



Report and Recommendation of the President to the Board of Directors

Project Number: 41915
July 2007

Proposed Loans Republic of Azerbaijan: Debt Financing to Bank of Baku

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 15 May 2007)

Currency Unit – Azerbaijan new manat/s (AZN)

AZN1.00 = \$1.0953
\$1.00 = AZN0.9130

ABBREVIATIONS

ADB	–	Asian Development Bank
BOB	–	Bank of Baku
CAR	–	capital adequacy ratio
CSPU	–	country strategy and program update
DMC	–	developing member country
EBRD	–	European Bank for Reconstruction and Development
GDP	–	gross domestic product
NBA	–	National Bank of Azerbaijan
SME	–	small and medium-sized enterprise

NOTE

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

Vice President	L. Jin, Operations 1
Director General	R. Bestani, Private Sector Operations Department (PSOD)
Director	W. Willms, Capital Markets and Financial Sectors Division, PSOD
Team leader	M. Balinghasay-Paterno, Investment Specialist, PSOD
Team members	R. Abbasov, Azerbaijan Resident Mission C. Armedilla, Senior Investment Officer, PSOD P. Bailet, Legal Consultant, OGC

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed (i) senior secured loan of up to \$4 million, and (ii) senior secured loan of up to \$2 million equivalent in Azerbaijan new manats (AZN), to the Bank of Baku (BOB).

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES

A. Azerbaijan Economy: Overview and Outlook

2. The rapid increase in oil production resulted in Azerbaijan's economy posting its fifth consecutive year of double-digit growth in 2006. Gross domestic product (GDP) expanded by a record 34.5% in real terms, the world's highest growth rate for the second year running. By far, the greatest engine of growth has been the industrial sector, in which value added was up by just over 56%, bringing cumulative growth in 2005–2006 to almost 150%. Within the industry sector, it is the oil and gas sector that is driving the growth. The non-oil economy is still growing strongly, expanding by 11.2% in 2006, but its contribution to GDP is falling as the oil economy expands. Non-oil sectors provided 47% of nominal GDP in 2006, down from 58% a year earlier and 61% in 2004.

3. The medium-term outlook for the economy of Azerbaijan is positive. GDP growth is expected to continue posting high double-digit growth over the next few years, mainly from increased oil and gas production and exports. Foreign investment is expected to decline over time as the major oil and gas projects move toward less intensive stages. However, the Government of Azerbaijan expects increased domestic public investment to offset some of this decline. Government expenditure rose by over 80% in 2006 and is projected to rise by a further 50% in 2007, which puts considerable pressure on inflation.¹ With the substantial increase in oil and gas revenues, and as imports are expected to ease, the current account surplus is expected to consolidate further.

4. 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 that the economy continues to grow on a sustainable path after the oil boom, meeting both short-term expectations and longer-term demands. A key objective is to develop income-generating and new employment opportunities in the non-oil sector, in such priority areas as banking and finance, trade, and small and medium-sized enterprise (SME) development.

5. In February 2007, Fitch Ratings upgraded Azerbaijan's foreign and local currency issuer default ratings to BB+ from BB. Fitch noted that the country's outlooks remain stable. Fitch's upgrade of Azerbaijan's sovereign ratings is justified 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 September 2006, Moody's assigned a foreign and local currency issuer rating of Ba1 to Azerbaijan.

¹ ADB projects 14% inflation in 2007. Source: ADB. 2007. Azerbaijan Country Chapter in *Asian Development Outlook*. Manila.

B. Banking Sector in Azerbaijan

6. Despite tremendous economic development, Azerbaijan's banking sector is one of the weakest among the sovereigns rated by Fitch.² The depth of bank intermediation activity is low (system assets were equivalent to only 17% of GDP as of the end of 2006). The provision of financial services to households and the private sector is very limited—only an estimated 10% of the total population has bank accounts, reflecting low confidence in the banking sector. Financial services have mainly been provided to the oil, construction, and trade sectors—leaving the retail and SME sectors notably underserved.

