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The World Bank

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Report No: 101012-TR

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF USD200 MILLION

TO

TÜRKİYE HALK BANKASI A.Ş. (HALKBANK)

WITH THE GUARANTEE OF

THE REPUBLIC OF TURKEY

FOR A

MICRO SMALL AND MEDIUM ENTERPRISE  
AND LARGE ENTERPRISE SUPPLY CHAIN FINANCE PROJECT

DECEMBER 1, 2015

Finance and Markets Global Practice  
Turkey Country Unit  
Europe and Central Asia Region

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**CURRENCY EQUIVALENTS**  
(Exchange Rate Effective Oct 8, 2015)  
Currency Unit = Turkish Lira (TL)  
TL 2.94 = USD 1  
USD 1.13 = EUR 1  
USD 1.41 = SDR 1

**FISCAL YEAR**  
January 1 – December 31

**ABBREVIATIONS AND ACRONYMS**

BRSA	Banking Regulation and Supervision Agency
CAR	Capital Adequacy Ratio
CAD	Current Account Deficit
CPS	Country Partnership Strategy
DIBs	Development and Investment Banks
DPL	Development Policy Loan
EFIL	Export Finance Intermediation Loan
EU	European Union
LEs	Large Enterprises
FI	Financial Intermediary
FM	Financial Management
GDP	Gross Domestic Product
HQ	Headquarters
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IDA	International Development Agency
IFRs	Interim Financial Reports
IFRS	International Financial Reporting Standards
LE	Large Enterprise
MENA	Middle East and North Africa
MIGA	Multilateral Investments Guarantee Agency
MSMEs	Micro, Small and Medium Enterprises
NDP	National Development Plan
NPL	Non-Performing Loan
OM	Operational Manual
PAD	Project Appraisal Document
PDO	Project Development Objective
PIU	Project Implementation Unit
ROA	Return On Assets
ROE	Return On Equity
SMEs	Small and Medium Enterprises
SOBs	State-Owned Banks
TBA	Turkish Bankers Association
TL	Turkish Lira
WB	World Bank

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**TURKEY**  
**Micro Small and Medium Enterprise and Large Enterprise Supply Chain Finance Project**

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## PAD DATA SHEET

Turkey

*Micro Small and Medium Enterprise  
and Large Enterprise Supply Chain Finance Project (P157691)*

### PROJECT APPRAISAL DOCUMENT

*EUROPE AND CENTRAL ASIA*

*FINANCE AND MARKETS GLOBAL PRACTICE*

Report No.: 101012-TR

Basic Information			
Project ID P157691	EA Category F - Financial Intermediary Assessment	Team Leader(s) Ilias Skamnelos, Alper Ahmet Oguz	
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]		
	Financial Intermediaries [ X ]		
	Series of Projects [ ]		
Project Implementation Start Date 25-Jan-2016	Project Implementation End Date 25-Jan-2019		
Expected Effectiveness Date 01-Feb-2016	Expected Closing Date 01-Jul-2019		
Joint IFC No			
Practice Manager/Manager Aurora Ferrari	Senior Global Practice Director Gloria M. Grandolini	Country Director Johannes C.M. Zutt	Regional Vice President Cyril E Muller
Borrower: Türkiye Halk Bankası A.Ş. (Halkbank)			
Responsible Agency: Türkiye Halk Bankası A.Ş. (Halkbank)			
Contact: Telephone No.:	Ali Fuat Taşkesenlioğlu 902165035917	Title: Email:	General Manager halkbank.ir@halkbank.com.tr
Project Financing Data(in USD Million)			
[ X ] Loan	[ ] IDA Grant	[ ] Guarantee	
[ ] Credit	[ ] Grant	[ ] Other	
Total Project Cost:	200.00	Total Bank Financing:	200.00
Financing Gap:	0.00		

<b>Financing Source</b>	<b>Amount</b>
Borrower	0.00
International Bank for Reconstruction and Development	200.00
<b>Total</b>	<b>200.00</b>

**Expected Disbursements (in USD Million)**

Fiscal Year	2016	2017	2018	2019	2020
Annual	25.00	50.00	50.00	50.00	25.00
Cumulative	25.00	75.00	125.00	175.00	200.00

**Institutional Data**

**Practice Area (Lead)**

Finance & Markets

**Cross Cutting Topics**

Climate Change
  Jobs  
 Fragile, Conflict & Violence
  Public Private Partnership  
 Gender

**Sectors / Climate Change**

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Finance	SME Finance	75		
Finance	Banking	25		
<b>Total</b>		<b>100</b>		

I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

**Themes**

Theme (Maximum 5 and total % must equal 100)

Major theme	Theme	%
Financial and private sector development	Micro, Small and Medium Enterprise support	75
Financial and private sector development	Other Financial Sector Development	25
<b>Total</b>		<b>100</b>

**Proposed Development Objective(s)**

The Project Development Objective (PDO) is to improve access to finance for micro, small and medium enterprises, and longer term finance to large enterprises involved in domestic supply chains.

<b>Components</b>		
<b>Component Name</b>	<b>Cost (USD Millions)</b>	
The establishment and operation of a credit facility for the provision of Sub-loans to MSMEs and LEs to finance the carrying out of Sub-projects.	200.00	
<b>Systematic Operations Risk- Rating Tool (SORT)</b>		
<b>Risk Category</b>	<b>Rating</b>	
1. Political and Governance	Low	
2. Macroeconomic	Moderate	
3. Sector Strategies and Policies	Moderate	
4. Technical Design of Project or Program	Low	
5. Institutional Capacity for Implementation and Sustainability	Low	
6. Fiduciary	Low	
7. Environment and Social	Low	
8. Stakeholders	Low	
9. Other		
<b>OVERALL</b>	Moderate	
<b>Compliance</b>		
<b>Policy</b>		
Does the project depart from the CPS in content or in other significant respect?	Yes [ ] No [ X ]	
Does the project require any waivers of Bank policies?	Yes [ ] No [ X ]	
Have these been approved by Bank management?	Yes [ ] No [ X ]	
Is approval for any policy waiver sought from the Board?	Yes [ ] No [ X ]	
Does the project meet the Regional criteria for readiness for implementation?	Yes [ X ] No [ ]	
<b>Safeguard Policies Triggered by the Project</b>	<b>Yes</b>	<b>No</b>
Environmental Assessment OP/BP 4.01	X	
Natural Habitats OP/BP 4.04		X
Forests OP/BP 4.36		X
Pest Management OP 4.09		X
Physical Cultural Resources OP/BP 4.11		X
Indigenous Peoples OP/BP 4.10		X
Involuntary Resettlement OP/BP 4.12		X
Safety of Dams OP/BP 4.37		X

Projects on International Waterways OP/BP 7.50			X
Projects in Disputed Areas OP/BP 7.60			X
<b>Legal Covenants</b>			
<b>Name</b>	<b>Recurrent</b>	<b>Due Date</b>	<b>Frequency</b>
Eligibility Criteria, Approval Procedures, and Terms and Conditions of Enterprise Sub-loans	X		Continuous
<b>Description of Covenant</b>			
Sub-loans to enterprises shall be made only in accordance with the Eligibility Criteria, Terms, Conditions and Approval Procedures listed in Loan Agreement Schedule 2 Section I.			
<b>Name</b>	<b>Recurrent</b>	<b>Due Date</b>	<b>Frequency</b>
Disbursement condition	X		Continuous
<b>Description of Covenant</b>			
No withdrawal shall be made for payments made prior to the date of the Loan Agreement, except that withdrawals up to an aggregate amount not to exceed \$30,000,000 may be made for payments made prior to this date but on or after January 15, 2015, for Eligible Expenditures under the Project.			
<b>Conditions</b>			
<b>Source Of Fund</b>	<b>Name</b>	<b>Type</b>	
IBRD	Operational Manual	Effectiveness	
<b>Description of Condition</b>			
The Borrower shall have adopted the Operational Manual satisfactory the Bank.			
<b>Team Composition</b>			
<b>Bank Staff</b>			
<b>Name</b>	<b>Role</b>	<b>Title</b>	<b>Unit</b>
Ilias Skamnelos	Team Leader (ADM Responsible)	Lead Financial Sector Specialist	GFMDR
Alper Ahmet Oguz	Team Leader	Senior Financial Sector Specialist	GFMDR
Salih Bugra Erdurmus	Procurement Specialist	Procurement Specialist	GGODR
Zeynep Lalik	Financial Management Specialist	Sr Financial Management Specialist	GGODR
Arzu Uraz	Safeguards Specialist	Social Development Specialist	GSURR
Donato De Rosa	Team Member	Program Leader	ECCU6
Esra Arikan	Safeguards Specialist	Senior Environmental Specialist	GENDR
Jasna Mestnik	Team Member	Finance Officer	WFALA
Jimena Garrote	Counsel	Senior Counsel	LEGLE
Ulrich Bartsch	Team Member	Lead Economist	GMFDR

## I. STRATEGIC CONTEXT

### A. Country Context

1. **Turkey's post-2001 economic development has resulted in impressive economic achievements.** After a banking crisis in 2001, the country embarked on a concerted path of structural reforms supported by strong fiscal consolidation, strengthened banking supervision, and a shift to a flexible exchange rate regime with an independent central bank responsible for inflation targeting. Per-capita income and the incomes for the bottom 40 percent tripled since the start of the century, but, in several dimensions of well-being, Turkey remains solidly a middle income country, facing numerous structural challenges.

2. **Turkey's achievements have recently been challenged by a less favorable economic and political outlook, and a large yet narrowing current account deficit in deteriorating financing conditions.** After a swift rebound from the recession of the global crisis of 2008-09, economic growth slowed significantly since 2012. Despite strong exports and supportive government spending, real GDP growth dropped to 2.9 percent in 2014. Exchange rate pass-through and higher food prices pushed inflation to 8.2 percent by end 2014, above the Central Bank's target rate. Moderate growth and exchange rate depreciation reduced external imbalances, and the current account deficit (CAD) narrowed to below six percent of GDP in 2014, from close to 10 percent in 2011. Nevertheless, the CAD remains large, while financing becomes challenging. The hoped-for external adjustment fueled by a weaker lira and significantly lower oil prices has not materialized. Despite a significantly lower energy deficit, Turkey's CAD widened to USD43 billion in the 12 months through August 2015 (gold adjusted). The deterioration is mainly due to weaknesses in trading partners, particularly slow growth in the European Union (EU), difficulties in the Middle East and North Africa (MENA) and Russia, and a fall in tourism revenues over the summer of 2015. On the financing side, domestic political concerns and global financial market jitters dried up short-term inflows.

3. **The growth outlook remains cautious, despite a stronger than expected first half in 2015.** Economic growth surprised positively with 3.4 percent in the first half of 2015, up from 2.9 percent in 2014, despite political uncertainty in the run-up to the June parliamentary election. The election results of November 1, 2015, have provided clarity over political uncertainties. Economic activity is expected to decelerate in the second half of 2015. Consumer confidence hit the lowest level since January 2009, and business confidence dropped notably in August and September. Moreover, credit growth momentum fell below the Central Bank's reference rate of 15 percent by mid-September. On the external side, considering the deterioration in the gold and energy adjusted current account balance, the positive impact of lower oil prices on the current account will be very limited. Against this backdrop, we see growth slightly rising to 3.2 percent, from 2.9 percent in 2014, CAD easing to 5.5 percent of GDP, and inflation remaining above the Central Bank's target in 2015. Over the medium-term, Turkey's growth prospects depend on the recovery of private investment, structural reforms and stronger economic institutions.

## **B. Sectoral and Institutional Context**

4. **The bank-dominated financial sector in Turkey lacks the depth one would expect given the size of the economy.** Total financial system assets amounted to about 180 percent of GDP in 2014, with the emerging market economies average at over 195, and newly industrialized Asian economies above 620. Banks represent almost 90 percent of the financial sector and 114 percent of GDP (with banking sector credit and deposits at 71 and 60 percent of GDP, respectively). The banking system remains highly-capitalized (Capital Adequacy Ratio – CAR– of 16.3 percent as of December 2014) and profitable (Return on Assets –ROA– and Return on Equity –ROE– of 1.3 percent and 12.3 percent, respectively), with a significant improvement in asset quality (Non-Performing Loan –NPL– ratio of 2.8 percent in December 2014, after reaching five percent in 2009). Despite significant progress to deepen the capital market, the diversity of corporate debt instruments is limited, banks dominate issuances and bonds are almost exclusively floating rate securities with an average maturity of one year and overall less than three years to maturity.

