



Report and Recommendation of the President to the Board of Directors

Project Number: 41925
October 2007

Proposed Subordinated Loan Republic of Azerbaijan: Bank Respublika Open Joint Stock Company

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 30 September 2007)

Currency Unit – Azerbaijan new manat (AZN)

AZN1.00 = \$1.0953

\$1.00 = AZN0.9147

ABBREVIATIONS

| | | |
|-----|---|---|
| ADB | – | Asian Development Bank |
| DEG | – | Deutsche Investitions- und Entwicklungsgesellschaft mbH |
| DMC | – | developing member country |
| GDP | – | gross domestic product |
| KfW | – | Kreditanstalt für Wiederaufbau |
| NBA | – | National Bank of Azerbaijan |
| NPL | – | nonperforming loan |
| SME | – | small and medium-sized enterprise |

NOTE

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

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I. THE PROPOSAL

1. The proposed transaction will provide a dollar-denominated subordinated loan (Tier II capital) of up to \$10 million to Bank Respublika Open Joint-Stock Company (Bank Respublika; the bank) in order to strengthen its capital position and underpin the expansion of its lending activities, particularly to small and medium sized enterprises.

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 the Azerbaijan economy posting its fifth consecutive year of double-digit growth. Gross domestic product (GDP) expanded by a record 34.5% in real terms during 2006, which was the world's highest growth rate for the second year running. By far the greatest driver of growth has been the industrial sector, specifically the oil and gas sector, which increased by 56% in 2006 (for a cumulative growth rate of 150% in 2005–2006). The non-oil economy has also expanded, rising by 12% in 2006; however, its contribution to GDP has fallen in the last 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 a significant strengthening of Azerbaijan's 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 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. It is expected that domestic public investment will partially offset the decline in foreign investment. Government expenditures rose by over 80% in 2006 and are projected to rise by a further 50% in 2007. Partly due to the increase in government spending and partly the continued strong foreign exchange inflows associated with the oil and gas sector and robust private consumption, there will be increasing inflationary pressure. Annual inflation is expected to rise from 11.4% in 2006 to over 15% in 2007.²

4. In February 2007, Fitch Ratings upgraded the Republic of Azerbaijan's foreign and local currency issuer default ratings to BB+ from BB. Fitch Ratings noted that the country's outlook remained stable. Fitch Ratings' upgrade of Azerbaijan's sovereign ratings is driven by (i) strong and sustainable economic growth, (ii) low government and external debt ratios, and (iii) a growing current account surplus underpinned by rapidly increasing 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. Future Challenges

5. In the long term, given potential volatility in the international oil market, Azerbaijan's high dependence on oil exports poses a potential threat to the economy. The main challenge is to

¹ In 2006, Azerbaijan had a current account surplus of \$3.7 billion, equivalent to 18.7% of GDP and 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 high demand growth, the inflation rate for the first quarter of 2007 was 16.6%.

develop the non-oil sector to ensure the economy continues to grow sustainably 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 enterprises (SMEs).

C. Banking Sector in Azerbaijan

1. Overview

6. The Azerbaijani banking system has shown significant improvement in key performance indicators since 2000, mainly due to strong growth in the economy and financial sector reform. It is, however, still considered one of the weakest among the sovereigns rated by Fitch Ratings.³ The financial system remains small and highly concentrated. As of the beginning of 2007, the Azerbaijani 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 Azerbaijani 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 are still relatively small, with total assets of \$30 million–\$80 million and equity of around \$10 million for a typical top-tier private bank. The leading private banks are generally owned by individuals or private business groups, and state-owned enterprises hold only small stakes (if any). In recent years, a top tier of approximately 10 private banks has emerged, and these account for half of the total bank capital in the country. The remaining banks are smaller, with low levels of total assets. It is expected that there will be consolidation within the banking sector 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 due to the small size of the domestic market and certain legal restrictions.