7. Banking sector deposits have grown rapidly but remain low, and are not commensurate with Azerbaijan's level of development. According to the National Bank of Azerbaijan (NBA), deposits rose by 50% in 2006 to AZN2.0 billion, an estimated 11% of GDP. Although dollarization continues to persist in the banking sector, the share of deposits held in AZN 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 total deposits were held in AZN, up from just 20% at the end of 2005.

8. 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 to date. As of December 2006, consolidated lending by banks was AZN2.36 billion, up 64% from the previous year. By April 2007, consolidated lending by banks reached AZN2.87 billion. However, despite the large increase in the deposit base, it is still too small to meet the growing demand for financial services, especially from SMEs.

9. The private and state-owned commercial banks each provide about 48% of total loans outstanding, with the remainder coming from non-bank 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, the banks provide mainly small and micro loans and typically do not serve the oil and gas sector.

10. A particular concern in the banking system is the ratio and quality of capitalization, particularly as credit continues to grow rapidly. In response to this, the authorities have worked to improve the supervision of the banking system. Minimum capital requirements will be raised from AZN6.4 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 toward strengthening the financial system in Azerbaijan. Currently, only 10 of Azerbaijan's 44 banks have AZN10.0 million in capital.

11. Despite substantial support from multilateral and bilateral agencies, most private banks are expected to remain illiquid and undercapitalized in the medium term. State-owned banks will continue to dominate the sector. Together with continued strong economic growth, this will ensure that the risk of a banking crisis is low. In February 2007, a presidential decree was enacted that called for the privatization of Kapital Bank. The privatization of one of two of the country's state-owned banks will be a welcome step in opening up the banking system to a more competitive environment.

² Fitch Ratings. March 2007. *Bank Systematic Risk Report*.

C. Small and Medium-Sized Enterprises in Azerbaijan

1. Overview

12. SMEs account for about 80% of registered private businesses operating in Azerbaijan, and represented an estimated 10% of GDP in the past 5 years. SMEs are the biggest source of domestic employment outside of the public sector, providing livelihood for over three quarters of the country's workforce. An estimated 70% of SMEs are located in Baku and the Absheron Peninsula, and have limited capacity for business and regional expansion, and new export opportunities.

13. The importance of SMEs in relation 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.³ The development of SMEs is therefore crucial to the development of the non-oil sector in Azerbaijan.

14. One of the biggest hurdles facing SMEs in Azerbaijan today is the lack of access to finance. This problem has been identified and recognized by both the Government and the donor community as a key constraint to SME development, especially outside Baku.

2. Government Efforts

15. The Government continues to support SME growth and improved 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.

16. 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 infrastructures for efficient operation of SMEs; (ii) expansion of the foreign economic activity of SMEs and export promotion; and (iii) expansion of opportunities for financial and investment assistance for SMEs.

17. To help alleviate the problem of lack of financing faced by SMEs, the Azerbaijani Government established a special state budget fund for SME development, supervised by the Ministry of Economic Development. The fund is expected to disburse a total of \$94 million in 2007 for various SME projects via 25 private bank agents, 1 nonbank institution, and 5 credit unions. While the loan size varies from \$50,000 to \$1 million, the annual interest rate is limited to 7% (market rates are in the range of 15–20%). However, the Ministry of Economic Development recognizes that (i) the fund should not be a continuing source of subsidized financing for SMEs, and (ii) private banks have to look actively for external sources to reduce market lending rates. In mid-2007, the Ministry of Economic Development is expected to revise the fund's charter in accordance with a new draft of the second state program on SME development to be approved in early 2008

³ SMEs and Poverty Reduction, a Report for the Ford Foundation's Affinity Group on Development Finance (AGDF) Small and Medium Enterprise (SME) Committee by CFED, 2004. This report reviews the current literature on the SME sector and its links to poverty reduction strategies in the United States and internationally.

III. THE BORROWER

A. Overview

18. BOB is a domestic commercial bank in Azerbaijan offering a wide spectrum of financial products and services to an estimated 67,000 retail clients and 1,770 corporate clients. It has two major lines of business—retail and corporate banking (except asset management and investment banking services). It has a significant presence in the retail sector, which accounts for about 60% of its business. It is also the third largest issuer of plastic cards in Azerbaijan.