5. **Micro, Small and Medium Enterprises (MSMEs) are the most affected by access to finance constraints, despite playing a critical role in employment and growth.** MSMEs are estimated to account for 99.9 percent of all enterprises, 76 percent of employment, 54 percent of investments, and 60 percent of exports. The last Investment Climate Assessment -From Crisis to Private Sector Led Growth (May 2010)- found strong evidence that MSMEs face disproportionate constraints in accessing finance. Overall, they receive only 27 percent of total loans and grow slower relative to both large enterprises in Turkey and MSMEs in peer comparison countries. Micro enterprises are particularly affected, receiving only 25 percent of MSME loans in volume, while accounting for over 75 percent of MSME borrowers. The IFC Enterprise Finance Gap Database of 2014 estimates a significant Small and Medium Enterprise (SME) credit gap of over USD72 billion.

6. **The banking sector is increasingly experiencing performance headwinds, impacting credit growth and MSMEs that are the most affected by financing pressures during a deceleration.** The banking sector’s profitability has decreased in recent years (compared to ROA and ROE of 1.6 and 14.2 percent, respectively, in 2013, and even higher rates prior to the global financial crisis). With the sector’s loan to deposit ratio increasing to 121 percent, in the face of external funding volatility due to global market uncertainty, and in part due to macro-prudential measures to curb household borrowing, credit growth has slowed down, dropping to 18.5 percent as of end 2014, about nine percentage points slower than the average of past years. Notably, the MSME share in total credit declined in the aftermath of the global crisis by about five percentage points to just over 20 percent in 2009, the sharp fall demonstrating how MSMEs are among the first and most affected during financial distress. During economic downturns, working capital becomes a priority for MSMEs as they typically experience delays in the payments for goods sold and services provided.

7. **The banking sector also lacks sufficient access to long-term finance** (see Annex 3). The banking system is funded mostly by stable customer deposits, backing 53 percent of total assets. However, about 87 percent of the sector’s deposits had maturity below three months, while 77 percent of the lending was concentrated above three months. Characteristically, only 4.1 percent of deposits had maturity of over one year, dropping to only 1.6 percent for Turkish

Lira (TL) deposits. The result is a negative liquidity gap (i.e. more liquid liabilities than assets, also known as the liquidity mismatch risk) that peaks in the one to five year maturity. With the system's loan to deposit ratio increasing to 121 percent in December 2014, banks have drawn on balance sheet liquidity and wholesale funding from abroad (with foreign liabilities to total assets standing at 22 percent). However, the maturity of the sector's foreign liabilities barely breaches three years. Longer term sources of foreign debt, through for instance securitizations and subordinated debt, remain limited and constitute just above 15 percent of the total. In addition, following the Banking Regulation and Supervision Agency's (BRSA) authorization in 2010, banks began to issue domestic bank bonds, with tenor ranging between six to 18 months. Nevertheless, only 1.5 percent of total assets are funded by Turkish lira bonds, while the weighted average of the maturity remains relatively short.

8. **Medium and large enterprises are particularly constrained by the lack of long-term finance, indirectly impacting MSMEs integrated into their local supplier chains.** Long term finance reduces firms' exposure to rollover and interest rate risks, enabling them to undertake longer term fixed investments. Medium and large enterprises, many times exporting firms, frequently undertake lumpy purchases of physical investment to remain competitive or explore new markets. The banking sector is the largest provider of long term finance in Turkey, and is characteristically facing maturity mismatches from limited access to long-term finance. In addition, banks and large enterprises (that are typically able to tap financial markets directly) have been negatively affected from the recent volatility on international markets through worsening loan availability and terms. Ultimately, MSMEs participating in supply chains, whereby smaller enterprises are integrated as local suppliers of larger enterprises, are strongly impacted by the effect of the economic uncertainty on the buyers of their goods and services.

9. **Halkbank's strategy is to increase the share of MSMEs in its loan portfolio, by ramping up existing and recently launched programs focused on smaller enterprises and the supply chain.** Halkbank is owned 51.06 percent by the State, the remaining floated through public offerings in 2007 and 2012, and was the seventh-largest bank in Turkey by total assets in 2014. The bank has traditionally focused on the MSME segment as a core business line. It had about 1.2 million MSME clients in 2014, accounting for over half of its total non-retail client base, with significant penetration in rural areas. It has the largest share of MSME loans in its loan portfolio among state-owned banks, at 39 percent, above the sector average of 27 percent. Halkbank has several products targeting the supply chain and MSMEs. Among them, Halkbank's artisan and craftsman loan program extends MSME loans with a guarantee from cooperatives, reaching more than 300 thousand clients. Building on this, Halkbank has recently developed a program graduating eligible clients in financing without the involvement of cooperatives or collateral. Another product, called direct borrowing system, aims to facilitate the cash flow between large producers and their MSME distributors. Halkbank extends a credit line for distributors' purchases from producers, and the producers are paid upon submitting invoices. The program helps producers reduce the risk of payment default, and distributors to increase sales. Finally, the MSME card program facilitates MSMEs by deferring payments for supplies and raw materials used in their production lines.

10. **Halkbank, similar to the overall banking sector, faces limited access to long term funding** (see Annex 3). Halkbank relies on short-term demand and time deposits as the primary source of funding, with customer deposits representing more than 75 percent of its liabilities.

Overall, almost 82 percent of the bank's liabilities had remaining maturities of one year or less, while over 47 percent of the bank's assets had remaining maturities of over a year. As a result, Halkbank had a negative liquidity gap spiking at the one to five year maturity. This is, indeed, in line with most of the banking sector in Turkey. However, Halkbank's loan portfolio above five years constitutes only eight percent of the total, well below the sector's average of 15 and the state-owned Vakif Bank and TKB figures of 22 and 33 percent respectively. Notably, Halkbank's loan to asset ratio increased significantly compared to the rest of the banking sector during the global credit crunch in 2007-09, playing an important counter-cyclical role when the economy was shrinking and the private banks were reluctant to provide loans to MSMEs.

**11. The World Bank has been working through various channels to support MSMEs, with Halkbank being a valuable partner in these efforts.** Over the past ten years, the World Bank has provided three credit lines focused exclusively on access to finance for SMEs (SME I – P082822, SME II – P118308, SME III – P130864), out of a total of 13 focused additionally on exporters and energy efficiency. Halkbank has been a key partner of the World Bank through SME I and the Small and Medium Enterprises Energy Efficiency project (P122178). Overall, reviews of Implementation Completion Reports of lines of credit in Turkey by the World Bank Group's Independent Evaluation Group rate outcomes above Satisfactory (see Section C), and the 2011 study "EFIL and SME Credit Line Projects: An Assessment of Outcomes" concluded that the projects were successful in targeting the medium- to long-term working capital and investment finance needs of exporters and MSMEs. The study was based on a survey of final borrowers, some 400 EFIL and SME project beneficiaries, and 200 control firms. Such lines of credit act as a bridge until financial infrastructure constraints are lifted and alternative sources of long-term finance are in place, which can be a long-term process. Recent and ongoing World Bank work on financial inclusion and infrastructure (see Annex 3, Box 1) includes a financial inclusion landscape report, as well as advisory support on the financial inclusion strategy and microfinance regulation, the movable collateral regime, the credit bureau capacity, and the insolvency and secured transactions framework.

**12. The government has been taking significant steps to increase long term finance, in many instances with the support of the World Bank** (see Annex 3, Box 1). The Capital Markets Law was passed in 2012, supported by the World Bank's "Competitiveness and Savings" Development Policy Loan (DPL, P127787). The Law aims to make capital markets deeper, more competitive and transparent. Recent World Bank work in Turkey has produced a Corporate Bond report, supported the drafting of new rules under the new Capital Markets Law, and produced a Mutual Fund report to support regulators and market players in strengthening Turkey's non-bank financial sector. The World Bank has also prepared a series of diagnostic reports and an action plan to address the remaining challenges and continues working on areas including the development of institutional investors, market infrastructure, potential issuers, promoting equity finance and usage of new products (e.g. long term *Sukuk*, mortgage backed securities, covered bonds, and infrastructure bonds).

### **C. Higher Level Objectives to which the Project Contributes**

**13. The project is consistent with and supports the IBRD/IFC/MIGA Country Partnership Strategy (CPS) for the FY12-16 period, including the updated Progress Report.** The CPS has three main strategic objectives and pillars: (i) enhanced competitiveness

and employment; (ii) improved equity and public services; and (iii) deepened sustainable development. The project supports the strategic objectives of enhancing competitiveness and employment that includes the provision of medium and long-term funding to MSMEs. The project is also complementary to other private and financial sector initiatives, including: (i) the Financial Sector Development technical assistance project that aims to support the development of the capital markets, the non-bank financial sector, and financial infrastructure, for example in the area of secured transactions; (ii) ongoing World Bank line of credit operations (Innovative Access to Finance – P147183, SME III – P130864, and SME Energy Efficiency – P122178) that aim to provide medium to long-term finance to MSMEs and exporters; and (iii) ongoing IFC projects targeting MSMEs, through bonds purchases and loans. In particular the proposed operation is a natural continuation of the SME series of projects (SME I-III, P107173, P118308, P130864) that focused on MSMEs.

14. **The project is also consistent with the government’s latest MSME Strategy and Action Plan, as well as the 10th National Development Plan (NDP).** The new five-year NDP was adopted by the government of Turkey in July 2013 and covers the period 2014 to 2018. Access to finance was one of the five strategic areas under the 2011-13 MSME Strategy, and a key provision of the 2007-13 NDP under the “Entrepreneurship and MSMEs” and the “Financial Markets” sections. The recently introduced SME Development Strategy and Action Plan (2015-18) also designated “Facilitating SMEs Access to Finance” as one of its five strategic targets. Key objectives include increasing the access of SMEs to bank finance and alternative financial sources of finance.

## II. PROJECT DEVELOPMENT OBJECTIVES

### A. Project Development Objectives

15. **The Project Development Objective (PDO) is to improve access to finance for micro, small and medium enterprises, and longer term finance to large enterprises involved in domestic supply chains.**

### B. Project Beneficiaries

16. **For the purpose of this project, MSMEs will be defined as firms employing fewer than 250 people, and Large Enterprises (LEs) as firms employing fewer than 1,000 people.** Halkbank will directly lend to MSMEs and LEs, the final beneficiaries. Sub-loans to MSMEs may be made longer term investment financing and for short term working capital financing (to accommodate potential delays in the payments for goods sold and services provided in an uncertain macro-financial environment, and provide, more generally, flexibility to smaller size enterprises). Sub-loans to LEs may be made only for longer term investment financing (a primary concern towards undertaking lumpy purchases of physical investment to remain competitive or explore new markets), and only if the LEs are involved in domestic MSME supply chains (whereby MSMEs benefit by their integration as local suppliers of or distributors for larger enterprises). The definition of a LE involved in domestic supply chains will be LEs with payables or receivables against MSMEs of at least 25 percent of sales or purchases. The supply chain linkage stems when: (i) MSMEs sell inputs to LEs, and LEs generate payables against MSMEs (i.e. MSMEs have receivables against LEs), and (ii) MSMEs distribute outputs

of LEs, and LEs have receivables against MSMEs (i.e. MSMEs generate payables against LEs). At least 60 percent of the Loan will be used to fund MSMEs. Although micro enterprises will be supported by the project, it is expected that the majority of the sub-loans will be to small and medium enterprises.

### **C. Project Development Objectives Level Results Indicators**

#### **17. Key PDO indicators include the following:**

- (a) Ratio of the average portfolio maturity of MSME and LE sub-loans under the project, over the average portfolio maturity of Halkbank's MSME and LE portfolio not financed under the project.
- (b) Number of MSME and LE beneficiaries financed under the project.
- (c) Volume of Bank support.

18. Key intermediate indicators and additional indicators, monitored for analytical purposes and aimed to help improve MSME related policies and projects, are explored in Annexes 1 and 3.

### **III. PROJECT DESCRIPTION**

#### **A. Project Components**

19. **The project will have a single component for the establishment and operation of a credit facility for the provision of Sub-loans to MSMEs and LEs to finance the carrying out of Sub-projects.** At least 15 percent of the proceeds of the Loan financing sub-loans to MSMEs shall be utilized for sub-projects in underserved Priority Regions, as defined in the Council of Ministers Decree Number 2015/8190, published in the Official Gazette numbered 29505 and dated October 17, 2015. There will be no sectoral restrictions, and financing will be extended on market terms to avoid any distortion.

20. **Annex 2 provides a detailed description of the project.** It includes: (i) the project terms and conditions between the World Bank and Halkbank; (ii) the eligibility criteria for the MSMEs and LEs; and (iii) terms and conditions of sub-loans between Halkbank and MSMEs and LEs.

