



Report and Recommendation of the President to the Board of Directors

Project Number: 41910
October 2007

Proposed Subordinated Loan Republic of Azerbaijan: International Bank of Azerbaijan

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 14 September 2007)

Currency Unit	–	Azerbaijan new manat (AZN)
AZN1.00	=	\$1.09529
\$1.00	=	AZN0.91300

ABBREVIATIONS

ADB	–	Asian Development Bank
ATM	–	automated teller machine
CSPU	–	country strategy and program update
GDP	–	gross domestic product
IBA	–	International Bank of Azerbaijan
NBA	–	National Bank of Azerbaijan
NPL	–	nonperforming loan
POS	–	point of sale
SMEs	–	small and medium-sized enterprises

NOTE

In this report, "\$" refers to US dollars

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed subordinated loan (tier 2 capital) of up to \$40.0 million to International Bank of Azerbaijan (IBA).

II. AZERBAIJAN ECONOMY AND BANKING SECTOR BACKGROUND— CHALLENGES AND PROJECT RATIONALE

A. Azerbaijan Economy

1. Overview and Outlook

2. The rapid increase in oil production has resulted in 5 consecutive years of double-digit economic growth in Azerbaijan. Gross domestic product (GDP) increased by a record 34.5% in real terms in 2006, the highest growth rate in the world for the second year in a row. By far, the largest engine of growth has been industry, specifically the oil and gas sector, which increased 56% in 2006 and grew cumulatively by 150% during 2005–2006. The non-oil economy also has expanded, rising 12% in 2006. However, its contribution to GDP has fallen over the past few years as the oil sector has grown. The non-oil sector was 47% of nominal GDP in 2006, down from 58% in 2005 and 61% in 2004. Rising oil prices and export volumes have contributed to Azerbaijan's significantly strengthened external position.¹

3. The medium-term outlook for the Azerbaijan economy is positive. GDP is expected to post double-digit growth for the next few years, in line with the increases in oil and gas exports. However, foreign investment is projected to decrease as the major oil and gas projects move towards less intensive stages. Domestic public investment is expected to partially offset the decline in foreign investment. Government expenditures, which rose by more than 80% in 2006, are projected to rise by an additional 50% in 2007. In part due to the increase in government spending, as well as the continued strong foreign exchange inflows associated with the oil and gas sector and robust private consumption, inflationary pressure will increase. Annual inflation is expected to accelerate from 11.4% in 2006 to more than 15.0% in 2007.²

4. In February 2007, Fitch Ratings upgraded Azerbaijan's foreign and local currency issuer default ratings to BB+ from BB. Fitch Ratings also noted the country's outlooks remain stable. The upgrade of Azerbaijan's sovereign ratings was driven by strong and sustainable economic growth, low government and external debt ratios, and a growing current account surplus, underpinned by rapidly rising oil and gas production. In addition, in September 2006, Moody's Investors Service assigned a foreign and local currency issuer rating of Ba1 to Azerbaijan.

B. Challenges of the Future

5. In the long term, Azerbaijan's high dependence on oil exports poses a potential threat to the economy, given the potential volatility in the international oil market. The main challenge for Azerbaijan is to develop the non-oil sector to ensure the sustainable growth of the economy continues after the oil boom, meeting short-term expectations and longer-term demands. A key objective is to develop income-generating and new employment opportunities in the non-oil

¹ In 2006, Azerbaijan had a current account surplus of \$3.7 billion, equivalent to 18.7% of GDP. This was a sharp reversal from the current account deficit of 30% of GDP recorded in 2004.

² As a result of the substantial increase in public spending and rapid demand growth, the inflation rate for the first quarter of 2007 was 16.6%.

sector, in such priority areas as banking and finance, trade, and small and medium-sized enterprises (SMEs).

C. Banking Sector in Azerbaijan

1. Overview

6. Key performance indicators for the Azeri banking system have improved significantly since 2000, mainly due to strong growth in the economy and financial sector reform. However, it is still considered one of the weakest banking systems among the sovereigns rated by Fitch Ratings.³ Despite recent progress, the financial system remains small and highly concentrated. At the beginning of 2007, the banking system consisted of 44 commercial banks operating under license of the National Bank of Azerbaijan (NBA), with total statutory capital of \$693 million⁴ (Figure 1).

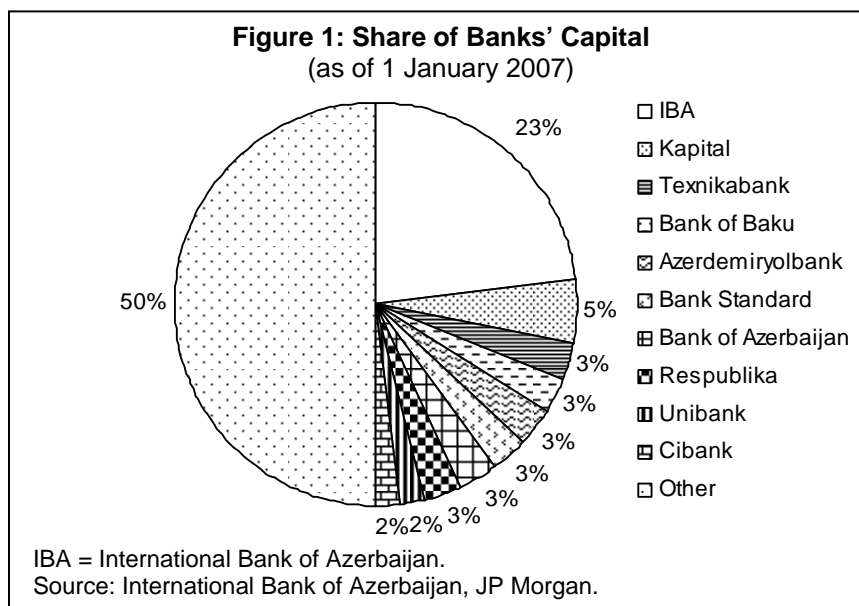
7. The Azeri banking sector is almost fully privatized. The last remaining 100% state-owned bank (Kapital Bank) is expected to be privatized in the near future. The private banks of the country are still relatively small, with total assets of \$30 million–\$80 million and equity of about \$10 million for a typical top tier private bank. Individuals or private business groups generally own the leading private banks, with state-owned enterprises holding small stakes—if any. In recent years, a top tier of about 10 private banks has emerged, representing half of the total bank capital in the country. The remaining banks are small players with low levels of total assets. The banking sector is expected to consolidate in the medium term, especially since the NBA is increasing the minimum required capital. Major international banks do not have substantial operations in Azerbaijan, mainly because of the small size of the domestic market and certain legal restrictions.

