



Report and Recommendation of the President to the Board of Directors

Project Numbers: 49093-001; 49137-001
March 2015

Proposed Senior Loans AccessBank Azerbaijan and Finca Azerbaijan Improving Financial Service Outreach for Agriculture (Azerbaijan)

This is an abbreviated 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.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 17 March 2015)

Currency unit – Azerbaijan manat (AZN)

AZN1.00 = \$0.9534

\$1.00 = AZN1.0488

ABBREVIATIONS

ABA	–	AccessBank Azerbaijan
ADB	–	Asian Development Bank
BOD	–	board of directors
BOM	–	board of management
CAGR	–	compound annual growth rate
CBAR	–	Central Bank of Azerbaijan
CEO	–	chief executive officer
FIA	–	Finca Azerbaijan
IFI	–	international financial institution
MIF	–	microfinance investment fund
MSMEs	–	micro, small, and medium-sized enterprises
SMEs	–	small and medium-sized enterprises

NOTES

- (i) The fiscal year (FY) of AccessBank Azerbaijan and Finca Azerbaijan ends on 31 December. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2015 ends on 31 December 2015.
- (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 (i) a proposed loan of up to \$75,000,000 or its AZN equivalent to AccessBank Azerbaijan (ABA); (ii) a proposed A-loan of up to \$20,000,000 or its AZN equivalent to Finca Azerbaijan (FIA), and (iii) a proposed B-loan of up to \$5,000,000 to FIA to be funded by participating commercial banks, for Improving Financial Service Outreach for Agriculture in Azerbaijan.¹

II. THE FINANCIAL INTERMEDIARIES

A. Investment Identification and Description

2. Fueled by hydrocarbons, the Azerbaijan economy grew at an average annual rate 12.4% during 2001–2013, supporting an impressive reduction in poverty by public work programs and budget transfers, with the poverty headcount falling from 50% in 2000 to 5% in 2013. However, rural areas have benefitted from this achievement less than urban areas, and the sustainability of this benefit is vulnerable, as hydrocarbon income is expected to diminish by 2034. In view of this challenge, the government is emphasizing inclusive growth with a focus on diversifying away from hydrocarbons into productive sectors. Foremost is agriculture, which employs 38% of the labor force, but only generated 5.7% of gross domestic product in 2013. The lagging performance of agriculture—which is the primary source of employment and income for nearly half the population—points to its low productivity, providing mainly low wage and seasonal jobs that contribute to poverty vulnerability.² Improving agricultural productivity is central to developing the rural economy and is the most direct route to improving employment and income opportunities.

3. Structural issues and inefficiencies contribute to low agricultural productivity. Land reforms after independence in 1990 distributed 1.3 million hectares of agricultural land to 870,000 households. Cereal production, which increased by a compound annual growth rate (CAGR) of 8% during 2000–2009, has since stagnated. Food and livestock production show a similar picture. Today, smallholders produce 90% of agricultural goods on farms of less than 3 hectares, posing challenges for improving farmer know-how and scale production, which requires massive fixed and working capital investments. Marketing of produce is largely uncoordinated by companies that lack adequate storage, causing high wastage of produce and excessive charges to farmers. Factors resulting in low agricultural productivity include (i) small farm size, (ii) low quality standards, (iii) the absence of efficient logistics and marketing, (iv) inadequate irrigation infrastructure, (v) limited research and slow adoption of modern agricultural practices, (vi) low integration of farmers into agribusiness value chains, and (vii) limited and costly access to financial services. Foremost, limited access to affordable funding constrains investment for many small farmers.

4. Rural residents have inadequate access to finance. Banking is highly concentrated in the capital, Baku, representing 83% of bank loans and 92% of deposits.³ Penetration to rural areas is poor, as many villages lack access to basic financial services. Regions outside Baku represent 78% of the population and 62% of entrepreneurs; they receive only 17% of lending. In 2013, agriculture obtained only 5% of institutional credit (footnote 3).

¹ The design and monitoring framework is in Appendix 1. On 21 February 2015, the Central Bank of Azerbaijan announced a 34% devaluation of the Azerbaijan manat against the dollar. In this report, historical financial analysis uses the historical exchange rate. The use of the new exchange rate is indicated where relevant.

² Sector Overview (accessible from the list of linked documents in Appendix 2).

³ Government of Azerbaijan, Central Bank of Azerbaijan. 2014. *Monthly Bulletin December*. Baku.

