



Periodic Financing Request Report

Project Number: 44060-027
June 2015

MFF 0048–KAZ: Small and Medium Enterprise Investment Program – Tranche 3 (Additional Financing)

This document is being disclosed to the public in accordance with ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 28 May 2015)

Currency unit	–	tenge (T)
T1.00	=	\$0.00538
\$1.00	=	T185.91

ABBREVIATIONS

ADB	–	Asian Development Bank
BCC	–	Bank CenterCredit
DAMU	–	Damu Entrepreneurship Development Fund
ESMS	–	environment and social management systems
MFF	–	multitranches financing facility
PAM	–	Project Administration Manual
PFI	–	participating financial institutions
SMEs	–	small and medium-sized enterprises

NOTE

In this report “\$” refers to US dollars.

Vice-President	W. Zhang, Operations 1
Director General	S. O’Sullivan, Central and West Asia Department (CWRD)
Director	B. Wilkinson, Public Management, Financial Sector, and Trade Division, CWRD
Team leader	I. Martinez, Private Sector Development Specialist, CWRD
Team members	G. Abel, Senior Portfolio Management Specialist (Integrity), CWRD R. Aquino, Operations Analyst, CWRD S. Campbell, Senior Social Development Specialist (Gender and Development), CWRD M. De Los Reyes, Treasury Specialist, Treasury Department N. Djenchuraev, Environment Specialist, CWRD C. Lim, Operations Assistant, CWRD M. Nurseitova, Economics Officer, CWRD D. Pham, Financial Management Specialist, CWRD D. Perkins, Counsel, Office of the General Counsel
Peer reviewer	S. Hruschka, Unit Head, Project Administration, Private Sector Operations Department

CONTENTS

	Page
TRANCHE AT A GLANCE	
I. BACKGROUND	1
II. ASSESSMENT OF MFF IMPLEMENTATION	2
III. PERIODIC FINANCING REQUEST	3
A. Impact and Outcome	3
B. Outputs	3
C. Investment and Financing Plans	4
D. Implementation Arrangements	4
E. Project Readiness	5
IV. DUE DILIGENCE	5
A. Economic and Financial	5
B. Governance	6
C. Poverty, Social and Gender Dimensions	6
D. Safeguards	6
E. Risks and Mitigating Measures	6
F. Risk Categorization	7
V. ASSURANCES AND CONDITIONS	7
VI. RECOMMENDATION	8

APPENDIXES

1. Periodic Financing Request from the Government
2. Revised Tranche Design and Monitoring Framework
3. Revised Project Administration Manual (tranche)
4. Updated Environmental Assessment and Review Framework
5. Gender Action Plan (unchanged from Tranche 3)
6. Summary of Poverty Reduction and Social Strategy (unchanged from Tranche 3)
7. Revised Economic Assessment
8. Revised Financial Assessment
9. Revised Contribution to the ADB Results Framework

SUPPLEMENTARY APPENDIXES

1. Loan Agreement
2. Guarantee Agreement
3. Project Agreements

TRANCHE AT A GLANCE

1. Basic Data		Project Number: 44060-027	
Project Name	MFF Small and Medium Enterprise Investment Program Tranche 3 (Additional Financing)	Department /Division	CWRD/CWPF
Country	Kazakhstan	Executing Agency	DAMU Entrepreneurship Development Fund
Borrower	Damu Entrepreneurship Development Fund		
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		98.00
		Total	98.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Private sector development (PSD)	Promotion of private sector investment	Effective gender mainstreaming (EGM)	✓
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. Risk Categorization: Low			
7. Safeguard Categorization Environment: FI Involuntary Resettlement: FI-C Indigenous Peoples: FI-C			
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		98.00	
Sovereign MFF-Tranche (Loan): Ordinary capital resources		98.00	
Cofinancing		0.00	
None		0.00	
Counterpart		24.50	
Beneficiaries		24.50	
Total		122.50	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		No	

10. Country Operations Business Plan

CPS

<http://www.adb.org/documents/kazakhstan-country-partnership-strategy-2012-2016>

COBP

<http://www.adb.org/documents/kazakhstan-country-operations-business-plan-2015-2017>**11. Tranche Summary**

On 29 September 2010, the Asian Development Bank (ADB) approved a multitranche financing facility (MFF) for the Kazakhstan Small and Medium Enterprise Investment Program for an aggregate amount not exceeding \$500 million. This is ADB's first sovereign operation that provides local currency (tenge) fixed interest rate financial intermediation loans which directly mitigate foreign exchange, interest rate and tenor mismatch risks for participating financial institutions (PFIs) and their small and medium-sized enterprise (SME) clients in Kazakhstan. The MFF is structured to have 3 or 4 tranches.

