



Report and Recommendation of the President to the Board of Directors

Project Number: 48320-001
November 2014

Proposed Senior Loan DemirBank Supporting Micro, Small, and Medium-Sized Enterprises (Azerbaijan)

This is the version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

CURRENCY EQUIVALENTS

(as of 31 October 2014)

Currency unit – Azerbaijan manat (AZN)

AZN1.00 = \$1.2750
\$1.00 = AZN0.7843

ABBREVIATIONS

ABA	–	AccessBank Azerbaijan
ADB	–	Asian Development Bank
AML	–	anti-money laundering
CAGR	–	compound annual growth rate
CEO	–	chief executive officer
DEG	–	Deutsche Investitions- und Entwicklungsgesellschaft
EBRD	–	European Bank for Reconstruction and Development
ESMS	–	environmental and social management system
FMO	–	development bank of the Netherlands
GDP	–	gross domestic product
IFC	–	International Finance Corporation
MSMEs	–	micro, small, and medium-sized enterprises
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of DemirBank ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2014 ends on 31 December 2014.
- (ii) In this report, "\$" refers to US dollars.

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed senior loan of up to \$20,000,000 to DemirBank for Supporting Micro, Small, and Medium-Sized Enterprises in Azerbaijan.

II. THE FINANCIAL INTERMEDIARY

A. Investment Identification and Description

2. After the collapse of the Soviet Union, exposure to macroeconomic shocks and financial crises has undermined public confidence in Azerbaijan's banking system. Private credit to gross domestic product (GDP) has averaged less than 25% since 2008, indicating a depth of financial intermediation far below other middle-income peers.¹ Access to financial services is low in Azerbaijan, and highly concentrated in the capital (Baku) where 86% of bank lending is extended. Azerbaijan's regions, which account for 78% of the population, lag far behind the capital in access to finance, receiving only 14% of bank lending.² Compared with emerging markets in Eastern Europe, the efficiency and stability of financial intermediation are low, as witnessed by high lending–deposit rate spreads and high defaults in 2008 and 2009. Supporting outreach of financial services to the regions and improving stability of the finance sector will have major qualitative impacts on the economy and people by stimulating rural income and employment. This will also support critical risk and income diversification away from the dominant and volatile energy sector.

3. Although rural economic activity contributes less than 10% of GDP, it supports 78% of the population and 38% of employment. The quality of growth is particularly significant in rural areas, as it provides major benefits for low-income families and stimulates demand for goods and services produced by micro, small, and medium-sized enterprises (MSMEs), which represent the bulk of activities in secondary towns and rural districts.³ The government recognizes that it needs to stimulate value-adding activities away from oil and gas, particularly in the regions. Stimulating economic activity and income generation in the regions is a government priority; it is pursuing rural investments in infrastructure, agriculture, and agribusiness.⁴

4. MSMEs in Azerbaijan are a critical contributor to income and employment with 42% of the labor force employed by small and medium-sized enterprises, and many more individuals operating as microentrepreneurs. However, MSMEs have consistently lacked access to finance because traditional security-based lending practices have not been able to accommodate the informal information available or address the lack of available collateral. The European Investment Bank estimates demand for finance from MSMEs in Azerbaijan to be in the vicinity of €3.5 billion.⁵ Insufficient access to finance has substantially impeded MSME development.

¹ World Bank. 2012. *Benchmarking Financial Systems around the World, Country Comparisons*. Washington, DC.

² In this report, "regions" refers to areas outside the capital city Baku; Government of Azerbaijan, Central Bank of Azerbaijan. 2013. *Monthly Bulletin*. Baku.

³ Most Azerbaijani enterprises are in the micro and small category. Only a few are medium-sized, according to the European Union threshold for large enterprises above 250 employees and business turnover of greater than AZN50 million equivalent. Azerbaijan is part of the European Union neighborhood region. The maximum thresholds for medium-sized enterprises under this project are businesses with up to \$5 million in annual turnover and up to 250 employees.