#### **B. Project Financing**

##### **Financing Instrument**

21. **The proposed Investment Project Financing uses IBRD funds, with Halkbank as the Borrower.** The Loan will be guaranteed by the Republic of Turkey. The Loan Choice Worksheet was completed at the Negotiations Stage. The Borrower requested an IBRD Loan in the amount of USD200 million, with the following loan terms: a fixed spread, March 15 and September 15 payment dates, 20-year repayment period including a 4-year grace period, repayments linked to commitment, level repayment of principal, front-end fee amounting to USD500,000 financed from the Borrower's own sources, with all conversion options.

##### **Project Cost and Financing**

22. **The project consists of a single Project Component of USD200 million equivalent.** It is expected that at least USD120 million will be utilized by MSMEs.

### **C. Lessons Learned and Reflected in the Project Design**

23. **The project follows and reflects lessons learned from a series of successful financial intermediation operations supported by the World Bank in Turkey.** Reviews of Implementation Completion Reports by the World Bank Group's Independent Evaluation Group rate outcomes above Satisfactory (EFIL I, P065188, Satisfactory; EFIL II, P082801, Highly Satisfactory; EFIL III, P093568, Highly Satisfactory; SME I, P082822, Satisfactory). Lessons learned from past lines of credit in Turkey suggest that a simple and flexible design, allowing for operational adjustments, is key for successful implementation. Moreover, better outcomes are achieved when: (i) key indicators that measure the quality of the loan portfolio are monitored intensively; (ii) quantified eligibility criteria for selecting financial intermediaries are used; and (iii) sound analysis and data on the financial performance of financial intermediaries, and external audit for verification, are available and used. The project also reflects lessons learned from World Bank credit lines in other countries. These indicate that problems have stemmed mainly from weak borrower accountability and management capacity, lack of clearly defined and transparent indicators for monitoring of the financial performance of the concerned financial intermediaries, poor monitoring of the overall project impact, inadequate demand from ultimate beneficiaries, lack of bankable sub-projects, and inflexibilities in project design that make it difficult to adjust to changing situations. Taking into account the above, the Project has also benefited by incorporating lessons learned from the recent Implementation Completion Report for SME II (P118308) and the restructuring of two Turkish operations (SME III – P130864 and SME EE – P122178) by revising financial covenants to accommodate the realities of enterprises in Priority Regions, as well as those of the micro and smaller enterprises.

## **IV. IMPLEMENTATION**

### **A. Institutional and Implementation Arrangements**

24. **Halkbank will be responsible for the implementation of the project and was selected based on its experience with MSMEs and with World Bank projects.** Halkbank, a public sector bank with a lending portfolio of almost USD35 billion, has extensive experience in offering credit to MSMEs in all regions of Turkey, thanks to a strong branch presence and a historic focus on the MSME sector. Halkbank's strategy is to increase the share of MSMEs in its loan portfolio, by ramping up recently launched programs focused on smaller enterprises and the supply chain. Additional criteria for selecting Halkbank include the bank's financial soundness, performance of its credit portfolio, and its good performance as one of the Borrowers in the recently closed SME I project (P082822) financed by the World Bank. Annex 3 provides background information on Halkbank, while Annex 6 provides a summary evaluation of Halkbank, including an analysis of its financial soundness, implementation capacity (also assessed in Annex 4) and specific considerations on the bank's ability to meet the World Bank requirements.

25. **The Project Implementation Unit (PIU) in Halkbank is staffed with capable and qualified personnel for the implementation of the project** (see Annex 4). The Implementation

Completion Report and the Independent Evaluation Group Review of the SME I project (P082822, implemented by Halkbank) rated the Outcome and Borrower's performance as Satisfactory. The PIU responsibilities will include: (i) monitoring of the direct lending to final beneficiaries; (ii) responsibility for adherence to all fiduciary and safeguard requirements of the World Bank for final beneficiaries; and (iii) monitoring and evaluation based on key project development indicators.

## **B. Results Monitoring and Evaluation**

26. **The Borrower will evaluate progress on the proposed indicators through regular reports.** Halkbank's PIU will monitor the PDO and intermediate indicators of the Results Framework (that includes MSME finance core indicators for Bank-wide monitoring, Annex 1) and additional indicators (that include gender specific indicators, Annex 3) on a quarterly, semi-annual and yearly basis. The data will come from Halkbank's internal reports. The PIU will prepare semi-annual project reports. Although the scope of reporting will be significant, the indicators will be effectively monitored. Halkbank has worked with the World Bank on the design of appropriate reporting templates in the Operational Manual (OM), and it is well accustomed to collecting such information from clients. The financial performance of Halkbank will be monitored through independent auditors' reports and separate management letters confirming adherence to prudential norms. Further details on the Results and Monitoring Framework are provided in Annexes 1 and 4.

## **C. Sustainability**

27. **Sustainability will be facilitated in the short run by the government's commitment to increasing MSME access to finance, and, in the long run, by the development of alternative sources of long term funding.** The Turkish government has committed itself to making MSMEs more competitive, and more capable of applying modern technologies to improve production processes. While the World Bank can play an important catalytic role at this stage by providing the sector with long-term financing that is currently scarce, it is expected that, in the long run, alternative sources will be developed. Work by the World Bank, primarily through technical assistance, aims to assist the development of longer term funding markets and instruments (see Annex 3, Box 1).

28. **To avoid market distortions, Halkbank will follow its respective pricing policy according to market conditions.** Halkbank will price its finance comparable to the market price and will incorporate administrative costs and the related credit risk of the final beneficiaries. The only significant market advantage from the World Bank funds is in terms of maturity, facilitating the provision of medium- and long-term finance to enterprises without taking on a significant maturity mismatch.

## **V. KEY RISKS**

### **A. Overall Risk Rating and Explanation of Key Risks**

29. **The overall risk for the project is assessed as Moderate.** Halkbank is a proven borrower, familiar with the World Bank's requirements, and the demand for funds is assessed as high. The project design is tested and proven under previous credit lines for MSMEs, with

performance and outcomes rated satisfactory/ highly satisfactory. However, global uncertainty and a retrenchment of emerging market risk appetite could negatively affect the demand for funds. The same conditions may, however, render the IBRD Loan more desirable.

## VI. APPRAISAL SUMMARY

### A. Economic and Financial Analysis

30. **MSME and LE sub-projects to be financed are not pre-identified and project costs are not defined, thus a traditional economic/financial analysis cannot be conducted.** Annex 2 describes the eligibility criteria of MSMEs and LEs, and terms and conditions of sub-loans under the project.

31. **Supporting access to finance for MSMEs, LEs and Priority regions, the project could have significant impact on employment and the bottom 40 percent of the population.** The project supports MSMEs that are estimated to account for 76 percent of employment, but are financially constrained by lack of collateral, poor credit history and other constraints. Notably, exports are mostly generated by MSMEs, accounting for 60 percent of the total. Furthermore, at least 15 percent of the proceeds of the Loan financing sub-loans to MSMEs will be used for sub-projects in Priority Regions that represent a high proportion of the bottom 40 percent of the population. With only nine percent of firms having a female senior manager, the project will also collect indicators on gender for analytical purposes and towards the design of future projects. World Bank work on gender in Turkey includes a SIDA funded “Women’s Access to Economic Opportunities in Turkey” project, which includes strengthening evidence-based policy making, increasing knowledge sharing and awareness raising, and support to women’s cooperatives. In addition, the draft Financial Inclusion Landscape Report, explores data at the individual level to show that men in the top 60 percent of the income distribution are about twice as likely as women to have a formal bank account, and men in the bottom 40 percent are more than three times as likely. This gap is among the widest in the world, and it is strongly influenced by labor force participation rates.

### B. Technical

32. **The financial condition of Halkbank is good (see Annex 2 and 6) and the final interest rates and/or other charges and fees will be in line with the market (see Annex 2).** Provisions are included in the project to ensure that interest rates and/or other fees reflect the cost of intermediating project funds and an appropriate credit risk margin.

### C. Financial Management

33. **The project financial management systems at Halkbank are Satisfactory.** Halkbank is an experienced borrower with the World Bank. Continued soundness of Halkbank and its compliance with domestic prudential regulations will be monitored through the annual entity audit reports. Halkbank will maintain records and will ensure appropriate accounting and documentation for the project funds. Interim un-audited Financial Reports (IFRs) will be prepared semi-annually and will be submitted to the World Bank no later than 45 days after the end of each calendar semester. The formats of the IFRs will be agreed upon with Halkbank during negotiations. The project accounts will be subject to independent audit on an annual basis.

The project audit report will be made publicly available as per the Access to Information policy of the World Bank. The World Bank may approve disclosure of an abridged version of the audit report when the financial statements contain proprietary or commercially sensitive information.

#### **D. Procurement**

34. **A procurement assessment of the project has been carried out.** The proposed operation is a natural continuation of the SME series of projects that focused on MSMEs. Halkbank is an experienced borrower and familiar with the World Bank procurement procedures, with the past performance under the SME I project rated as Satisfactory. The demand-driven nature of the project precludes an estimation of the sub-beneficiaries and their procurement requirements at the appraisal stage, rendering impossible for Halkbank to develop a Procurement Plan. Halkbank will continue to maintain the existing staff capacity for procurement oversight and monitoring arrangements, including supervision of the sub-project implementation progress through regular project audits/reviews and site visits. Mitigation measures and arrangements for a more efficient implementation are provided in detail under Annex 4.

#### **E. Social (including Safeguards)**

35. **The project is not expected to have negative social effects.** By increasing access to finance, the project is expected to have a positive impact on the growth of MSMEs, LEs and employment, including in the underserved Priority Regions. One of the positive social impacts of the project may also be on access to finance for female entrepreneurs. The project will collect indicators on gender for analytical purposes and towards the design of future projects. The project beneficiaries are MSMEs and LEs, and the project will ensure that Halkbank collects and responds to feedback from these beneficiaries as necessary to inform implementation of this project and possibly design of future projects. Any involuntary land acquisition or associated involuntary resettlement that would trigger the World Bank Operational Policy (OP) 4.12 on Involuntary Resettlement will not be eligible for financing under the scope of this project. In light of this, Halkbank will be screening the sub-projects accordingly to ensure that the OP 4.12 is not triggered. The Environmental Review Framework for the project details how sub-projects will be screened to ensure that they do not trigger OP 4.12.

#### **F. Environment (including Safeguards)**

36. **The project has been categorized as “FI” in accordance with World Bank OP 4.01 (Environmental Assessment).** Due to the nature of the project, working capital or investment finance applications are expected to include machinery purchase/replacement or small scale construction works. Therefore, it is expected that there will be no large scale significant and/or irreversible impacts. Sub-projects in environmental Category A will not be eligible for funding. Moreover, the project will not finance sub-projects which may have impacts on natural habitats. An Environmental Review Procedures document (Environmental Review Framework) was prepared by Halkbank and was disclosed on its website on October 9, 2015, followed by InfoShop disclosure on October 12, 2015. The draft framework document, included as part of the draft OM, describes the environmental assessment and environmental due-diligence procedures to be used in sub-project evaluation. The environmental procedures defined in the draft

Environmental Review Framework document are consistent with the Government of Turkey's Environmental Assessment requirements and OP 4.01.

37. According to the Environmental Review Framework, sub-loan applicants will be required to carry out an environmental screening, due-diligence (for the existing facilities) and assessment of the proposed subprojects according to the World Bank safeguard procedures, and to obtain environmental permits as prescribed by national legislation. Halkbank will be responsible for the quality assurance of these environmental documents and monitoring of the sub-projects. In this regard, Halkbank has been found successful during the implementation of the previous MSME credit line operations. It is highly recommended that Halkbank sustains its staff responsible for environmental safeguards compliance and continues receiving guidance from the World Bank on environmental safeguard issues.

#### **G. Other Safeguards Policies Triggered**

38. **International Waterways (OP/BP 7.50) was not triggered**, and it is clearly stated in the draft OM that the project will not finance any investment that can involve the use or pollution of, or otherwise affect the quality or quantity of water of international waterways, as defined in OP/BP 7.50. The waterways identified as NOT an international waterway (do not trigger OP 7.50) in Turkey are as follows: Susurluk, North Aegean, Gediz, Kuçuk Menderes, Buyuk Menderes, Western Mediterranean, Antalya, Sakarya, Western Black Sea, Yesilirmak, Kizilirmak, Konya Kapali, Eastern Mediterranean, Seyhan, Ceyhan, Eastern Black Sea, Burdur, Afyon, Orta Anadolu, and Van.

#### **H. World Bank Grievance Redress**

39. **Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).

## Annex 1: Results Framework and Monitoring

### TURKEY: Micro Small and Medium Enterprise and Large Enterprise Supply Chain Finance Project

#### Results Framework

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#### Project Development Objectives

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##### PDO Statement

The Project Development Objective (PDO) is to improve access to finance for micro, small and medium enterprises, and longer term finance to large enterprises involved in domestic supply chains.