19. One of the first commercial banks in Azerbaijan, BOB was registered on 14 February 1994 originally under the name of Tugay Bank. The key founder of BOB was the Turkish company Nab Dış Ticaret. On 10 February 1997, BOB's name was changed to Bank of Baku and it was reregistered as a joint stock commercial bank in August 1997.

20. BOB's client base began to grow beyond serving its corporate owners when, in May 2001, it partnered with Kreditanstalt für Wiederaufbau (KfW) to provide credit to SMEs under the Germany-Azerbaijan fund. To date, BOB is the largest participant in the program. In 2002, BOB decided to broaden its focus on retail services, while further developing its SME products. Efforts to target the SME market received a further boost from a credit line with the European Bank of Reconstruction and Development (EBRD) in February 2004.

21. In February 2005, BOB was merged with OJSC İlbank, making it one of the 10 largest banks in the country.⁴ The merger was a consolidation of BOB's strength in retail banking and İlbank's strength in corporate banking. As of 31 March 2007, BOB had 287 full-time employees with 207 staff at the branches.

III. PROPOSED ASIAN DEVELOPMENT BANK ASSISTANCE

A. Overview

22. Proposed assistance to BOB from the Asian Development Bank (ADB) will be in the form of: (i) a senior secured term loan of up to \$4 million (ADB US dollar loan), and (ii) a senior secured term loan of up to \$2 million equivalent in local currency (ADB AZN loan).

B. Main Terms and Conditions

23. The ADB US dollar loan will have a maturity of up to 5 years, with an amortizing repayment structure.

24. The ADB AZN loan will have a maturity of up to 2 years. ADB would buy local currency spot at financial close. To protect ADB from any foreign exchange downturn, the repayment of the ADB AZN loan will be linked to the AZN/US dollar exchange rate and capital protected. The coupon will have a built in AZN/US dollar swap, which will be structured and priced to allow ADB to participate in AZN upward movements.

25. The ADB US dollar loan and ADB AZN loan, sourced from ordinary capital resources, will carry an interest rate based on the London interbank offered rate (LIBOR) plus a margin determined by ADB's credit enhancement and pricing committee. The committee will also determine the up-front and commitment fees.

⁴ The share capital of the newly merged bank was formed in equal amounts by BOB and İlbank.

26. Proceeds of the proposed loans will be used by BOB for onlending to SME clients in Azerbaijan. The proposed loans will be secured by the rights and receivables under the sub-loans.

IV. PROJECT BENEFITS, IMPACTS, AND ASSUMPTIONS

A. Justification for ADB Investment

1. Development Outcome

27. The proposed ADB assistance will promote development at the following key levels:

- (i) **Increased access to finance for SMEs.** SMEs play a significant role in all of ADB's developing member country (DMC) economies and are key drivers of employment, economic growth, and development. They often have a significant impact on the GDP and in most cases grow faster than state-owned enterprises. The development of SMEs is therefore an important engine of growth and a key contributor to poverty reduction by creating employment, increasing individual incomes, and generating tax revenues.

SMEs rely heavily on access to external capital to finance their operations. However, in most of ADB's DMCs, SMEs have difficulty accessing financial services and securing financing. Although bank loans are dominating any external financing (because of the underdeveloped corporate bond markets), only a small number of SMEs in the region have access to bank lending (mostly only for working capital). In most DMCs, lack of access to bank lending is considered the main financing difficulty and an obstacle for sustaining the growth of SMEs. This is no different in Azerbaijan. Appendix 1 discusses the development impact of SME finance and Appendix 2 analyzes the SME financing gap in Asia.

The proposed assistance will allow BOB to provide increased financial intermediation to SMEs, in line with its strategic plans. The increased availability of capital or funding to SMEs would help in promoting their operations and profitability and enhancing their competitiveness, contributing to private sector development and translating into sustainable economic growth in Azerbaijan.