8. While the authorities continue to improve prudential regulations, significant vulnerabilities in the banking system remain. In response to rising credit and foreign exchange risks, NBA has tightened the prudential rules on loan collateral and open positions in foreign currencies, and has increased the minimum capital requirement.

9. The Heritage Foundation Banking Index rating of 3.5 (on a scale of 1–5) shows a relatively restrictive environment for banks, which is reflected in the absence of any major international bank operating in the country. However, this result is similar to the average index score of 3.73 for Asian Development Fund (ADF) borrowing countries.

³ Fitch Ratings. 2007. *Bank Systemic Risk Report*. London. March.

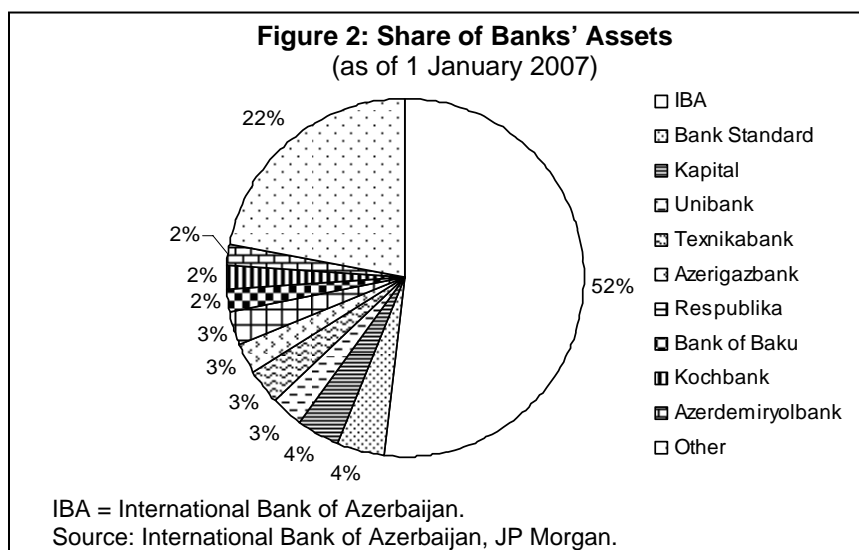
⁴ As many as 138 credit institutions held financial operating licenses from the NBA by 1 January 2007; this included 94 nonbanking organizations (including 77 credit unions and 17 microfinance institutions funded mainly by international aid organizations) and 44 commercial banks.



2. Detailed Analysis

10. The depth of bank intermediation activity is low—system assets were equivalent to only 17% of GDP at the end of 2006. The provision of financial services to households and the private sector is very limited. Only an estimated 10% of the population has bank accounts, reflecting low confidence in the banking sector. Financial services have been provided mainly to the oil, construction, and trade sectors, leaving retail clients and SMEs notably underserved.

11. The banking system's assets, the pillar of the Azerbaijan financial system, represented only 21% of GDP in 2006, significantly below the ratios for the Russian Federation (53%) and Kazakhstan (91%). At the end of 2006, the volume of assets grew by almost 60% and totaled \$4,344 million. The most significant element in the structure of bank assets are loans issued to customers, which totaled \$2,537 million (58.4% of total assets). State-owned IBA holds half of the country's banking assets (Figure 2).



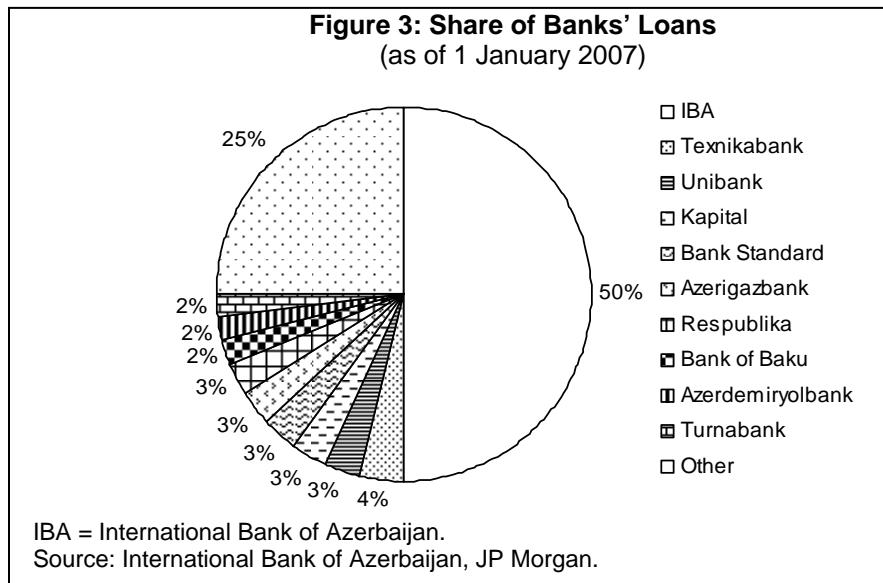
12. The most significant component of banking sector liabilities are deposits issued to corporate and individual customers, which totaled \$2,253 million (64.23% of total liabilities).