On 15 December 2014, ADB approved the tranche 3 project (Tranche 3), a \$130 million financial intermediation loan from ADB's ordinary capital resources, based on the periodic financing request received from the Government of Kazakhstan on 31 October 2014. The borrower, as in previous tranches, is Damu Entrepreneurship Development Fund (Damu), the government entity tasked with SME development. The loan will be guaranteed by the Republic of Kazakhstan. The internal processes to obtain the sovereign guarantee for this project have not yet finalized. Thus, the legal agreements for the Tranche 3 loan have not been executed to date and, accordingly, the loan has not yet been declared effective.

Given the deteriorating conditions for SME financing, Damu has requested \$98 million additional financing for Tranche 3, bringing the overall Tranche amount to \$228 million. Deposit dollarization has continued rising, going from 46% at the end of September 2014 to over 56% at the end of January 2015 fueled by fears of a new currency devaluation against the backdrop of the Russian crisis. Commercial banks continue to have a shortage of tenge liquidity and have stopped lending in local currency to SMEs. The Government has made an urgent call to SME development agencies like Damu to raise funding from donors to support SME lending, given the budgetary constraints exacerbated by the decline in the price of oil and the Russian crisis.

Tranche 3 will help Damu continue with the implementation of the government's Action Plan to increase access to medium term finance for SMEs. The funds will be relent in local currency (tenge) fixed-interest loans to qualified participating financial institutions (PFIs) to fund their respective market-based loans, leases and other financial products to SMEs.

Impact and Outcome: The impact will be sustained job creation and economic growth. The outcome will be SMEs have increased access to medium-term credit on a sustainable basis.

Outputs: (i) Medium-term financing to SMEs, and (ii) improved financial sector outreach, with a focus on women entrepreneurs.

Implementation Arrangements: DAMU Entrepreneurship Development Fund will be the executing agency.

Project Readiness: Damu provided a list of 13 commercial banks in Kazakhstan who were willing to expand their SME loan portfolios and could borrow from Damu within the prudent risk exposure limits established by Damu's Board of Directors. ADB and Damu agreed on a long list of seven potential PFIs based on preliminary compliance with selection criteria. Those PFIs confirmed their interest in participating in the program and confirmed a demand for up to T87.8 billion (\$480 million) of medium-term tenge fixed interest rate wholesale funding under Tranche 3 over the period 2015-2017. Most of the demand have come from medium-sized banks not overly exposed to the property market. Follow-up discussions with five short-listed PFIs supported the proposed size of the Tranche 3 loan.

The terms of relevant financing arrangements and structure of Tranche 3 have been agreed by ADB, Damu and the Ministry of Finance on behalf of the Republic of Kazakhstan as guarantor. The selection criteria and process for PFIs to be qualified to obtain subloans from Damu have been followed. Based on this, potential PFIs were short-listed and relevant financial management assessment, financial analysis and integrity due diligence were completed. SME eligibility criteria have also been established, along with a monitoring framework to track implementation progress, key project outputs, gender targets, and outcome.

This program is categorized as financial intermediary (FI) with respect to environment and social safeguards. Safeguards due diligence has been conducted to assess potential environmental and social risks and impacts associated with PFIs likely future portfolios, along with their commitment and capacity for environmental management. It is anticipated that PFI subprojects can have site-specific environmental impacts and pose moderate environment risks (category B for environment). No involuntary resettlement or impact to indigenous peoples for subproject is expected. Each PFI will have an environmental and social management system (ESMS) satisfactory to ADB and appoint designated staff to implement it before ADB's first disbursement. If at that time the PFIs do not have an ESMS satisfactory for the financing of the subproject that have site-specific environmental impacts, PFIs activity will be limited to subprojects with minimal or no environmental risk (Category C for environment). All PFIs will ensure that their subprojects are in compliance with applicable laws and regulations of Kazakhstan and ADB's Safeguard Policy Statement. PFIs will prepare and submit to ADB semi-annual environmental monitoring reports on ESMS implementation. Sample subprojects will be checked during review missions.