5. Low financial services outreach to agriculture is a major impediment to improving productivity. Typical financial services to farmers are limited to basic payments and deposits and, to a lesser extent, credit, as lending processes require collateral and financial documentation that most farmers are unable to produce. Services customized to a farmer's cash flow are still in their infancy. Creative solutions are needed to address the challenge of limited financial inclusion and low agricultural productivity.

6. Compared with emerging markets in Eastern Europe, Azerbaijan's depth and efficiency of financial intermediation is low, as evidenced by the low private credit–gross domestic product ratio of 30.5% (2014) and high lending–deposit rate spreads. The finance sector depends largely on external borrowing, as evidenced by the high loan–deposit ratio of 166% (2014) reflecting weak savings. A 2011 survey indicated that only 15% of the adult population had a savings account and only 2% of those who indicated having saved during the preceding year had done so through a bank, reflecting public mistrust of the banking system.⁴

7. On 21 February 2015, the Central Bank of Azerbaijan (CBAR) announced a 34% devaluation of the manat against the dollar. The devaluation follows the decline in oil prices, the drain of foreign reserves and bank deposit, as well as deposit shifts from manat to dollar. CBAR's move aims to improve diversification and competitiveness of the non-oil sectors, especially agriculture. The immediate impact to the finance sector is a significant reduction of bank and nonbank capital adequacy given their significant foreign currency lending.⁵ Adverse asset liability currency mismatches can be mitigated by (i) prudential open currency position limits imposed by CBAR, (ii) currency hedging contracts, and (iii) prudent underwriting policies of some banks that require comfortable debt service ratios as risk buffers. As some loans will show stress in debt service, financial intermediation will be subdued in 2015. This underscores the need for international financial institutions (IFIs) to instill public confidence in markets by continuing operations with commercially sound financial institutions.

8. To improve financial inclusion in Azerbaijan and, in particular, the low outreach of the formal financial sector to agriculture, the Asian Development Bank (ADB) selected ABA, an existing partner and the sixth largest bank in Azerbaijan with \$1.2 billion assets (25 February 2015); and FIA, the largest nonbank financial institution with \$231 million of assets (25 February 2015) and the most extensive rural footprint, as a new ADB partner. ABA provides loans typically in the range of \$1,000 to \$3 million with an average loan size of \$5,200; whereas FIA, through its village banking model, offers smaller loans of up to \$100,000, with an average size of \$1,557. While the customer segments targeted by ABA and FIA overlap, the market is quite large and demand is high. Customers in remote villages and small enterprises can also benefit from competition of services, thereby improving their connectivity to markets and value chains. Given the leading role of ABA and FIA in agriculture finance over the past 8 years, both should retain their continued focus despite the adverse devaluation impact. Both institutions have strong corporate governance, supported by their IFI shareholders, sound and responsible lending processes, strong development orientation, and an ability to develop products to further penetrate underserved agriculture segments. The December 2014 Fitch rating upgrade of ABA to BBB– investment grade underscores ADB's and Fitch's comfort with shareholder support.⁶

⁴ A. Demirguc Kunt and L. Klapper. 2012. Measuring Financial Inclusion: The Global Findex Database. *World Bank Policy Research Paper 6025*. Washington, DC: World Bank. p. 35.

⁵ Moody's Credit Outlook. 2015. *Azerbaijani Currency Devaluation is Credit Negative for Banks with High Foreign-Currency Exposures*. 23 February.

⁶ Fitch Ratings. 2014. *Fitch Upgrades Azerbaijani AccessBank to BBB–; Outlook Stable*. 10 December.

9. ADB has supported the development of private finance in Azerbaijan since 2005 with interventions to build up banks that finance micro, small, and medium-sized enterprises (MSMEs). Initially, this support largely benefited banks and enterprises centered in the capital. To support increased access to finance in secondary towns and rural regions, ADB provided in 2013 a loan to ABA who expanded its regional footprint through branch openings and support to farmers and small trade and service businesses.⁷ However, an enhanced focus is needed to advance the outreach of custom-suited financial products for agriculture through sound financial institutions and, especially in the short term, to respond to the adverse devaluation impact.

