



Extended Annual Review Report

Project Number: 39930
Loan Number: 2233-001
February 2010

Loan

Azerbaijan: Private Banks and Leasing Companies in Azerbaijan

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

Asian Development Bank

CURRENCY EQUIVALENTS

Currency Unit – Azerbaijan manat/s (AZN)

		At Appraisal	At Project Completion
		20 February 2006	31 December 2009
AZN1.00	–	\$1.0914	\$1.2558
\$1.00	–	AZN0.9163	AZN0.7963

ABBREVIATIONS

ADB	–	Asian Development Bank
CAGR	–	compounded annual growth rate
EBRD	–	European Bank for Reconstruction and Development
EMS	–	environmental management system
GDP	–	gross domestic product
IFC	–	International Finance Corporation
IFI	–	international financial institution
NBA	–	National Bank of Azerbaijan
ROIC	–	return on invested capital
SMEs	–	small and medium-sized enterprises
XARR	–	extended annual review report
WACC	–	weighted average cost of capital

NOTE

- (i) Calendar year denotes the year in which the fiscal year ends, e.g., FY2010 ends on 31 December 2010.

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BASIC DATA
Private Banks and Leasing Companies in Azerbaijan (39930 - Azerbaijan)

Key Project Data	As per ADB Loan Documents (\$ million)	Actual (\$ million)
Total project cost	4.0	4.0
ADB investment:		
Loan:		
Committed	4.0	4.0
Disbursed	4.0	4.0

Key Dates	Expected	Actual
Concept clearance approval	2005	27 Sep 2005
Board approval	2006	30 Mar 2006
Loan agreement	2006	14 Dec 2006
Loan effectiveness	2007	14 Jun 2007
First disbursement	2007	14 Mar 2007

Financial and Economic Internal Rates of Return on Invested Capital (%)	Appraisal	XARR
Financial return on invested capital	16.2%	16.7%
Economic return on invested capital	20.0%	20.4%

Project Administration and Monitoring	No. of Missions	No. of Person-Days
Fact-finding	1	26 Jul to 2 Aug 2005
Appraisal	1	12 to 25 Oct 2005
Project administration	1	23 to 25 Nov 2009
XARR mission	–	
Others (including exit, final repayment, workout transfer)	–	

ADB = Asian Development Bank, XARR = extended annual review report.

– None

EXECUTIVE SUMMARY

The initial private sector activities of the Asian Development Bank (ADB) in Azerbaijan were defined in the report and recommendation of the President on Proposed Assistance to Private Banks and Leasing Companies in Azerbaijan. Approved by ADB's Board of Directors in March 2006, assistance—consisting of loans and equity investments to private banks and leasing companies—totaled up to \$15 million. Fact-finding and due diligence missions conducted among candidate banks for ADB assistance revealed that AGBank had strong management, good credit processes, low delinquency rates, and adequate capital. In December 2006, ADB and AGBank entered into a \$4 million senior secured term loan agreement that provided for onlending to small and medium-sized enterprises (SMEs) to (i) strengthen the country's private bank and leasing sectors to contribute to sustainable economic growth and private sector development, and (ii) increase the extension of small and micro loans by targeted private banks to support the creation of employment and livelihood opportunities outside of the oil and gas sector.

The development impact of the ADB assistance to AGBank is rated *satisfactory* when evaluated against four criteria: (i) private sector development, (ii) business success, (iii) economic development, and (iv) ADB's additionality. It had a positive impact on the development of the banking sector and private enterprises, with the market share of private sector banks in Azerbaijan increasing from about 50% in 2005 to 62% as of March 2009.

Despite a decrease in its return on invested capital (ROIC) in 2007, the computed 2008 ROIC of 16.7% exceeded the computed weighted average cost of capital of 9.0% by more than 700 basis points bps, the assistance is rated *excellent* based on ADB's 2007 Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations.

The loan's contribution to economic development is rated *excellent* based on AGBank's economic ROIC, which was computed at 20.4% in 2008. This is above the hurdle rate of 20.0% for an *excellent* rating. In addition, AGBank made a positive contribution to the Azerbaijan economy by paying corporate income taxes from 2004 to 2008.

The loan's investment profitability is also rated *excellent* as it was able to charge a margin spread superior to the benchmark rate.

The assistance was classified as category FI (financial intermediary) under ADB's Environment Policy (2002). The loan terms provided that AGBank establish an environmental management system (EMS) (ADB, December 2006. Schedule 9 of Agreement on Pledge of Rights between ADB and AGBank) capable of screening, assessing, and monitoring loans to its borrowers using the environmental policy issued by the Ministry of Ecology and Natural Resources. Part of AGBank's EMS includes screening loan applications based on an exclusion list of business activities. With regard to social safeguards, the assistance was classified as category C, as there was no involuntary resettlement or impact on indigenous peoples resulting from AGBank's activities. Given AGBank's compliance with the EMS through its initial efforts to manage the environment, safeguard health, and maintain social structure, the assistance is rated *satisfactory*.

ADB's work quality is rated *satisfactory* based on (i) screening, appraisal, and structuring of the assistance; (ii) monitoring and supervision; and (iii) ADB's role and contribution. Monitoring and supervision of the assistance is rated *satisfactory*, with the Private Sector Operations Department monitoring AGBank's compliance with the financial covenants on a

quarterly basis. ADB's role and contribution is also rated *satisfactory*. The loan to AGBank served as a catalyst for other international financial institutions to extend financial assistance through additional loans and equity investments to Azerbaijan's banking sector. In the years following ADB's loan, Kazimir Investment Caspian Fund invested 10% additional equity, while the International Finance Corporation extended \$15 million in subordinated debt in 2009. As of the third quarter of 2009, AGBank's loans from the Government of Azerbaijan and international financial institutions had grown by 185% since year end 2007.

AGBank has also shown a rapid increase in its deposit base. ADB's involvement has, to a certain extent, supported AGBank's credibility, thereby increasing depositor trust in AGBank. Such increased liquidity has further strengthened AGBank's competitive position in the SME market, thereby contributing to an improved market share of private banks in the industry's total assets. In this regard, ADB's additionality is rated *satisfactory*.

Although ADB was unable to move forward with its proposed equity investment in AGBank, ADB's experience with AGBank has been satisfactory and suggests that ADB should pursue other projects with private banks in Azerbaijan to contribute to private sector and SME development.

I. THE PROJECT

A. Project Background

1. The Republic of Azerbaijan joined the Asian Development Bank (ADB) in 1999 and signed the Private Sector Operations Framework Agreement in June 2004.¹ This paved the way for the first private sector operations project in the country.

2. The country's economy had an average real gross domestic product (GDP) expansion of 10.6% per year during 2000–2004. This growth was driven by oil and gas revenues, which made up nearly 40% of Azerbaijan's GDP in 2004. To develop, diversify, and strengthen the economy, international financial institutions (IFIs) were working to increase private sector participation by supporting local banks to increase the level of bank intermediation. In 2004, total bank assets amounted to only 19.9% of the GDP, which was low by international standards. In an effort to improve bank intermediation, the European Bank for Reconstruction and Development (EBRD) was providing lending facilities to seven banks, for an estimated total of \$15 million, and had introduced its regional Trade Facilitation Programme in Azerbaijan. In addition, the International Finance Corporation (IFC) was providing loan facilities to small and medium-sized enterprises (SMEs) from private banks and had made an equity investment in the Micro Finance Bank of Azerbaijan. KfW also became a shareholder of this bank, while Deutsche Investitions- und Entwicklungsgesellschaft, had made an equity investment in Bank Respublika.

3. ADB's initial private sector activities in Azerbaijan were approved by ADB's Board of Directors in March 2006.² The approval was for total assistance of up to \$15 million, consisting of loans and equity investments to private banks and leasing companies. Ten banks emerged as candidate institutions for ADB assistance. Fact-finding and due diligence missions resulted in the selection of three banks—Azerigazbank (later renamed AGBank), Bank Respublika, and Micro Finance Bank of Azerbaijan.