⁴ The key elements of the government's strategy were presented during the Azerbaijan 2020: The Vision of the Future conference held on 3 December 2012 in Baku under the auspices of the President of Azerbaijan.

⁵ European Investment Bank. 2013. *Azerbaijan: Private Sector Financing and the Role of Risk-Bearing Instruments*. Luxembourg.

More than half of MSMEs face problems obtaining access to finance, particularly at earlier stages in their life cycle. In addition, financing vehicles tailored to meet the needs of MSMEs, including microfinance, are limited in Azerbaijan relative to other countries in the region.⁶

5. The Asian Development Bank (ADB) continues to have an important role in supporting deepening of services in Azerbaijan's finance sector. Since 2005, ADB has provided nonsovereign loans of \$95 million to Azerbaijani banks, comprising (i) \$15 million in total senior loans to AccessBank Azerbaijan (ABA), Azerigas Bank, and Bank Respublika; (ii) a \$20 million subordinated loan to the International Bank of Azerbaijan; (iii) a \$10 million subordinated loan to Bank Respublika; and (iv) a \$50 million senior loan to ABA approved and fully disbursed during 2013. ABA, Bank of Baku, Bank Respublika, and DemirBank participate in ADB's Trade Finance Program. The proposed loan would be ADB's first loan to DemirBank, building on the success of previous loans to other banks in the sector, and complementing the most recent loan to ABA, which exclusively targeted MSMEs in the regions where access to finance is most limited.

6. ADB has met with several financial institutions in Azerbaijan to identify suitable partners to collaborate with to continue to promote greater access to finance for MSMEs, particularly in the underserved regions. However, many of the banks lack the required expertise and reach to service MSMEs in these areas. DemirBank is one of six banks that participated in the first MSME lending initiative of the Azerbaijan government in 2004.⁷ It is one of the leading mid-sized banks in the country, and has been successful in transforming its strategy from financing predominantly the corporate segment to developing a much stronger retail and MSME focus. DemirBank currently has the second largest microfinance portfolio among banks in Azerbaijan after ABA.⁸ It has developed the required infrastructure (credit expertise and information technology systems) to expand its retail and MSME platform, and offers MSME services in all of its 33 branches, including its 20 branches located in the regions. DemirBank has developed extended outreach in underserved areas of the country, and its MSME portfolio is currently divided with 36% of MSME loans provided in Baku and the residual 64% in the regions. The bank plans to open an additional three branches by the end of FY2015, all in the regions. ADB's loan will augment the bank's MSME portfolio expansion, including its planned expansion in underserved villages and regions. This strategy will allow the bank to diversify its portfolio away from the highly competitive corporate segment, offering several advantages including greater portfolio granularity, greater growth potential, and higher profitability. DemirBank has participated in ADB's Trade Finance Program since 2010, and expressed interest in working with ADB to support its MSME lending program.

7. DemirBank has been recognized for its high governance standards, driven by the quality and principles of its shareholders, management team, supervisory board, and corporate principles and policies.⁹ It continues to demonstrate asset quality better than the industry average. The loan will allow greater access to finance in Azerbaijan, and provides ADB with an opportunity to deepen its existing relationship with DemirBank. In light of its targeted MSME expansion plans, its strong regional branch platform to service MSMEs in the most underserved

⁶ International Monetary Fund. 2012. *Republic of Azerbaijan: Selected Issues*. Washington, DC.

⁷ This was under the German–Azerbaijan Fund, established in 1998 as a joint initiative of the German Ministry for Economic Cooperation and Development and the Azerbaijan government to provide financing to domestic banks for onlending to MSMEs.

⁸ DemirBank has the third largest microfinancing business of all financial institutions after ABA and the Foundation for International Community Assistance, which operates as a dedicated microfinance institution.

⁹ In 2010, Standard & Poor's rated DemirBank as one of the top five banks in Azerbaijan for transparency and disclosure of information. In 2013, the Ministry of Economic Development of Azerbaijan rated DemirBank first for corporate governance standards among 33 companies.

areas of the country, as well as history of sound corporate governance, DemirBank is considered a good candidate for ADB funding.