B. AccessBank Azerbaijan

10. **Business overview and strategy.** Established in 2002 as a greenfield bank by international investors, ABA is now the leading lender to MSMEs in Azerbaijan, serving 160,000 borrowers with a loan portfolio of \$0.9 billion (28 February 2015). In 2007, ABA established its micro-agriculture loan product, which represents 18% of its loans. ABA's extensive network of 37 branches located outside Baku provides a good platform to reach farmers. ABA's non-IFI commercial borrowing is expected to increase more than twofold by 2017 from \$204 million (2014) to become at par with traditional IFI and microfinance investment fund (MIF) borrowing and deposits. During 2013–2014, annual credit growth averaged 40%, or double the business target. The ABA business plan for 2015–2018 projects a more moderate loan portfolio CAGR of 15%, which is prudent in the context of the adverse impact on demand under moderating growth scenarios. ABA will review its business plan for 2015 to reflect the market impact of the recent manat devaluation. While moderation of credit demand is likely for 2015, it is expected to be temporary.

11. **Ownership.** ABA is predominantly owned by IFIs, with Black Sea Trade and Development Bank, the European Bank for Reconstruction and Development, the International Finance Corporation, and German development cooperation through KfW each holding 20% of shares. Access Microfinance Holding AG holds 16.5% and LFS Financial Systems 3.5%.⁸ IFIs provide strong support through continued funding.

12. **Management.** ABA's board of management (BOM) is chaired by the chief executive officer (CEO), and has two additional members responsible for (i) business banking and risk, and (ii) retail banking and operations. The CEO, a German commercial banker with 19 years of experience in Europe and the Russian Federation, joined ABA in mid-2012. The other members are Azerbaijani nationals with strong academic backgrounds and in-depth knowledge of ABA operations, having moved up from credit officers to their current positions since ABA's establishment. The BOM sets strategic targets for approval by the board of directors (BOD).

13. **Governance structure.** A two-tier board, the BOD and the BOM, governs ABA. The BOD oversees implementation of key policies, approves strategies and business plans, appoints management, and monitors their performance. The four IFIs nominate four of the five directors (including the chairperson), who are currently all senior bankers with international experience. Access Microfinance Holding nominates the other director, a German banker, who was ABA's first CEO.

⁷ ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loan to Accessbank Azerbaijan for Promoting Rural Finance Inclusion*. Manila (\$50 million). In 2014, ADB approved a \$20 million loan to Demir Bank, which also lends to rural areas: ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loan to Demir Bank for Supporting Micro, Small, and Medium-Sized Enterprises*. Manila.

⁸ Ownership, Management, and Governance (accessible from the list of linked documents in Appendix 2).

14. ABA's audit department reports directly to the BOD audit committee and is led by an experienced auditor. The external auditor changes periodically, with Ernst and Young holding the mandate since 2013. Historically, audit observations relate to addressing minor fraud cases identified at branches. ABA dismisses staff if fraud is substantiated. To reduce operating risk and meet the requirements of its growing business, ABA successfully migrated to Temenos 24, an advanced core banking system. Audits have not identified any major accounting, operating risk, or compliance issues. ABA internal audits have improved through a focus on risk-based audit supported by specialized software. ABA's audit function is well established. In 2013 ABA established a unit reporting to the CEO to identify suspicious transactions by scanning information by source of wealth, politically exposed persons, and watch lists. ABA has established "know your customer" processes and policies countering money laundering and the financing of terrorism. ABA reports findings to the CBAR Financial Services Unit.⁹

15. **Total capital adequacy.** Under Basel I (using international financial reporting standards) and national prudential regulations, ABA comfortably exceeded prudential requirements, backed by a conservative dividend policy and high profitability supporting the buildup of capital through retained earnings. Although Basel I capital adequacy declined from 24.3% to 22.5% during February 2015, and regulatory capital adequacy declined from 16.3% to 14.0% due to the manat devaluation, it remains well within the prudential limit of 12%.

16. **Loan portfolio and asset quality.** ABA's loan book is segmented into 41% micro loans (18% agriculture), 47% small and medium-sized enterprise (SME) loans, and 12% retail and mortgage loans (31 March 2015). The manat devaluation resulted in an 11% reduction of the loans in dollar terms. Currently, 62% of the loans are in dollars to about 16,000 borrowers that earn revenues in manat—mainly SME and mortgage borrowers—who almost all continue to report very strong asset quality. ABA's asset quality remains very strong due to rigorous client selection and monitoring, short cash-flow cycle of loans, high degree of repeat loans, effective integration of sales and risk functions, and a quality-oriented bonus system. The nonperforming loan ratio was 1.2% in 2014, and since 2007 has never exceeded 1.4%.¹⁰ While asset quality may temporarily deteriorate in 2015, it is expected to remain very healthy. To comply with International Financial Reporting Standards 9, ABA developed a model to estimate probability of default and loss-given default through back testing its portfolio on the 2008–2009 crisis scenario. This model is currently being updated to reflect the latest devaluation. The granularity of the loan portfolio and MSME sector diversification support the robustness of asset quality.