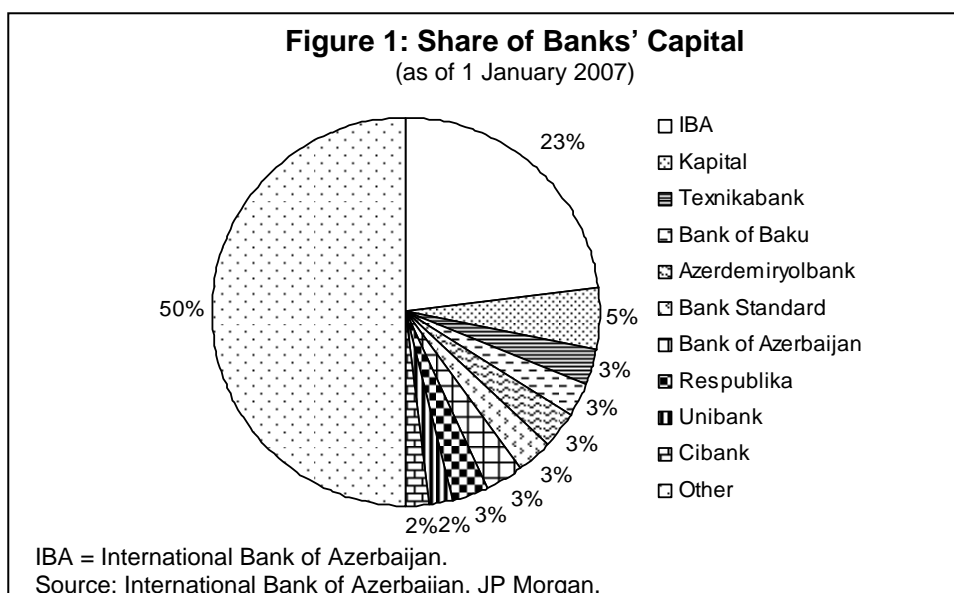
8. While the authorities continue to improve prudential regulations, significant vulnerabilities in the banking system remain. In response to rising credit and foreign exchange risks, the NBA has tightened the prudential rules pertaining to loan collateral and open positions in foreign currencies, and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

9. The Heritage Foundation Banking Index⁵ rating of 3.5 (on a scale of 1 to 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 banking index score of 3.73 for ADF borrowing countries.

³ Fitch Ratings. 2007. *Bank Systemic Risk Report*. New York: Fitch Ratings Ltd. (March).

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

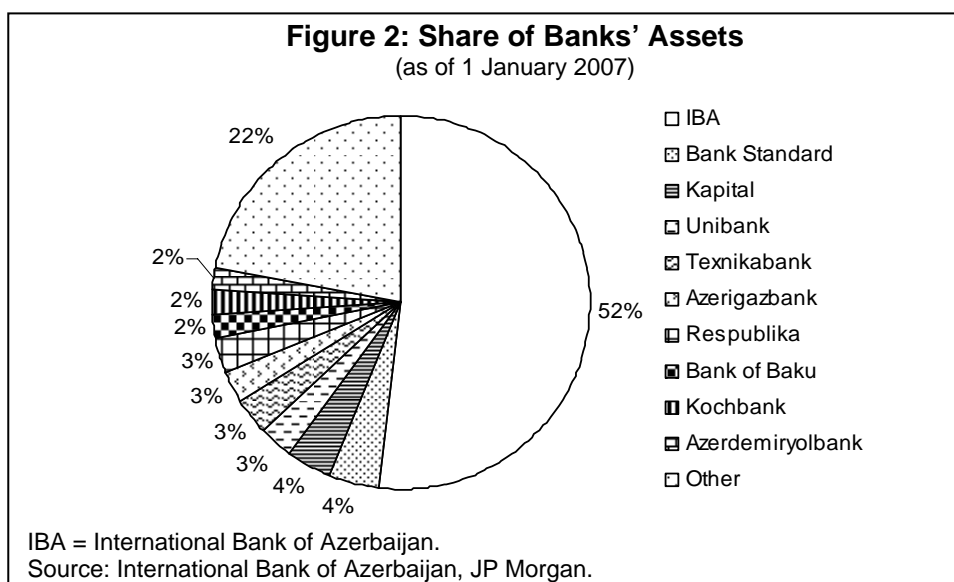
⁵ Heritage Foundation. 2006. *Economic Freedom Advances, 2006*. Washington, DC (January).



2. Detailed Analysis

10. 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.

11. The banking system's assets (the main pillar of the Azerbaijan financial system) represented only 21% of GDP in 2006, significantly below the ratios for Russia (53%) and Kazakhstan (91%). As of the end of 2006, the total volume of assets grew by almost 60% and amounted to \$4,344 million. The most significant element in the structure of bank assets are loans issued to customers, which total \$2,537 million (58.4% of total assets). Half of the total banking assets in the country are held by the state-owned International Bank of Azerbaijan (Figure 2).