B. Key Project Features

4. ADB entered into a term loan facility agreement with AGBank on 14 December 2006. The agreement provided for a \$4 million senior secured 3-year floating rate loan. ADB and AGBank also entered into a pledge-of-rights agreement to secure the loan.

C. Progress Highlights

5. Shortly before the conclusion of loan negotiations between ADB and AGBank in June 2006, IFC took a 17.5% equity stake in AGBank. This was followed by a 10.0% equity investment made by Kazimir Investment Caspian Fund, an asset management company, in May 2008. Both investments and the ADB loan have served to enhance AGBank's competitive position in the Azerbaijan banking sector and to reinforce its reputation. In addition, they have acted as a catalyst for other sources of funding, including credit lines (para. 27) and grants from the National Entrepreneurship Support Fund and the German Azerbaijan Fund.

6. AGBank's institutional development has been strengthened through its participation in various technical assistance programs provided by IFIs. Such programs have included

¹ Director General, East and Central Asia Department, ADB. 2006. *Framework Agreement for Private Sector Operations of ADB*. Manila.

² ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Assistance to Private Banks and Leasing Companies in Azerbaijan*. Manila.

strengthening corporate governance standards (IFC) and credit underwriting standards for microloans and SME loans (IFC and EBRD). AGBank's institutional development has also been enhanced by adopting environmental safeguard policies as prescribed by ADB.

7. In 2003, AGBank joined EBRD's Trade Facilitation Programme to promote foreign trade to, from, and within Central and Eastern Europe the Commonwealth of Independent States. In 2006, AGBank also joined ADB's Trade Finance Facilitation Program to offer a broader range of products to its corporate customers. By joining these programs, AGBank has asserted its strategy to grow with its customers by offering a variety of banking products and services. By the end of 2008, ADB facilitated a total of \$9.6 million for trade finance and a revolving credit facility through these programs.

8. In 2008, AGBank became the first bank in Azerbaijan to receive a rating from Standard and Poor's. In the same year, Fitch Ratings also rated AGBank. Both rating agencies rated AGBank as a "B-". In February 2009 and October 2009, AGBank had maintained these ratings.

II. EVALUATION

A. Project Rationale and Objectives

9. The purpose and objective of the ADB loan to AGBank was to³ strengthen the private bank and leasing sector to contribute to sustainable economic growth and private sector development. Over the past several years, private sector bank growth has been encouraging, characterized by an increased market share in terms of total banking assets. At the start of 2005, about 50% of aggregate bank assets were controlled by two state-owned banks, the International Bank of Azerbaijan and Kapital Bank. The market share of private sector banks has risen to 62% as of March 2009—a result of increased funding made available by IFIs and commercial banks, which supported private sector bank lending activities—and the privatization of Kapital Bank in 2008. Increase private sector bank financing of small and medium-sized enterprises and microenterprises to generate employment and livelihood opportunities outside of the oil and gas sector. Although the oil and gas sector still dominates the Azerbaijan economy, important progress has been made in developing the non-oil and gas sector during the past 3 years. The demand for credit from corporations (including SMEs) and households, as well as the lending activities from private sector banks, have increased markedly during this time and underpinned the development of the non-oil and gas sector. In 2008, the National Bank of Azerbaijan reported that for the first time in 5 years, the non-oil and gas sector growth rate was not only higher than that of the oil and gas sector, but had significantly surpassed the overall economic growth rate, peaking at 15.7% (year-on-year). The GDP also grew by 10.8% in 2008. Figure 1 illustrates that the oil and gas sector accounted for 4.0% of overall economic growth in 2008, while the non-oil and gas sector accounted for 6.8% of overall economic growth.

³ ADB. 2005. *Concept Clearance Paper to Azerbaijan: Bank and Leasing Support Package*. Manila.

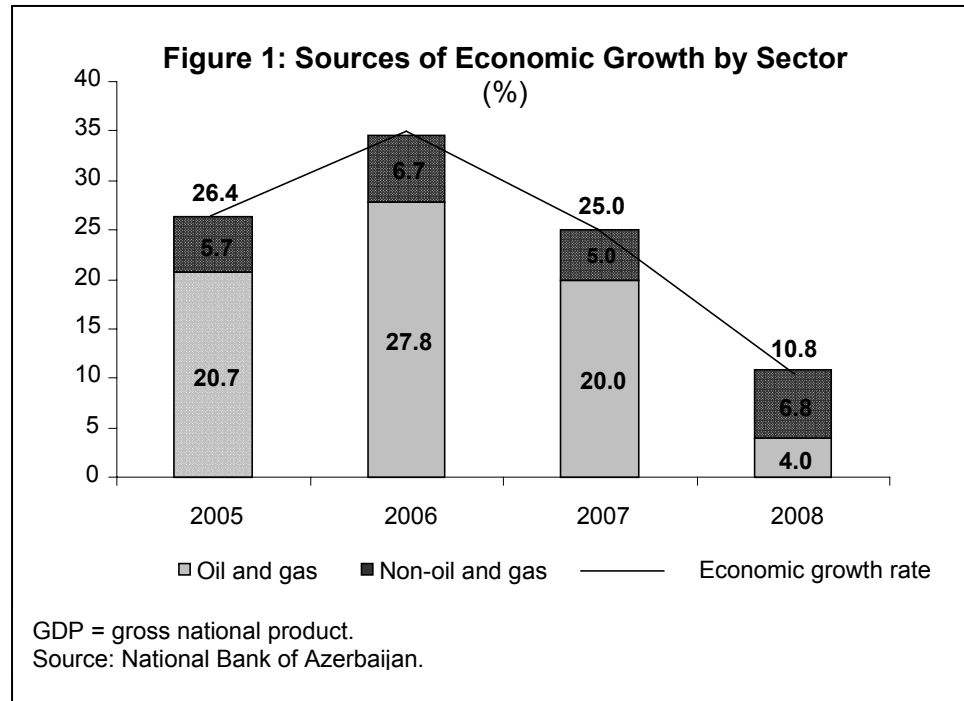
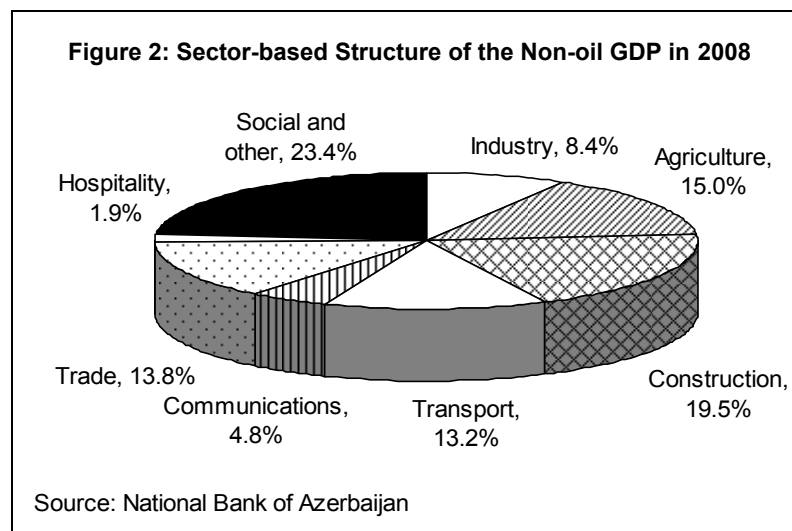


Figure 2 shows the distribution of the non-oil and gas sector, with agriculture, construction, and domestic services posting the highest contributions to the GDP. In 2008, strong growth in planting products as well as livestock production were recorded for the agricultural sector, while the implementation of large-scale infrastructure and social projects contributed to sustained growth in construction and social services. Notwithstanding the significant growth rate in non-oil and gas sector, the country still faces several challenges in diversifying the economy from its oil and gas dependence.



B. Development Impact

10. The development impact is rated *satisfactory*, evaluated under the following subheadings: (i) private sector development; (ii) business success; (iii) economic sustainability; and (iv) environmental, social, health, and safety performance. The framework for assessing development impact of the loan can be found in Appendix 6.