Banking sector deposits have grown rapidly but remain low, and not commensurate with Azerbaijan's level of development. NBA reported that deposits rose by 50% in 2006 to AZN2.0 billion, an estimated 11% of GDP.

13. Dollarization of the economy remains high, with more than 50% of savings held in foreign currency at the end of 2006, and 53% of the lending volume in foreign currency. However, the share of deposits held in Azerbaijan new manats has increased notably over the past year, at least in part because of the appreciation of the local currency against the US dollar. By November 2006, 37% of deposits were held, up from 20% at the end of 2005.

14. Azerbaijan's commercial banks have used the rapidly growing deposit base to expand their loan portfolios, an important and positive development given the marginal financial intermediation role that they have played in the economy. As of December 2006, consolidated lending by banks was AZN2.36 billion, an increase of 64% from the previous year. By April 2007, consolidated lending by banks reached AZN2.87 billion. Despite the large increase in the deposit base, it is still too small to meet the growing demand for financial services, especially from SMEs.

15. Private and state-owned commercial banks each provide about 48% of total loans outstanding, with the remainder coming from nonbank institutions. However, most private banks focus exclusively on lending to the private sector, primarily individual entrepreneurs and SMEs. Because of their small size and customer focus, these banks provide mainly small and micro loans, and typically do not serve the oil and gas sector.



16. The share of nonperforming loans (NPL) and the level of capital at risk are moderate. According to national statistics, the share of NPLs in 2006 was low at 3.33%, compared with 4.73% in previous year. However, the European Bank for Reconstruction and Development's *Transition Report 2006*⁵ noted that level of NPLs in the entire banking system was 14.9% in 2005, 0.4% higher than 2004. The ratio and quality of capitalization in the banking system is a concern, particularly as credit continues to grow rapidly. In response to this issue, the authorities have worked to improve the supervision of the banking system. Minimum capital requirements

⁵ EBRD. November 2006. *Transition Report 2006: Finance in transition*. London.

will be raised from AZN8.2 million to AZN10.0 million by July 2008, which is expected to translate into further consolidation and mergers resulting in fewer and better-capitalized banks. This is a positive step towards strengthening the financial system. Currently, only 10 of Azerbaijan's 44 banks have AZN10.0 million in capital.

17. The financial condition of Azeri banks remains stable, while displaying positive dynamics. Based on 2006 data, the average return on equity of Azeri banks was about 30% and the return on assets was 2%. As oil prices remain high and new investments flow into Azerbaijan, interest rates are expected to decrease. As interest rates decrease and the economy grows, the banking sector almost certainly will expand. Moreover, as the domestic economy is growing at 10% a year in real terms, investment opportunities will increase in areas such as hotels and tourism, retail, catering, and real estate. Oil construction also stimulates related sectors, such as transportation, engineering, and the steel industry. Even without any structural improvement, the banking sector might show good growth, comparable to GDP expansion. However, structural improvement might give a much more significant boost to the banking sector. The pace of growth will be determined by the success of structural reforms. Appendix 1 provides a historical overview of the development of the Azeri banking sector.

3. Outlook

18. Despite substantial multilateral and bilateral support to banks, most private banks are expected to remain illiquid and undercapitalized in the medium term. State-owned banks will continue to dominate the sector, which—together with continued strong economic growth—will help keep the risk of a banking crisis low. Structural changes in the banking sector will foster further consolidation and greater foreign participation. The new banking system and central bank laws have significantly strengthened banking sector legislation. Authorities are confident that this will provide the basis to improve the quality of the financial sector in Azerbaijan, particularly given the strengthening of the supervisory framework. Furthermore, the Government is developing banking infrastructure to make it better suited to channeling savings into the economy. The Government and the NBA have issued prudential regulations conforming to best international practices, including risk-based capital, loan-loss provisioning, and asset classification regulations. Details are in Appendix 2.

D. Small and Medium-Sized Enterprises in Azerbaijan

1. Private Sector Development

19. Between 1995 and 2006, the privatization of state-owned property and the creation of new businesses have contributed greatly to the development of the private sector in Azerbaijan. At the beginning of 2007, the country had 74,354 registered legal entities, of which 80.6% were private enterprises. At present, 4,161 foreign legal entities are registered in Azerbaijan.

20. In 2006, the private sector accounted for about 81% of GDP. Private firms are the major source of employment and government budget revenues. The share of the nongovernment sector in the manufacturing and service areas, such as agriculture, industry, trade, hotels, catering services, civic construction, and transport and communication, is 70%–95%.