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**These results are at** | Project Level

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#### Project Development Objective Indicators

Indicator Name	Baseline	Cumulative Target Values			
		YR1	YR2	YR3	End Target
Ratio of the average portfolio maturity of MSME sub-loans under the project, over the average portfolio maturity of Halkbank's MSME portfolio not financed under the project. (Number)	1				>1
Ratio of the average portfolio maturity of LE sub-loans under the project, over the average portfolio maturity of Halkbank's LE portfolio not financed under the project. (Number)	1				>1
Number of MSME beneficiaries financed under the project (cumulative). (Number)	0.00	60.00	120.00	180.00	240.00
Number of LE beneficiaries financed under the project (cumulative). (Number)	0.00	5.00	10.00	15.00	20.00
Volume of support (cumulative, USD million). (Number)	0.00	50.00	100.00	150.00	200.00

## Intermediate Results Indicators

Indicator Name	Baseline	Cumulative Target Values			
		YR1	YR2	YR3	End Target
Volume of support to MSMEs (cumulative, USD million). (Number)	0.00	30.00	60.00	90.00	120.00
Based on Core Indicator: Outstanding MSME finance portfolio (USD million). (Number)	n/a				n/a
Based on Core Indicator: Number of active MSME finance accounts (not cumulative). (Number)	n/a				n/a
Based on Core Indicator: Portfolio Quality: Portfolio at risk (%). (Percentage)	3.6				n/a
Based on Core Indicator: Financial Sustainability: Return on Assets (%) (Percentage)	1.5				n/a
Based on Core Indicator: Financial Sustainability: Return on Equity (%) (Percentage)	14.4				n/a
Percent of MSME sub-loans financing sub-projects in priority regions. (Percentage)	0.00				15.00
Compliance with prudential regulation. (Yes/No)	Yes	Yes	Yes	Yes	Yes
Citizen Engagement: MSMEs and LEs that feel project sub-loans reflected their needs. (Percentage)	0.00				n/a

### Indicator Description

#### Project Development Objective Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Ratio of the average portfolio maturity of MSME sub-loans under the project, over the average portfolio maturity of Halkbank's MSME portfolio not financed under the project.	No description provided.	Semi-annual	Project report	PIU
Ratio of the average portfolio maturity of LE sub-loans under the project, over the average portfolio maturity of Halkbank's LE portfolio not financed under the project.	No description provided.	Semi-annual	Project report	PIU
Number of MSME beneficiaries financed under the project (cumulative).	No description provided.	Semi-annual	Project report	PIU
Number of LE beneficiaries financed under the project (cumulative).	No description provided.	Semi-annual	Project report	PIU
Volume of support (cumulative, USD million).	No description provided.	Quarterly	Project report	PIU

#### Intermediate Results Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Volume of support to MSMEs (cumulative, USD million).	Note: Under this project, MSMEs are defined as firms employing fewer than 250 people. In addition, the size of an individual MSME sub-loan is not to exceed USD3.5 million, reflecting the local market conditions.	Semi-annual	Project report	PIU
Based on Core Indicator: Outstanding MSME finance portfolio (USD million).	Note: The top indicator will report the entire MSME portfolio of Halkbank, not just the Bank-financed portion, as per Core Indicator guidance. However, the accompanying text will report the Bank-financed	Semi-annual	Project report	PIU

	portion.			
Based on Core Indicator: Number of active MSME finance accounts (not cumulative).	Note: The top indicator will report the entire portfolio of Halkbank, not just the Bank-financed portion, as per Core Indicator guidance. However, the accompanying text will report the Bank-financed portion.	Semi-annual	Project report	PIU
Based on Core Indicator: Portfolio Quality: Portfolio at risk (%).	Note: The indicator is not MSME specific and follows the local definition for NPLs, as regulated by BRSA. The top indicator will report the entire portfolio of Halkbank, not just the Bank-financed portion, as per Core Indicator guidance. However, the accompanying text will report the Bank-financed portion.	Semi-annual	Project report	PIU
Based on Core Indicator: Financial Sustainability: Return on Assets (%)	No description provided.	Semi-annual	Project report	PIU
Based on Core Indicator: Financial Sustainability: Return on Equity (%)	No description provided.	Semi-annual	Project report	PIU
Percent of MSME sub-loans financing sub-projects in priority regions.	Note: Priority regions are defined in the Council of Ministers Decree numbered 2015/8190, published in the Official Gazette numbered 29505 and dated October 17, 2015.	Semi-annual	Project report	PIU
Compliance with prudential regulation.	No description provided.	Semi-annual	Project report	PIU
Citizen Engagement: MSMEs and LEs that feel project sub-loans reflected their needs.	A mid-term survey will measure the satisfaction of the sub-beneficiary (MSMEs and LEs) with the sub-loan in term of their needs (e.g. short-term working capital and long-term investment finance). This will exclude satisfaction with FI decisions related to the size, terms and conditions that need to be market based (as required by OP10). The survey results will inform the project implementation, as appropriate.	Mid-term	Survey basis	PIU

**Annex 2: Detailed Project Description**  
**TURKEY: Micro Small and Medium Enterprise  
and Large Enterprise Supply Chain Finance Project**

**1. This Annex describes the following in summary:**

- (a) Project terms and conditions between the World Bank and Halkbank;
- (b) Sub-loan terms and conditions for Halkbank's sub-project financing to MSMEs and LEs;
  - (i) Eligibility criteria for the MSMEs that will be financed by Halkbank;
  - (ii) Eligibility criteria for the LEs that will be financed by Halkbank;
  - (iii) Terms and conditions of sub-loans between Halkbank and MSMEs or LEs.

**(a) Project terms and conditions between the World Bank and Halkbank**

- Halkbank will directly lend the Loan proceeds by extending at least 60 percent of the total Sub-loan volume to MSMEs and a maximum of 40 percent of the total Sub-loan volume to LEs.
- At least 15 percent of the proceeds of the Loan financing sub-loans to MSMEs shall be utilized for Sub-projects in Priority Regions, as defined in the Council of Ministers Decree Number 2015/8190, published in the Official Gazette numbered 29505 and dated October 17, 2015.
- Halkbank will maintain, during project implementation, a Project Implementation Unit (PIU) with procedures, responsibilities and staffed with qualified personnel capable of implementing all aspects of the project in a satisfactory manner.
- Halkbank must be in compliance with the requirements (including the Environment and Procurement requirements) listed in the OM.
- For the duration of the project implementation period, beginning with the year 2016, Halkbank will submit annually an audit report in accordance with the International Standards on Auditing that is prepared in accordance with International Auditing Standards and International Financial Reporting Standards.
- Halkbank must submit relevant reports including the semi-annual project reports certified by its Management.
- Halkbank will be subject to monitoring of the PDO and Intermediate Results indicators in Annex 1 "Results Framework and Monitoring" and the Additional indicators in the OM and Annex 4 on a quarterly, semi-annual and yearly basis.

**(b) Sub-loan terms and conditions for Halkbanks' sub-project financing to MSMEs/ LEs.**

**(i) Eligibility criteria for the MSMEs that will be financed by Halkbank**

- For the purpose of this project, MSMEs are defined as firms with fewer than 250 employees.
- All private MSMEs (private ownership more than 50 percent), irrespective of their sector, will be eligible for participation as sub-beneficiaries on a commercial basis.

**(ii) Eligibility criteria for the LEs that will be financed by Halkbank**

- For the purpose of this project, LEs are defined as firms with fewer than 1,000 employees, except as the Bank shall otherwise agree.
- The definition of a LEs involved in domestic supply chains will be LEs with payables or receivables against MSMEs of at least 25 percent of sales or purchases.
- All private LEs (private ownership more than 50 percent), irrespective of their sector, will be eligible for participation as sub-beneficiaries on a commercial basis.

**(iii) Terms and conditions of sub-loans between Halkbank and MSMEs or LEs**

- Sub-loans will be evaluated in accordance with Halkbank's normal project and finance evaluation guidelines.
- The cost of sub-loans by Halkbank to MSMEs and LEs will include, at a minimum, the cost to Halkbank of the Loan plus a margin reflecting: (a) administrative costs, and (b) a credit risk markup.
- Sub-loans to MSMEs may be made for working capital and investment purposes. Sub-loans to LEs may be made for investment purposes only, including incremental working capital.
- The amount of an individual sub-loan will not exceed USD3.5 million equivalent for MSMEs and USD6 million equivalent for LEs, except as the World Bank shall otherwise agree. The aggregate amount of outstanding Sub-loans to any one MSME or LE shall not exceed USD5 million equivalent and USD10 million equivalent, respectively.
- All investment sub-loans to MSMEs must have at least two years maturity and to LEs at least three years maturity.
- For all sub-loans above USD1 million equivalent (excluding sub-projects in Priority Regions), sub-beneficiaries must submit a cash flow statement following a format agreed upon with Halkbank.
- For sub-loans above USD1 million equivalent (excluding sub-projects in Priority Regions), sub-beneficiaries to have a financial debt/equity ratio of not more than 85:15 after the receipt of the sub-loan, unless agreed otherwise by the World Bank.
- For sub-loans above USD1 million equivalent (excluding sub-projects in Priority Regions), sub-beneficiaries should, after the receipt of the sub-loan, be projected to maintain a financial debt service coverage ratio of at least 1.1:1 and calculated on an average basis over the sub-loan life, unless agreed otherwise by the World Bank.
- The first two sub-loans, irrespective of size, will be subject to prior review by the World Bank. Sub-loans to be provided to a MSME exceeding USD2.5 million equivalent and to a LE exceeding USD4.5 million equivalent will require prior approval by the World Bank.
- All sub-loans not subject to prior review may be subject to ex-post review by the World Bank to verify compliance with the terms and conditions.

- The relevant authorities must certify that the MSMEs and LEs (sub-beneficiaries) and sub-projects meet environmental laws and standards in force in Turkey. The World Bank policy on environmental assessment will also be complied with.
- Sub-projects classified as World Bank's Environmental Category A or involving dams and international waterways will not be financed.
- Sub-projects that would trigger OP 4.12, as well as used equipment, and goods, works, non-consulting services and consultant services on the World Bank's negative list will not be eligible for financing.
- Sub-beneficiaries must comply with the World Bank's procurement procedures for the procurement of goods, works, non-consulting services and consulting services to be financed under the project.
- Sub-beneficiaries will be required to keep copies of invoices for all expenses financed with working capital and investment finance received under the project and will be required to send to Halkbank invoice and other documentation for sub-projects, except in the case of non-procurement working capital expenditures. Sub-beneficiaries will send the list of non-procurement expenses financed with working capital loans to Halkbank. The invoices/ documentation for these expenses will be kept by the sub-beneficiaries and made available to Halkbank and the World Bank upon request.
- Sub-beneficiaries will be required to provide reasonable information for the purpose of monitoring and impact assessment during the life of the project (and for certain period after the project), as may be requested by the World Bank, and/ or Halkbank.