B. Business Overview and Strategy

8. Founded in 1989, DemirBank is a commercial bank offering corporate and retail banking services. The bank's core strategy is to expand into the MSME and retail areas by offering better services to its customers through the use of modern technology. DemirBank's internal research and a gap analysis study conducted with support from FMO, the development bank of the Netherlands, show that Azerbaijan has significant scope for growth in these segments. With the aid of the German–Azerbaijan Fund, the bank began developing a core competency in MSME lending in 2004, and in 2009 it began developing its own MSME business. It is currently implementing a large-scale capacity-building project to develop noncredit-sales skills of its employees, with a focus on card business and MSME products. The objective is to attract new clients by offering better service than its competitors. DemirBank has invested heavily in a new core banking software (SAP), which provides market-leading tools to identify and analyze target groups of customers. In addition, in 2014 the bank launched a 5-month diagnostic program to build up the bank's MSME lending capacity in the regions.

9. MSME lending is synergistically aligned with DemirBank's product strategy of continued retail lending, which is backed by growing aspirations of the middle class for consumer durables, cars, and housing. As a result, DemirBank is one of the few banks with a wide network of branches in regions other than Baku, which allows it to build on its retail presence and promote MSME lending. It is also seeking to leverage the advantage provided by its strong regional branch network by exploring channels to better service businesses in agriculture. MSME lending is therefore the core driver of DemirBank's growth strategy. Since 2009, DemirBank has made significant investments in training staff and developing the required infrastructure for MSME lending to allow a short turnaround time for loan disbursement, which is a key success factor in MSME lending dealing with small loans.

C. Ownership, Management, and Governance

1. Ownership

10. The shareholding structure of DemirBank includes the Hajiyev family with 40% (with Rahman Hajiyev individually holding 19.6%), the European Bank for Reconstruction and Development (EBRD) 25%, FMO 10%; Roman Amirjanov 5.4%, and more than 800 other individuals and legal entities 19.6%.

2. Management

11. DemirBank's management team has remained stable since 2012. The executive board comprises the CEO and four senior executives. All members of the executive board have gained extensive professional experience working for local banks and finance organizations.

3. Governance Structure

12. DemirBank's corporate governance compares well with the industry in Azerbaijan. In 2011, IFC conducted a detailed corporate governance assessment of the bank; DemirBank has since worked to implement the IFC recommendations, including establishment of standardized assessment and evaluation tools for the executive and supervisory boards. In March 2013, the

government's Ministry of Economic Development gave DemirBank the highest rating for corporate governance standards. DemirBank's supervisory board has five members with diversified professional and banking experience. Rahman Hajiyev has chaired the board since 1994 and has 35 years of banking experience. EBRD and FMO each nominate a director to the board; they bring extensive international banking experience. The remaining two board members are considered independent.

13. DemirBank has established anti-money-laundering (AML) practices in line with Central Bank of Azerbaijan requirements, with two employees at the head office responsible for AML issues and reporting to the CEO. All 33 branches have an officer responsible for checking AML and know-your-customer issues, and reporting them to the head office. Aside from the information provided by the Central Bank of Azerbaijan Financial Monitoring Service regarding screening of financial transactions, the bank uses other databases for more detailed analysis. DemirBank has implemented an AML program to detect suspicious transactions, and also performs manual checks.

III. THE PROPOSED ADB ASSISTANCE

A. The Assistance

14. The proposed ADB assistance comprises a senior loan facility of up to \$20 million with a tenor of up to 5 years. The proceeds will be used to support DemirBank's plan to increase lending to MSMEs, including MSMEs in the underserved regions outside Baku. The assistance will enhance access to longer-term finance for the MSME segment, which is critical to support income and employment generation in the country. The assistance complements technical assistance (TA) which has already been approved by ADB of up to \$200,000 to support DemirBank's expansion into the MSME segment.¹⁰ Potential areas of TA support are expected to include MSME product and strategy development, and internal capacity building as the bank refines its policies and procedures to allow it to better serve the MSME segment.