2. Constitution of Small and Medium-Sized Enterprises

21. The development of SMEs is crucial to the development of the non-oil sector in Azerbaijan. Because of structural reforms and improvements in legislation and taxation, the

number of entrepreneurs increased considerably over the past 10 years. In 2006, 243,473 people were registered as individual entrepreneurs. Most of them are involved in trade (49.4%); transport, storage, and telecommunications (17.9%); agriculture (9.5%); public and social services (8.2%); and real estate (5.9%). SMEs account for about 80% of registered private businesses operating in Azerbaijan, and have generated on average an estimated 10% of GDP over the past 5 years. SMEs are the largest source of domestic employment outside of the public sector, providing livelihood for more than three quarters of the country's workforce. An estimated 70% of SMEs are in Baku and the Absheron Peninsula, and have limited capacity for regional expansion.

22. The importance of SMEs to general economic vitality is widely acknowledged. Studies have shown that, in most countries, SMEs and the informal sector account for about 45%–75% of employment and 65%–70% of GDP, regardless of the development stage of the economy.⁶ This is true for Azerbaijan as well.

23. Still, further efforts are needed to develop SMEs. One of the biggest hurdles facing SMEs in Azerbaijan today is the lack of access to finance. The Government and the development community have identified and recognized this problem as a key constraint to SME development.

3. Government Efforts

24. The Government continues to support SME growth and improve the business environment. In the past 2 years, the state policy has shifted from providing direct aid to SMEs to improving the regulatory and business infrastructure to facilitate the development of the private sector. In consultation with the World Bank's *Doing Business* team, the Government has identified a list of urgent measures and actions to simplify business regulations in the country.

25. In 2005, the Government completed the 2-year state program for SME development. The major objectives of the program were (i) creation and development of legal and physical infrastructure for efficient operation of SMEs, (ii) expansion of foreign economic activity of SMEs and export promotion, and (iii) expansion of opportunities for financial and investment assistance for SMEs.

26. To help alleviate SMEs' lack of financing, the Government established a special state budget fund for SME development, supervised by the Ministry of Economic Development. The fund is expected to disburse \$94 million in 2007 for various SME projects via 25 private bank agents, one nonbank institution, and five credit unions. While the loan size varies from \$50,000 to \$1 million, the annual interest rate is limited to 7% (market rates are 15%–20%). However, the ministry recognizes that the fund should not be a continuing source of subsidized financing for SMEs, and that private banks have to step in. Private banks are asked to look for external sources to reduce market lending rates. The ministry is expected to revise the charter of the fund in accordance with a new draft of the second state program on SME development to be approved in early 2008. Further, the President issued a special decree in May 2007 aimed at accelerating SME development in Azerbaijan. According to the decree, development of entrepreneurship requires new measures to reduce impediments, such as time-consuming registration procedures and licensing, etc. The cabinet of ministers and other line agencies have

⁶ Corporation for Enterprise Development. 2004. *SMEs and Poverty Reduction*. A report commissioned by the Ford Foundation's Affinity Group on Development Finance (SME committee), it reviews the current literature on SMEs and their links to poverty reduction strategies in the United States and internationally.

been authorized to prepare and submit to the President their suggestions on elimination of abuses, acceleration of entrepreneurial development, and creation of advantageous business environment.

III. THE BORROWER

A. Overview

27. IBA was established in 1990 as a successor to the Azerbaijan branch of Vnesheconombank, the foreign trade bank of the former Soviet Union, following the dissolution of the Soviet Union. In 1991, IBA was incorporated as a fully state-owned bank. In 1992, IBA was transformed into a joint-stock commercial bank, and the Ministry of Finance became the major shareholder of the bank. At the end of 2006, IBA was the largest bank in Azerbaijan, accounting for almost half of the total assets and loans in the banking sector, and more than half of the total deposits. It is also the largest bank in the South Caucasus in terms of asset scope, customer base, international banking relations, and number of products and services provided to customers.

28. Corporate banking traditionally has been IBA's core business. IBA collaborates with companies across various sectors of the economy, including air transportation, oil and gas, electricity, telecommunications, construction, food, tourism, and trade. Most of IBA's customers have international operations. Transactions with large corporations constitute the bulk of IBA's revenues from commercial banking, as well as a large portion of the bank's assets and liabilities. However, in the 3–4 years, IBA has been developing its SME and retail banking operations, along with its as well institutional and investment banking. Appendix 3 provides more details on IBA's business activities.

29. IBA's head office is in Baku. IBA has 36 branches and more than 100 subbranches in Azerbaijan, a subsidiary bank in Moscow (Russian Federation) with branches in three regions of the country, a subsidiary bank in Tbilisi (Georgia), and representative offices in London and Frankfurt. At the beginning of 2007, IBA's infrastructure comprised 525 automated teller machines (ATM), 1,180 point of sale (POS) terminals, and 100 payment-information kiosks.

30. IBA's customer base, which consists of more than 30,600 corporate and more than 412,000 individual customers, is served by 1,318 employees. The majority of corporate entities registered in Azerbaijan are clients of IBA. Almost all large and medium companies operating in Azerbaijan are clients of IBA, as are many smaller companies.

31. IBA is rated by two rating agencies: Fitch Ratings and Moody's Investors Service. Table 1 shows IBA's foreign currency ratings.

Table 1: International Bank of Azerbaijan Credit Ratings

	Fitch Ratings	Moody's Investors Service
Long term	BB+	Ba2
Short term	B	NP
Outlook	Stable	Stable

Sources: Fitch Ratings, Moody's Investors Service (September 2007).

