate primary legislation on deposit insurance and bank resolution is the essential pre-condition for the proposed project. New Banking (Special Provisions) Act is expected to be enacted in Spring 2023. The new law would significantly upgrade the deposit insurance and bank resolution framework, providing the CBSL with a wide range of resolution instruments (including bail-in powers), ensuring that existing shareholders bear the first loss in a bank failure, and enabling the SLDIS to financially contribute to resolution decisions. The law would also allow the CBSL to set the rates of ordinary premiums to SLDIS (rather than having a fixed rate on the legislation), introduce the possibility of charging extraordinary premia, and reduce the maximum time for the start of payout from 60 to 30 days.

Component 2: Institutional capacity building for SLDIS

15. This component will cover technical assistance activities, given the large capacity building agenda as demonstrated by the recent IADI assessment. The substantial TA will be needed to help CBSL achieve the agreed PBCs in

[1] Funding ratio is the standard measurement of financial capacity of a deposit insurance scheme and is defined as the ratio of total reserves of the scheme to total insured deposits.

a quality and timely manner, as well as to support the institutional strengthening of SLDIS across the board. The overarching objective would be to boost, as soon as feasible, the capacity of CBSL to fulfill its financial sector safety net mandate considering the present financial sector risks, and, in the long run, to improve compliance with IADI CPs.

Component 3: Project implementation and monitoring

16. **This component aims to provide support to the CBSL for effective project implementation**, in line with WB's applicable standards of financial management (FM), procurement, social and environmental safeguards, and monitoring and evaluation (M&E).

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

17. **The project's environmental and social risk is rated as 'low'.** The project will not support any civil/infrastructure works, however there will be purchase of some IT equipment to support the operational and accounting requirements of the deposit insurance system. This will generate E-waste at the end of the use of their lifecycle of use. E-waste will be managed by adopting the existing country regulations with registered collectors and vendors put in place by the Central Environmental Authority of Sri Lanka. In addition, health and safety risks linked to Covid-19 is not expected since the Pandemic has now ended, and associated restrictions have been lifted. Therefore, interventions under this project will not result in any associated adverse environmental impacts. While the project will create overall positive social impacts, there is a risk of citizens' concern over reforms, lack of communication, and lack of understanding of impacts leading some beneficiaries not to be able to fully participate and benefit from project interventions. These risks will be mitigated through a robust Public Communication Strategy which will be implemented as part of the project and ensuring access the Grievance Redress Mechanism (GRMs) for all stakeholders to provide feedback and bring any grievances related to exclusion to the attention of the project.

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APPROVAL

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