12. Significant Developments in the MFF and Previous Tranches

Tranche 1 loan became effective on 28 September 2011. ADB entered into a cross-currency swap to raise T22.2 billion (equivalent of \$150 million) with a fixed interest rate and 5-year bullet repayment. On the swap settlement date of 30 September 2011, ADB disbursed the entire Tranche 1 loan of T22.2 billion to Damu and Damu relent T7.4 billion each to three PFIs: Alliance Bank (ALB), Bank CenterCredit (BCC) and KazKommerts Bank (KKB). The project was completed on 21 September 2013. The PFIs disbursed the entire T22.2 billion to SME sub-borrowers by April 2013 and liquidation was completed by September 2013. As of 1 September 2014, on a cumulative basis, the PFIs had provided T48 billion of SME loans, of which 25% funded new investments, 63% financed working capital, and 12% refinanced existing loans. A total of 3,771 loans benefitted 897 SME borrowers. More than half of the loans were for the trade sector (48%), followed by services (21%). Over 2,200 new jobs were created. The average amount lent to each SME borrower was T53 million (\$290,000) and the average loan was T13 million (\$72,000). Women were 33% of total SME borrowers.

Tranche 2 was approved on December 2013, amounting to \$150 million (T22.5 billion at the time). Discussions for sourcing local currency either through a cross-currency swap or by ADB issuing a local currency bond were well advanced. However, market conditions changed in February 2014 as a result of a devaluation of the tenge of close to 20% against the dollar. Given Damu and the government's interest for quick disbursement, on 10 July 2014, ADB approved a minor change to the MFF to allow ADB to extend foreign currency denominated loans to Damu, provided that acceptable arrangements with the National Bank of Kazakhstan were in place to hedge the foreign currency risk during the loan period. The foreign currency risk has been hedged through internal swap agreements between the National Bank of Kazakhstan and each PFI. The sovereign guarantee for the loan was granted on 15 October 2014. Loan signing took place on 29 October 2014. Loan effectiveness and disbursement took place in November 2014. As of 31 January 2015, \$2.6 million equivalent had been disbursed to SME borrowers.

Through the processing and implementation of these tranches, Damu's institutional capacity has been strengthened. This was also supported by associated technical assistance, which was rated highly successful at its completion in 2013.

The FFA undertakings and loan covenants under Tranche 1 and 2 have been complied with.

13. Milestones

Estimated Approval	Estimated Effectiveness	Estimated Completion*
10 June 2015	10 July 2015	11 August 2016

14. Linked Documents

	Required Document	Disclosure Date
(i) Environment		
Weblink:		
(ii) Involuntary resettlement		
Weblink:		
(iii) Indigenous peoples		
Weblink:		

I. BACKGROUND

1. On 29 September 2010, the Asian Development Bank (ADB) approved a multitranche financing facility (MFF) for the Kazakhstan Small and Medium Enterprise Investment Program for an aggregate amount not exceeding \$500 million.¹ The facility was originally designed to provide local currency (tenge) fixed interest rate financial intermediation loans to participating financial institutions (PFIs) for onlending to small and medium-sized enterprises (SMEs).² The Tranche 1 project, with a cost of T22.2 billion (\$150 million equivalent), became effective on September 2011 and was completed on September 2013. The Tranche 2 project, with a cost of \$122 million, became effective on November 2014 and was fully disbursed to the PFIs in December 2014. Disbursements to SME borrowers began in January 2015.

2. On 15 December 2014 ADB approved the Tranche 3 project, a \$130 million financial intermediary loan from ADB's ordinary capital resources, based on the periodic financing request received from the Government of Kazakhstan on 31 October 2014. The borrower, as in previous tranches, is Damu Entrepreneurship Development Fund (Damu), the government entity tasked with SME development. The loan will be guaranteed by the Republic of Kazakhstan. The government's internal processes to obtain the sovereign guarantee for this project have not yet been finalized. Thus, the legal agreements for the Tranche 3 loan have not been executed to date. Accordingly, the loan has not yet been declared effective.