32. In September 2007, Fitch Ratings upgraded IBA's credit rating from BB to BB+ based on its (i) growing importance in Azerbaijan's banking system, which implies the highest support from the government if needed; (ii) track record of ongoing support from the state in terms of

external capital contributions and regulatory forbearance; and (iii) potential growth in its dominant and expanding domestic franchise.

33. The achievements of IBA have been recognized by esteemed international institutes and publications, such as Euromoney magazine (Best Bank of Azerbaijan), The Banker magazine (Bank of the Year in Azerbaijan), Global Finance (Best Emerging Market Bank in the Central Caucasus region), Geneva Higher Institute of Business and Management, and Switzerland Business-Club (Golden Medallion award). In 2006, Global Finance magazine included IBA in the list of the top 16 banks in Asian region.

B. Network

34. As of December 2006, IBA had the largest national coverage with 36 branches and more than 100 subbranches in the country. In line with IBA's regional expansion strategy to promote retail and SME banking, which remain substantially underbanked in Azerbaijan, new branches will be established in regional areas (outside of Baku) in the near future. Apart from those local branches, IBA has representative offices in London and in Frankfurt, as well as two subsidiaries established in Moscow (Russian Federation) and in Tbilisi (Georgia).

IV. PROPOSED ADB ASSISTANCE

A. Overview

35. ADB's assistance will be a subordinated loan of up to \$40.0 million to serve as tier 2 capital for IBA.⁷ The proposed loan is expected to have a term of up to 10 years.

36. The proposed loan will enable IBA to diversify and improve its capital structure, enabling the bank to expand its lending to SMEs and retail businesses, while meeting NBA's capital adequacy ratio requirements.

B. Main Terms and Conditions

37. NBA has prescribed prudential guidelines for a commercial bank's issuance of tier 2 capital. The major restrictions are no security, and subordination to the claims of depositors. Furthermore, NBA requires that subordinated debt instruments, such as the proposed loan, not exceed 50% of tier 1 capital. These instruments, together with other components of tier 2 capital, cannot exceed 100% of tier 1 capital.

38. The proposed loan will be sourced from ADB's ordinary capital resources and will carry an interest rate based on the London interbank offered rate plus a margin determined by ADB's Pricing and Credit Enhancement Committee. The committee also will determine the upfront and commitment fees.

V. PROJECT BENEFITS, IMPACTS, AND ASSUMPTIONS

A. Justification for ADB Investment

1. Development Outcome

39. The proposed loan will promote development at the following key levels:

⁷ Tier 2 capital is used to supplement the bank's tier 1 capital or core capital in the computation of the capital adequacy ratio.

- (i) **Strengthen banking sector.** The weakness of the banking sector hampers the development of the economy, particularly the non-oil sector. IBA is important to the Azerbaijan economy; it plays a critical role in supporting the development and implementation of key private and public projects and its relative standing in the domestic banking sector makes it essential to the proper functioning of the banking sector in the country. Effectively, the financial health of IBA is a key measure of the health of the banking sector as a whole. The increased financial strength of IBA represents an important development factor for the national banking industry and the national economy in general and fosters its integration into the world economy.

The level of confidence of the general public in the country's banking system is extremely low due largely to the Soviet legacy. Depositors fear that in case of a bank failure, they would not get their money back. Only an estimated 10% of the total population maintains bank accounts. The proposed loan will help strengthen the banking sector at a critical point in its development and enhance confidence in the country's banking system. It would also help promote long-term consumer deposits which would reduce the risk of mismatch of maturities.

- (ii) **Support the privatization of IBA.** The provision of Tier 2 capital will strengthen IBA's capital base which is necessary for IBA to sustain and grow its operations, and allow IBA to meet regulatory capitalization requirements. Such development will provide increased confidence on the part of depositors, creditors and potential investors alike and thus, directly supports the Azerbaijan Government's efforts to privatize IBA. The privatization of IBA is mandated by a 2005 presidential decree which requires the Government of Azerbaijan to gradually reduce its share in IBA's charter capital either by selling its existing shares or by issuing additional shares on the open market, including on international financial markets. The Government is targeting a privatization within the next two years. In September 2007, Kapital Bank, the second largest state owned bank in the country, was privatized—the Azerbaijan Government's stake in Kapital Bank is now down to 50% from the previous 100%. The privatization of the state owned banks, which provide banking services for most institutions and the majority of the country's large, state-owned enterprises, will have a positive effect on the development of Azerbaijan's private commercial banks, as the competition for banking services will be on a more level playing field. As such, IBA's transformation into a full fledged market player will further enhance the country's banking sector in the long-term, and sends a clear signal of the Government's intention to implement financial and banking reforms.

- (iii) **Promote development in the non-oil sector.** Azerbaijan's economy is dominated by the oil sector and is expected to remain so for the foreseeable future. In the absence of further oil discoveries, the country's oil wealth is set to peak relatively early. As such, the diversification of the economic base will become an increasingly important means to sustaining growth and will reduce the country's vulnerability to a sustained fall in oil prices. The proposed loan will allow IBA to provide increased funding to SMEs and retail clients who are presently underbanked, which in turn will support the creation of employment and livelihood opportunities for a broader portion of the population, outside the oil and gas sector.

- (iv) **Provide a template for other banks to raise subordinated debt.** In a country with a rapidly developing economy and a fast growing banking sector such as Azerbaijan, there is inevitable pressure on banks' capital adequacy. Access to subordinated debt, which counts as tier 2 capital, is key to addressing this issue. Banks make use of subordinated debt as a capital instrument—i.e., to achieve their regulatory capital requirements. This is a common practice worldwide and is prevalent even in relatively unsophisticated markets. Such structure could serve as a benchmark and be replicated by other Azerbaijan banks following the IBA tier 2 capital management model.