1. Private Sector Development

a. Beyond Company Impact

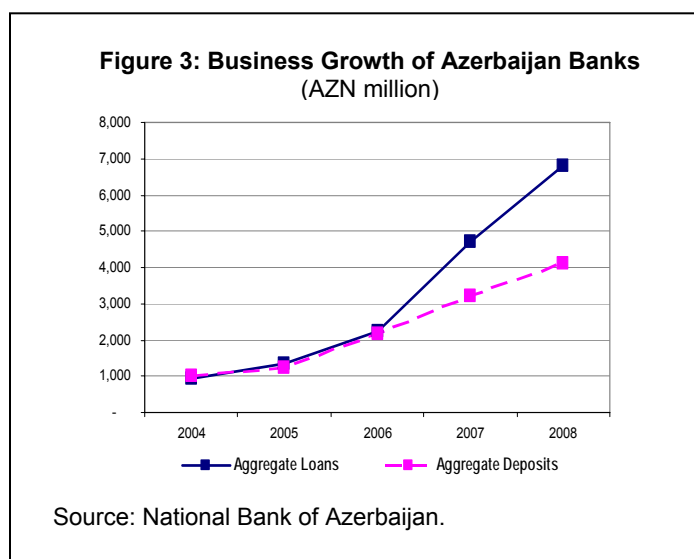
11. **Promote development in the private banking sector.** Robust macroeconomic conditions in Azerbaijan over the past 4 years, combined with the government's efforts to diversify and expand the non-oil and gas sector, have contributed to the rapid development of the country's banking sector. Table 1 illustrates that the banking sector showed strong growth led by the expansion of private sector banks, with total assets increasing by a compounded annual growth rate (CAGR) of 65.9% from AZN2.252 million at year end 2005 to AZN10.273 million at year end 2008. This impressive growth reflects increased financial intermediation due to continued confidence by foreign investors in the Azerbaijan economy and increasing demand for credit from both corporations and households.

Table 1: Total Banking System Assets in Azerbaijan
(AZN million)

2005	2006	2007	2008
2,252	3,778	6,726	10,273

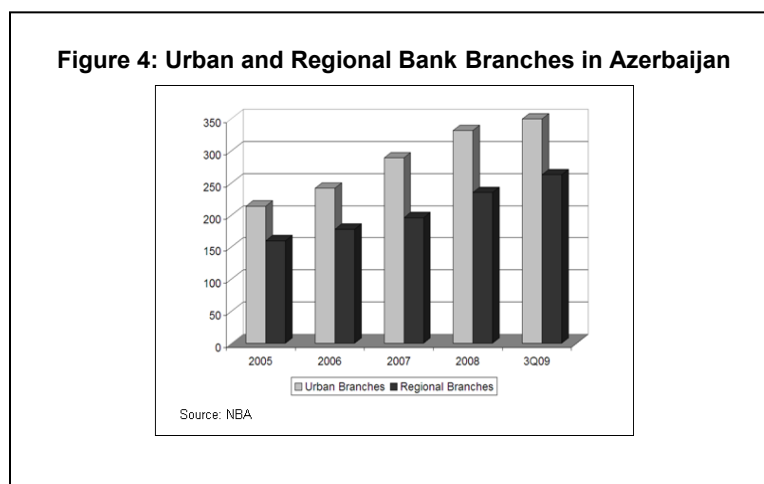
Source: National Bank of Azerbaijan.

12. Figure 3 shows the aggregate loan and deposit growth in the banking sector during 2004–2008.



13. The aggregate loan portfolio of the banking sector (excluding loans to financial institutions) increased by 55% to AZN6.8 billion at the end of 2008 compared to AZN4.4 billion 1 year earlier. Customer deposits also grew, albeit at a more moderate rate, rising by 18% to AZN4.1 billion in 2008.

14. Figure 4 shows the increasing number of bank branches in Azerbaijan, both in urban centers and regional areas. As of 30 September 2009, there were 567 bank branches in Azerbaijan, 41% of which were located in regional areas. The creation of bank branches in regional areas contributes to the development of the SME sector, as these branches provide access to finance for previously under-banked SMEs.



15. **Increase the market share of the private banking sector.** The market share of private sector banks in Azerbaijan increased from about 50% in 2005 to 62% as of March 2009. This growth is largely attributable to the increase in funding made available by IFIs and commercial banks to private sector banks, which funded the expansion of AGBank's lending activities. Although the primary source of funding remains the domestic deposit base, external borrowing among private sector banks—particularly the top-tier private banks—has expanded substantially over the past 4 years in line with increased IFI activity targeting microfinance and SME development. This has, in turn, also brought about increased funding from commercial banks interested in expanding into the country.

16. The increase was also due to the privatization of Kapital Bank. In July 2008, Kapital Bank announced the completion of the second and final stage of its privatization.

17. **Promote private sector employment.** The private sector has increasingly become the main growth driver of the Azerbaijan economy. Table 2 shows that the private sector's contribution to the Azerbaijan economy has grown from 73.5% in 2005 to 84.5% in 2008.

Table 2: Azerbaijan Gross Domestic Product and Private Sector Gross Domestic Product

Item	2005	2006	2007	2008
GDP (AZN million)	12,522.50	18,746.20	28,360.50	38,005.70
Private sector GDP	9,204.04	14,622.04	23,822.82	32,114.82
Private sector % of GDP	73.5%	78.0%	84.0%	84.5%

GDP = gross domestic product.

Source: National Bank of Azerbaijan.

18. Set against the background of growing demand, the employment rate in Azerbaijan continued to rise in 2008 with 123,000 new jobs, of which 73% were full-time, permanent jobs. Table 3 showed that employment in the private sector made up 69.3% of total employment in Azerbaijan and that 70.7% of private sector employment was generated by SMEs in 2008.

Table 3: Azerbaijan Employment Data

Item	2005	2006	2007	2008
Total number of employees ('000)	3,850.2	3,973.0	4,014.1	4,056.0
Employed by government	1,229.8	1,271.9	1,234.6	1,244.4
Employed by private sector	2,620.4	2,701.1	2,779.5	2,811.6
Private sector employment as % of total employment	68.1	68.0	69.2	69.3
Employed by SMEs (subset of private sector)	1,825.0	1,891.1	1,975.9	1,988.5
SME employment as % of private sector employment	69.6	70.0	71.1	70.7

SMEs = small and medium-sized enterprises.

Source: National Bank of Azerbaijan.

b. Direct Company Impact

19. AGBank is among the fastest-growing banks in the country, with total assets increasing by more than two-fold within 2006–2008. Ranked 10th in the Azerbaijan banking sector as of the end of 2008, in line with its medium-term business strategy, AGBank has a market share of 2.3% in terms of total assets and 5.0% in terms of retail deposits.⁴

20. **Portfolio of small and medium-sized enterprises.** Although originally established as a specialized bank to look after the needs of enterprises involved in the oil and gas sector, AGBank repositioned itself as a universal bank in the late 1990s. AGBank now primarily focuses on microfinance and SME lending in the trade sector as well as other non-oil and gas sectors, while attracting deposits from retail customers. When the ADB loan was disbursed in the first quarter of 2007, AGBank had only eight branches, the majority of which were located in and around Baku. In keeping with AGBank's strategic objectives, the branch network has expanded, and as of the third quarter of 2009, comprised 22 branches with 10 outside of the capital. The regional network is predominantly engaged in lending to SMEs and microenterprises.

21. AGBank defines microbusinesses as enterprises having up to 10 employees with maximum annual revenues of AZN500,000. SMEs are defined as enterprises of up to 250 employees with annual revenues between AZN500,000 and AZN5 million. Table 4 shows the growth in the number of AGBank's micro and SME loans. Micro and SME loans increased by 6.0% on average during 2006–2009, while the average value of loans rose by 48.9%.

Table 4: Number of Micro, Small, and Medium-Sized Enterprise Borrowers

2006	2007	2008	2009 ^a
310	343	344	368

^a As of the third quarter.

Source: AGBank Management Reports.