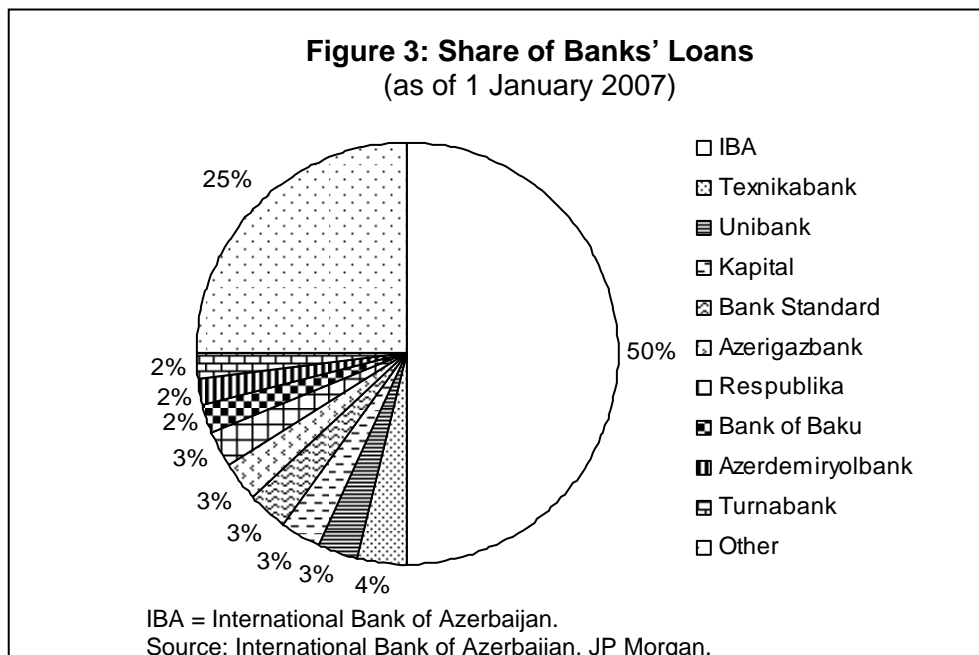


12. On the liability side, the most significant element comprises deposits issued to corporate and individual customers, which total \$2,253 million (64.23% of total liabilities). Banking sector deposits have grown rapidly but remain low, and are not commensurate with Azerbaijan's level of development. According to NBA, deposits rose by 50% in 2006 to AZN2.0 billion, an estimated 11% of GDP.

13. The use of dollars in the economy remains high, with the share of savings in foreign currency as at the end of 2006 being more than 50%, and the volume of lending in foreign currency being 53%. The share of deposits held in Azerbaijan new manats has, however, increased notably during 2006, at least in part because of the appreciation of the local currency against the dollar. By November 2006, 37% of total deposits were held in Azerbaijan new manats, up from just 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 up until now. As of December 2006, consolidated lending by banks was AZN2.36 billion, up 64% from the previous year. By April 2007, this figure reached AZN2.87 billion. Despite the large increase in the deposit base, this figure is still too small to meet the growing demand for financial services, especially from SMEs.

15. The 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. By virtue of their small size and customer focus, the private banks provide mainly small and micro loans and typically do not serve the oil and gas sector.



16. The share of nonperforming loans (NPLs) and the level of capital at risk are moderate. According to national statistics, the share of NPLs in 2006 was considerably low at 3.33%, compared to 4.73% in the previous year. However, the European Bank for Reconstruction and

Development's (EBRD) *Transition Report 2006*⁶ noted that the level of NPLs in the entire banking system should have been 14.9% in 2005, 0.4% higher than 2004. Of 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 the current level of AZN8.2 million to AZN10.0 million by July 2008, and this 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 in Azerbaijan. Currently, only 10 of Azerbaijan's 44 banks have capital of AZN10.0 million or more.