- (ii) **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 transaction, which will indirectly lead to increased lending to SMEs that, as of the present, have limited access to bank financing, will support the creation of employment opportunities for a broader portion of the population, outside the oil and gas sector.
- (iii) **Support the emerging private banking sector.** The proposed intervention will help strengthen the banking sector at a critical point in its development and enhance confidence in the county's banking system. The private banking sector

is small and underdeveloped, and not fully able to mobilize the available liquidity and channel it toward SME investment through extension of credit. Support for the growth of a promising and well-managed private bank will contribute to the shift away from the state-owned banks' dominance of the sector. As private banks are a key source of small and micro loans for the private sector, in particular individual entrepreneurs and SMEs, they are critical to the economy (state-owned banks are not geared to service SMEs, particularly private ones).

- (iv) **New and innovative way of local currency funding.** ADB is introducing a new and innovative form of local currency financing. This particular structure can be replicated by BOB and other banks in Azerbaijan to gain access to local currency funding, thereby reducing currency mismatches. Although Azerbaijan is still heavily dollarized, local currency lending is on the rise given the ongoing appreciation of the AZN.

2. Value Added by the Asian Development Bank

28. ADB's partnership with BOB will further enhance its reputation in the market, improving its ability to raise long-term deposits and issue bonds. This in turn will allow BOB to better manage and reduce the risk of maturities mismatch. ADB's proposed loans will also allow BOB to expand its SME loan portfolio, while deposit growth catches up with loan growth. This translates into higher financing intermediation available to the SME sector.

29. ADB will encourage and support BOB's adoption of better practices for critical banking functions (e.g., credit, asset liability management, anti-money laundering, anticorruption, and environmental safeguard policies and procedures).

3. Design and Monitoring Framework

30. ADB will measure the expected development outcome of the loans in accordance with the Design and Monitoring Framework (Appendix 3).

4. Fit to Country and Sector Strategy

31. In response to ADB's draft country strategy and program initiating paper for Azerbaijan, the Government has specifically requested ADB to focus on four priority areas: transport, water supply and sanitation, renewable energy, and private sector development.⁵ 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 is also consistent with ADB's country strategy and program updates for Azerbaijan and the interim operational strategy for Azerbaijan.⁶

32. ADB has the opportunity to play a significant role in private sector development in Azerbaijan, with a number of possibilities for private sector operations in activities that could serve as important demonstration projects with a catalytic effect on regional economic development. The deepening of financial intermediation, especially to SMEs, is crucial to private sector development. SMEs typically generate the most new jobs; introduce locally (and

⁵ Letter to ADB from the Ministry of Economic Development dated 27 October 2006.

⁶ Five country strategy and program updates (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.

sometimes globally) relevant innovative ideas, products, and business methods; and can push economic reform and the modernization of uncompetitive economies. SME development is, thus, a critical component of pro-poor growth strategies and is an important focus for ADB and other multilateral and bilateral development institutions.

33. In March 2006, ADB's Board of Directors approved a private sector project involving the provision of a financing package of up to \$15 million consisting of equity investments and loans to privately owned banks and leasing companies in Azerbaijan.⁷ This was ADB's first private sector operations project in Azerbaijan. Since then, the Capital Markets and Financial Sector Division (PSCM) of the Private Sector Operations Department (PSOD) has invested considerable effort in exploring new opportunities and strengthening client relationships. ADB continues its dialogue with various banks in the country, in line with ADB's focus on the banking sector to improve financial intermediation to the non-oil sector. This Project is a continuation of those efforts.

34. The proposed loans are also aligned with ADB's poverty reduction strategy,⁸ which states that ADB seeks to promote "sound and efficient banking systems and capital markets," since 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

35. The proposed loans are classified category FI (financial intermediary) under ADB's *Environment Policy* (2002). BOB will be required to establish an environmental management system that will cover the environmental assessment procedures of all sub-loans to be financed with ADB funds. The proposed loans are classified category C under ADB's *Involuntary Resettlement Policy* (1995) and *Policy on Indigenous Peoples* (1998), as no involuntary resettlements or adverse impacts on indigenous peoples are foreseen in relation to any activities of BOB. The environmental policies of EBRD are already in place. ADB will ensure that BOB's existing environmental management system, which is based on EBRD standards, conforms to ADB standards. Significant environmental impacts are not expected, as BOB will use proceeds of the proposed loans for onlending exclusively to SMEs (verified during due diligence).