⁴ Fineko Informational & Analytic Agency. 2008. *Bulletin of Rankings of Banks for December 2008*. Azerbaijan. <http://www/abc.az>

22. **External funding.** The ADB loan with IFC's equity investment allowed AGBank to have greater access to international markets for additional funding. This is reflective on its borrowings from IFIs, which totaled AZN6.9 million in 2006. By 2008, these increased to AZN12.6 million.

Table 5: Borrowings from International Financial Institutions
(AZN million)

Item	2006	2007	2008	2009 ^a
EBRD	3.0	4.9	7.5	6.9
ADB	0.0	3.3	2.0	0.5
IFC	3.4	3.0	2.0	5.2
GAF	0.5	0.5	1.1	1.4
OPEC	0.0	0.0	0.0	2.8
Total	6.9	11.7	12.6	16.8

ADB = Asian Development Bank, EBRD = European Bank for Reconstruction and Development, GAF = German Azerbaijan Fund, IFC = International Finance Corporation, OPEC = Organization of the Petroleum Exporting Countries.

^a As of the third quarter.

{Source: AGBank Management Reports.}

c. Overall Assessment of Private Sector Development

23. Because it met its objectives, the contribution of the ADB assistance to private sector development is rated *satisfactory*. However, strong financial support from IFIs to help the budding industry reach maturity, including the development of corporate governance standards in accordance with international best practices, is necessary.

2. Business Success

24. **Financial performance.** Financial highlights of AGBank are shown in Table 6 from year end 2005 through the third quarter of 2009. Data for the 2 years preceding ADB's investment period are also included in the evaluation to present a broader picture of AGBank's growth story.

Table 6: AGBank Selected Financial Data
(AZN million)

Item	2005	2006	2007	2008	2009 ^a
Balance Sheet					
Liquid assets	14.528	18.720	28.931	35.211	27.085
Total assets	58.603	87.306	156.788	206.788	222.735
Total equity	7.303	13.490	18.344	30.137	31.729
Total deposits	43.865	57.442	96.115	125.402	120.241
Total loans	33.230	53.331	107.866	148.609	171.913
Income Statement					
Net interest income	2.905	4.334	6.943	8.519	8.137
Net non-interest					
Income	2.736	3.139	4.216	7.094	4.178
Operating income	5.641	7.473	11.159	15.613	12.315
Net income	1.670	2.630	3.417	3.876	3.929

^a As of the third quarter.

Source: AGBank.

25. AGBank's balance sheet grew significantly from 2005. Total assets increased from AZN58.6 million in 2005 to AZN206.8 million in 2008 for a CAGR of 52.2%. Asset growth was led by AGBank's aggressive building of its loan portfolio—comprising SMEs, local entrepreneurs, and individual borrowers—which grew from AZN33.2 million in 2005 to AZN148.6 million in 2008 for a CAGR of 64.8%. The expansion of the loan portfolio was mainly funded by the growth in customer deposits, which rose from AZN43.9 million in 2005 to AZN125.4 million in 2008 (a CAGR of 41.9%). This impressive growth rate in deposits was due to the reputation built by AGBank. To support the growth in its loan portfolio and to maintain capital adequacy, AGBank's equity was strengthened from AZN7.3 million in 2005 to AZN30.1 million in 2008 (a CAGR of 60.4%) via combined equity infusions from IFC and Kazimir Investment Caspian Fund, as well as through the accumulation of equity from AGBank's internally generated earnings.

26. AGBank demonstrated robust profitability within the 3-year period (2005-2008). Net income grew from AZN1.7 million in 2005 to AZN3.9 million in 2008, for a CAGR of 32.4%. During this period, the CAGRs for net interest income and net non-interest income were 43.1% and 37.4%, respectively. Growth in interest income was mainly due to the high growth rate of the loan portfolio. In addition to the increase in interest income, moderate growth was also achieved in AGBank's fee-based businesses, which includes plastic card operations, foreign currency transactions, cash collections, and guarantees. Given the accelerated pace of growth in its loan portfolio, contraction of net interest margins was a key risk factor. However, AGBank reported that, in 2009, its net interest margin increased. AGBank explained that this was due to high liquidity in the market, that is, depositors were risk-averse and were looking for more secure term deposits, a likely offshoot of the global financial crisis.

27. Table 7 shows that AGBank has maintained its tier 1 ratio and its risk-weighted capital adequacy ratio, well above the regulatory requirements of 5.0% and 10.0%, respectively. In the second quarter of 2009, AGBank posted a hefty tier 1 ratio of 13.0% and risk-weighted capital adequacy ratio of 16.0%, demonstrating its capacity to absorb possible losses. AGBank's nonperforming loan ratio increased from 2.1% in 2008 to 4.2% in the second quarter of 2009. The increase in this ratio was expected in consideration of the loan book's rapid expansion in previous years as well as its maturation.

Table 7: Tier 1 and Risk-Weighted Capital Adequacy Ratios of AGBank (%)

Item	30 Jun 07	31 Dec 07	30 Jun 08	31 Dec 08	30 Jun 09
Tier 1 ratio	11.0	11.7	14.0	13.8	13.0
Risk-weighted capital adequacy ratio	14.0	12.5	16.0	16.4	16.0

Source: AGBank.

28. AGBank's loan–deposit ratio climbed from 75.8% in 2005 to 143.0% in the third quarter of 2009. This trend shows increased financial intermediation, mainly from foreign lenders, as the cost of borrowing from the local market increased from 17.0% in 2005 to 19.8% in 2008. Table 8 also shows that in 2007, AGBank posted a record cost–income ratio of 59.2%, because three new branches were opened in 2007, with 10 more additional branches anticipated in 2008. Such a huge expansion entailed preparation for manpower, training, and capital expenditure for the new branches. Hence, administrative and other operating expenses increased by 64% in 2007 and 58% in 2008. During the third quarter of 2009, AGBank's cost–income ratio decreased to 52.4%, with AGBank subsequently attaining operational efficiency.

Table 8: AGBank Select Financial Ratios
(%)

Selected Ratios	2005	2006	2007	2008	2009^a
Return on equity	22.9	19.5	18.6	12.9	12.4
Return on assets	2.8	3.0	2.2	1.9	1.8
Cost-income ratio	47.4	48.6	59.2	50.6	52.4
Liquid assets-total assets	24.8	21.4	18.5	17.0	12.2
Total equity-total assets	12.5	15.5	11.7	14.6	14.2
Total deposits-total liabilities	81.0	60.0	53.0	67.0	63.0
Total loans-total deposits	75.8	92.8	112.2	118.5	143.0
Nonperforming loans-total loans	1.5	3.2	0.9	2.1	4.2

^a As of the third quarter.

Source: AGBank.

29. **Return on invested capital.** For corporate loans, real financial return on invested capital (ROIC)⁵ is used as a proxy for the financial internal rate of return. Table 9 shows AGBank's annual ROIC from 2005 to 2008. At the time of the ADB loan in 2007, AGBank's ROIC was 23.4%, which decreased to 16.7% at year 2008. The decrease in ROIC was mainly due to an increase in AGBank's long-term debt and issuances of new shares. AGBank's long-term debt increased by AZN122.2 million from AZN50.9 million in 2005 to AZN173.1 in 2008. Additionally, 1,500 new shares were issued in 2008, which brought the shareholder equity to AZN9.9 million. The aggregate value of new issuances, including the corresponding share premium, represented a 64.3% increase from 2007 balances. Using key variables in estimating the cost of equity, the weighted average cost of capital (WACC) was calculated at 9.2%.⁶ The 2008 ROIC of 16.7% is above AGBank's real WACC. Based on the Guidelines for Preparing Performance Evaluation Reports on Non-Sovereign Operations using ROIC as a parameter (Return On Invested Capital is the greater or equivalent of the sum of Weighted Average Cost of Capital and 700 basis points), the standalone project is rated *excellent*.⁷

30. AGBank's high ROIC is evidence that its capital is being efficiently used. AGBank maintains that capital expenditure in 2008 for information technology development, such as the purchase of comprehensive credit management software, increased its operating expenses and diminished its net income on a short-term basis. However, this nonrecurring expense is expected to increase operational efficiency, which will be reflected in AGBank's bottom line in the long term.