17. The financial condition of Azerbaijani banks remains stable while displaying positive dynamics. Based on the results of 2006, the average return on equity of Azerbaijani banks was approximately 30%, and the return on assets was 2%. As oil prices remain high and new investment comes to Azerbaijan, interest rates are set to decrease. As interest rates decrease and the economy grows, the banking sector is almost certainly set for further expansion. Moreover, as the domestic economy is growing at an annual rate of 10% in real terms, there will be more investment opportunities in areas like hotels and tourism, retail, catering, and real estate. Construction related to the oil industry also stimulates some sectors, such as transportation, engineering, and the steel industry. In fact, even without any structural improvement, the banking sector may show quite good growth (comparable to GDP growth). Structural improvement may give a much more significant boost to the banking sector, and the pace of growth will be determined by the success of structural reforms. Appendix 1 gives an overview of the development of the Azerbaijani banking sector.

3. Outlook

18. Despite substantial support to banks 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, which, together with continued strong economic growth, will ensure that the risk of a banking crisis is 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 the banking sector legislation. The authorities are confident that this will provide the basis for improving the quality of the financial sector in Azerbaijan, especially with 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 NBA have issued prudential regulations conforming to best international practices, including risk-based capital, loan loss provisioning, and asset classification regulations. For more details refer to 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 greatly contributed to the development of the private sector in Azerbaijan. As of 1 January 2007, the number of registered legal entities was 74,354, 80.6% of which were private enterprises. As of March 2007, there are 4,161 foreign legal entities registered in Azerbaijan.

⁶ EBRD. 2006. *Transitions Report 2006*. London.

20. In 2006, the share of the private sector in GDP was about 81%. Private firms are the major source of employment and Government revenue. Presently, the share of the nongovernment sector in the manufacturing and service areas such as agriculture, industry, trade, hotels, catering services, civic construction, transport, and communication is in the range of 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. As a result of structural reforms and improvements in legislation and taxation, the number of entrepreneurs has increased considerably in the past 10 years. In 2006, there were 243,473 people registered as individual entrepreneurs. They are involved in fields such as trade (49.4%), transport, storage, and telecommunications (17.9%), agriculture (9.5%), public and social services (8.2%) and real estate operations (5.9%). SMEs currently account for approximately 80% of registered private businesses operating in Azerbaijan, and over the past 5 years have, on average, represented an estimated 10% of GDP. SMEs are the largest source of domestic employment outside of the public sector, providing a livelihood for over 75% of the country's workforce. An estimated 70% of SMEs are located in Baku and the Absheron Peninsula, and have limited capacity for regional expansion.

22. The importance of SMEs in relation to general economic vitality is widely acknowledged. Studies have shown that in most countries the SME and the informal sector account for about 45–75% of employment and 65–70% of GDP, regardless of the development stage of the economy.⁷ This is especially true for Azerbaijan, as explained in the preceding paragraph.

23. Further efforts are therefore needed to develop the SME sector. One of the biggest problems 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.

3. Government Efforts

24. The Government continues to support SME growth and improve the business environment. In the past 2 years, state policy has shifted from providing direct aid to SMEs to improving the regulatory and business infrastructure in order 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 necessary 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) the creation and development of legal and physical infrastructures for efficient operation of SMEs, (ii) the expansion of foreign economic activity of SMEs and export promotion, and (iii) the expansion of opportunities for financial and investment assistance for SMEs.

26. To help alleviate the problem of lack of financing faced by SMEs, the 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, one nonbank institution and five credit unions.

⁷ Corporation for Enterprise Development. 2004. *SMEs and Poverty Reduction*. New York. The report, commissioned by the Ford Foundation's Affinity Group on Development Finance (SME committee), reviews current literature on the SME sector and its links to poverty reduction strategies in the United States and internationally.

While the loan size varies from \$50,000 to \$1 million, the annual interest rate is limited to 7% (market rates are in the 15–20% range). However, the Ministry of Economic Development recognizes that the fund should not be a continuing source of subsidized financing for SMEs and that private banks have to actively become involved. The private banks are asked to actively look for external funding sources in order to reduce the market lending rates. Before year-end 2007, the Ministry of Economic Development is expected to revise the charter of the budget fund in accordance with a new draft of the second state program on SME development to be approved in early 2008. Further, in May 2007, the president issued a special decree aimed at accelerating SME development in Azerbaijan. According to the decree, development of entrepreneurship requires new measures to reduce impediments, such as changing the time-consuming registration procedures and licensing. The cabinet of ministers and other line agencies have been authorized to prepare and submit to the president their suggestions for (i) the elimination of abuses, (ii) the acceleration of entrepreneurial development, and (iii) the creation of an advantageous business environment.