B. Implementation Arrangements

15. DemirBank will issue and administer subloans to MSMEs consistent with its established loan and risk management guidelines, and maintain an appropriate performance and loan tracking system. The bank will provide (i) unaudited interim management updates, (ii) audited annual financial statements, (iii) compliance certificates for agreed covenants, (iv) progress updates on its use of proceeds for subloans and regional service outreach (including progress on meeting relevant design and monitoring framework indicators), and (v) an annual environmental and social management system (ESMS) report.

C. Value Added by ADB Assistance

16. ADB will provide stable long-term financing, which currently cannot be raised from the local market. Azerbaijan's capital markets are nascent, and public confidence in the finance sector is only gradually being restored. Commercial bank funding is not readily available given current market conditions in Europe. International financial institutions that are funding Azerbaijani banks are now operating within tighter country, sector, and single investment and borrower exposure limits, thereby increasing the need for ADB engagement. More broadly, the

¹⁰ ADB. 2013. *Technical Assistance for Promoting Financial Inclusion and Stability in ADB's Transition Member Countries*. Manila.

loan may contribute to increasing public confidence in the banking system, through the support for this growing MSME lender with significant outreach in underserved regional areas.

17. The previously approved TA will augment DemirBank's expansion plans into the underserved MSME segment thereby improving access to finance, allowing it to better serve MSME clients and build more robust MSME service delivery platforms. Through close monitoring and dialogue with DemirBank management, ADB will also support DemirBank's adherence to high corporate governance, social, environmental, reporting, and fiduciary standards; as well as sound risk management practices.

IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impact, Outcome, and Outputs

1. Impact

18. The impacts are (i) increased availability of bank credit to the non-oil economy, and (ii) expansion of private banking services, particularly in the regions outside Baku. This will be reflected by an increase in the private credit–GDP ratio, and increased private credit to regions outside Baku. The contribution of MSMEs to Azerbaijan's economic output is expected to increase.

2. Outcome

19. The outcome is sustainable growth of DemirBank's MSME loan portfolio. DemirBank will fulfill its core objective of prudently serving more MSMEs and their diverse business needs. DemirBank is expected to set an example for other banks in deepening its outreach to the regions, while retaining good asset quality and funding private business activity in the country with employment and income benefits.

3. Outputs

20. The primary output is DemirBank's financial capacity to service MSMEs is increased. The bank will improve its service outreach to MSMEs, and ensure that adequate investment is made in human resources, processes, and branch infrastructure. The provision of funding to MSMEs, including regional businesses, will strengthen their role as important sources of employment, especially in poor regional areas. ADB's continuing technical support will augment DemirBank's expansion plans into the underserved MSME segment thereby improving access to finance, allowing it to better serve MSME clients and build more robust MSME service delivery platforms. ADB will also support DemirBank's adherence to high corporate governance, social, environmental, reporting, and fiduciary standards.

B. Alignment with ADB Strategy and Operations

1. Consistency with Strategy 2020 and Country Strategy

21. Under Strategy 2020 and its midterm review, ADB aims to strengthen its support for the finance sector by supporting the development of financial infrastructure, institutions, and

products and services; and by promoting inclusive growth.¹¹ Building inclusive financial systems will be supported through DemirBank's emphasis on funding regions where productivity is low, and the potential for employment and income generation is high. This loan will help DemirBank to reach underserved MSMEs, and is consistent with government efforts to promote growth in these areas, particularly to diversify economic growth in private non-oil activities. Strategy 2020's target for poverty reduction through private sector development will be supported via DemirBank's business expansion in the regions where poverty vulnerability is highest.