Table 9: Return on Invested Capital

2005	2006	2007	2008	2009
29.2%	24.1%	23.4%	16.7%	17.9% ^a

^a Annualized.

Sources: AGBank financial statements.

⁵ The ROIC is the net profit divided by the total of the shareholder capital plus the long-term subordinated debt.

⁶ Ibbotson and Associates, 2007. *Key Variables in Estimating Cost of Capital*.

⁷ ADB. 2007 Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations, Manila

3. Economic Sustainability

31. **Economic return on invested capital.** To assess the contribution to economic development of the ADB loan, the economic ROIC was calculated.⁸ Since the ADB loan was not targeted at specific capital investment projects, the economic internal rate of return is not considered to be an appropriate measure.

32. Table 10 shows AGBank's annual economic ROIC from 2005 to 2008. At the time of the ADB loan disbursement in 2007, AGBank's economic ROIC was 29.0%. It decreased to 20.4% in 2008 as AGBank's capital structure was increased by AZN9.9 million or 64.3% from 2007. This was further compounded by the capital expenditure for information technology development, which put a strain on AGBank's net income in 2008. Despite the decrease in the economic ROIC, the ADB assistance is rated *excellent* (because the economic ROIC is greater than 20%) based on the Guidelines for Preparing Performance Evaluation Reports on Non-Sovereign Operations. AGBank has sizeable capital as evidenced by a risk-weighted capital adequacy ratio of 16.0% in the second quarter of 2009. Also, AGBank has made a positive contribution to the Azerbaijan economy by paying corporate income taxes.

Table 10: Economic Return on Invested Capital

2005	2006	2007	2008
37.0%	29.9%	29.0%	20.4%

Sources: AGBank financial statements.

4. Environmental, Social, Health, and Safety Performance

33. **Environmental.** The ADB loan was classified as category FI (financial intermediary) under ADB's Environment Policy (2002). Such a project involves a credit line or an equity investment to a financial intermediary, where an environmental management system (EMS) is required unless all subprojects will result in insignificant environmental impact. According to the terms of ADB's loan, AGBank was required to establish an EMS and to provide for its staffing and capacity-building requirements. The EMS is a tool for ensuring that AGBank's policies and procedures with regard to environmental safeguard issues will be effectively implemented by its business units.⁹ The EMS also enumerates the procedures as well as guidelines for safeguarding the environment.

34. AGBank adopted an initial EMS by defining an exclusion list that identifies activities for which loans cannot be extended. AGBank loan officers are primarily responsible for reviewing the borrower's qualifications in terms of EMS eligibility. If minimum compliance is met by the borrower, the loan application is further reviewed by the Credit Committee, authorizing the approval or rejection of the loan application. If necessary, borrowers are required to submit additional information and an environmental management plan detailing the project scope and a mitigation plan on the project's perceived environmental impacts. Approved subloans are classified as low risk, medium risk, and high risk according to the loan's level of environmental risk impact. AGBank also has provided for a post-project approval audit as an oversight function through the creation of an environmental audit, which is headed by a project manager appointed by AGBank. The project manager is responsible for evaluating the nature and extent of

⁸ The economic ROIC is the earnings adjusted for taxes divided by the shareholder capital plus the long-term subordinated debt.

⁹ ADB. 2006. *Agreement on Pledge of Rights between ADB and AGBank*. Manila (Schedule 9).

environmental impacts in an annual report. To date, neither exception to the EMS nor any significant issue involving a negative environmental impact has been noted.

35. AGBank reported that its equity partner, IFC, provided environmental management guidelines, which its risk management department uses. The head of the risk management department is responsible for ensuring that AGBank adheres to these guidelines. The department screens, assesses, and monitors loans to its borrowers using the guidelines and in accordance with the environmental policy issued by the Ministry of Ecology and Natural Resources. AGBank does not issue loans to high-risk projects, which are identified in the exclusion list, such as production or trade in any product or activity deemed illegal by national regulation or international law.

36. **Social safeguards.** The ADB loan was classified as a category C project. No involuntary resettlement or impact on indigenous peoples resulted from AGBank activities.

37. As part of AGBank's health and safety performance management systems, AGBank plans to outsource the major hazard assessment to an independent consultant. Like the EMS, the independent consultant is expected to submit a comprehensive hazard assessment report and the corresponding management systems.

38. Given AGBank's modest yet proactive compliance efforts to environmental standards, practices, and procedures, the ADB assistance is rated *satisfactory*.

C. ADB Investment Profitability

39. The investment profitability is rated *excellent*.

40. The ADB loan was priced at a spread over the 6-month London interbank offered rate for a duration of 3 years. The interest rate margin charged was based on prevailing market pricing in 2006. Due to inadequate public data, the loan was specifically benchmarked to loans made to AGBank by other IFIs.

41. AGBank has been paying the interest and principal on the loan in a timely manner. The repayment of principal started on 7 September 2007, and the final repayment is scheduled for 7 March 2010. AGBank is not expected to encounter any difficulty in meeting its repayment obligations.

D. ADB Work Quality

42. ADB's work quality is rated *satisfactory* based on (i) screening, appraisal, and structuring of the project; (ii) monitoring and supervision; and (iii) its role and contribution.

1. Screening, Appraisal, and Structuring of the Project

43. ADB's involvement in AGBank began as part of the \$15 million assistance program designed to support the banking and leasing sectors in Azerbaijan (footnote 2). The program aimed to strengthen the private banking sector in a transition economy where the banking system was still dominated by state-owned banks. The program extended loans to three banks, which included AGBank, Bank Respublika, and Micro Finance Bank of Azerbaijan. Prior to selecting the three banks, ADB conducted two fact-finding and due diligence missions in which most of the top-tier banks in Azerbaijan were considered candidates. Selection criteria included

(i) development impact, (ii) additionality, (iii) potential to implement strong governance, and (iv) commercial considerations. Further, as it was the first time that ADB was entering the Azerbaijan private sector, the prevailing activities of other development partners in the country, such as EBRD, IFC, and KfW, were taken into consideration.

44. Due diligence conducted revealed that AGBank had strong management, good credit processes, low delinquency rates, and adequate capital. AGBank was among the first banks in Azerbaijan to establish proper corporate governance structures and standards.

45. The proposed assistance to AGBank was a combination of maximum loans of \$4 million and a maximum equity investment of \$4 million, subject to a limit of \$7 million. The maximum limit was smaller than the sum of the individual sublimits to allow flexibility in the allocation of resources between components during implementation, such that if one transaction did not materialize, the total intervention size would not automatically be reduced. At the time of loan disbursement, IFC had already made a 17.5% equity investment in AGBank. Hence, ADB's entry as a creditor was complementary to the role that IFC had already taken.

46. ADB's screening, appraisal, and structuring of its assistance is *satisfactory*.

2. Monitoring and Supervision

47. The ADB's Capital Markets and Financial Sectors Division's project administration unit closely monitored AGBank's operational and financial performance following loan approval and disbursement. AGBank submits unaudited financial statements on a quarterly basis and audited financial statements on a yearly basis. A quarterly private sector investment management note is prepared by the project administration unit, which evaluates the financial results of AGBank, analyzes financial ratios and trends, and ascertains compliance with financial covenants. To date, AGBank has not been in breach of any financial covenants.

48. In addition to quarterly reports, the project administration unit also prepares annual review reports for submission to the Office of the Risk Management. As part of the annual review report, a rating sheet is prepared to determine the appropriate risk rating of AGBank.

49. ADB's monitoring and supervision is *satisfactory*.

3. ADB's Role and Contribution

50. ADB's involvement in private sector development in Azerbaijan aims to support the growth of the non-oil and gas sector to diversify the economy and to broaden access to employment and business opportunities. ADB's lending to private banks seeks to enhance their roles as important alternative sources of capital for borrowers and to reduce the domination of state-controlled banks in terms of lending.