3. The conditions for SME financing have deteriorated since late 2014. Deposit dollarization has increased from 46% at the end of September 2014 to over 56% by the end of January 2015, fueled by fears of currency devaluation. Commercial banks continue to have a shortage of tenge liquidity and have stopped lending in local currency to SMEs.³ The government has made an urgent call to SME development agencies, including Damu, to raise additional funding from donors to support SME lending. The government's budgetary constraints, which are exacerbated by the decline in the price of oil and the Russian financial crisis, have led the government to request additional external financing.⁴

4. SME financing demand continues to be significant.⁵ The four PFIs under the Tranche 3 project have requested additional funding for the project, which could not be accommodated at the time of Tranche 3 approval given Damu's lending limits. Under the new circumstances, Damu has negotiated a revision of its lending limits with its sole shareholder (Baiterek) to increase its exposure with commercial banks and allow Damu to intermediate larger amounts raised from external funders.⁶

¹ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Multitranche Financing Facility to the Republic of Kazakhstan for the Small and Medium Enterprise Investment Program*. Manila.

² Currency market developments hindered sourcing of tenge since February 2014. A minor change in the MFF was approved to allow provision of foreign currency loans with appropriate hedging arrangements. Further details are in paras. 8 and 18 (below).

³ The dollarization of time deposits, the deficient functioning of the interbank market, and lack of effective monetary policy instruments are driving up the price of tenge liquidity.

⁴ The government has separately requested ADB for countercyclical budget support in the amount of \$1 billion.

⁵ Damu estimates SME demand for medium-term credit during 2015–2017 to be \$5 billion (T1,000 billion equivalent).

⁶ Baiterek is a wholly government-owned entity that represents the government's stake in the development finance institutions of Kazakhstan. It is Damu's sole shareholder. Damu's exposure limits are determined individually, but are aggregated at the holding level (Baiterek). Larger risk exposures to one borrower can be accommodated for holding entities such as Damu on a case-by-case basis, considering the overall holding exposure to that borrower. The European Bank for Reconstruction and Development and the World Bank are negotiating with Damu regarding possible financial intermediation loans to support SME lending. The World Bank is also preparing a new project to support SME competitiveness. ADB is working closely with these partners in SME development.

5. **Additional financing.** Damu has requested an increase of \$98 million in the ADB loan financing for the Tranche 3 project, bringing the aggregate financing to \$228 million, and exhausting the available resources under the MFF. A periodic financing request in respect of the additional financing was received on 6 March 2015 (Appendix 1). The additional financing will be used to expand the project and the program's outreach, increase the number of SME beneficiaries, and help address the increased unmet demand for local currency financing.

6. **Eligibility of additional financing.** The requested funding is in line with government's prioritization of SME support.⁷ The project's development objectives and expected impact and outcome remain unchanged with the additional financing. Tranche 3 is included in the country operations business plan.⁸ The project is expected to remain technically, economically, and financially viable. As such, the additional financing meets the eligibility criteria in ADB's Additional Financing policy.⁹

II. ASSESSMENT OF MFF IMPLEMENTATION

7. **Tranche 1.** The Tranche 1 loan became effective on 28 September 2011.¹⁰ ADB entered into a cross-currency swap to raise T22.2 billion (\$150 million equivalent) with a fixed interest rate and 5-year bullet repayment. On the swap settlement date of 30 September 2011, ADB disbursed the entire Tranche 1 loan of T22.2 billion to Damu, and Damu lent T7.4 billion each to three PFIs—Alliance Bank, Bank CenterCredit (BCC) and KazKommerts Bank. The project was completed on 21 September 2013.¹¹ The PFIs disbursed the entire T22.2 billion to SME subborrowers by April 2013 and liquidation was completed by September 2013.¹² As of 1 September 2014, on a cumulative basis, the PFIs had provided T48 billion of SME loans,¹³ of which 25% funded new investments, 63% financed working capital, and 12% refinanced existing loans. A total of 3,771 loans benefitted 897 SME borrowers. The majority of the loans were for the trade sector (48%), followed by services (21%). Over 2,200 new jobs were created. The average amount lent to each SME borrower was T53 million (\$290,000) and the average loan was T13 million (\$72,000). Women made up 33% of the SME borrowers.