III. THE BORROWER

A. Overview

27. Bank Respublika, headquartered in Baku, was established as a joint-stock company in 1992 by a group of entrepreneurs led by Natig Gouliyev. The bank operates under a general banking license, although the scope of its activities has been upgraded in two instances: (i) in 1994 the bank received approval to commence foreign exchange operations; and (ii) in 1999 the bank was authorized to issue credit cards. Throughout the early and mid-1990s, Bank Respublika's principal focus was on corporate banking, providing services to businesses, several of which were related parties. Following the turmoil of the Russian financial crisis in 1998, however, Bank Respublika has repositioned itself as a universal bank expanding into the retail market, specifically targeting the consumer banking needs of the middle class, in addition to servicing the corporate needs of the SME sector.

28. Under International Financial Reporting Standards, as of the end of 2006 Bank Respublika reported total assets of AZN111.3 million and shareholder equity of AZN11.9 million. The bank has increased its market share in the Azerbaijan banking system from 2.5% in 2005 to 2.95% at the end of 2006 (3.2% as of 1 May 2007). It ranks 5th among the private sector banks in the country in terms of assets and is among the top 10 banks by deposits and loans (Appendix 3 gives a detailed peer analysis).

29. As a means of strengthening its position in the market, Bank Respublika has forged relationships with several international financial institutions. In January 2002, the bank began participating in the German-Azerbaijan Fund, with a €2 million credit line for SMEs. In addition, Bank Respublika received extended technical assistance under the Retail Banking Development Project in mid-2002 from the Savings Banks Foundation for International Cooperation. In 2004, Bank Respublika became involved in the Kreditanstalt für Wiederaufbau (KfW)-funded Corporate Standards Implementation project. Bank Respublika's relationship with KfW deepened with the sale of a 16.67% equity interest to Deutsche Investitions- und Entwicklungsgesellschaft mbH (DEG, a member of the KfW banking group) and of 8.33% to Sparkassen International Development Trust in early 2005.

30. Bank Respublika received its initial credit rating from Moody's Investors Services in December 2006. The assessed rating was B2 (foreign currency deposit rating) with a positive outlook (upgraded in June 2007), and this was the highest rating among the private sector

banks in Azerbaijan. Moody's indicated that its rating reflected Bank Respublika's (i) strengthening franchise in the country's banking market and its ability to increase its market share while maintaining rigid credit underwriting procedures, supported by a dedicated management team; (ii) access to wholesale funding from foreign banks; (iii) strategic repositioning to focus on retail and SME banking activities; (iv) relatively good loan granularity or diversification; and (v) equity partnership with two German public sector financial institutions which has a positive influence on corporate governance, systems, and controls.

B. Business Strategy: Retail and Small and Medium-Enterprise Focus

31. For several years after its founding, Bank Respublika focused on corporate banking. However, in the late 1990s, after surviving the turmoil of the Russian financial crisis, the bank began shifting its strategy. To better position itself, Bank Respublika sought transition into a universal bank, offering retail banking services and expanding its corporate banking activities, specifically its SME portfolio. As part of this transition process, the bank has expanded its distribution network to 12 branches and seven service points throughout the country (five additional branches are to be opened in the second half of 2007) and broadened the types of products that it offers to service consumer needs.

32. Bank Respublika currently offers eight different types of loans. Retail banking products include car, new family, useful trip, education, and mortgage loans. SME and corporate banking products are categorized by size as follows: (i) micro loans from AZN300 to AZN10,000, (ii) SME loans from AZN10,000 to AZN500,000, and (iii) macro loans over AZN500,000. Appendix 6 gives an overview over the various loan products.

33. Going forward, Bank Respublika seeks to build on its presence in the Azerbaijan banking sector and gain market share in retail and SME banking. In addition to conducting an aggressive marketing campaign to strengthen brand-name recognition and attract new depositors and borrowers, the bank also seeks to improve customer service to develop customer loyalty, as well as offer other loan products tailored to customer needs.

34. Bank Respublika's focus on SME and retail lending offers good opportunities for sustainable growth, as both sectors are currently underdeveloped in Azerbaijan. Further, this business focus avoids excessive concentrations, to which many of the other small banks in the country are prone.

IV. PROPOSED ADB ASSISTANCE

A. Overview

35. ADB's proposed assistance to Bank Respublika will be in the form of a US dollar denominated subordinated loan of up to \$10 million in order to strengthen the bank's capital position and underpin the expansion of its lending activities, particularly to SMEs. The subordinated loan will be structured in a way to qualify as Tier II capital.