51. AGBank's customers are primarily SMEs. AGBank partly gauges its development impact by extending lending to 50% of its borrowers outside of Baku. The rapid growth in the number of regional branches of AGBank, 10 out of 22 total branches as of September 2009, is proof that its financial services are expanding outside of the capital. Further, AGBank not only increased the number of SME borrowers that availed of subloans, but also nominally increased the average loan value extended per borrower.

52. ADB's loan to AGBank has served as a catalyst for other IFIs to extend financial assistance through additional loans and equity investments to Azerbaijan's banking sector. In the years following the ADB loan, Kazimir Investment Caspian Fund invested 10% additional equity, while IFC extended \$15 million in subordinated debt to AGBank in 2009. As of the third quarter of 2009, AGBank's loans from the Government of Azerbaijan and IFIs had grown by 185% from its balance since year ended 2007. Notwithstanding the modest amount of financial assistance extended by ADB to Azerbaijan, it provided an impetus to other IFIs to drive down the market share of state-owned banks to 38% in 2009 from more than 50% before ADB's investment.

53. Given the abovementioned developmental impacts, ADB's role and contribution is rated *satisfactory*.

E. ADB's Additionality

54. ADB's involvement buoyed AGBank's reputation, thereby facilitating deposit mobilization. As discussed previously, AGBank has shown a rapid increase in its deposit base since ADB's assistance began in March 2007. The ADB loan also provided supplemental funding for the expansion of AGBank's loan portfolio, which could not have been sufficiently covered by the growth in its deposit base alone. This increased liquidity further strengthened AGBank's competitive position in the SME market, thereby contributing to an increased market share of private banks in the banking sector's total assets.

55. ADB has strengthened AGBank's compliance with environmental standards by requiring compliance with ADB's Environment Policy.

56. ADB's assistance through a loan has complemented the equity investments of IFC and Kazimir Investment Caspian Fund in AGBank. ADB thus enhanced the development impact of its assistance through coordination and cooperation with other development institutions.

57. ADB's additionality is rated *satisfactory*.

F. Overall Evaluation

58. Overall, ADB's assistance is rated *successful*. Table 11 shows a summary of the individual category ratings.

Table 11: Evaluation of ADB's Loan to Private Banks and Leasing Companies in Azerbaijan

Item	Unsatisfactory	Partly Satisfactory	Satisfactory	Excellent
A. Development Impact				
1. Private sector development			√	
2. Business success			√	
3. Contribution to economic development				√
4. Environment, social, health, and safety				√
5. Performance			√	
B. ADB's Investment Profitability				√
C. ADB's Work Quality				

Item	Unsatisfactory	Partly Satisfactory	Satisfactory	Excellent
1. Screening, Appraisal and Structuring			√	
2. Monitoring and Supervision			√	
3. ADB's Role and Contribution			√	
D. ADB's Additionality			√	
Overall Rating			√	

ADB = Asian Development Bank.

III. ISSUES, LESSONS, AND RECOMMENDED FOLLOW-UP ACTIONS

A. Issues and Lessons

59. The following main issues were identified.
- (i) Looking for other possible investment opportunities at the early stage of banking sector development is an important means for ADB to assist in the institutional development of an individual bank, as well as to contribute toward the overall development of private sector banks.
 - (ii) Targeting the use of loan proceeds for SMEs was consistent with the strategic objectives of AGBank. It is important that the use of proceeds for other ADB loans also be tailored to support the borrower's strategic goals to provide the greatest value added.

B. Recommended Follow-Up Actions

60. The following are recommended follow-up actions.
- (i) Azerbaijan's banking sector remains in a nascent stage. There is a need for continued strong financial support and technical assistance from IFIs to help it reach maturity.
 - (ii) Increased and continued participation is also needed in second- and third-tier financial institutions.

PROJECT-RELATED DATA

A. Overview

1. AGBank was founded in 1992 as a specialized bank to oversee the needs of state and commercial enterprises involved in the oil and natural gas industry. Following the Russian financial crisis in the late 1990s, AGBank repositioned itself as a universal bank and expanded into the retail market as well as the non-oil and gas corporate sector, specifically targeting small and medium-sized enterprises (SMEs). In line with the change in focus, its shareholding also changed. Shareholders among state-owned companies representing the oil and natural gas industry now possess less than 0.5% of AGBank's shares.

2. As of the end of 2008, AGBank ranked 10th in terms of assets among Azerbaijan's 46 private banks. AGBank's strength lies in SME and retail lending. In June 2006, the International Finance Corporation (IFC) took a 17.5% equity stake in AGBank, and in May 2008, Kazimir Investment Caspian Fund, an international asset management company, took an additional 10.0% equity stake. The participation of these two international financial institutions paved the way for improvements in corporate governance, operational efficiency, and risk management.

B. Products and Services

3. AGBank offers various types of banking products and services.

4. **Corporate banking.** Corporate banking services offered include teller services, deposit taking, and corporate lending. AGBank classifies loans to businesses according to amount. The minimum amount of loan to large businesses is AZN700,000.

5. **Microcredit lending and small and medium-sized enterprise banking.** One of AGBank's strengths is in micro and SME financing. According to its credit policy, AGBank defines small business loans as up to AZN100,000 and SME lending is in the range of AZN100,000–AZN700,000.

6. **Retail banking.** Retail banking services include teller services, deposit taking, loans (e.g., mortgages and car loans), guarantees, and remittances.

7. **Plastic cards.** Plastic cards offered by AGBank include Custom Card, MasterCard Business, Visa Business, Maestro Business Prepaid, Maestro (salary), and Electron (salary). AGBank also offers plastic card packages like the AG Club Business, which includes a set of four plastic cards comprising MasterCard Business, Visa Business, Kart Sigorta, and AGClub. Benefits of owning this package include accident insurance and shopping discount privileges.

8. **Trade finance.** AGBank extends letters of credit and guarantees to corporate clients to facilitate their international trade transactions. AGBank issues a guarantee and/or an irrevocable standby letter of credit against receivables. AGBank also has a current Trade Finance Facilitation Program agreement with the Asian Development Bank.

C. Organizational Structure

1. Organization

9. Supervision is carried out by the supervisory board while day-to-day management is carried out by the executive board of directors. The audit committee, strategic project group, and six other committees report directly to the supervisory board of directors (Risk Management Committee, Asset-Liability Committee, Credit Committee, Information Technology Committee, Evaluation Committee, and Human Resources Committee).

2. Human Resources Management

10. AGBank had 190 employees in 2006, increasing to 441 in the third quarter of 2009, equivalent to an average growth rate of 44%. Roughly 40% of the employees are women.

11. AGBank has taken a number of steps aimed at increasing employee satisfaction. One such initiative included improvement of performance-based pay along with implementation of a computerized personnel database and payroll calculation system. In addition, in 2008, AGBank opened a corporate training center and a library to address the increasing training needs of its employees. The training center provides mandatory general banking and introduction courses to new recruits on a regular basis and conducts specialized training programs for focus groups. AGBank employees also receive specialized training from local and international third parties. As a result of successful personnel management strategies, the staff turnover rate remains very low.

D. Risk Management

1. Credit Risk Management

12. In 2007, AGBank established a risk management department and signed a 1-year cooperation agreement with IFC aimed at increasing AGBank's risk management effectiveness. An expert from Germany was hired as a consultant to establish its risk management systems and to develop a working plan for the risk management department. To date, IFC continues to help AGBank develop its risk management policy and modernize its management information and information technology systems.

13. AGBank is currently developing a credit scoring and grading system that incorporates sound risk management principles. Its development and planned implementation in all branches will facilitate the quick and efficient processing of SME loan applications.

14. AGBank has established a systematic credit review process. The expert groups at branch level are authorized to approve loans up to 0.02% of AGBank's capital. At the head office level, loans of up to AZN300,000 are approved by a junior credit committee. Loans in excess of AZN300,000 or up to 10% of AGBank's capital are authorized by a senior credit committee. Credit above 10% of AGBank's capital is approved by the supervisory board.