8. **Tranche 2.** Tranche 2 was approved by the President on 13 December 2013 for the tenge equivalent of \$150 million.¹⁴ Discussions for sourcing local currency, through a cross-currency swap or by ADB's issuance of a local currency bond, were well advanced. However, market conditions changed in February 2014 as a result of a substantial devaluation of the

⁷ Government of Kazakhstan. 2014. *Kazakhstan's New Economic Policy*, Nurly Zhol (<http://www.kazakhembus.com/content/nurly-zhol-path-future>); Government of Kazakhstan. 2010. *Roadmap for Business-2020*. Astana.

⁸ ADB. 2014. *Kazakhstan: Country Operations Business Plan 2015–2017*. Manila. The government urgently requested part of this funding in late 2014. Thus, Tranche 3 for \$130 million was approved in December 2014.

⁹ ADB. 2010. *Additional Financing: Enhancing Development Effectiveness*. Manila, and ADB. 2011. *Additional Financing. Operations Manual*. OM H5/BP. Manila.

¹⁰ Loan signing and effectiveness were delayed due to (i) domestic requirements for issuance of the sovereign guarantee, including counter-guarantee of Damu's obligations under the tranche 1 loan and requirement of advance deposit of amounts due prior to the payment due date; and (ii) PFI implementation concerns regarding compliance with environmental and social safeguards requirements.

¹¹ Preparation of the project completion report for the Tranche 1 project has commenced and is expected to be completed by the end of 2015.

¹² ADB consented to two extensions of the disbursement period under the subsidiary loan agreements between Damu and each PFI, from 30 September 2012 to 31 July 2013.

¹³ Recycling of funds has started, increasing the impact of the tranche so far by a factor of 1.46.

¹⁴ The government approved a loan of T22.5 billion (which was \$150 million equivalent at loan approval); subsequent devaluation of the tenge in February 2014 resulted in a reduction in the government's approved Tranche 2 loan amount in dollar terms to \$122 million.

tenge. Damu and the government were seeking rapid disbursement of the funds, and on 10 July 2014 ADB approved a minor change to the MFF to allow ADB to extend foreign currency denominated loans to Damu, provided that acceptable arrangements were in place with the National Bank of Kazakhstan to hedge the foreign currency risk during the loan period. The PFIs for this tranche are BCC and Tsesna Bank. Loan signing and effectiveness took place on 29 October 2014 and 26 November 2014, respectively, after the approval of the government's resolution for the issuance of the sovereign guarantee on 15 October 2014. The tranche was disbursed to the PFIs in December 2014, and disbursement to SME subborrowers began in January 2015.

9. The Roadmap for Business 2020 is the key strategic document for this program. The implementation of the action plan to improve SME access to finance is on track.¹⁵ No significant changes have been made to the policy framework.

10. **Changes to the Design and Monitoring Framework.** During the Tranche 1 midterm review mission in November 2012, problems were identified with interpretation of the MFF and Tranche 1 design and monitoring framework performance indicator definitions, baseline and target years, and data sources. Corrections to the MFF design and monitoring framework were agreed upon during a review mission in April 2013 and finalized in August 2013.¹⁶

11. **Compliance.** The MFF framework financing agreement undertakings and Tranche 1 and Tranche 2 loan agreement covenants have been complied with. PFIs are in compliance with the National Bank of Kazakhstan's prudential requirements and other financial covenants. ADB's selection criterion of having a non-performing loan ratio below 10% proved difficult to meet, in particular for Alliance Bank and KazKommerts Bank under Tranche 1 and BCC under Tranche 2. Compliance was achieved though corrective action plans that are being monitored throughout implementation. Market developments are being monitored on a regular basis.

12. **Multitranchise financing facility utilization.** The Tranche 1, Tranche 2 and Tranche 3 loans equal \$402 million, leaving a balance of \$98 million, which has now been requested as additional financing for the Tranche 3 project. With the approval of this additional financing, the MFF resources will be exhausted. The availability period of the MFF is until 31 December 2018.