**Annex 3: Sector and Halkbank Background**  
**TURKEY: Micro Small and Medium Enterprise  
and Large Enterprise Supply Chain Finance Project**

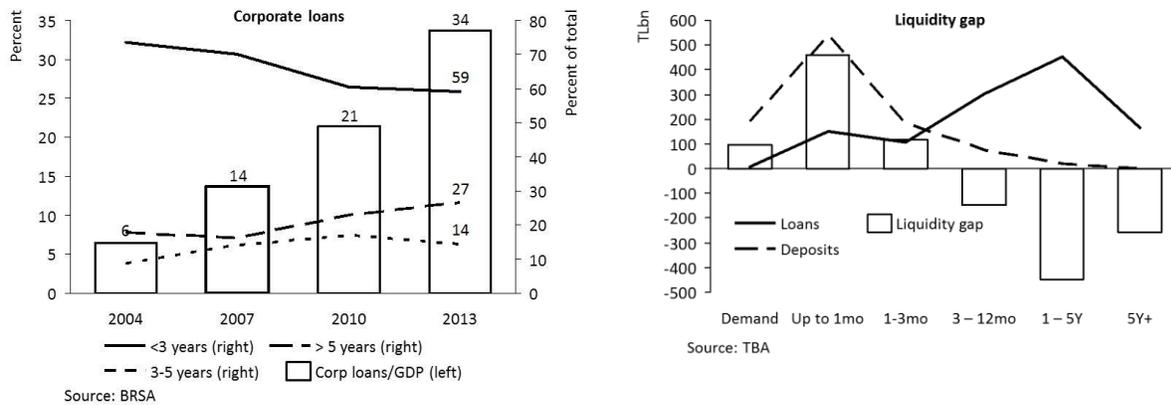
**Sector Background**

*Banking sector*

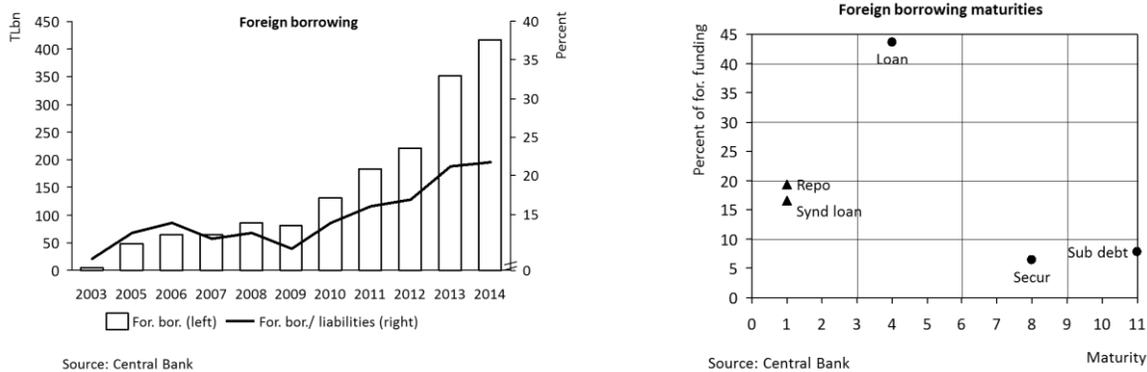
1. **The Turkish financial sector lacks the depth one would expect given the size of the economy, and is dominated by the banking sector.** Financial markets increased almost seven fold, from TL461 billion in 2003 to about TL3,156 billion in December 2014. Total financial system assets amounted to 180 percent of GDP in 2014, with the emerging market economies average at about 195, and newly industrialized Asian economies at 620. Banks represent 89 percent of the financial sector and about 114 percent of GDP (with banking sector credit and deposits at 71 and 60 percent of GDP, respectively).
2. **The modern Turkish banking sector foundations were laid by a comprehensive reform program undertaken in the aftermath of the 2000-01 financial crisis.** The banking sector reforms included: (i) the establishment of an independent monetary authority; (ii) the transparent recapitalization of the core banking system; (iii) the introduction of a new banking sector legal framework with the establishment of an independent regulator and introduction of stronger regulation and supervision; and (iv) restructuring and partial privatization of the State Owned Banks (SOBs).
3. **The reforms helped in the emergence of a stronger and more competitive banking sector resulting in higher financial intermediation.** Characteristically, the sector managed to overcome the challenges of the recent global financial crisis without any state intervention. The sector remains well-capitalized (CAR of 16.3 percent), profitable (ROA and ROE of 1.3 and 12.2 percent, respectively), and with historically low non-performing loans (NPLs of 2.8 percent, after reaching five in 2009). Following high credit growth in late 2011 of almost 40 percent, the rate has recently fluctuated in response to tightening measures and uncertainties, settling at the milder level of 18.5 percent in 2014.
4. **Despite such strong growth, challenges remain particularly in the availability of long term finance.** About 87 percent of the banking sector's deposits have maturity below three months, while 77 percent of the lending is concentrated above three months. As a result, there is a negative liquidity gap that peaks in the one to five year maturity. With the loan to deposit ratio breaching 121 percent, banks are increasingly relying on foreign funding in absolute terms – but this is limited and the average maturity of the sector's foreign liabilities barely breaches three years (see Figure 2).

## Figure 2. Long term finance challenges in the banking sector

Corporate loan book growth is high, yet still short term despite... ...significant maturity mismatches, with the liquidity gap at its widest in the one-five year range.



Foreign borrowing of banks has played an increasingly important role... ...but average maturity of the foreign liabilities barely breaches three years in average.



5. **The development of capital markets is a challenging but critical endeavor to ensure stable sources of long-term financing and secure sustainable growth.** High dependency on external (and volatile) financing, a bank centric model and strong demand for investments in areas such as infrastructure are just part of the reason why capital markets development is critical. Developing deeper and longer-term bond markets would help diversify and provide more stable financing for productive real-sector activity. Furthermore, well-developed local bond markets could help larger corporates tap bond markets and eventually reduce their reliance on bank funding, in turn providing larger space for MSME lending in banks' balance sheets.

## **Box. World Bank support in long-term finance and MSME access to finance**

The latest Development Plan (2014-18), alongside priority action plans (introduced late 2014 on Savings and the Istanbul Financial Center) and the SME Strategy, prioritize long term finance and SME's access to finance as key areas of focus for the government. In line with these priorities, the World Bank supports these reform areas both through advisory services and development policy lending.

One of the major constraints for MSMEs access to finance is not having sufficient amount of collateral. Improving the movable collateral framework can alleviate this constraint by enabling the MSMEs' use of movable assets, including receivables, stocks, machinery and equipment to access loans. Firms face onerous collateral requirements in Turkey. On average, the value of the collateral was 199 percent of the loan amount, which is above the global average of 194 percent. The most common form of collateral required was land or buildings (58 percent), followed by personal assets (30 percent). The World Bank has provided technical assistance and has prepared a diagnostic report assessing the current movable collateral regime, proposing a roadmap to improve the secured transactions framework in line with international standards. Two key recommendations were the establishment of a central collateral registry in line with international standards, and the preparation of a unified collateral regulation in line with best practices. The Turkish government has decided to prioritize this program by including it in the priority action plans, as well as the SME Development Strategy Action Plan. The access to finance committee, working under the Coordination Council for Improving the Investment Environment (YOIKK) with the membership of all relevant organizations (BRSA, CMB, Ministry of Justice, Treasury, Credit Bureau, Business Associations, etc), has begun drafting the unified collateral law in line with international standards.

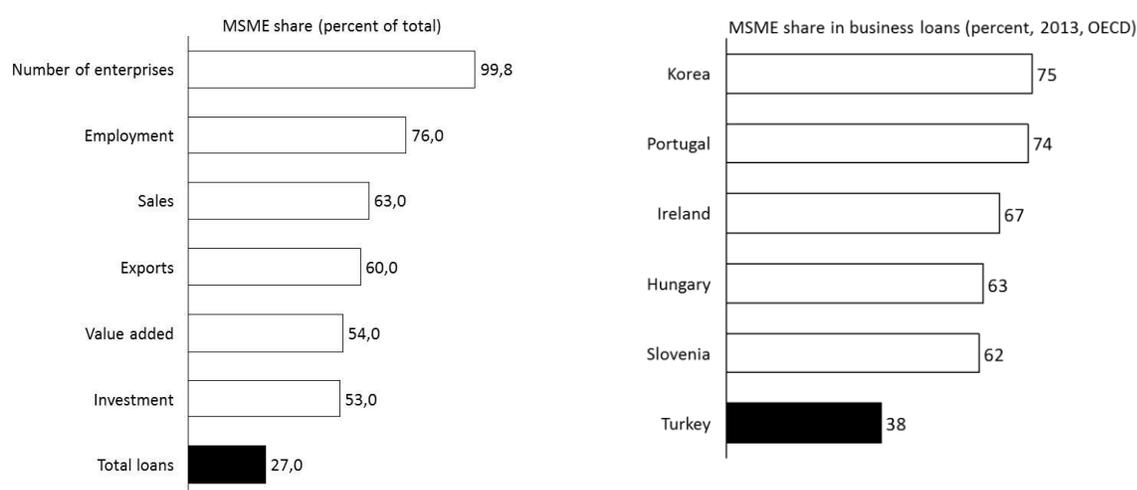
In addition, MSMEs have less transparent financial statements and problems related to the bankruptcy framework. This creates constraints in banks' efforts to expand lending to the MSME segment, with the cost of financing to SMEs increasing and the available amount of funding decreasing. The World Bank has been working with the government on reforms in these areas through advisory work and development policy lending. The Sustaining Shared Growth Development Policy Loan (DPL) supported the Risk Center of the Banks Association of Turkey, which became fully operational in June 2013. This aims to improve the depth of credit information belonging to firms and individuals, thereby providing cost effective systematic information on potential borrowers, laying the basis for orderly growth of the financial services industry and promoting management of credit risk. In addition, the World Bank, in cooperation with the Ministry of Justice, organized a conference on the challenges of the current bankruptcy framework with an aim to assist the drafting committee of the new bankruptcy law.

Lack of long term finance has serious implications on economic growth by limiting available long term funds for investments. Turkey has made substantial progress towards a deeper capital market, but there are non-trivial challenges to be overcome. Progress is evident in several areas: (i) the government was able to extend the yield curve issuing nominal and inflation-linked instruments with maturities up to 10 years; (ii) the corporate bond market grew from a negligible base prior to 2010 to reach more 330 issuances in 2013 worth more than TL 55 billion; and (iii) institutional investors and in particular pension funds have shown considerable growth since the implementation of government measures. In spite of these significant milestones, low levels of savings and investors' preferences for short-term investments, among other bottlenecks, have constrained the development of long-term financing. Diversity of corporate debt instruments is very limited. Banks account for close to 90% of issuances and bonds are almost exclusively floating-rate securities with an average maturity of one year and overall less than three years to maturity. The World Bank has been working with the Turkish government to address these challenges through technical assistance and development policy lending. The World Bank has provided support to the government on corporate bond market development, mutual funds, secondary regulations of the capital markets law, and, recently, on diagnostic reports for deepening capital markets with a comprehensive capital markets deep dive action plan addressing challenges in: (i) demand (especially institutional investors and international investors); (ii) supply (potential issuers, companies, municipalities, utility companies); (iii) tax and market infrastructure (especially liquidity); and, (iv) new instruments (covered bonds, securitizations, project bonds, long term *Sukuks*, etc.).

6. **In addition, challenges are pronounced in the provision of MSME finance, with access to services and loans, in particular, lower compared to 2008.** MSMEs receive only 27 percent of the total bank loans in spite of their large share in economic activity - they account for 99.8 percent of all enterprises, 76 percent of employment, 54 percent of investments, and 60 percent of exports. Lack of cash flow based financing, credit history, and high collateral requirements acutely constrain their access to funding. Enterprise surveys show that access to finance is still one of the most important constraints for business growth, despite strong credit growth recently making it the fourth rather than first ranked obstacle overall. Access to basic financial services (firms having a checking or saving accounts) has dropped compared to 2008 from 91 to 78.7 percent, which is below both the ECA (88.2 percent) and World average (88.4 percent). The percent of firms with a bank loan/ line of credit has dropped from 57 percent in 2008 to 40 percent in 2013, although this is slightly higher than the ECA (36 percentage) and World average (35 percent). Collateral required as a percentage of loan amount is 319 percent, among the highest in the world and a significant increase to 90 percent in 2008.

**Figure 3. MSME finance challenges in the banking sector**

*MSME's share in economic activity is significant... ..but their share in total business loans is low.*



7. **SOBs play a significant role within the Turkish banking sector.** There are 51 banks overall, including four participation banks (i.e. Islamic finance banks), three state-owned commercial banks and 13 Development and Investment Banks (DIBs). Ziraat Bank, Halkbank and Vakif Bank are the three state-owned commercial banks, licensed to accept deposits. Iller Bank, Exim Bank, and Kalkinma Bank are the state-owned DIBs, and cannot accept deposits.<sup>1</sup> SOBs account for 31, 30 and 31 percent of total assets, deposits and loans respectively. State-owned DIBs represent only 3 and 3.4 percent of total assets and loans. Among DIBs, Exim Bank is the largest state-owned and TSKB is the largest privately-owned.

8. **SOBs perform a “gap filling” role in certain sectors and in the Priority Regions, while they also had an active counter-cyclical role in recent years.** Some of the state-owned lenders are concentrating in specific sectors, reflected in the high loan book concentrations

<sup>1</sup> Takasbank is also classified as a development and investment bank, but it mainly functions as the clearing and settlement institution to the Istanbul Stock Exchange.

relative to the banking sector average. TKB, Ziraat Bank and Exim Bank have the largest share in their loan portfolio in energy, agriculture and export sectors respectively. Halkbank has the largest share of the MSME loans in its loan portfolio (37 percent) among state-owned banks, followed by Vakif Bank (27 percent). Both are above the sector average of 27 percent, with Ziraat Bank falling below (12 percent). State owned deposit banks have a larger share of their branches in priority regions compared to privately owned deposit banks (28 versus 15 percent) and extend a larger portion of their loan portfolio as well (18 versus nine percent). Indeed, the share of the state owned deposit-taking banks in terms of the total number of branches in Turkey is 46 percent in priority regions, whereas it drops to 28 percent in other regions. TKB has the largest share of long term loans (longer than five years) in its loan portfolio at 33 percent, followed by Vakif Bank (22 percent). The other state-owned lenders (Ziraat Bank, Halkbank and Exim Bank) remain well below the sector averages in extending longer term loans. Finally, Ziraat Bank, Halkbank and TKB loan to asset ratios increased significantly compared to the rest of the banking sector during the global credit crunch in 2007-2009, playing a significant counter-cyclical role when private banks were reluctant to extend MSME loans.