2. Value Added by the Asian Development Bank

40. The proposed loan will allow IBA to strengthen its capital base. This, in turn, will enhance the bank's ability to expand its lending, particularly to SMEs and retail clients, providing greater financing intermediation in Azerbaijan. The strengthening of IBA's capital base also would increase in investor confidence in IBA and expand the pool of potential investors, which will be particularly important to the successful privatization of IBA in the future. The loan also will support the development and growth of a sustainable banking sector by introducing the tier 2 capital model. ADB will play a highly catalytic and demonstrative role, and will encourage other financial institutions to enter the market for this type of instrument, as banks in Azerbaijan are severely undercapitalized.

3. Design and Monitoring Framework

41. ADB has prepared a design and monitoring framework (Appendix 16) and will measure the expected development impact of the loan in accordance with ADB's Project Performance Management System.

4. Fit to Country and Sector Strategy

42. In response to ADB's initiating paper for the country partnership strategy for Azerbaijan, the Government has asked ADB to focus on four priority areas: transport, water supply and sanitation, renewable energy, and private sector development.⁸ Private sector development is an integral component of the Government's sustainable development strategy, which is also an important thematic priority for ADB. Support for private sector development, therefore, is a key focus area in ADB's country strategy and program updates (CSPU) and the interim operational strategy for Azerbaijan.⁹

43. ADB has the opportunity to play a significant role in private sector development in Azerbaijan. A number of possibilities for private sector operations in activities could serve as important demonstration projects with a catalytic effect on regional economic development. A key to private sector development is the deepening of financial intermediation, especially to SMEs. SMEs typically generate the most new jobs; introduce locally (and sometimes globally) relevant innovations, products, and business methods; and can push economic reform and the modernization of uncompetitive economies. Thus, SME development is an essential component of pro-poor growth strategies, and is an important focus for ADB and other multilateral and bilateral development institutions.

⁸ Letter to ADB from the Ministry of Economic Development, dated 27 October 2006.

⁹ Five CSPUs have been prepared to better reflect the changing needs and development priorities of Azerbaijan: CSPU 2002–2004, CSPU 2003–2005, CSPU 2004–2006, CSPU 2005–2006, and CSPU 2006.

44. ADB took its first steps into the Azerbaijan market in 2006 with the provision of a financing package of up to \$15 million to privately owned banks and leasing companies.¹⁰ These loans have been well received in the market, and have provided a number of follow-up opportunities. Since then, ADB has made considerable efforts to explore new opportunities and strengthen client relationships, in line with its focus on banking, to improve financial intermediation in the non-oil sector.

45. ADB's efforts in Azerbaijan have focused on providing assistance to private sector banks, and have excluded state-owned banks. As ADB shifts to the next phase of financial sector development—i.e., the provision of new and more sophisticated products, such as securitization—it will need to form partnerships with institutions that have the technical and financial capacity to implement such transactions. By and large, private banks are not yet in a position to transition to these types of products. IBA has shown keen interest in pursuing a Diversified Payment Rights securitization in 2008 once it successfully concludes its planned inaugural eurobond issue in 2007, and has initiated discussions with ADB on this transaction.

46. In addition, given its financial resources and international standing, IBA plays a fundamental role in the country's banking sector and economy. The successful recapitalization of IBA supports the Government's long-term plans and efforts to privatize the bank, which has been mandated by law. Further, IBA's efforts to provide increased financial intermediation to SMEs and retail clients, where private banks hold a significant share of the market, will support the creation of jobs and livelihood opportunities outside the oil and gas sector. This, in turn, will contribute to sustainable economic growth and private sector development. In this sense, IBA is not crowding out private sector banks, but is playing a complementary role in growing the SME sector.

47. Subordinated (tier 2) debt has been identified as a key development product¹¹ that should be utilized even by ADB. ADB is implementing this recommendation and processing other subordinated loans in Azerbaijan. ADB perceives this as a step toward more complex transactions. IBA, as a leading bank in the country, also can become an important example in this respect. In this sense, this loan is a direct answer to the request of the Government for recapitalization of IBA (and other banks in the country).

48. The proposed loan is also aligned with ADB's poverty reduction strategy,¹² which states that ADB seeks to promote "sound and efficient banking systems and capital markets," as these are seen as "indispensable for macroeconomic stability, mobilizing savings, and ensuring availability of long-term financing, an essential requirement for pro-poor growth."

B. Environmental and Social Safeguard Policies

49. The proposed loan is classified as Category FI (financial intermediary) under ADB's Environment Policy (2002). IBA has an environmental management system (EMS) in place based on the Black Sea Development Bank's environmental safeguards (Appendix 17 for a short summary). The implementing procedures and the underlying policy are in line with ADB's requirements for a bank of this nature and have been reviewed by ADB. IBA has the capacity to

¹⁰ ADB. 2006. *Proposed Assistance to Private Banks and Leasing Companies in Azerbaijan*. Manila.

¹¹ ADB. 2007. *Special Evaluation Study. Private Sector Development and Operations: Harnessing Synergies with the Public Sector*. Manila. Para. 126 (p. 49) and para. 161 (p. 60).