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

36. BOB has been advised of ADB's *Anticorruption Policy* (1998, as amended to date) and policy on combating money laundering and the financing of terrorism.⁹ Consistent with its commitment to good governance, accountability, and transparency, ADB will require BOB 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.

⁷ To date, a total of \$12 million of loans have been disbursed: \$4 million to Microfinance Bank of Azerbaijan, \$4 million to Azerigazbank, and \$4 million to Bank Respublika.

⁸ ADB. 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy*. Manila (p. 29).

⁹ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

V. EXPOSURE LIMITS

37. The proposed investment would, if approved by the Board, be ADB's second non-sovereign investment in Azerbaijan, represent 33% of ADB's total non-sovereign exposure in Azerbaijan and increase ADB's non-sovereign investments in the banking sector from 11.17% to 11.33%. The proposed loan is within ADB's aggregate country, industry, group, and single project exposure limits for non-sovereign investments.

VI. ASSURANCES

38. ADB will enter into suitable loan agreements and other required legal documents, following approval of the proposed loans by the Board. These agreements will be on terms and conditions satisfactory to ADB. In addition, ADB will need to be satisfied with all terms and conditions of any other documents associated with the proposed financial assistance.

39. 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 BOB. No funding under the loans will be made available until ADB receives such confirmation.

VII. RECOMMENDATIONS

40. I am satisfied that the proposed loans would comply with the Articles of Agreement of the Asian Development Bank and recommend that the Board approve (i) the proposed senior secured loan of up to \$4 million; and (ii) the proposed senior secured loan of up to \$2 million in AZN equivalent to Bank of Baku, both on terms and conditions substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

9 July 2007

DEVELOPMENT IMPACT OF SMALL AND MEDIUM-SIZED ENTERPRISES¹

1. Growth and modernization in the small and medium-sized enterprise (SME) sector is often associated with successful economic development, particularly in low-income countries. In turn, such growth and modernization are associated with general poverty reduction. SMEs play a crucial role in driving economic growth in both developing and developed countries. They typically generate the most new jobs; introduce locally (and sometimes globally) relevant innovative ideas, products, and business methods; and can push economic reform and the modernization of uncompetitive economies.

2. SME development is also often seen as a critical component of pro-poor growth strategies:

- (i) SMEs generate many of the new jobs in the economy. Since many of these jobs are suitable for semiskilled or unskilled workers, they can be taken up by the poor.
- (ii) SMEs introduce business methods, products, and services that help restructure weak agricultural sector or other uncompetitive transition economies, thereby absorbing labor that would otherwise drop into the ranks of the poor.
- (iii) SMEs help spread the benefits of economic growth by engaging low-income groups in national development. They form dynamic supply chain linkages between small-scale producers and lucrative urban, national, or export markets. In the reverse direction, they link large urban business with mass consumer markets in remote areas.

3. The following are the effects of SMEs on poverty:

- (i) **Removal of bias against labor-intensive production.** The removal of market distortions that lead to a bias against labor-intensive production techniques should have a clearly positive impact in reducing poverty. Reducing poverty may improve the environment for SME expansion, so that these efforts can be expected to be mutually reinforcing. Although the expansion of SMEs may not be sufficient for poverty reduction, the likely positive effects—through the families of SMEs employees, better utilization of more general aid donor interventions across firms, and the resulting acceleration of human and community development—make it plausible to suppose that there is an enormous “value” in fighting poverty by investing in SMEs.
- (ii) **The effect of employing relatively low skilled workers.** It is likely that both SMEs and their suppliers, on average, employ a greater share of local, low skilled workers than large firms or suppliers to large firms. Since these workers plausibly spend a larger share of their income on other products produced by less skilled workers, there is more likely to be a positive multiplier effect on the alleviation of poverty through SME support than through development projects that lack this focus.

¹ SEAF. *The development impact of small and medium enterprises: lessons learned from SEAF investments. Volume 1.* Washington: Small Enterprises Assistance Funds.