III. PERIODIC FINANCING REQUEST

A. Impact and Outcome

13. The additional financing for the Tranche 3 project will not change the outcome and the target values of the outcome indicators of the MFF. The impact of the overall Tranche 3 project will remain the same as the existing project: sustained job creation and economic growth. The outcome will be SMEs with increased access to medium-term credit on a sustainable basis, with target indicators increasing from T1,042 billion to T1,060 billion as a result of the impact of additional financing in Damu's SME programs.

B. Outputs

14. The outputs and activities remain unchanged: (i) medium-term financing to SMEs; and (ii) increased financial sector outreach, with a focus on women entrepreneurs and lending outside the bigger cities. As a result of the additional financing, two of the output performance

¹⁵ A status update on this Action Plan is included in the Project Administration Manual (Appendix 3).

¹⁶ A minor change allowing revisions to the MFF design and monitoring framework was approved by the President on 19 August 2013.

targets will increase—to 3,100 new SME loan accounts, up from 1,800; and T50 billion in SME loans, up from T30 billion. The revised tranche design and monitoring framework is in Appendix 2.

C. Investment and Financing Plans

15. The terms and conditions for additional financing will be substantially the same as those approved under Tranche 3. Since the Tranche 3 legal agreements have not been executed, revised legal documents for the tranche (reflecting the aggregate ADB financing amount of \$228 million, comprising the \$130 million currently approved for Tranche 3 and \$98 million of additional financing) have been prepared and agreed to (see supplementary appendixes). The additional loan will be provided from ADB's ordinary capital resources, guaranteed by the Republic of Kazakhstan. The additional loan will have (i) a 5-year term, with one principal repayment at loan maturity; (ii) an annual interest rate determined in accordance with ADB's London interbank offered rate-based lending facility; (iii) a commitment charge of 0.15% per year on the full amount of the loan (less all drawdown amounts disbursed from time to time) commencing 60 calendar days after the date of the loan agreement; and (iv) such other terms and conditions as are set forth in the draft loan, guarantee and project agreements.

16. To ensure that the PFIs are not exposed to currency risk and can lend to borrowers in local currency, ADB will require that hedging arrangements are in place for Damu and the PFIs. Given financial market conditions, the options for ADB to raise tenge funds to provide a local currency loan are currently limited to the possibility of ADB issuing a local currency bond. While this option continues to be explored, such a bond may not be issued on time to fund Tranche 3. Thus, a US dollar loan with appropriate currency hedging arrangements, similar to Tranche 2 and consistent with the MFF is the preferred option. Under Tranche 2, the PFIs entered into long-term swap agreements with the National Bank of Kazakhstan.

17. The revised investment and financing plan is in Table 1.

Table 1: Revised Investment and Financing Plan

Source	Current		Additional Financing		Total	
	Amount (\$ million)	Share of Total (%)	Amount (\$ million)	Share of Total (%)	Amount (\$ million)	Share of Total (%)
Asian Development Bank						
Financial intermediation loan ^a (subloans from PFIs)	130.0	80.0	98.0	80.0	228.0	80.0
SME subborrowers ^b	32.5	20.0	24.5	20.0	57.0	20.0
Total	162.5	100.0	122.5	100.0	285.0	100.0

PFIs = participating financial institutions, SMEs = small and medium-sized enterprises.

^a Using the proceeds of the Asian Development Bank's financial intermediation loan to Damu.

^b Estimated value of equity, collateral and third party guarantees contributed by SME subborrowers.

Sources: Asian Development Bank and Damu estimates.

D. Implementation Arrangements

18. Implementation arrangements will remain the same as those approved under Tranche 3. Damu will be the executing agency responsible for overall implementation, including administration and disbursement of the proceeds of the ADB loan. The additional financing will be allocated to the same four PFIs, with each acting as the implementing agency for their

allocation under a subsidiary loan agreement with Damu and a project agreement with ADB.¹⁷ Implementation arrangements are summarized in Table 2 and described in detail in the revised Tranche 3 Project Administration Manual (PAM, Appendix 3).

Table 2: Implementation Arrangements

Aspects	Arrangements
Implementation period	June 2015–July 2016 ^a
Estimated project completion date	31 July 2016
Estimated loan closing date	1 year and 60 days from loan signing (approximately August 2016)
Management	
(i) Executing agency	Damu
(ii) Key implementing agencies	Qualified PFIs (Delta Bank, Kazinvest Bank, KazKommerts Bank, Tsesna Bank)
Disbursement	Loan proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2012, as amended from time to time), and arrangements agreed to between Damu, PFIs and ADB.