¹² ADB. 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy*. Manila (p. 29).

implement these procedures. ADB will be furnished with an annual environmental report. The proposed loan is classified as Category C under ADB's policy on Involuntary Resettlement (1995) and ADB's Policy on Indigenous Peoples (1998)

C. Anticorruption Policy, and Combating Money Laundering and the Financing of Terrorism

50. IBA has been advised of ADB's *Anticorruption Policy* (1998, as amended to date) and policy on combating money laundering and the financing of terrorism.¹³ Consistent with its commitment to good governance, accountability, and transparency, ADB will require IBA through covenants in the loan documentation to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism, and to covenant with ADB to refrain from engaging in such activities.

VI. EXPOSURE LIMITS

51. Once approved, the proposed loan to IBA will represent 77% of ADB's total nonsovereign exposure in Azerbaijan and will increase ADB's nonsovereign exposure to the banking sector from 17.22% to 18.15%. The proposed loan is within ADB's aggregate country, industry, group, and single project exposure limits for nonsovereign investments.

VII. ASSURANCES

52. ADB will enter into acceptable loan agreements and other required legal documents, following approval of the proposed loan by the Board. These agreements will be on terms and conditions satisfactory to ADB.

53. Consistent with the Agreement Establishing the Asian Development Bank, the Government will be asked to confirm that it has no objection to the proposed ADB loans to IBA. No funding under the loan will be made available until ADB receives such confirmation.

VIII. RECOMMENDATION

54. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the subordinated loan of up to \$40,000,000 to International Bank of Azerbaijan for ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; and such other terms and conditions as are substantially in accordance with those set forth in this report, and as may be subsequently reported to the Board.

Haruhiko Kuroda
President

15 October 2007

¹³ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

HISTORY AND DEVELOPMENT OF THE BANKING SECTOR IN AZERBAIJAN

A. Historical Overview

1. Institutional and legal establishment of the banking system in Azerbaijan began after independence in 1991. The basic objectives of the development stage of the banking system were to establish the institutions and infrastructure, and to provide for the normal functioning of the system.
2. Adoption of the Law on the National Bank of the Azerbaijan Republic and the Law on Banks and Banking Activity in the Azerbaijan Republic established the legal-normative basis of the banking system. The initial stage of the banking system was marked by liberal conditions of entry into the market. With the objective of stimulating the establishment of banking system institutions, the National Bank of Azerbaijan (NBA) required minimal capital and used relatively soft control mechanisms. As a result, 233 banks and 370 bank branches registered and operated during 1993–1994 in Azerbaijan.
3. The evolution stage of the banking system, which began in 1996, established new priorities by taking into account of the institutional establishment of the banking system. Administrative means, which NBA used to regulate the banking sector, were gradually replaced by prudent supervision.
4. As a result of the strengthening of the banking system, protection of depositors' interests, and promotion of sound competition, quantitative parameters were transformed to qualitative parameters. Special attention was paid to financial indicators of banks, i.e., capital, liquidity, profitability, security of transactions, use of progressive technological processes, and management information systems.
5. With the consolidation of the banking system, development of banks, and strengthening of their capitalization, aggregate bank capital increased by 22 times, total investment by 3 times, and attracted savings by 8 times. The weight of bank assets in gross domestic product (GDP) reached 28%.
6. At this stage of banking system development, to restructure the state banks, the capital of banks was incorporated and the share of the state in the banking system as a proprietor was reduced. Programs were carried out to prepare state banks for privatization and institutional development.
7. In 1998, the Government established as an objective increasing institutional variety on the legal basis of nonbank credit organizations. Financial entities, which numbered 13 in 1998, reached 82 in 2001. The next stage of historical evolution of the banking system, i.e., intensive restructuring and recovery of the banking system, started in 2000. Such recovery measures were aimed at establishing a banking system that was adequately capitalized with sound, sufficient management systems. To establish precise efficiency parameters, audits were carried out to evaluate financial condition, capitalization, liquidity, profitability management mechanisms and systems, in-house procedures, and other aspects. Furthermore, raising the efficiency of bank services, improving management information systems, and applying new bank technologies was supported. These measures fully embraced the private banking sector.
8. Restructuring and recovery of the banking system were carried out in two systems—restructuring of state banks and the private banking system. In the process, Industrial-

Investment Bank, Savings Banks, and Agrarian-Industrial Bank were merged, and BUS Bank was established. In addition, Mbank and Promtekhbank announced their merger in July 2002 to create Unibank, Azerbaijan's third largest bank by assets.

9. Other state bank structures were consolidated into the Agrarian-Industrial Bank. The Agrarian-Industrial Bank was transformed into a nonbank credit organization acting under a limited license to regulate bad debts and, thereby, solve the problem of low-quality assets inherent in former states of the Soviet Union.

B. Role and Regulations of the National Bank of Azerbaijan

10. On 7 August 1992, in addition to the law on banks and banking activity, the NBA law was adopted. The manat, the national currency of Azerbaijan, was issued on 15 August 1992. On 1 December 1992, the Milli Mejis¹ of Azerbaijan passed the Resolution on Approval of the Charter of the NBA. These legislative acts established the NBA as the supreme state bank, which has exclusive right to issue banknotes and carry out reserve system functions. At the same time, NBA was granted regulatory and supervisory authority over the banking system. NBA is the central bank of Azerbaijan. Its status, basic functions and duties, organization, and principles of activity are determined by the constitution, the NBA law, and other legislative acts.

11. The basic objectives of NBA are to (i) ensure stability of the manat, take measures to regulate its purchasing power and exchange rate versus foreign currency, and determine monetary and credit policy; (ii) carry out cash emission; (iii) pay off state debts in accordance with the current laws of Azerbaijan; and (iv) participate in the preparation of balance of payments forecasts, and to draw up balanced payment reports of Azerbaijan.