**Table 1. Key characteristics of state ownership in the Turkish banking sector**

As of December 2014, percent of total	Total Assets	Total Loans	Total Deposits
<b>Banking System</b>	100.0	100.0	100.0
<b>Deposit Banks</b>	95.8	95.3	100.0
State-owned	28.3	27.4	30.4
Ziraat Bank	12.4	11.2	14.0
Halk Bank.	7.8	8.0	8.2
Vakıf Bank	8.0	8.3	8.2
Privately-owned	47.7	48.4	48.3
Foreign	14.6	14.4	15.1
<b>Development and Investment Banks</b>	4.2	4.7	-
State-owned	3.0	3.4	-
İller Bank	0.8	0.9	-
Exim Bank	1.7	2.2	-
TKB	0.2	0.2	-
Privately-owned	1.1	1.2	-
o/w TSKB	0.8	0.8	-
Foreign-owned	0.1	0.1	-

Source: BRSA

**Table 2. SOB performance**

	Portfolio (% of total, 2013)					Fin. sustainability (% , 2014)			
	MSME	Export	Agriculture	Energy	>5year*	CAR	NPL	ROA	ROE
Ziraat	11.9**	2.4	18.9	3.1	7.4	18.2	1.9	1.8	17.7
Vakif	25.8	4.3	1.5	5.0	22.4	14.0	3.7	1.2	13.8
Halk	36.9	2.9	0.6	1.6	7.4	13.6	3.6	1.5	15.6
TKB	63.1	0.0	0.4	69.1	33.3	20.4	3.7	1.3	7.8
Exim	7.5	20.6**	3.6	0.3	0.4	24.1	0.5	1.4	11.0
<b>Sector</b>	<b>25.9</b>	<b>5.0</b>	<b>3.4</b>	<b>4.8</b>	<b>14.6</b>	<b>16.3</b>	<b>2.8</b>	<b>1.3</b>	<b>12.3</b>

Source: BRSA

\*Bankers Association Statistical Reports

\*\*Less strict definitions place Ziraat's MSME portfolio at 32 percent and Exim's Export portfolio at 76 percent.

**Table 3. SOB’s share of branches and loans in Priority Regions, 2013**

	<b>PR branches over own branches (%)</b>	<b>PR loan portfolio over own portfolio (%)</b>
State-Owned Deposit Banks	28.1	17.98
Privately-Owned Deposit Banks	15.9	9.10

Source: TBA

## **Halkbank Background**

### *Halkbank’s origins and market presence*

9. **Halkbank has its roots in MSME lending and, despite being a universal bank, has traditionally focused on this market segment as a core business line.** Türkiye Halk Bankası AŞ (Halkbank) was incorporated in Turkey in 1933 as a state economic enterprise established under law no. 2284. It began its operations in 1938 and its purpose was to provide loans to artisans, tradesmen and MSMEs in economically underdeveloped parts of Turkey. It was initially established as a credit union by small cooperatives, providing its loans through the “People’s Fund”. Halkbank was authorized to directly open branches and grant loans to customers in 1950. Today, Halkbank allocates 39 percent of its total loans to MSMEs. It had over 1.2 million MSME clients, accounting for 53 percent of its total non-retail client base. It has the sixth-largest branch network in Turkey, with significant penetration in rural areas. The bank is still the exclusive provider of state-subsidized loans to small businesses through cooperatives. The Treasury pays 50 percent of the interest payment to Halkbank on behalf of the borrowers. Halkbank’s headquarters migrated from Ankara to Istanbul in 2013.

10. **Halkbank is owned 51.06 percent by the State, following two public offerings in 2007 and 2012.** The controlling shareholder of Halkbank is the Prime Ministry Privatization Administration with 51.06 percent share. Halkbank’s first floatation in 2007 was registered in the history of the Istanbul Stock Exchange as the largest public offering carried out in Turkey up to that date. It resulted in the floating of 24.98 percent of Halkbank shares. The free float ratio was raised to 48.8 percent through a secondary public offering in 2012.

11. **Halkbank’s board is composed of nine members, including three independent, all with over 20 years of experience in banking.** The majority holds postgraduate degrees or doctorates. All of the board members are appointed by the government and three are independent members in accordance with corporate governance practices. The board meets at least once a month. Key committees in Halkbank include the Corporate Governance, Audit, and Compensation. The functions of the committees, their working principles, and members are designated by the board of directors and disclosed to the public on the corporate web site. All chairmen of the committees are elected among the independent board members. The chief executive officer and the chairman of the board of directors are not on the committees. The Corporate Governance Committee is formed by two members of the board of directors that are independent and non-executive members. It oversees the bank’s compliance with the corporate governance principles, identifies conflicts of interest that may arise in this matter, and undertakes improvement efforts. It meets minimum four times a year and at a request of a member with predetermined agenda if necessary. The Audit Committee is composed of two members of the board of directors that are independent and non-executive members. It reports to the board on risk management, internal control and internal audit activities, as well as its views on any other

risk-related issues that it deems important. It undertakes risk-oriented auditing activities, and covers all branches within a two year period. Halkbank is in full compliance with BRSA prudential regulations. The external audit of the bank is conducted by Akis Bağımsız Denetimve Serbest Muhasebecilik Mali Müşavirlik A.Ş., a member of KPMG. The independent audit report for the year-ended 31 December, 2013, issued a modified opinion with only one qualification about the reversal of a provision made in previous years. The independent audit report for the year-ended 31 December, 2014, concluded that the financial statements gave a true and fair view of the bank's position.

**12. Halkbank's corporate governance rating was 9.19 out of 10 for 2014, as prepared by the SAHA Corporate Governance and Credit Rating Services.** The Corporate Governance Compliance Report is prepared within the framework of "Principles of Corporate Governance" published by the Capital Markets Board, considering both international and sectoral principles. The Capital Markets Board based these principles on the work of the World Bank, the Organization of Economic Cooperation and Development, and the Global Corporate Governance Forum. A nine to 10 rating corresponds to a performance that is considered to represent best practice, with the identification and active management of all significant corporate governance risks through comprehensive internal controls and management systems.

#### *Halkbank's financial standing*

**13. Halkbank has a strong financial standing, based on a core MSME business and a stable retail deposit base.** Return on equity was 14.4 percent for 2014, with the banking sector average standing at 12.3 percent. Return on assets was 1.5 percent, with the banking sector average at 1.3. Overall, Halkbank depends on strong net interest income from a well-established core MSME business (77 percent of net interest income originated from loans, the remaining being securities).<sup>2</sup> Interest margins are high (NIM at 4.5 percent), reflecting a large proportion of high yielding MSME lending at 39 percent of the loan book.<sup>3</sup> Fees and commissions play a smaller but growing role in its profitability (33 percent of which is credit card related, followed by non-cash loans at 18 percent). Halkbank enjoys a stable retail deposit base and good efficiency ratios from a similarly well-established franchise paired with strong controls. It exhibits strong capital adequacy, with the capital adequacy ratio at 13.6 percent (and Tier I adequacy ratio at 12.9). The BRSA minimum is eight percent and 12 percent if the bank operates in offshore markets, like Halkbank. Total loans classified as NPLs were 3.6 percent of its gross loan portfolio. It should be noted that a large portion is legacy NPLs from 2001 and before, bringing the consolidated ratio down to 2.5 if subtracted. Halkbank sets specific provisions for non-performing loans and 65 percent of non-performing loans are provisioned. Unlike many banks in Turkey, Halkbank does not sell impaired loans, and its asset quality ratios further underline the good quality of its credit book. Restructurings are very rare (below one percent).

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<sup>2</sup> Loans account for 60.7 percent of the total Halkbank assets, followed by securities making up another 20.4 percent (including securities held as available-for-sale or as held-to-maturity investments). The securities portfolio is dominated by floating rate and inflation linked bonds that protect margins in times of volatility. The share of investment securities in total assets is decreasing, reflecting Halkbank's current strategy to increase focus on its customers and to expand the share of loans in its assets portfolio.

<sup>3</sup> Sector concentration is limited - loans in the services and manufacturing sectors comprised 35 and 31 percent, in a consolidated basis. Construction is a low three percent of the portfolio. The bank's top 20 on-balance sheet loans, all of which are performing, represented about 12 percent of total loans

**Table 4. Key Halkbank financial indicators**

(TL million)	2014	2013	2012	2013- 14 Change (%)
Total Assets	155,423	139,944	108,282	11
Liquid Assets	21,560	21,825	15,120	(1)
Loans	101,767	84,848	65,894	20
Securities	26,844	28,559	22,954	(6)
Total Deposits	103,708	100,756	79,974	3
Shareholders' Equity	16,536	14,146	12,323	17
Net Interest Income	5,112	4,829	4,476	6
Net Fee and Commission Income	1,023	930	858	10
Gross Profit	2,727	3,365	3,329	(19)
Net Profit	2,206	2,751	2,595	(20)
<b>Key Ratios (%)</b>				
Interest Bearing Assets/Total Assets	84.4	81.4	83.2	
Loans/Total Assets	65.5	60.6	60.90	
Non-performing Loans/Total Loans (Gross)	3.6	2.6	2.9	
Demand Deposits/Total Deposits	18.9	18.6	20.1	
Loans/Deposits	98.1	84.2	82.4	
Average Return on Assets (ytd)	1.5	2.2	2.6	
Average Return on Equity (ytd)	14.4	20.8	24.8	
Capital Adequacy Ratio**	13.6	13.9	16.2	

Source: Halkbank's Audited Unconsolidated Financial Statements

\*\*Basel II for 2012-13, Basel III for 2014

14. **In common with other Turkish banks, Halkbank faces a significant maturity mismatch.** It relies on short-term demand and time deposits as its primary source of funding, but primarily has medium-term assets, which results in asset-liability maturity gaps. As of 31 December 2014, the Bank's core time deposit ratio, which is defined as the rollover ratio of the Bank's time deposits, was 92 percent which makes a large contribution to the Bank's liquidity. Overall, deposits constitute 75 percent of liabilities, with funds borrowed another nine percent. In terms of foreign borrowing, Halkbank has completed since 2012 four Eurobond issuances with five to seven year maturities; it has annually rolled over its syndicated loans of one year maturity; and has engaged IFIs for longer term loans – two EIB loans with five and eight year maturities and an IBRD loan providing the longest maturity at 30 years. Overall, almost 82 percent of the bank's liabilities had remaining maturities of one year or less. As of the same date, over 47 percent of the bank's assets had remaining maturities of over a year. As a result, Halkbank had a negative liquidity gap spiking at the one to five year maturity. This liquidity mismatch risk is, indeed, in line with most of the banking sector in Turkey. Liquid assets to short-term liabilities stood at 34.7 percent. It should be noted that Halkbank is also a government debt securities market maker.

**Table 5. Halkbank's international borrowing since 2012**

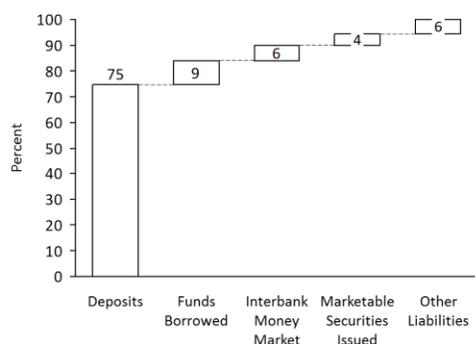
Transaction format	Signing date	Amount (million)	Currency	Maturity (years)	Int. rate /Coupon
Eurobond	7/19/2012	750	USD	5	Fixed
Eurobond	2/5/2013	750	USD	7	Fixed
Eurobond	6/4/2014	500	USD	5	Fixed
Eurobond	2/11/2015	500	USD	6	Fixed
EIB Loan	5/30/2012	50	EUR	5	n.a.
IBRD Loan	5/6/2013	67	USD	30	n.a.
EIB Loan	9/24/2013	100	EUR	8	n.a.
EIB Loan	11/21/2014	100	EUR	8	n.a.
Syndicated Loan*	7/8/2014	112	USD	1	Floating
Syndicated Loan*	7/8/2014	511.5	EUR	1	Floating
Syndicated Loan*	7/20/2015	169	USD	1	Floating
Syndicated Loan*	7/20/2015	640	EUR	1	Floating

\*Rollover

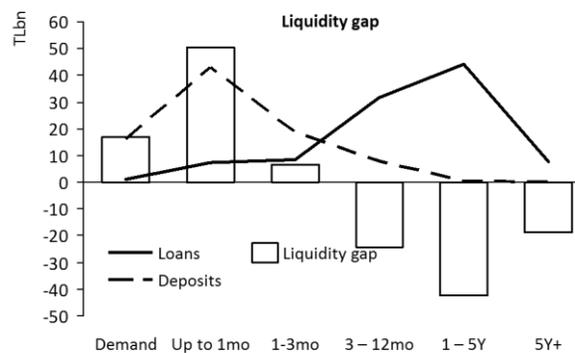
**Figure 4. Halkbank's liability structure and liquidity gap**

*High dependence on short-term deposits...*

*...results on a significant liquidity mismatch risk.*



Source: Halkbank IFRS financial statement



Source: TBA

15. **Nevertheless, Halkbank's large depositor base provides significant stability.** Notably, 70 percent of saving deposits are covered by the savings deposit fund, with the top 20 customer deposits representing about 18 percent of total deposits and state related deposits at about 10 percent. The loan to deposit ratio stands at 98.1 percent (compared to 124 for the sector), and the bank has a well-established track record in successfully managing liquidity. BRSA requires banks to maintain strict liquidity regulatory ratios and Halkbank meets those comfortably. A contingency plan regarding the liquidity risk management is approved by the Board of Directors and the liquidity position is regularly reported to BRSA.