2. Liquidity Management

15. Customer deposits are the main source of AGBank's business growth, which accounted for 43% of liabilities and have been growing at a compounded annual growth rate of 41.9% during the last 3 years. Borrowings from the government and international financial institutions

were the second largest source of AGBank's funding, with AZN18 million coming from the National Entrepreneurship Support Fund and the Azerbaijan Mortgage Fund, as well as international financial institutions such as the Asian Development Bank, European Bank for Reconstruction and Development, and IFC.

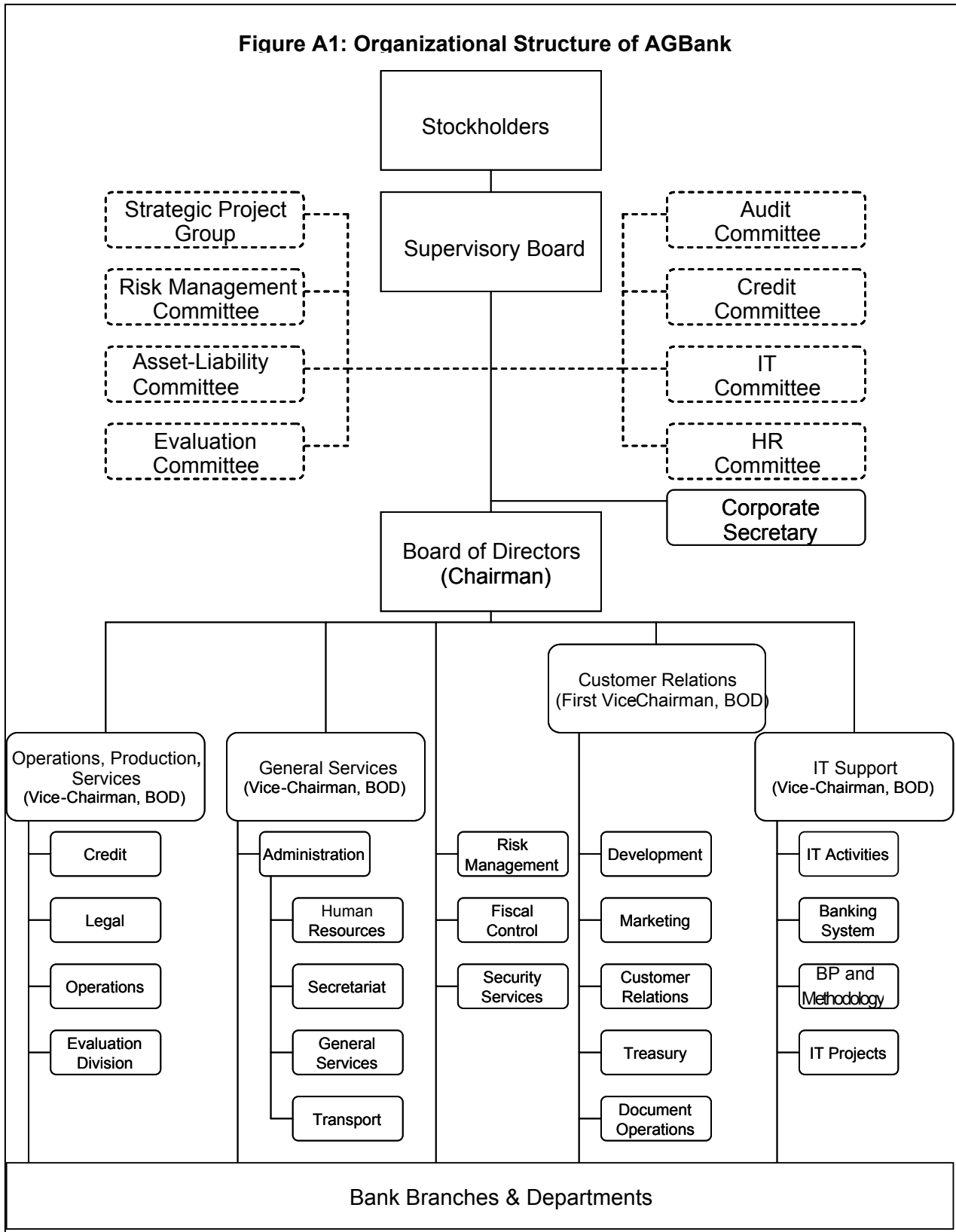
16. Liquidity is managed by AGBank's treasury department through the use of daily cash flow forecasting and gap analysis to comply with National Bank of Azerbaijan requirements. Additional liquidity can be sourced from standby credit lines from the European Bank for Reconstruction and Development. Furthermore, in the second quarter of 2009, AGBank signed an agreement for a \$9.5 million long-term loan facility with the OPEC Fund for International Development and a \$15.0 million subordinated loan agreement with IFC, which should improve AGBank's liquidity position.

E. Capital Adequacy

17. In 2008, AGBank's capital position was supported by additional share issuance, bought by Kazimir Investment Caspian Fund at a premium. In total, AGBank's capital was increased by AZN9.9 million.

18. AGBank has maintained its tier 1 ratio and its risk-weighted capital adequacy ratio well above the regulatory requirements of 5.0% and 10.0%, respectively. In the second quarter of 2009, AGBank posted a tier 1 ratio of 13.0% and a risk-weighted capital adequacy ratio of 16.0%.

Figure A1: Organizational Structure of AGBank



BOD = Board of Directors, BP = Business Process, HR = Human Resources, IT = Information Technology.
 Source: AGBank Management Reports.

**PRIVATE SECTOR DEVELOPMENT INDICATORS AND RATINGS:
FINANCIAL INTERMEDIARIES**

Indicators	Ratings ^a	Justifications								
1. Beyond Intermediary and Subborrower Impacts										
<p>1.1. Private sector expansion and institutional impact</p> <p>1.1.1. Contributes to an increased private sector share and role in the economy and to sustainable jobs or self-employment</p>	Satisfactory	<p>The private sector's gross domestic product contribution grew from 78% in 2005 to 81% in 2008.</p> <p align="center">Table A2.1: Real Gross Domestic Product Growth Rates of Azerbaijan</p> <table border="1" data-bbox="829 709 1382 783"> <thead> <tr> <th>2005</th> <th>2006</th> <th>2007</th> <th>2008</th> </tr> </thead> <tbody> <tr> <td>26.4%</td> <td>34.5%</td> <td>25.0%</td> <td>10.8%</td> </tr> </tbody> </table> <p>Source: National Bank of Azerbaijan</p> <p>The Government of Azerbaijan's efforts to diversify and expand the non-oil and gas sector have contributed to the rapid development of the country's banking sector. Total banking system assets in Azerbaijan grew from AZN6.7 billion in 2007 by 52%, to AZN10.3 billion in 2008.</p> <p>Of the 46 banks operating in Azerbaijan, only the International Bank of Azerbaijan remains state-controlled, as government efforts to implement reforms in the financial market, including the privatization of state banks, have diminished its domination of total banking assets. As of March 2009, the International Bank of Azerbaijan's market share was reduced to 38% from 53% (including Kapital Bank) in 2006. The decreasing trend in state-controlled market share of banking assets was also partly the result of stronger asset growth of private banks relative to the asset growth of state-controlled banks. In addition, a new private bank began operations in October 2009.</p> <p>The average unemployment rate of the Azerbaijan workforce was estimated to be 0.9% during 2008. Although this was low, it was an improvement from the 1.1% reported in 2005. As of the second quarter of 2009, the number of employees at AGBank grew to 441 from 190 in 2006, for a compounded annual growth rate</p>	2005	2006	2007	2008	26.4%	34.5%	25.0%	10.8%
2005	2006	2007	2008							
26.4%	34.5%	25.0%	10.8%							