V. PROJECT BENEFITS, IMPACTS AND ASSUMPTIONS

A. Justification for the ADB Investment

1. Development Outcome

36. The proposed ADB assistance will promote development in the following key areas.

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

SMEs rely heavily on access to external capital to finance their operations. However, in most ADB DMCs, SMEs have difficulty accessing financial services and securing financing. Although bank loans dominate external financing (due to 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 the lack of access to bank lending is considered the main financing difficulty and hindrance to sustaining growth of SMEs.⁸ This is no different in Azerbaijan, as discussed in Section II. SME development is key to the country's future development and economic diversification.

The proposed assistance will allow Bank Respublika to provide increased financial intermediation in line with its strategic plan. The increased availability of capital or funding will help clients promote their operations, increase profitability, and enhance their competitiveness, thus contributing to private sector development and 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, diversification of the economic base will become an increasingly important means of sustaining growth and reducing the country's vulnerability to a sustained fall in oil prices. The proposed transaction, which will indirectly lead to increased lending to SMEs that are presently underserved, will support the creation of employment and livelihood 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 available liquidity and channel it towards SME investment through extension of credit. Support for the growth of a promising and well-managed private bank will contribute to the shift

⁸ Appendix 14 discusses the development impact of SME finance and Appendix 15 discuss the SME financing gap in Asia.

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 (particularly individual entrepreneurs and SMEs), they are critical to the economy.

B. Value Added by ADB

37. The proposed loan from ADB will allow Bank Respublika to strengthen its capital base and this will in turn enhance the bank's ability to expand its lending activities, providing greater financing intermediation in Azerbaijan, especially to SMEs.

38. In addition, ADB will strengthen its relationship with Bank Respublika, and in doing so encourage and support the adoption of better practices (through covenants) for critical banking functions (such as credit, asset-liability management, anti-money laundering, anticorruption, and environmental safeguard policies and procedures).

C. Environmental and Social Safeguard Policies

39. The proposed loan will be classified as category FI (financial intermediary) under ADB's *Environment Policy* (2002). Pursuant to the terms and conditions of ADB's existing senior loan to Bank Respublika, the bank has issued an environmental and social policy in 2007 and developed and implemented detailed environmental management procedures which are acceptable to ADB (a short summary appears in Appendix 17). ADB will be furnished with an annual environmental and social report, which will document the compliance with ADB's safeguard policies. Bank Respublika has the capacity to run the procedures put in place. The proposed loan will be 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 Bank Respublika.

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

40. Bank Respublika has been advised of ADB's *Anticorruption Policy* (1998, as amended to date) and policy relating to the *Combating of Money Laundering and Financing of Terrorism* (2003). Consistent with its commitment to good governance, accountability, and transparency, ADB will require Bank Respublika, 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. Bank Respublika has adequate anti-money laundering and anti-financing of terrorism procedures in place.

VI. ASSURANCES

41. ADB will enter into an acceptable loan agreement 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.

42. 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 loan to Bank Respublika. No funding under the loan will be made available until ADB receives such confirmation.

VII. RECOMMENDATION

43. I am satisfied that the proposed subordinated loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve a US dollar-denominated subordinated loan of up to \$10,000,000 to Bank Respublika Open Joint Stock Company in order to strengthen its capital position and underpin the expansion of its lending activities, particularly to small and medium-sized enterprises.

Haruhiko Kuroda
President

12 October 2007

HISTORY AND DEVELOPMENT OF BANKING SECTOR IN AZERBAIJAN

A. Historic Overview

1. Institutional and legal establishment of the banking system of the Republic of Azerbaijan began after independence in 1991. The basic objectives of the development stage of the bank system were to establish the institutions and infrastructure and provide for the normal functioning of the banking system.

2. Adoption of the Law on the National Bank of the Azerbaijan Republic (NBA) and the Law on Banks and Banking Activity in the Azerbaijan Republic laid foundation for the legal-normative basis of the banking system. The initial stage of the banking system was accompanied by liberal conditions of entry into the banking market. With the objectives of stimulating the process of institutional establishment of the bank system, the NBA made minimal capital requirements and used relatively soft control mechanisms. As a result of those processes, 233 banks and 370 bank branches were 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 completion of the institutional establishment of the banking system. Administrative means, which were used by the NBA for regulation of bank sector, were gradually replaced by prudent supervision. Measures were taken on international standardization of the normative legal basis, which regulated banking activity and the economic normative requirements were continuously tightened.