17. **Earnings and profitability.** Net income grew at a CAGR of 27% during 2008–2014 reaching \$43 million in 2014. In 2014, return on equity was a solid 33.2% and return on assets 4.7%. Although ABA's net interest margin (NIM) dropped by 150 basis points in 2014, reflecting falling interest rates due to increased competition, it remained strong relative to emerging market comparators and appropriate due to ABA's staff-intensive business model. Profitability is expected to moderate, with a temporary decline in 2015 reflecting cost of the branch expansion and tightening margins due to increased competition and the recent manat devaluation.

18. **Liquidity, funding, and market risk.** Deposits increased from 14% in 2008 to 39% in 2014, while commercial borrowings dropped to 61% of total funding. However, significant manat

⁹ Azerbaijan participates in the Financial Action Task Force. Its compliance is monitored by MONEYVAL Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism.

¹⁰ In this report, nonperforming loans are defined as the sum of loans (i) overdue above 90 days but not impaired, (ii) impaired according to International Financial Reporting Standards, and (iii) restructured within 12 months of the reporting date and not included in (i) or (ii).

deposits has been shifted to dollars and partly withdrawn, indicating that retail deposits are vulnerable to withdrawal and dollarization. To address this vulnerability, ABA plans to improve its customized services and provide a more customer-friendly branch environment, as well as new contractual term investment products for retail customers. ABA's funding strategy aims to minimize deposit volatility through commercial borrowings targeted to reach equal funding for (i) deposits, (ii) commercial external borrowings, and (iii) IFI and MIF borrowing. ABA matches its foreign currency funding with lending in the same currency, and requires customer debt service ratios of at least 1.5. In the absence of cross currency swaps, the minimum debt service ratios are appropriate to manage currency-induced credit risk.

C. Finca Azerbaijan

19. **Business overview and strategy.** Established in 1998 and licensed as a nonbank credit institution, FIA is the leading nonbank lender to microenterprises and farm households serving 156,000 borrowers, with \$191 million in loans (25 February 2015). In 2012, FIA shifted from group to individual lending, which now represents more than 75%. Agriculture represents 52% of its loans and its 56 rural branches give it a large platform to reach farmers. FIA's funding strategy relies on external borrowings from IFIs and MIFs and limited domestic borrowing. During 2012–2014, loans grew at a CAGR of 35% before moderating to 20% in 2014 due to increasing competition. FIA expects agriculture loan growth at \$30 million per annum and total loan growth at a CAGR of 15% (2015–2019) with a temporary moderation in 2015 due to the devaluation.

20. **Ownership.** FIA is owned by Finca Microfinance Cooperatief UA, Netherlands,¹¹ which is owned by Finca Microfinance Holding LLC, Delaware,¹² which is owned 62% by Finca International Inc. New York, a not-for-profit corporation in the United States (US), and 38% by IFIs including Financierings Maatschappij voor Ontwikkelingslanden N.V., Netherlands, the International Finance Corporation, and KfW, and private MIFs (responsAbility and Triodos). With their support, FIA has adopted high integrity and responsible finance standards.

21. **Management.** FIA's BOM comprises the CEO (chair), chief finance officer, and chief operations officer, all experienced bankers. The CEO, a US national, is a microfinance banker with 16 years of experience in Eastern Europe and various Finca subsidiaries. The newly appointed chief finance officer was previously chief finance officer of Finca Tajikistan. The chief operations officer is an Azerbaijan national who has worked for FIA since its establishment. The BOM manages FIA's business and sets strategic targets for approval by the BOD.