ADB=Asian Development Bank, Damu=Damu Entrepreneurship Development Fund, PFIs=participating financial institutions.

^a PFIs will be given 12 months from receipt of the loan proceeds to disburse to subborrowers. Actual implementation dates may be shifted depending on the sovereign guarantee issuance for the overall Tranche 3 project.

Sources: Asian Development Bank and Damu.

E. Project Readiness

19. The additional financing will be channeled through the four PFIs selected for Tranche 3, whose interest and readiness to disburse the loan proceeds to qualified SMEs is confirmed. The terms of relevant financing arrangements have been agreed between ADB, Damu and the Ministry of Finance (on behalf of the Republic of Kazakhstan as guarantor) and remain substantially the same as those for Tranche 3.

IV. DUE DILIGENCE

20. Due diligence has been undertaken to update the findings from the one conducted for the current Tranche 3. Given the short time lag since approval of the current Tranche 3, there is limited new information to incorporate into the assessments. Relevant appendixes have been revised (PAM, Economic Assessment, Financial Assessment and Contribution to ADB's Results Framework) and are included in the appendixes of this Periodic Financing Request Report. The Summary Poverty Reduction and Social Strategy remains unchanged from the one approved under Tranche 3 (Appendix 6).

A. Economic and Financial

21. The financial performance of Damu and the PFIs was reviewed to ensure that they remain compliant with prudential regulations, asset quality, profitability ratios and other requirements to qualify for Tranche 3.¹⁸ Compliance was confirmed. Findings from the financial analysis conducted for the current Tranche 3 have not changed as result of the additional financing.

¹⁷ The allocation of the additional financing is proposed as follows: \$36 million to Tsesna Bank, \$15 million to KazKommerts Bank, \$35 million to Delta Bank, and \$12 million to Kazinvest Bank.

¹⁸ ADB. 2003. Financial Intermediation Loans. *Operations Manual*. OM D6/BP. Manila. Key benchmark ratios for selection were: (i) compliance with National Bank of Kazakhstan's prudential regulations, (ii) a credit rating of at least "B-", (iii) a ratio of total non-performing loans to total loans of less than 10%, and (iv) be profitable for its most recently completed fiscal year.

B. Governance

22. The financial management assessment of Damu and the PFIs done for Tranche 3 was updated, and findings remain the same. Monitoring of PFI's compliance with eligibility criteria and with ADB's Safeguard Policy Statement will follow the same procedures as those agreed under Tranche 3. The auditing procedures of Damu and the PFIs will meet ADB requirements.

23. Integrity due diligence was performed to update the findings of the assessment conducted under Tranche 3, with no relevant changes.¹⁹ ADB's Anticorruption Policy (1998, as amended to date) was explained and discussed with Damu and the PFIs. Specific policy requirements and other measures are described in the PAM.

C. Poverty, Social and Gender Dimensions

24. Social and gender impacts remain the same as those described under Tranche 3. The Gender Action Plan remains unchanged and is in the PAM (Appendix 3).

D. Safeguards

25. The safeguards assessments and classification of the project remain the same as those for Tranche 3. This program is categorized as financial intermediary (FI) with respect to environment and FI (treated as C) for involuntary resettlement and indigenous peoples, following ADB's Safeguard Policy Statement (2009) categorization. The additional financing for the Tranche 3 project will not fund activities that are Category A for environment and social safeguards, or Category B for social safeguards.²⁰ ADB's prohibited investment activity list will be appended to the loan agreement and each project agreement. Safeguards due diligence was conducted while processing Tranche 3 to assess potential environmental and social risks and impacts associated with the likely future portfolios of the PFIs, along with their commitment and capacity for environmental management. No subproject involuntary resettlement or indigenous peoples impacts are expected.

26. In response to due diligence conducted while processing Tranche 3, the four PFIs are currently increasing their capacity and upgrading their environment and social management systems (ESMSs), partly with the support of ADB. ADB will ensure that satisfactory ESMSs are adopted by the PFIs before ADB's first disbursements. Damu's capacity to review PFI performance under ESMS requirements will be further enhanced. In case of any non-compliance, Damu will prepare a corrective action plan and submit it to ADB for review and approval.