22. ADB completed a finance sector assessment and an evaluation of ADB assistance to Azerbaijan in 2012, and country partnership strategy, 2014–2018 for Azerbaijan in 2014.¹² The reports highlight the importance of developing private and financial institutions, and the need for intensified financial intermediation. More diversified financial services away from Baku and the oil industry will capture essential qualitative growth opportunities in neglected regions and sectors, and encourage sound risk management. The reports highlight that agriculture and MSMEs have inadequate access to financial services, and that lending support via financial institutions presents the greatest opportunity for ADB's private sector operations. The finance sector assessment specifically highlights the low financial intermediation across all segments of the finance sector and its negative impact on overall economic and social development, with the provision of small and medium-sized enterprise credit lines to individual banks listed as a potential area for ADB assistance.

2. Consistency with Sector Strategy and Relevant ADB Operations

23. Finance sector development is a key focus of ADB assistance as set out in ADB's Private Sector Development Strategy and Enhanced Poverty Reduction Strategy, which identify economic growth, stimulated by private sector investment, as a key contributing factor in reducing poverty.¹³ The strategies note the importance of generating jobs, with private sector employment being the major source of income for workers and their families. The Private Sector Development Strategy emphasizes ADB's role in strengthening the finance sectors in its developing member countries. It provides that MSME beneficiaries of financial intermediation are important employers and providers of income to contribute to poverty reduction. The loan is consistent with ADB's finance sector operational plan and the 2007 report of the Working Group on Rural Poverty, which underscores the importance of rural finance, and promotes financial inclusion of underserved poor households, farmers, and MSMEs.¹⁴

¹¹ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila; ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

¹² ADB. 2012. *Azerbaijan: Financial Sector Assessment*. Manila; ADB. 2012. *Azerbaijan: Validation of the Final Review of Country Operations, 2000–2011*. Manila; ADB. 2014. *Country Partnership Strategy: Azerbaijan, 2014–2018*. Manila.

¹³ ADB. 2000. *Private Sector Development Strategy*. Manila; ADB. 2004. *Enhancing the Fight Against Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

¹⁴ ADB. 2011. *Financial Sector Operational Plan*. Manila; ADB. 2007. *Rural Poverty Reduction and Inclusive Growth: Report of the Working Group on Rural Poverty*. Manila.

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

24. The loan is category FI for impacts on the environment, involuntary resettlement, and indigenous peoples. Subprojects classified A for environment and either A or B for involuntary resettlement or indigenous peoples will not be financed under this loan. DemirBank's MSME loans are mostly in low- to medium-risk areas such as trade, transport, agriculture, services, and light manufacturing. The environmental impacts due to the MSME lending are expected to be site-specific and reversible.

25. DemirBank has an ESMS to manage the environmental and social impacts and risks of its activities. It takes into account EBRD and IFC performance standards and requirements. The ESMS and the project portfolio of the bank were assessed. DemirBank's current practice ensures that all projects are evaluated against the current ESMS exclusion list and comply with national and local regulations, and the safeguard requirements of international financial institution stakeholders. DemirBank has committed to update the ESMS, satisfactory to ADB requirements, prior to the first disbursement. The financial intermediary's ESMS will include arrangements to comply with national labor laws and measures in relation to adherence to internationally recognized core labor standards (including provisions prohibiting any discrimination against women in hiring and providing equal pay for equal work of men and women), in compliance with ADB's Social Protection Strategy.¹⁶ As female clients are targeted to increase, the transaction is classified as some gender elements.

B. Anticorruption Policy

26. DemirBank was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

C. Investment Limitations

27. The proposed senior loan is within the medium-term, country, industry, group, and single investment exposure limits for nonsovereign investments.

D. Assurances

28. Consistent with the Agreement Establishing the Asian Development Bank (the Charter), the Government of Azerbaijan will be requested to confirm that it has no objection to the proposed assistance to DemirBank.¹⁷ ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the ADB Board of Directors.

¹⁶ ADB. 2003. *Social Protection Strategy*. Manila (adopted in 2001).

¹⁷ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

VI. RECOMMENDATION

29. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the senior loan of up to \$20,000,000 to DemirBank for Supporting Micro, Small, and Medium-Sized Enterprises in Azerbaijan, from ADB's ordinary capital resources, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Takehiko Nakao
President

17 November 2014