22. **Governance structure.** FIA has a two-tier board including the BOD and the BOM. The BOD issues and supervises FIA's strategy, policies, and management. It comprises Finca International nominees, currently all experienced international bankers, two of which are senior staff at Finca International; the others are 2 CEOs of Finca Eurasia and Middle East South Asia subsidiaries and Senior Investment Officer from Finca International. FIA's governance standards follow that of all 23 subsidiaries of Finca International, with a strong mission focus on supporting lending to low income households and businesses, staff integrity, transparency, prudent lending policies and underwriting, and adequate risk management. FIA governance structures and functions are well established reflecting an adequate separation of functions by (i) micro loans; (ii) SME loans; (iii) administration and security; (iv) human resources; (v) legal

¹¹ The Netherlands cooperative structure benefits from a double taxation treaty between the two countries, which is a common solution for many international MSME lenders to reduce transaction tax.

¹² The incorporation in Delaware is for many US-based companies a choice of default, due to its advanced investor-friendly legislation and favorable corporate taxation.

and compliance; and (vi) treasury, accounting, and financial control.

23. FIA's audit department is led by an experienced auditor. The external auditor changes periodically, with Deloitte holding the mandate since 2012. Usually audit observations relate to addressing minor fraud identified at branches, leading to staff dismissal if substantiated. Audit observations have not identified any major accounting, operating, or compliance issues. FIA's audit function is well established and supervised by Finca International. FIA has dedicated staff reporting to the CEO to identify suspicious transactions by scanning information by source of wealth, politically exposed persons, and watch lists. It has "know your customer" policies countering money laundering and the financing of terrorism, and reports findings to CBAR.

24. **Capital adequacy.** As a nonbank financial institution, FIA uses a more restrictive capital–assets ratio than the capital to risk-weighted assets used by banks. Since 2010, FIA has comfortably exceeded prudential minimum requirements for banks supported by healthy profits and moderate dividends, allowing a buildup of capital through retained earnings. Although the recent manat devaluation resulted in a drop of capital adequacy from 18% to 16%, it remains above the 12% prudential limit for banks.

25. **Loan portfolio and asset quality.** Micro loans made up 98% of FIA's loans, 56% of these for agriculture and 2% for SMEs (25 February 2015). FIA has maintained sound asset quality with a portfolio at risk greater than 30 days of 1.4% of the gross loan portfolio at the end of 2014. This is supported by a rigorous client selection and monitoring process, the short cash-flow cycle of loans, and the high granularity of the loan portfolio. Although the nonperforming loan ratio increased by 100 basis points due to increased competition and signs of cross-indebtedness of some borrowers in 2014, it remained comfortable at 1.4%. About 13,000 (or 8%) FIA borrowers currently borrow dollar-denominated loans while relying on manat revenues have now realized the adverse impact of the manat devaluation through an increase in their loan principal. The impact on FIA is mitigated through prudent underwriting policies, requiring a minimum debt service ratio of 1.4, which is likely to absorb the devaluation impact. While asset quality may temporarily deteriorate in this segment in 2015, it is manageable given FIA's robust asset quality and underwriting standards.

26. **Earnings.** Net income was \$10 million in 2014 with a CAGR of 31%. Return on equity exceeded 20% during 2011–2014, primarily the result of high business growth and healthy interest margins. While FIA's NIM contracted by almost 7% during 2011–2014, and is expected to contract further due to increasing competition, profitability remained sound with return on equity at 23.1% and return on assets at 4.2% in 2014. FIA's NIM remains strong and appropriate due to FIA's staff-intensive, low transaction volume business model. Although FIA anticipates an annual loan growth rate of 15% during 2015–2019, it expects net profits to temporarily contract in 2015 due to higher provisioning, reduced operating margins, and the adverse impact of the manat devaluation.

27. **Liquidity and market risk.** With its development-focused business model and good profitability and asset quality, FIA is attractive for IFI and MIF funding, which represents 78% of its funding. Domestic commercial banks provided the remaining 22% in 2014. FIA is hedging its foreign exchange exposures through hedges with domestic and international counterparties arranged by The Currency Exchange, MFX Solutions, and the International Finance Corporation.