- (iii) **Linkage to small suppliers.** It is plausible that SMEs have more supply links than large firms to the local economy, given their small size or lesser sophistication, which would generally inhibit sourcing directly from abroad. SMEs probably import fewer intermediate goods than large firms, suggesting a larger local multiplier effect. It is also a reasonable hypothesis that SMEs buy a greater percentage of these products from labor-intensive SMEs. This, in turn, should lead to a greater expansion of sustainable, local, employment benefits.
- (iv) **Security of employment.** When employees leave microenterprises to accept SME employment, their wage incomes are likely to rise and become less variable, making it easier to plan for their families' welfare.
- (v) **Impact on children through employment of mothers.** If investment in an SME raises the incomes of poor mothers with small children, the impact on poverty can be great. Development microeconomics consistently shows that a much larger fraction of an extra dollar earned by a mother goes to the welfare of her children than of an extra dollar earned by the father. This holds for spending on children's health and education, as well as home improvements and other important factors. The impact is especially significant for daughters.
- (vi) **Magnified impact on poverty reduction among very poor people.** Targeting a small number of very poor people provides greater social benefits than targeting a larger number of less poor people. Thus, to the degree that SMEs hire relatively poor people, the impact of any given income increase on poverty would be magnified. Given the correlation between wage level and skill level, the tendency of SMEs to hire more unskilled people than larger enterprises suggests that this magnified impact is likely at the SME level.
- (vii) **SME tax payments.** Tax revenues are used to implement poverty impacting programs, such as local infrastructure improvements, health services, or school meals. Since SMEs contribute more tax revenue than microenterprises (which in practice may pay few or no taxes) or large firms (which can often find loopholes or use their influence to pay less than statutory tax rates), support to SMEs could be expected to have a greater indirect impact on poverty reduction than other forms of developmental assistance.

SMALL AND MEDIUM-SIZED ENTERPRISE FINANCING GAP IN ASIA

1. Restricted access to formal credit is one of the main challenges faced by small and medium-sized enterprises (SMEs) in Asia today, and often hinders them from developing their full potential. Whereas all types of firms mostly rely on retained earnings, SMEs are more dependent on these funds than large firms.

2. The larger the firm, the easier is access to bank credit and the better the loan conditions it receives. Loans to large customers are encouraged by banks through employee incentive schemes, which are often based on the amount of credit granted. In addition, a vast array of alternatives to domestic bank loans are available to large firms, e.g., recourse to capital or international financial markets, augments their bargaining power in negotiation a loan. In contrast to large firms, SMEs are often unable to cover their financing needs. Since SMEs receive less finance or face worse conditions than larger firms, they are at a competitive disadvantage. Without sufficient long-term finance, SMEs are unable to expand their business and introduce productivity enhancing technology.

3. The limitation of banking services available to SMEs is mainly due to the following reasons.

- (i) State-owned banks (as in the People's Republic of China) are not geared to service SMEs, particularly private ones.
- (ii) Other banking institutions have limited coverage and financial products. The high frequency and short-term nature of SME loans, unfamiliar markets, ownership structures that are often complicated, and lack of sufficient and reliable operational and financial data for loan appraisal have resulted in high business development and administration costs for banks. Because of the long process of recognition, registration, and evaluation for the SME borrower's collateral, banks have difficulties meeting the SMEs' frequent and seasonal demand for debt.
- (iii) To reduce nonperforming loans, many commercial banks have adopted a policy of permanently assigning the responsibility of loan performance to loan officers. This has resulted in acute risk aversion at the subbranch and loan officer level, curtailing the amount of loans to SMEs.
- (iv) Most developing member countries (DMCs) lack a diversified financial sector capable of serving SMEs, i.e., focused financial institutions that are specialized in providing loans for SMEs are missing or are only marginal market participants.
- (v) In many markets, credit allocation is distorted by continued policy lending through government-owned banks, and restrictions on competition from foreign financial institutions.
- (vi) In many instances, regulated (domestic) bank lending rates do not allow domestic banks to price risks appropriately and therefore, banks shy away from this asset, which is often perceived as highly risky. However, this is not true for all cases, if appropriate protection is sought and thorough due diligence is undertaken.