E. Risks and Mitigating Measures

27. The potential risks remain largely the same as those identified under Tranche 3, though macroeconomic risks triggered by external shocks to the economy are now greater. The risks

¹⁹ There have been changes in the ownership structures of Kazinvest Bank and KazKommerts Bank, two of the participating financial institutions. These changes are reflected in the updated Financial Assessment and Project Administration Manual. Integrity due diligence was conducted on new shareholders in accordance with ADB. 2010. *Enhancing the Asian Development Bank's role in combating money laundering and the financing of terrorism. Operations Manual*. OM Section C6/BP. Manila. It is recognized that Kazakh banks predominantly have politically exposed persons as investors.

²⁰ See Appendix 4. Environmental Assessment and Review Framework.

will continue to be addressed by mitigating measures in consultation with Damu and the government. Major risks and mitigating measures are in Table 3.

Table 3: Summary of Potential Risks and Mitigation Measures

Risks	Mitigating Measures
Macroeconomic instability continues putting pressure on the currency, which can result in sudden, large, and disruptive capital outflows and may lead to another devaluation	The National Bank of Kazakhstan has large international reserves and remains focused on restoring market confidence. A new de-dollarization plan has recently started to be implemented. Tranche 3 and additional financing resources will be provided in local currency to PFIs (or in foreign currency with appropriate hedging arrangements) and onlent to SMEs in local currency, limiting the impact of a potential devaluation.
Government-subsidized lending programs distort market competition	Ongoing dialogue with Damu and MNE to ensure that new subsidized lending programs do not compete with the project.
PFIs face constraints to expansion of SME portfolios due to i) limited experience with non-collateral-based lending, and ii) higher-than-expected delinquency rates because of limited experience in managing these portfolios	PFIs are willing and have the ability to lend to SMEs as evidenced by solvency, liquidity, NPL levels, and profitability. Most of the selected PFIs have lower NPLs than the sector average. ADB and Damu will review and support steps taken by PFIs to improve internal audit and corporate governance practices and reduce portfolio concentrations. Training on risk management and SME lending methodologies is envisaged.
Adoption of Basel III regulations may put some PFIs in breach of compliance with NBK prudential limits	ADB and Damu will monitor PFI compliance with eligibility criteria. Action plans will be agreed on if necessary.

ADB = Asian Development Bank, Damu = Damu Entrepreneurship Development Fund, MNE = Ministry of National Economy, NBK= National Bank of Kazakhstan, NPL= non-performing loan, PFI = participating financial institution, SMEs = small and medium-sized enterprises.
Source: Asian Development Bank.

F. Risk Categorization

28. The risk categorization is low risk because the additional financing does not exceed \$200 million, ADB has good experience in the sector through tranches 1 and 2, Damu has developed capacity for externally-financed project administration, and the safeguard categorization is FI (B for the environment, and C for all other areas).

V. ASSURANCES AND CONDITIONS

29. The government, Damu and the PFIs have assured ADB that implementation of the project shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and legal documents. Damu and the PFIs have agreed with ADB on covenants set forth in the loan and project agreements.

30. It is a condition of loan effectiveness that (i) the subsidiary loan agreements, each in the form and substance acceptable to ADB, shall have been duly executed and delivered on behalf of, and shall have become legally binding upon, the relevant PFIs and Damu, and all conditions precedent to their effectiveness, other than a condition requiring the effectiveness of the loan agreement, shall have been fulfilled; and (ii) each PFI has established an ESMS to the satisfaction of ADB and appointed designated staff trained in implementing the ESMS to screen

prospective subprojects.

VI. RECOMMENDATION

31. On the basis of the approval by ADB's Board of Directors for the provision of loans under the multitranche financing facility in an aggregate principal amount not exceeding the equivalent of \$500,000,000 to Damu Entrepreneurship Development Fund for the Small and Medium Enterprise Investment Program, it is recommended that the President approve the proposed additional financing of the Tranche 3 project as described in para. 15 of this report and the revised draft guarantee agreement, loan agreement and project agreements for Tranche 3 substantially in the forms attached to this report.