III. THE PROPOSED ADB ASSISTANCE

A. The Assistance

28. The proposed ADB assistance entails two direct senior, unsecured loan facilities for (i) ABA of up to \$75 million (or AZN equivalent) with a maximum 7-year tenor, and (ii) FIA of up to \$25 million comprising, of an A-loan of up to \$20 million (or AZN equivalent) with a maximum 6-year tenor, and a B-loan of up to \$5 million with a 4-year tenor to be funded by participating commercial banks. The loan to ABA will be structured in several tranches, each with a 5-year maturity, to be drawn down within a 2-year period. The loan to FIA will also be structured in tranches, each with a 4-year maturity, to be drawn down within a 2-year period. The proceeds will be used exclusively to support borrowers engaged in agricultural production, processing, logistics, and marketing.¹³

B. Implementation Arrangements

29. ABA and FIA will provide annual audited financial statements, quarterly financial statements, and compliance certificates for agreed covenants. Reporting includes updates on (i) financial, solvency, and profitability metrics; (ii) governance, safeguards, and social protection compliance; and (iii) business performance and utilization of the ADB loans. ADB will field missions at least annually to review and discuss progress with ABA and FIA management.¹⁴

C. Value Added by ADB Assistance

30. **Economic diversification and access to finance.** The proposed loans to ABA and FIA will support economic diversification away from hydrocarbons and improve access to working and fixed investment capital for agriculture, and lead the way for the finance sector to fund households and MSMEs operating in agriculture. The concurrent support of two leading institutions will support competition to the benefit of farmers by earning higher incomes. This in turn will support poverty reduction in the regions.

31. **Long-term funding.** ADB loans will help increase the tenor for lending to agriculture MSMEs and provide stable long-term funding to ABA and FIA that cannot be raised through deposits and domestic borrowings, given the public's limited confidence in Azerbaijan capital markets. While commercial funding is expected to return, financial institutions continue to rely heavily on IFIs to fund their asset growth. ADB's contribution also helps diversify ABA and FIA funding sources. Along with ongoing IFI support, the loans will send a strong signal to the market to boost confidence that is currently shaken by the manat devaluation.

32. **Leveraging resources from the private sector.** ADB expects to mobilize commercial participation in the project and leverage its assistance through expected risk participations and a B-loan, which is important given the country's current environment.

33. **Technical assistance.** ADB's loans will be complemented by technical assistance to help improve ABA's manat resource mobilization (retail term deposits and contractual investment products) and agriculture finance product offerings; as well as FIA's outreach to remote villages and farmers through mobile banking and financial literacy programs.¹⁵ The

¹³ Subloans will not exceed \$3 million equivalent.

¹⁴ Details of Implementation Arrangements (accessible from the list of linked documents in Appendix 2).

¹⁵ ADB. 2014. *Technical Assistance to the Republic of Azerbaijan for Capacity Building for Rural Financial Inclusion*. Manila.

literacy programs will help address potential over-indebtedness of households. Through close on-site monitoring and dialogue with ABA and FIA management and their shareholders, ADB will strengthen relationships with holding companies of both institutions and develop business opportunities to support financial inclusion in the south Caucasus and Central Asia regions.

D. Risks

34. **Country risk.** Financial institutions are exposed to the hydrocarbon market cycles, given Azerbaijan's dependence on oil production and to a lesser extent non-oil exports in the context of currency devaluations and slowing demand of Azerbaijan's neighboring trade partners. ABA and FIA have well-diversified risk exposures through substantial business in the regions and granular MSME loans in multiple sectors.

35. **Currency risk and related asset liability management.** The manat devaluation was an unprecedented step taken by CBAR to respond to the significant net outflow of foreign currency reserves, prompted by the devaluation of trading partners' currencies and decline of oil prices. This has impacted banks' capital adequacy, dollarization of deposits, and to some extent asset quality and profitability. ABA and FIA have strong IFI shareholder and parent support to raise new equity and debt. Both have robust risk management processes that have proven effective. Experience from the 2009 crisis has proven their ability to withstand large shocks such as the impact of devaluation. ABA and FIA have effectively mitigated an important part of this risk by hedging and limiting open dollar positions. Subject to market conditions and availability, the ADB loans may be partly funded in manat. While further adjustment cannot be ruled out, the recent devaluation somewhat mitigates market uncertainty regarding government actions.

36. **Corporate governance and integrity.** Azerbaijan banks typically have significant exposure to related party transaction lending and weakness in corporate governance and integrity. Supported by their international and IFI shareholders, ABA and FIA have built a strong integrity culture to withstand such pressures and are leading the way for other institutions.

37. **Asset quality and internal controls.** Although asset quality is very strong, rapid loan growth and signs of household cross-indebtedness may expose ABA and FIA to higher credit risk, particularly for borrowers affected by the manat devaluation. ABA and FIA are limiting this risk by maintaining prudent underwriting and using credit registry information.