4. Banks cite four main reasons for their reluctance to extend credit to SMEs.

5. **High Administrative Costs of Small-Scale Lending.** Since most of the administrative costs of lending are fixed, i.e., independent of the size of the administered loan, economies of

scale arise—the larger the loan, the lower the unit costs of extending credit. Furthermore, administrative costs also include information gathering costs, e.g., visiting borrowers, analyzing their applications, and monitoring their loans. For a number of reasons, these costs tend to be higher for small than for large firms. SMEs are often located away from the main urban centers, their accounting skills and standards are usually lower, and banks lack experience in servicing them.

6. **Asymmetric Information.** A prerequisite for the efficient allocation of resources by market forces is that all participants share the same relevant information. This is not the case in financial markets. Borrowers will always know more about the viability of their projects and their ability and willingness to repay than lenders. The lender is thus faced with uncertainty—both with respect to the expected rates of return of the project he is financing, as well as the integrity of the borrower. This uncertainty increases with the length of the loan. Borrowers face difficulties in transmitting information about their projects to lenders, as lenders will suspect them of underestimating the risks of failure. The problem of asymmetric information is more acute for SMEs than larger firms because of lower information standards and greater variability of risk—small, privately owned firms face no legal reporting requirements and are more vulnerable than large firms.

7. Because of asymmetric information, it is impossible to distinguish accurately between good and bad borrowers. The two main problems associated with asymmetric information are adverse selection and moral hazard, both of which may affect the quality of the loan. Adverse selection refers to the fact that the probability of default increases with the interest rate—the quality of the borrower pool worsens as the cost of borrowing rises. A higher interest rate will attract risky borrowers and drive out good borrowers for two reasons: (i) worse risks are willing to borrow at higher interest rates because they know that their repayment probability is low; and (ii) if riskier projects are associated with higher returns, a rise in the interest rate will drive out low-risk projects as borrowers try to compensate for the higher cost of the loan by earning a higher return with a risky project. An optimal interest rate may therefore exist, beyond which additional loans are not made available despite excess demand. Consequently, a backward-bending credit supply curve and equilibrium credit rationing will exist because raising the interest rate above the optimal level would lower banks' profits as the amount of risky projects in their portfolio rises (Stiglitz & Weiss, 1981). SMEs are more likely to be rationed because they are seen as particularly risky. Although they might be willing to pay more to compensate for this additional risk, banks will refuse to raise the interest rate sufficiently to equate supply and demand.

8. Moral hazard refers to a situation in which an agent (the borrower) takes an action that adversely affects the return to the principal (the lender). It occurs if the parties involved have diverging interests and the action taken by the agent cannot be monitored accurately by the principal. A borrower may, for example, be tempted to exert less effort or secretly switch to riskier projects in order to increase his return. Because of a higher probability of default, the return to the bank will be reduced. Banks can resort to two methods to reduce moral hazard: (i) by making it profitable to tell the truth, e.g., through the promise of renewed credit in the future; and/or (ii) by including penalties for low effort levels, e.g., collateral, which are lost if the firm becomes insolvent. Because of information imperfections and costly control mechanisms, the superior selection criteria based on cash-flow projections is often abandoned in favor of loan selection according to firm size and collateral. This results in suboptimal allocation of credit since some firms with profitable projects may be deprived of credit simply because of their size or insufficient capital.

9. **High Risk Perception.** Commercial banks tend to assign a high risk to SMEs and are reluctant to extend credit to them. Because of their small size and inherent vulnerability to market fluctuations, the mortality rates of SMEs are relatively high. These firms are often relatively young, and lack a financial history and track record of profitable projects. Organizational and administrative deficiencies, lower quality management, and lack of appropriate accounting systems may also compromise the accessibility and reliability of information from small firms on their repayment capacity. In addition, small loans to industry are often classified as personal loans. Therefore, banks may lack concrete figures of the level of profitability of loans to small enterprises and what costs they entail. Finally, the relative labor intensity of SMEs implies a high debt-to-asset ratio if loans are made. The associated vulnerability and lack of sufficient and adequate collateral further limits the amount of finance that banks are willing to grant them.