12. The main functions of NBA are (i) pursuing state policy in monetary, credit, and currency relations; (ii) facilitating settlements and stable operation of the payment system; (iii) accomplishing transactions in the securities market, as well as purchase and sale of foreign currency; (iv) taking necessary measures to develop and strengthen the banking system in Azerbaijan; (v) carrying out currency regulation, determining procedures for settlements with foreign countries, and managing foreign currency reserves; and (vi) adopting normative acts in the field of banking activity.

13. In recent years, NBA has used the exchange rate of the manat to help anchor domestic price levels, contributing to low inflation, increasing international reserves, and growing external competitiveness, as reflected in the rapid growth of non-oil exports in recent years. It also plans to continue to follow carefully the developments in the domestic market.

¹ Azerbaijan Parliament.

BANKING SECTOR OUTLOOK

1. The asset growth trend in Azerbaijan during the next few years is forecast to exceed the pace of previous years. The National Bank of Azerbaijan (NBA) expects banking indicators and bank performance to improve. Banks will continue to increase their capital; attract more foreign investments; improve risk management; and increase profitability, efficiency, and asset quality.
2. The process of revising the legislative framework of the Azeri banking system will continue. New legislation will foster banking sector development, strengthen banks' corporate governance, provide a new framework for mortgage lending, bolster the central bank's supervisory control, improve the ability to fight money laundering and the financing of terrorism, strengthen NBA's independence in the formulation and execution of monetary policy, improve the accountability of NBA, and enhance its transparency by establishing a clear mechanism for distributing NBA's profit.
3. In addition, NBA started re-denomination of the manat. From 1 January 2006, the value of the manat has increased by a factor of 5,000. Six new banknotes and five types of coins have been issued. NBA said the main reason for re-denomination is preventing further dollarization of the economy, as the nominal exchange rate is now close to the current US dollar rate. Furthermore, the re-denomination plays a vital role in strengthening the national currency and simplifying arithmetical calculations during trade operations. It also will ease the work of banks. Currently, the International Bank of Azerbaijan (IBA) is the largest bank with the largest number customer current accounts. Therefore, IBA's responsibility in the re-denomination process is significant.
4. On 15 April 2005, the Mortgage Law was adopted. As of 1 March 2006, authorized banks submitted the first applications for mortgage loans, and a number of them have granted mortgages to individuals. During 2005, NBA adopted regulations on corporate governance.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
<p>Impact</p> <p>The GDP composition of the Azerbaijan economy is more diversified (i.e., more SMEs, in more sectors, contribute to a more diversified economy)</p>	<ul style="list-style-type: none"> • Percentage of GDP contributed by SMEs rises from 10% to 15% in 5 years • Percentage of employment contributed by SMEs rises from 75% to 85% in 5 years 	<ul style="list-style-type: none"> • NBA statistics 	<p>Assumptions</p> <ul style="list-style-type: none"> • Increased access to finance from banks will lead to more SMEs receiving loans and expanding their role in the economy • Stable or increased economic development in Azerbaijan
<p>Outcome</p> <p>IBA provides increased, sustainable access to finance for SMEs and individuals in Azerbaijan</p>	<ul style="list-style-type: none"> • IBA's SME loan portfolio increases to 10% of total loan portfolio in 24 months • IBA's retail loan portfolio increases to 20% of total loan portfolio in 24 months • IBA's credit quality remains high with NPL levels less than 5.0% • IBA's ROE stays above 25.0% • IBA's CAR meets NBA requirements 	<ul style="list-style-type: none"> • IBA's quarterly and annual financial statements • Reports specifically requested by ADB 	<p>Assumptions</p> <ul style="list-style-type: none"> • SMEs have demand loans • IBA does not breach domestic prudential/ NBA norms • No adverse economic developments in Azerbaijan • No regulatory changes for the banking sector • No other exogenous factors that have a negative impact on banking sector development
<p>Outputs</p> <ul style="list-style-type: none"> • ADB provides subordinated loan • IBA 	<ul style="list-style-type: none"> • At the end of 2007, IBA has additional tier 2 capital of \$40 million 	<ul style="list-style-type: none"> • IBA's quarterly and annual financial statements 	<p>Assumptions</p> <ul style="list-style-type: none"> • Stability of prevailing market conditions • All regulatory approvals

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
operationalizes use of subordinated proceeds	<ul style="list-style-type: none"> Loan requests received by IBA from SMEs and retail clients increase by 25% per year from current levels 	<ul style="list-style-type: none"> Reports specifically requested by ADB 	in place for ADB <ul style="list-style-type: none"> IBA is able to raise tier 1 capital to access \$40 million of subordinated loan from ADB
Activities with Milestones 1.1 Provide IBA with up to \$40.0 million subordinated loan by September 2007 <ul style="list-style-type: none"> ADB and IBA enter into a subordinated loan agreement 1.2 Operationalization of proceeds of subordinated loan by IBA (ongoing). <ul style="list-style-type: none"> Origination of (new) SME and retail client opportunities Due diligence on clients Completion of loan agreements with clients Disbursement of loans to clients 			Inputs <ul style="list-style-type: none"> ADB—\$40.0 million

ADB = Asian Development Bank, CAR = capital adequacy ratio, IBA = International Bank of Azerbaijan, GDP = gross domestic product, NBA = National Bank of Azerbaijan, NPL = nonperforming loan, ROE = return on equity, SMEs = small and medium-sized enterprises.