38. **Profitability.** Competition in Baku and the manat devaluation will impact the margins and profitability of ABA and FIA in 2015. Their business focus will strengthen their competitive position in the regions, and efforts to enhance efficiency will mitigate this risk.

IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impact, Outcome, and Outputs

39. **Impact.** The expected impact is increased availability of credit to agriculture in Azerbaijan. This will be reflected by increased private bank credit to agriculture.

40. **Outcome.** The expected outcome is sustained financial service provision by ABA and FIA to farmers, and agriculture MSMEs. ABA and FIA are expected to set examples for other financial institutions in funding farmers and agriculture MSMEs, thus providing employment and income opportunities.

41. **Outputs.** ABA and FIA will improve their service outreach to agriculture in particular by offering a wider product range customized to farmer and MSME needs. Emphasizing lending based on MSME cash flows, expanding into remote areas, and providing term finance will help serve the regional economy and diversify ABA's risk and income profile.

B. Alignment with ADB Strategy and Operations

42. **Consistency with ADB strategy and country strategy.** Inclusive finance is a key focus of ADB assistance as set forth in the Midterm Review of Strategy 2020, which notes economic growth, stimulated by private investment and finance sector development, as a key contributing factor in reducing poverty; and emphasizes the importance of generating jobs, with private employment being the major income source for workers and their families.¹⁶ Inclusive finance will be supported through the emphasis of ABA and FIA on agriculture where productivity is low, and the potential for employment and income generation is high. The loans to ABA and FIA will reach agriculture MSMEs and farmers, providing longer tenors for their investments. This is consistent with government and ADB strategy to promote diversification to private non-oil activities through deepening financial intermediation across the agriculture value chain.¹⁷

43. **Consistency with sector strategy and relevant ADB operations.** Inclusive finance is also a key focus of ADB's Financial Sector Operational Plan. MSME beneficiaries of financial intermediation are important employers and providers of income. Supporting financial intermediaries is important to instill confidence and restore the finance sector in countries affected by macroeconomic shocks and financial crises. Since 2005, ADB has provided nonsovereign loans of \$120 million to banks, comprising loans to ABA, Azerigas Bank, Bank Respublika, and Demir Bank, as well as to International Bank of Azerbaijan. ADB also plays an important role in supporting microfinance in Azerbaijan through sovereign interventions.¹⁸

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

44. The investments are classified category FI for environment, and FI treated as C for involuntary resettlement and indigenous peoples. The potential environmental and social impacts of the investments and associated risks were assessed, as well as the commitment and capacity of ABA and FIA for environmental and social management. Their business activities are unlikely to entail impacts on involuntary resettlement and indigenous peoples. ABA and FIA will apply ADB's prohibited investment activities list; exclude subloans categorized A for environment and A or B for involuntary resettlement and indigenous peoples; ensure that investments using ADB funds abide by applicable national laws and regulations, as well as ADB Safeguard Policy Statement (2009); take measures to comply with internationally recognized core labor standards including provisions prohibiting any discrimination against women in hiring and providing equal pay for equal work for men and women in compliance with ADB Social Protection Strategy (2001); and in the case of FIA, finalize its environmental and social management system satisfactory to ADB before ADB's first disbursement of the respective

¹⁶ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

¹⁷ ADB. 2014. *Country Partnership Strategy: Azerbaijan, 2014–2018*. Manila.

¹⁸ ADB. 2014. *Technical Assistance to the Republic of Azerbaijan for Microfinance Sector Development*. Manila.

loan.¹⁹ As female clients are targeted to increase, the loans are classified as having some gender elements.

B. Anticorruption Policy

45. ABA and FIA were 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

46. The proposed senior loans from ADB's ordinary resources are within the medium-term country, industry, group, and single investment exposure limits for nonsovereign operations, and, in the case of ABA, loan disbursements will be monitored over the availability period to ensure that amounts will only be disbursed if, at the time of such disbursement, the single investment exposure limit is complied with.