10. In Asia, the disadvantage of SMEs with regard to risk perception is aggravated by a number of factors. Many SMEs have evolved in the informal economy, making it difficult for them to document their business history and demonstrate their economic potential. Additionally, small entrepreneurs in emerging economies are typically less skilled in bookkeeping, marketing, and management than their counterparts in industrial countries, adding to the risk perception with regard to their projects. This is exacerbated by inadequate legal frameworks, which make the enforcement of contracts difficult for lenders.

11. **Lack of Collateral.** Under optimal conditions, the net present value of a firm's profit stream should determine the amount of credit it receives. However, because of the existence of asymmetric information, banks base their lending decisions on the amount of collateral available. Collateral acts as a screening device and reduces the risk of lending for commercial banks. By pledging its assets, a borrower signals the quality of its project and intention to repay. In the case of default, collateral puts the lender in a privileged position with regard to other creditors. Banks' acceptance of a certain asset as collateral depends on the present and anticipated transaction costs involved. These include the costs of verifying ownership of assets, determining their value and marketability, as well as the ease of appropriating and access in comparison to other lenders. Despite its advantages for lenders, the policy of demanding collateral often inhibits SMEs with viable projects from attaining credit. Their lack of adequate collateral arises from their labor intensity and from the low value of their machinery and property.

12. In Asia, problems in the legal system make debt enforcement and the use of collateral difficult. Potential borrowers may be unable to pledge some of their assets as collateral because they are unable to prove they own them, because of inappropriately defined property rights. Additionally, moveable assets such as machinery or livestock, which constitute a large share of small firms' assets, are often excluded as collateral. Since movable property may be difficult to store, its value declines over time (equipment depreciates and livestock dies), and inefficient secondary markets lead to high liquidation costs, lenders typically demand real estate as collateral instead. However, this is likely to belong to large firms or rich landowners.

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 SME sector rises from 10% to 15% in 5 years • Percentage of employment contributed by SME sector 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"> • Increase 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>BOB provides increased, sustainable access to finance to SMEs in Azerbaijan, in part in local currency</p>	<ul style="list-style-type: none"> • BOB's number of outstanding SME loans increases (10% in next 24 months, from 296 to 325) • BOB's credit quality is high – NPL level less than 3.0% • BOB's ROE stays above 18.0% • BOB'S maintains at least 2.0% ROA • BOB's CAR remains above NBA requirements 	<ul style="list-style-type: none"> • BOB's quarterly and annual financial statements • Reports specifically requested by ADB 	<p>Assumptions</p> <ul style="list-style-type: none"> • There is demand for loans from SMEs • BOB 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 and USD and AZN loans • BOB operationalizes use of loan proceeds 	<ul style="list-style-type: none"> • As of July 2007, BOB has \$6 million in USD equivalent • Loan requests received by BOB increase by 15% per annum from current levels 	<ul style="list-style-type: none"> • BOB's quarterly and annual financial statements • Reports specifically requested by ADB 	<p>Assumptions</p> <ul style="list-style-type: none"> • Stability of prevailing market conditions • All regulatory approvals in place for ADB

Activities with Milestones	Inputs
<p>1.1 Provide BOB with a \$4.0 million loan and \$2.0 million loan in local currency by July 2007</p> <ul style="list-style-type: none"> • ADB and BOB enter into a loan agreement <p>1.2 Operationalization of loan proceeds by BOB (ongoing).</p> <ul style="list-style-type: none"> • Origination of (new) client opportunities • Due diligence on clients • Completion of loan agreements with clients • Disbursement of loans to clients 	<ul style="list-style-type: none"> • ADB - \$4.0 million + \$2.0 million in local currency

ADB = Asian Development Bank; BOB = Bank of Baku; AZN = Azerbaijan manat; NBA = National Bank of Azerbaijan; NPL = non-performing loan; ROA = return on asset; ROE = return on equity; SME = small and medium-sized enterprise.
Source: ADB.