4. As a result of the strengthening of the banking system, protection of depositors' interests, 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. Consolidation of the banking system, development of banks and strengthening of their capitalization resulted in an increase of aggregate bank capital by 22 times, total investment by 3 times, and the amount of attracted savings increased by 8 times. The weight of bank assets in GDP has now reached 28%.

6. At this stage of development of the banking system, in order 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. Twinning Programs with foreign banks were carried out to prepare state banks for privatization and institutional development.

7. The objective of increasing institutional variety on the legal basis of non-bank credit organizations was established in 1998. The number of such financial entities was 13 in 1998 and 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. Recovery measures were aimed at the establishment of 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, improvement of management-information systems, and application of 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, i.e. 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, in July 2002, Mbank and Promtekhbank announced their merger 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 non-bank credit organization acting under a limited license to regulate bad debts and, thereby, solve the problem of low quality assets inherent in post-soviet states.

B. Role and Regulations of the National Bank of Azerbaijan

10. As early as 7 August 1992, in addition to the Law on Banks and Banking Activity in the Azerbaijan Republic, the Law on the National Bank of Azerbaijan was adopted. On 15 August 1992, the manat, the national currency of the Azerbaijan Republic, was issued. On 1 December 1992, the Milli Mejis of the Azerbaijan Republic passed the Resolution on Approval of the Charter of the NBA. The aforesaid 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, the NBA was granted regulatory and supervisory authority over the banking system. The NBA is the central bank of the Azerbaijan Republic. Its status, basic functions and duties, organization and principles of activity are determined by the Constitution of the Azerbaijan Republic, Law on the National Bank of the Azerbaijan Republic and other legislative acts.

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

12. The main functions of the NBA are pursuing state policy in the sphere of monetary, credit and currency relations; facilitating accomplishment of settlements and stable operation of the payment system; accomplishing transactions in the securities market, as well as purchase and sale of foreign currency; taking necessary measures for development and strengthening of the banking system in Azerbaijan; carrying out currency regulation, determining procedures for settlements with foreign countries and managing foreign currency reserves; adopting normative acts in the field of banking activity.

13. The NBA has in recent years successfully 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.

BANKING SECTOR OUTLOOK

1. It is forecasted that the asset growth trend in Azerbaijan during the next few years will exceed the pace of previous years. The National Bank of Azerbaijan (NBA) expects improvements of banking indicators and bank performance. Banks will continue to increase their capital, further attract foreign investments, improve risk management, 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 the NBA's independence in the formulation and execution of monetary policy, improve the accountability of the NBA and enhanced its transparency by establishing a clear mechanism for distributing NBA's profit.
3. Additionally, NBA started redenomination of the manat, from 1 January 2006 the value of the manat has increased by a factor of 5,000. Six new banknotes and 5 types of coins have been issued. According to NBA, the main reason behind redenomination is preventing further dollarization of the economy since the nominal exchange rate is now close to the current US dollar rate. Furthermore, the redenomination plays a vital role in strengthening the national currency and simplifying arithmetical calculations during trade operations and it will also ease the work of banks. Currently, the International Bank of Azerbaijan (IBA) stands as the largest bank with the largest number of current accounts of physical customers. Therefore, the responsibility of IBA in the process of re-denomination is significant.
4. On 15 April 2005, the Mortgage Law was adopted. As of 1 March 2006, the first applications for mortgage loans were submitted by the authorized banks and a number of them have already granted mortgages to individuals. During 2005 regulations concerning corporate governance were adopted by NBA.

TOP 10 PRIVATE BANKS IN AZERBAIJAN AND BANK RESPUBLIKA'S RANKING

Table A3.1: Bank Respublika's Ranking Among Private Banks
(as of 31 December 2006)

| Item | Rank | Value (ANZ million) |
|---------------------------|-------------|-------------------------------|
| Total Assets | 5 | 111,266 |
| Total Credit Portfolio | 4 | 75,428 |
| Total Individual Deposits | 9 | 59,368 |
| Total Capital | 9 | 11,906 |
| Net Profit | 5 | 2,346 |
| Return on Assets | 14 | .99% |

Source: Consulting and Business. 2007. *Azerbaijan Banking Sector*. Baku.