**Annex 4: Implementation Arrangements**  
**TURKEY: Micro Small and Medium Enterprise**  
**and Large Enterprise Supply Chain Finance Project**

**Project Institutional and Implementation Arrangements**

1. **Halkbank will be responsible for project implementation.** The responsibilities of the Project Implementation Unit (PIU) at Halkbank (the Borrower) will include: (i) monitoring of the direct lending to final beneficiaries; (ii) responsibility for adherence to all fiduciary and safeguard requirements of the World Bank for final beneficiaries; and (iii) monitoring and evaluation based on key project development indicators.

2. **Halkbank's PIU is staffed with capable and qualified personnel for the implementation of the project.** Halkbank has experience from the SME I project (P082822). The Implementation Completion Report and the Independent Evaluation Group Review of the SME I project rated the Outcome and Borrower's performance as Satisfactory.

**Financial Management, Disbursements and Procurement**

*Financial Management*

3. Halkbank is experienced in implementing World Bank financed projects in a Satisfactory manner. There is an established PIU composed of qualified professionals. The same teams will work during the implementation of this project.

4. Halkbank will comply with the prudential requirements set by the Banking Regulation and Supervision Agency (BRSA). Banks submit quarterly financial reports to BRSA and publish annual audited financial statements. The applicable standards for accounting and auditing are the standards issued by the Public Oversight, Accounting and Auditing Standards Authority, and are in compliance with the IFRS and International Standards on Auditing. The external auditors are required to report to BRSA on the banks' internal control and risk management systems. They are also obliged to report directly to BRSA with respect to certain issues that may threaten the going concern nature of a bank.

*Accounting*

5. Halkbank will integrate the project in its existing accounting systems. As was the case in previous operations funded by the World Bank, the main accounting system will be used to account for the transfers from the World Bank, transfers to MSMEs and LEs, as well as other project transactions that may arise. Halkbank will open sub-accounts in the main accounting system, which will allow the PIU to extract data in the detail necessary to prepare detailed project reports.

6. Halkbank has also an html based webpage available on the portal, where the branches can directly enter the necessary data about invoices and procurement processes. This system allows the PIU to extract detailed lists from the system.

### *Internal Control*

7. Halkbank has established internal controls system and will apply its usual lending procedures for the Project. Accordingly, the beneficiary enterprises will apply to Halkbank branches, which will prepare pre-appraisal files for the approval of the Regional/General Directorate. The Project Appraisal and Financial Analysis department will prepare a client assessment report for the branch that will initiate the proposal for the Loans Department of Halkbank. The loan will then submitted to the Senior Manager, to the General Manager/Deputy General Manager, to the Credit Committee, and to Halkbank's Board of Directors. After the board approval, the loan contract will be concluded.

8. The branches will be responsible for verifying the eligibility of the MSMEs and LEs as well as checking the invoices submitted for financing under the project. Upon verification and approval, the Loans Department will make the funds available to beneficiary enterprises. A detailed list of invoices for the eligible expenditures financed will be ready at Halkbank's branches together with copies of invoices, which will be made available to World Bank upon request.

9. For the purposes of the previous project financed from the World Bank, the PIU had developed several mechanisms to monitor the loans given to beneficiary enterprises, and similar mechanisms will be put in use for this Project. These will be described in the OM. These mechanisms were as follows: (i) macro programs to download project-related data and generate detailed reports from Halkbank's management information system; (ii) a 'limit compliance' system in which the branches submit electronic approval forms to the PIU for SME loans approved by the Loans Department in order to monitor the availability of funds and the corresponding regional distribution.

### *Internal Auditing*

10. Halkbank has an Inspectors' Board and a Risk Management and Internal Controls Directorate within its organizational structure and the Project loans will be in the scope of their review. The Internal Controls Department is responsible for conducting and coordinating internal audit activities within the Bank. The internal audit function is structured on a regional basis to cover all branches of Halkbank. One internal auditor is responsible for the activities in four branches on average, which implies that each branch is visited at least six times a year. The Internal Controls Department plans the audit activities using a risk-based approach and implements them through routine audits and spot audits. Internal auditors are notified from the intranet about the branches they should visit. The internal auditors are required to report back using the same system, which communicates the internal audit findings with relevant managers immediately. Responses of managers are tracked from the system as well. The overall quality of the internal audit reports is ensured by the Internal Controls Department at the headquarters.

11. Loans financed from World Bank funds are part of these internal audit activities, as Halkbank's loan portfolio is 100 percent audited by internal auditors. During the implementation of the previous Access to Finance for SMEs Project, the Internal Controls Department identified additional check points for World Bank financed loans (such as compliance with SME definition, limit approvals, 20 percent firm contribution, documentation, interest rates, etc.) A similar

approach will be adopted for this Project. The PIU will compile the findings of the internal auditors on the sub-loans under the Project and submit to the World Bank on an annual basis.

*Financial Reporting*

12. Halkbank will submit interim un-audited financial reports (IFRs) on a semi-annual basis. The format and content of IFRs will be agreed upon during the negotiations and will be included in the OM.

*Auditing*

13. Halkbank will submit two sets of audit reports on an annual basis during the lifetime of the Project and the grace period of the loan: the audit of Halkbank’s financial statements prepared in accordance with the International Financial Reporting Standards and the audit of the project financial statements. The independent auditors will be firms licensed by the Public Oversight Authority and approved by the BRSA. The audits will be conducted in accordance with the International Standards on Auditing.

14. Annual and semi-annual (limited review) audits of Halkbank financial statements in accordance with the International Financial Reporting Standards (IFRS) are publicly available as per the regulations. The last three years’ audit reports (in accordance with IFRS and ISA) were reviewed and summarized below:

<b>Year</b>	<b>Auditor</b>	<b>Opinion</b>
2014	KPMG	Unmodified (clean).
2013	KPMG	Qualified for significant general reserves and reversal of reserves for worsening economic conditions.
2012	KPMG	Qualified for significant general reserves and reversal of reserves for worsening economic conditions.

*Funds Flow*

15. Halkbank will open a designated account to disburse funds from the World Bank Project loan account. The project will have a special code in the accounting system and sub-loans extended to MSMEs and LEs will be earmarked with the code.

*Disbursement arrangements*

16. The disbursement procedures will be communicated in the Disbursement Letter that is an integral part of the legal package of the Project.

*Retroactive Financing*

17. Retroactive Financing in an aggregate amount not exceeding USD30 Million may be made in respect of sub-loans made in accordance with criteria and procedures set forth in the Loan Agreement and OM.

*Procurement*

18. The overall procurement risk is evaluated as Low at the Appraisal stage.

19. The proposed operation is a natural continuation of the SME series of projects that focused on MSMEs. Halkbank is an experienced Borrower and familiar with the World Bank procurement procedures, with the past performance under the SME I project rated as Satisfactory and the ongoing SME-EE Project.

20. In the completed similar operations in Turkey, it was determined that there are well established commercial practices for the procurement of goods, works and services by the private sector enterprises, autonomous commercial enterprises and individuals. Furthermore, the gradual implementation of the new Commercial Code, which provides a completely new and modern “constitution” for private sector commercial activity and entrepreneurship, is grounded in financial transparency and strengthened corporate governance. This code also regulates the reporting requirements for intergroup transactions among group companies. In this context, the communique on “Minimum content for the annual activity report” requires the group companies to report on the group transactions, which will eventually strengthen arms-length arrangements between them. In the case of goods, the local practice is to prepare the technical specifications and solicit quotations from the local and/or international market. In the case of medium and large works, the technical specifications are usually prepared by consultant companies and bids are collected from qualified contractors. Minor works are generally tendered on a lump sum basis by collecting bids from a number of local contractors. When equipment and machinery is needed for the expansion of existing facilities, the purchasers usually prefer proprietary goods from a single source for standardization and minimization of the operation and maintenance cost. Therefore, the local private sector or commercial practices can be considered to be consistent with the World Bank’s criteria with respect to economy and efficiency. The general rule in the sector is to procure the least cost goods, works and services consistent with minimum quality requirements.

21. Procurement of goods, works and non-consulting services for the proposed Project will be carried out in accordance with the World Bank's "Guidelines: Procurement of Goods, Works and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers" dated January 2011 and revised July 2014, (Procurement Guidelines); and procurement of consultant services will be carried out in accordance with the World Bank's "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers" dated January 2011 and revised July 2014, (Consultant Guidelines) and the provisions stipulated in the Loan Agreement. The World Bank's "Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants", dated October 15, 2006, and revised in January 2011 (Anti-Corruption Guidelines) will apply to this Project. A General Procurement Notice shall be published for the procurements under the Project by Halkbank.

22. Well-established Private Sector Procurement Methods or Commercial Practices will be followed for Goods, Works and Non-Consulting Services contracts in accordance with paragraph 3.13 of the Procurement Guidelines; and for Consulting Services contracts in accordance with paragraph 3.13 of the Consultant Guidelines, and the provisions stipulated in the OM. Given the demand-driven nature of the project, it is not possible to estimate neither the sub-beneficiaries nor their procurement requirements under the credit line financing of the sub-projects at the appraisal stage of the Project. Therefore, it is not possible for Halkbank to develop a Procurement Plan. Simplified procurement plans as detailed in the OM, where feasible and practical, will be prepared for the sub-finances between Halkbank and the sub-beneficiaries. A

definition of non-procurement working capital expenditures will be provided in the OM, so that these will not be listed in the future procurement plans.

23. The World Bank will review the procurement arrangements performed by Halkbank including contract packaging, applicable procedures, and the scheduling of the procurement processes for conformity with the World Bank's Procurement and Consultant Guidelines, the proposed implementation program and disbursement schedule. The procurements will be subject to ex-post review by the World Bank on a random basis in accordance with the procedures set forth in Appendix 1 of the Procurement Guidelines and Consultant Guidelines, respectively. Post review of the procurement documents will normally be undertaken during the World Bank's supervision mission or upon the World Bank's request to review any particular contracts at any time. In such cases, Halkbank shall provide the World Bank the relevant documentation for its review. Sampling for the review of the procurement documents will be done in accordance with the OM.

24. Sub-project agreements will refer to the World Bank's Anti- Corruption Guidelines as well as the Procurement and Consultant Guidelines. Halkbank will check the contracts from sub-beneficiaries so that the contracted firms are not on the World Bank's lists of debarred or suspended firms.

25. Halkbank will be responsible through its PIU for ensuring that the procurement rules for sub-projects specified in the PAD and OM are followed. Halkbank will keep the records and the originals/copies of relevant invoices of the procurement transactions handled by the sub-beneficiaries. Updated procurement plans of all sub-finances will be kept in Halkbank's PIU, and they will be furnished to the World Bank along with other procurement documents whenever requested.

26. Halkbank has a PIU established under the closed SME I Project which is still active for the ongoing SME EE Project financed by the Bank. Halkbank will need to maintain its existing staff capacity and tools for record keeping under its PIU to oversee the procurement activities and to support the PIU's procurement function for the project.

27. Although the risk is rated as "Low" at the appraisal stage, the following measures are needed for an effective implementation by: (i) maintaining the record keeping system for the follow-up on the procurement related documents to be received from branches; (ii) development of an informative tool on procurement procedures for branch staff; (iii) close working relationship between the Bank's procurement specialist and the PIU throughout the duration of Project implementation.