D. Assurances

47. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),²⁰ ADB will take the necessary steps to ensure that the Government of Azerbaijan has no objection to the proposed assistance to ABA and FIA. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

VI. RECOMMENDATION

48. I am satisfied that the proposed loans would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve (i) a loan of \$75,000,000 or its AZN equivalent to AccessBank Azerbaijan, (ii) an A-loan of \$20,000,000 or its AZN equivalent to Finca Azerbaijan from ADB's ordinary capital resources, and B-loans of up to \$5,000,000 to Finca Azerbaijan, to be funded by participating commercial banks, for Improving Financial Service Outreach for Agriculture in Azerbaijan, 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

31 March 2015

¹⁹ Summary Poverty Reduction and Social Strategy; Safeguards and Social Dimensions Summary; and Financial Intermediaries: Environmental and Social Management System Arrangement (accessible from the list of linked documents in Appendix 2).

²⁰ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and/or Indicators with Baselines	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
<p>Impact Availability of commercial credit to agriculture in Azerbaijan increased</p>	<p>Commercial bank credit to agriculture sector increased to more than 8% of total credit in 2023 (2014 baseline: 5%)</p>	<p>CBAR reports</p>	<p>Assumption Banks develop ability to service rural markets</p> <p>Risks Political risks, economic volatility, and fiscal risks</p>
<p>Outcome ABA and FIA financial services to farmers and agriculture MSMEs sustained</p>	<p>ABA's volume of agriculture and agribusiness loans increases to \$500 million by 2022 (2014 baseline: \$190 million)</p> <p>ABA's volume of local currency deposits from retail customers increases to AZN500 million in 2022 (2014 baseline: AZN203 million)</p> <p>FIA's volume of agriculture MSME loans reaches \$260 million by 2022 (2014 baseline: \$130 million)</p>	<p>ABA reports</p> <p>FIA reports</p>	<p>Assumption Demand for new deposit products, and agriculture and MSME lending continues</p> <p>Risks Climate and agriculture risks impact the provision of services</p>
<p>Outputs</p> <p>ABA ABA's agriculture financing expanded</p> <p>ABA customers make active use of retail deposit and investment products</p> <p>ABA improves financial service coverage for women</p> <p>FIA FIA's agriculture financing expanded</p>	<p>ABA provides credit to 100,000 farmers and 1,000 agriculture SMEs (2020) (2014 baseline: 64,000 farmers and 127 agriculture SMEs)</p> <p>ABA has tested at least two agricultural value-chain financing channels by 2020</p> <p>By 2020, at least 10 ABA branches, of which at least 5 are outside Baku, have introduced new local currency retail products</p> <p>At least 50,000 women are serviced by ABA by 2020 (2014 baseline: 31,645)</p> <p>Number of FIA's SME borrowers exceeds 400 in 2018 (2014 baseline: 130)</p>	<p>ABA reports</p> <p>FIA reports</p>	<p>Assumption Loan demand from farmers continues to increase</p> <p>Risk Loan defaults increase</p>

Design Summary	Performance Targets and/or Indicators with Baselines	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
<p>Commercially viable mobile service approaches to remote regions are tested</p> <p>FIA improves financial service coverage for women</p>	<p>Number of FIA's MSME borrowers exceeds 170,000 in 2018 (2014 baseline: 156,000)</p> <p>FIA's new MSME loan product launched by 2018</p> <p>At least 1,000 FIA rural customers are served by branchless banking services by 2020</p> <p>At least 50,000 women are serviced by FIA by 2020 (2014 baseline: 43,500)</p>		
<p>Activities with Milestones</p> <ol style="list-style-type: none"> 1. ADB executes loan agreements with ABA and FIA (July 2015) 2. ADB executes risk participation and B-loan agreements by December 2015 3. Loans disbursed by June 2017 4. ADB provides technical assistance to support deposit mobilization and product development activities from June 2015 through December 2017.^a 5. Monitoring and review missions (2016 and onward) 		<p>Inputs</p> <p>Loans</p> <p>ADB: up to \$75 million loan to ABA</p> <p>ADB: up to \$25 million loan to FIA (including up to \$5 million B-loan)</p>	

ABA = AccessBank Azerbaijan, ADB = Asian Development Bank, CBAR = Central Bank of Azerbaijan, AZN = Azerbaijan manat, FIA = Finca Azerbaijan, MSMEs = micro, small, and medium-sized enterprises, PAR = portfolio at risk, SMEs = small and medium-sized enterprises.

Note: Portfolio at risk is defined as overdue loans (more than 90 days) as a percentage of the gross loan portfolio.

^a ADB. 2014. *Technical Assistance to the Republic of Azerbaijan for Capacity Building for Rural Financial Inclusion*. Manila.

Sources: ABA, FIA, and ADB.