Table A3.2: Top 10 Private Banks in Azerbaijan in Terms of Assets, Loans, Deposits, Return on Assets and Return on Equity
(as of 31 December 2006)

| Rank | Asset Size | | Loan Size | | Consumer Deposit Size | | ROA | |
|------|---------------------------------|----------------|---------------------------------|----------------|------------------------|----------------|-----------------------------|-------------|
| | Bank | in AZN Million | Bank | in AZN Million | Bank | in AZN Million | Bank | % |
| 1 | StandardBank | 257,458 | Bank Standard | 139,060 | Bank Standard | 147,194 | Azer-Turk Bank | 5.10 |
| 2 | Kapital Bank | 148,879 | UniBank | 87,289 | Kapital Bank | 105,224 | Bank Melli Iran Baku Branch | 4.97 |
| 3 | UniBank | 140,991 | Texnikabank | 76,235 | Texnikabank | 80,823 | Bank of Baku | 4.19 |
| 4 | Texnikabank | 135,379 | Bank Respublika | 75,428 | UniBank | 80,486 | Yapi Credit Bank | 3.83 |
| 5 | Bank Respublika | 111,266 | Kapital Bank | 61,046 | Xalq Bank | 63,122 | AF-Bank | 3.67 |
| 6 | Azerdemiryolbank | 90,051 | Azerdemiryolbank | 60,162 | Azerigazbank | 56,909 | Bank of Azerbaijan | 3.33 |
| 7 | Azerigazbank | 88,685 | Xalq Bank | 57,813 | Bank of Baku | 53,674 | Turan Bank | 3.13 |
| 8 | Xalq Bank | 77,009 | Azerigazbank | 53,603 | Atabank | 52,575 | Ganja Bank | 3.11 |
| 9 | Bank of Baku | 72,995 | Nikoil Bank | 51,810 | Bank Respublika | 52,566 | Azerigazbank | 2.95 |
| 10 | Nikoil Bank | 66,251 | Bank of Baku | 50,784 | Bank of Azerbaijan | 48,211 | Texnikabank | 2.79 |
| 11 | Atabank | 62,672 | Bank of Azerbaijan | 48,304 | Azerdemiryolbank | 40,734 | Azerdemiryolbank | 2.69 |
| 12 | Yapi Credit (former Kocbank) | 59,142 | Microfinance Bank of Azerbaijan | 43,258 | Nikoil Bank | 35,961 | Amrahbank | 2.62 |
| 13 | Bank of Azerbaijan | 56,159 | Atabank | 42,668 | Rabitabank | 32,195 | UniBank | 2.32 |
| 14 | Microfinance Bank of Azerbaijan | 54,057 | TuranBank | 33,730 | Azer-Turk Bank | 16,583 | Bank Respublika | 1.99 |
| 15 | Zaminbank | 44,506 | Rabitabank | 29,444 | Mugan | 16,322 | Mugan Bank | 1.99 |

ROA=return on assets.

Source: Consulting and Business. 2007. *Azerbaijan Banking Sector*. Baku.

DEVELOPMENT IMPACT OF SMALL AND MEDIUM ENTERPRISES (SMEs)¹

1. Growth and modernization in the 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. SMEs 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 semi-skilled 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. Moreover, reducing poverty may improve the environment for SME expansion, so that these efforts can be expected to be mutually reinforcing. And although the expansion of SMEs may not be sufficient for poverty reduction, the likely positive effects through the families of the SMEs' employees, the 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 "bang for the buck" in fighting poverty through investing in SMEs.
 - (ii) **The effect of employing relatively more low skilled workers.** Since it is likely that both SMEs and their suppliers, on average, employ a greater share' of local, low skilled workers than do large firms or the suppliers to large firms, and since to the extent that SMEs' hire less skilled workers, 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 The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments. Volume 1.

- (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 micro-enterprises to accept SME employment, their wage incomes are likely to rise, but also to 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. The development microeconomics literature 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 on improvements in the home and other important factors. The impact is especially significant for daughters. Though no
- (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 do larger enterprises suggests that this magnified impact is likely at the SME level.
- (vii) **SME tax payments.** To the extent that tax revenues are used to implement poverty impacting programs such as local infrastructure improvements, health services, or school meals, and to the extent that SMEs contribute more tax revenue than do micro-enterprises (who 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.