*Environmental and Social (including safeguards)*

28. The project has been categorized as "FI" in accordance with World Bank OP 4.01 (Environmental Assessment). Any sub-loan applicant will apply to Halkbank for financing after all the necessary environmental clearance is obtained from Turkish environmental authorities. Then it is the responsibility of Halkbank to apply the World Bank screening to the sub-projects. In order for the World Bank to fulfill its fiduciary responsibilities, for the first five sub-project applications submitted to Halkbank, Halkbank will provide information on the sub-project to the World Bank for "prior review", together with its proposed classification of the sub-project

(Category B or C) and the advice it proposes to give to the sub-borrower regarding additional actions needed to fulfill World Bank requirements as detailed in the OM. Following this “pilot” period, if Halkbank and the World Bank agree, the World Bank will change to spot checking the screening and environmental review process on a “post review” basis. Implementation of environmental procedures as defined for Category B and C sub-projects above is the responsibility of Halkbank as the financial intermediary. Regarding the monitoring issues, Halkbank will monitor the sub-project implementation to assure that all conditions specified in the granting of the approvals are being followed. Environmental evaluations and review procedures will be subject to ad hoc post review by World Bank supervision missions. The World Bank will have the authority to review and post review all sub-projects.

29. The project is not expected to have negative social effects. By increasing access to finance, the project is expected to have a positive impact on the growth of MSMEs, LEs and employment, including in the underserved Priority Regions. One of the positive social impacts of the project may also be on access to finance for female entrepreneurs. The project will collect indicators on gender for analytical purposes and towards the design of future projects. The project beneficiaries are MSMEs and LEs, and the project will ensure that Halkbank collects and responds to feedback from these beneficiaries as necessary to inform implementation of this project and possibly design of future projects. Any involuntary land acquisition or associated involuntary resettlement that would trigger the World Bank Operational Policy (OP) 4.12 on Involuntary Resettlement will not be eligible for financing under the scope of this project. In light of this, Halkbank will be screening the sub-projects accordingly to ensure that the OP 4.12 is not triggered. The draft Environmental Review Framework for the project details how sub-projects will be screened to ensure that they do not trigger OP 4.12. The World Bank will provide training to Halkbank staff to ensure that they understand the requirements of OP 4.12 and what the screening would require, and the World Bank would also provide continuous support and guidance as necessary.

### *Monitoring & Evaluation*

30. Key indicators for measuring the PDO include:

- (a) Ratio of the average portfolio maturity of MSME sub-loans under the project, over the average portfolio maturity of Halkbank’s MSME portfolio not financed under the project.
- (b) Ratio of the average portfolio maturity of investment LE sub-loans under the project, over the average portfolio maturity of Halkbank’s investment LE portfolio not financed under the project.
- (c) Number of MSME beneficiaries financed under the project (cumulative).
- (d) Number of LE beneficiaries financed under the project (cumulative).
- (e) Volume of Bank support (cumulative, USD million).

31. Key Intermediate Results indicators include:

- (a) Volume of Bank support to MSMEs (cumulative, USD million).

- (b) Outstanding MSME finance portfolio (USD million). The indicator will be reported by Halkbank, both for its entire portfolio and the Bank-financed portion only.
- (c) Number of active MSME finance accounts (not cumulative). The indicator will be reported by Halkbank, both for their entire portfolio and the Bank-financed portion only.
- (d) Portfolio at risk. The indicator will follow the local definition for NPLs, as regulated by BRSA. The indicator will be reported by Halkbank, both for its entire portfolio and the Bank-financed portion only.
- (e) Return on Assets (%).
- (f) Return on Equity (%).
- (g) Percent of MSME sub-loans financing sub-projects in priority regions.
- (h) Compliance with prudential regulation.
- (i) Citizen Engagement: Beneficiaries that feel project sub-loans reflected their needs (percentage)

32. In addition to the above indicators, the project will monitor some additional indicators. These indicators will be monitored for analytical purposes only and will serve as useful inputs to define policies and projects aimed at further improving MSMEs' access to finance in Turkey:

- (a) *Performance of MSMEs and LEs under the project:* (i) Increase in employment; (ii) Increase in sales.
- (b) *Profile of MSMEs and LEs under the project:* (i) Size of MSMEs and LEs (number of employees); (ii) Economic sector; (iii) Geographical location; (iv) Female owner or shareholder.
- (c) *Profile of loans under the project:* (i) Size of sub-loan; (ii) Maturity of sub-loans; (iii) Interest of sub-loans.

33. Annex 1 includes the data source, frequency, and responsibility for data collection for the Project Development Objective and Intermediate Results Indicators. Table 7 below describes the arrangements for monitoring for the Additional Indicators.

34. The data will come from Halkbank's internal reports. Although the scope of reporting will be significant, Halkbank has worked with the World Bank team in the design of the appropriate reporting templates in the OM, and it is well accustomed to collecting such information from its clients. Financial performance of Halkbank will be monitored through independent auditors' reports and separate management letters confirming adherence to prudential norms.

**Table 7. Additional Indicators and Arrangements for Monitoring**

Indicator Name	Frequency	Data Source/ Methodology	Responsibility for Data Collection
<i>Performance of MSMEs and LEs under the project</i>			
Increase in employment	Annual	Project report	PIU
Increase in sales	Annual	Project report	PIU
Increase in exports	Annual	Project report	PIU
<i>Profile of MSMEs and LEs under the project</i>			
Size of MSMEs and LEs (number of employees)	Annual	Project report	PIU
Economic sector	Annual	Project report	PIU
Geographical location	Annual	Project report	PIU
Female owner or shareholder	Annual	Project report	PIU
<i>Profile of loans under the project</i>			
Size of sub-loans	Annual	Project report	PIU
Maturity of sub-loans	Annual	Project report	PIU
Interest of sub-loans	Annual	Project report	PIU

**Annex 5: Implementation Support Plan**  
**TURKEY: Micro Small and Medium Enterprise**  
**and Large Enterprise Supply Chain Finance Project**

**Strategy and Approach for Implementation Support**

1. The implementation support strategy was developed taking into account the risks and mitigation measures related to the operation and targets the provision of flexible and efficient implementation support to the clients.

- a. **Technical Support** – IBRD implementation support missions will include a Financial Sector Specialist to help guide Halkbank with project implementation and policy dialogue.
- b. **Procurement** – A country office based procurement specialist will carry out ongoing supervision and will participate in project implementation support missions and site visits, respond to just-in-time requests and provide ongoing guidance to Halkbank based on its procurement activities.
- c. **Financial Management** – During project implementation, the World Bank will supervise the project’s financial management arrangements in two main ways: (i) review the project’s semi-annual project reports as well as Halkbank’s and the project’s annual audited financial statements; and (ii) during the World Bank’s implementation support missions, review the project’s financial management and disbursement arrangements to ensure compliance with the World Bank’s minimum requirements. As required, a World Bank-accredited Financial Management Specialist will assist in the supervision process.
- d. **Safeguards** – A Project Implementation Unit (PIU) is already established. Although Halkbank has implemented World Bank Loans before, implementation support will need to be provided, especially by the World Bank Specialist on Environmental Safeguards.

**Implementation Support Plan**

<b>Time</b>	<b>Focus</b>	<b>Skills Needed</b>	<b>Resource Estimate</b>
Year 1	Task management	Project management (HQ based)	8 staff weeks (SWs)
	Technical reviews	Financial Sector Specialist (Ankara based)	6 SWs
	Procurement support	Procurement Specialist (Ankara based)	3 SWs
	FM supervision	FM Specialist (Ankara based)	3 SWs
	Safeguards	Environmental specialist (Ankara based)	2 SWs
Year 2-4	Task management	Project management (HQ based)	6 SWs per year
	Technical reviews	Financial Sector Specialist (Ankara based)	4 SWs per year
	Procurement support	Procurement Specialist (Ankara based)	2 SWs per year
	FM supervision	FM Specialist (Ankara based)	3 SWs per year
	Safeguards	Environmental specialist (Ankara based)	2 SWs per year

**Annex 6: Financial Intermediary Assessment**  
**TURKEY: Micro Small and Medium Enterprise**  
**and Large Enterprise Supply Chain Finance Project**

*Financial Intermediary Assessment*

**1. An assessment of Halkbank took place at the appraisal stage based on eligibility criteria in accordance to OP10.0:**

- a. The bank must be duly licensed and at least two years in operation.
- b. The bank's owners and managers must be considered "fit and proper". It must have qualified and experienced management, adequate organization and institutional capacity for its specific risk profile.
- c. The bank must be in "good standing" with its supervisory authority (i.e., it should meet all pertinent prudential and other applicable laws and regulations) and remain in compliance at all times.
- d. The bank must maintain capital adequacy prescribed by prudential regulations.
- e. The bank must have adequate liquidity.
- f. The bank must have positive profitability and acceptable risk profile. It must maintain the value of its capital.
- g. The bank must have well defined policies and written procedures for management of all types of financial risks (liquidity, credit, currency, interest rate and market risk, as well as risks associated with balance sheet and income statement structures) and operational risk.
- h. The bank must classify its assets and off-balance-sheet credit risk exposures (at least four times per year) and make adequate provisions. It must have adequate portfolio quality. The bank should not have more than 10 percent of criticized assets (i.e., classified as doubtful and loss).
- i. The bank must have adequate internal audits and controls for its specific risk profile.
- j. The bank must have adequate management information systems.

In addition, Halkbank is expected to fully comply with the prudential regulations of BRSA.

**2. A detailed confidential appraisal report has been internally filed with summary results presented in Table 8 below.** These are based on the following sources of information: (i) The externally audited consolidated and unconsolidated financial statements by Akis Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik A.S. (the Turkish Member firm of KPMG International Cooperative, a Swiss entity) as of June 30, 2015 (limited review), prepared in accordance with Turkish Accounting Standards, Turkish Financial Reporting Standards, and Communiqués and Interpretations of BRSA; (ii) The externally audited consolidated financial statements by Akis Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik A.S. (the Turkish Member firm of KPMG International Cooperative, a Swiss entity) as of December 31, 2014, and prepared in accordance with IFRS; (iii) Halkbank's Annual Report for 2014; (iv) The H1 2015 Earnings Presentations by Halkbank, according to the BRSA unconsolidated financial statements; (v) The Corporate Governance Rating report for 2014, on Halkbank by prepared by Saha Kurumsal Yönetim ve Kredi Derecelendirme A.Ş. (SAHA Corporate Governance and

Credit Rating Services, Inc.) according to the Corporate Governance Principles by the Turkish Capital Markets Board; (vi) Interviews with senior management, including review of the related policy documents.

**Table 8. Summary of Halkbank appraisal (Unconsolidated basis, H1 2015)**

<b>Criterion</b>	<b>Comments</b>
<b>1. License</b>	Criterion met. Halkbank was incorporated in 1933 and begun operations in 1938.
<b>2. Owners/Managers “fit &amp; proper”, governance quality</b>	Criterion met. The controlling shareholder of Halkbank is the Prime Ministry Privatization Administration with 51.06 percent share. Board members cleared by BRSA as “fit and proper”, with over 20 year experience in banking and management. Halkbank has a rating of 9.19/10 on Corporate Governance based on the principles of the Capital Markets Board.
<b>3. Good standing with the BRSA</b>	Criterion met. In full compliance with BRSA prudential regulations, and on-site supervision did not find any serious problem or breach of BRSA regulations.
<b>4. Capital Adequacy</b>	Criterion met. The capital adequacy ratio was 13.5 percent, and Tier I was 12.9 percent. Leverage ratio was 8.5X.
<b>5. Liquidity</b>	Criterion met. LTD of 102.1 percent, Liquid assets to short-term liabilities of 34.7 percent.
<b>6. Profitability</b>	Criterion met. Yearly Net Income of TL1,229m, 5.7 percent increase yoy. ROE 14.4 percent, ROA 1.5 percent. NIM of 4.4 percent.
<b>7. Policies and Risk Management Functions</b>	Criterion met. Halkbank has appropriate internal control, risk management and internal audit systems that operate effectively through centralized and on-site audits in compliance with the Banking Law and BRSA regulations.
<b>8. Asset Quality and Provisions</b>	Criterion met. NPL ratio at 3.1 percent. NPL coverage of 76.0 percent.
<b>9. Internal Audit and Controls</b>	Criterion met. The internal audit function is organized in line with the legal and regulatory requirements of the BRSA. Duties and functional responsibilities are well documented, and the department is adequately staffed.
<b>10. Adequate MIS</b>	Criterion met. The IT and MIS system is of adequate quality and meets the current Halkbank needs. Halkbank ranks among the most pioneering banks in the effective deployment of new technology. There is satisfactory disaster recovery planning.

3. **Background information on Halkbank, including key financial indicators, can be found in Annex 3.** Overall, Halkbank depends on strong net interest income from a well-established core MSME business, while fees and commissions play a smaller role in its profitability. It enjoys a stable retail deposit base and good efficiency ratios from a similarly well-established franchise paired with strong controls. Halkbank enjoys strong capital adequacy, while loan impairments are at low levels.