Indicators	Ratings ^a	Justifications																																								
<p>1.1.2. Contributes to expanded SME lending with good portfolio and subborrower performance</p>	<p>Satisfactory</p>	<p>of 40.1%. AGBank has maintained about a 40% ratio of female employees since 2006.</p>																																								
		<p>AGBank’s loan portfolio has been relatively strong on SME lending and retail franchises. In 2008, retail loans and loans to entrepreneurs comprised 64.3% of the total loan portfolio.</p> <p style="text-align: center;">Table A2.2: AGBank's SME Loans</p> <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th>Item</th> <th>2006</th> <th>2007</th> <th>2008</th> </tr> </thead> <tbody> <tr> <td>Loan Portfolio (AZN million)</td> <td>53.3</td> <td>107.9</td> <td>148.6</td> </tr> <tr> <td>SME Loans (%)</td> <td>38.0%</td> <td>49.0%</td> <td>64.3%</td> </tr> </tbody> </table> <p>SME = small or medium-sized enterprise. Source: AGBank Audited Financial Statements</p> <p>As of the third quarter of 2009, the amount of loans released to micro and SME customers totaled \$55.1 million. At AGBank, a loan is considered an SME loan if the borrower has a minimum of 11 employees and a maximum of 250 employees, or its annual revenue is AZN0.5 million–AZN5.0 million. A loan to a borrower whose number of employees and annual revenue are below the minimum limit for an SME is considered a micro loan. Conversely, a borrower whose number of employees and annual revenue are over the maximum limit for SMEs is considered a large borrower. Over the years, the number of loans released and the average loan amount per borrower have consistently increased at AGBank.</p> <p style="text-align: center;">Table A2.3: Average Loan Value per Borrower (\$'000)</p> <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th>Loan Category</th> <th>2006</th> <th>2007</th> <th>2008</th> <th>2009</th> </tr> </thead> <tbody> <tr> <td>Less than \$1,000</td> <td>0</td> <td>0</td> <td>0</td> <td>1</td> </tr> <tr> <td>Less than \$10,000</td> <td>4</td> <td>3</td> <td>4</td> <td>4</td> </tr> <tr> <td>Less than \$100,000</td> <td>29</td> <td>0</td> <td>37</td> <td>42</td> </tr> <tr> <td>Less than \$1 million</td> <td>229</td> <td>150</td> <td>261</td> <td>271</td> </tr> <tr> <td>Number of SME and Micro Loans</td> <td>310</td> <td>343</td> <td>344</td> <td>368</td> </tr> </tbody> </table> <p>SME = small or medium-sized enterprise. Source: AGBank Management Reports</p> <p>AGBank was able to improve the asset quality in 2007 with a nonperforming loan ratio of less than 1%. However, due to the global financial crisis, AGBank's nonperforming loan ratio rose to 4% by the third quarter of 2009. This ratio is,</p>	Item	2006	2007	2008	Loan Portfolio (AZN million)	53.3	107.9	148.6	SME Loans (%)	38.0%	49.0%	64.3%	Loan Category	2006	2007	2008	2009	Less than \$1,000	0	0	0	1	Less than \$10,000	4	3	4	4	Less than \$100,000	29	0	37	42	Less than \$1 million	229	150	261	271	Number of SME and Micro Loans	310	343
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Indicators	Ratings ^a	Justifications
<p>1.1.3. Contributes to institutional change by</p> <ul style="list-style-type: none"> (i) improving supply and access to formal credit and banking service for SMEs; and (ii) influencing an enabling environment for SMEs via lobby activity, policy dialogue, or otherwise 	Excellent	<p>however, still below the covenant limit of 5%.</p> <p>AGBank was able to increase available credit to SMEs through loan agreements with IFIs (including ADB). In early 2009, despite the liquidity crunch brought about by the global financial crisis, AGBank was able to tap IFIs for sizeable funding, proving its competitive advantage in the local banking sector. Such borrowings have doubled since ADB became one of the creditors of AGBank. In April 2009, AGBank drew loans from the OPEC Fund for International Development in the amount of \$9.5 million. Furthermore, in May 2009, IFC issued a \$15 million subordinated loan to AGBank to support SME lending.</p> <p>AGBank's core clientele includes SMEs involved in trade, manufacturing, and construction business of the middle- and upper middle-class individuals. To support the growing number of SME borrowers, AGBank use available funding from the government and IFIs, whose aggregate value of funds in the third quarter of 2009 increased by 185% from 2007.</p> <p>Right before ADB extended assistance, AGBank had eight branches, two of which were outside of Baku. As of the third quarter of 2009, AGBank had 22 branches, 10 of which were outside of Baku. Branch expansion improves access to SME banking services, because many SMEs are located in regional areas. In the fourth quarter of 2009, AGBank planned to open a big branch in a large shopping mall creating a new spectrum of client services. This mall houses 3,500 small shops, and AGBank aims to provide its banking services to a majority of the shops.</p>
<p>1.2. Competition. Contributes to new competition for SME business among local banks (including new product and service offerings and local currency products) and/or to increased competition in key subborrower markets</p>	Satisfactory	<p>Twelve banks are operating in Azerbaijan that can be considered belonging to a peer group that caters primarily to the banking needs of the SME market. To improve its competitive advantage, AGBank increased the number of branches from 5 in 2003^b to 22 in 2008. It also introduced new approaches for providing services to its clients, such as opening a new branch inside a shopping mall, where a host of existing and potential customers could be served.</p>

Indicators	Ratings ^a	Justifications
		<p>To counter competition, AGBank has capitalized its good reputation as one of the most reliable banks in Azerbaijan. It attracts new clients through word of mouth from its satisfied clientele. AGBank has also benefited from the fact that bank penetration in Azerbaijan, while improving, still remains fairly low. As of the third quarter of 2009, AGBank's loan–deposit ratio remained high, at 140%.</p> <p>The loan application processing of AGBank separates micro loans from SME loans to simplify the lending process and to allow for better efficiency in managing and monitoring individual portfolios.</p>
<p>1.3. Innovation. Contributes to new ways of offering effective banking services to clients (including new products, services, and technologies) in ways that are replicated by other banks and in the financial system (item 2.2)</p>	Satisfactory	<p>AGBank is a leader in the high-end market for plastic card products. It recently launched the Master Sigma and Visa Infinity. Among the benefits of owning such cards are concierge services and health and travel insurance. AGBank reported that such privileged products are in demand. Customers are willing to pay such amount in exchange for the prestige and privilege accorded to cardholders.</p> <p>AGBank was the first bank that began to finance agro-industrial projects (from May 1997) within the framework of the Regional Agricultural Reform Program (RARP-1) Partnership Fund of the European Union Program. AGBank credited four projects with a total amount of AZN3 million, including the credit given for the building of a large mill in Mingacheur.</p>
<p>1.4. Links. Contributes to local saving and deposit mobilization via networks of participating bank(s), and/or relative to size of subportfolios, and contributes to notable upstream or downstream link effects to subborrowers' businesses in their industries or the economy</p>	Satisfactory	<p>AGBank reports that its existing products and services promote economic links among its subborrowers. Such links are evident when a corporate or SME loan applicant or client is encouraged to avail of AGBank's business plastic cards or cash or payroll management system as collateral businesses.</p> <p>SME businesses have contributed to the development of the national economy. For example, AGBank has 2 clients which rose from humble beginnings to become the largest cement producer and a well-known manufacturer and distributor of food products,</p>

Indicators	Ratings ^a	Justifications
		respectively. Another SME obtained a product line from Homak in Germany and helped achieve a 20% market share in the laminating business of Azerbaijan.
<p>1.5. Catalytic element. Contributes to mobilization of other local or international financing to SMEs and to positive demonstration to market providers of debt and risk capital to SMEs</p>	Excellent	<p>The ADB loan to AGBank helped strengthen AGBank's reputation.</p> <ul style="list-style-type: none"> (i) As of the third quarter of 2009, total national government and IFI loans to AGBank amounted to AZN45.5 million or 85% higher than 2007 figures. Increased public confidence in AGBank also brought about 25% growth in customer deposits. (ii) A positive demonstration effect of the above investments and loans is reflected in the capital investments to Azerbaijan, which increased from AZN6.0 billion in 2006 to AZN9.1 billion in 2008. This increase represents a compounded annual growth rate of 15%.
<p>1.6. Affected laws, frameworks, and/or regulation. Contributes to improved laws, regulation, and inspection affecting formal SME banks and banking services to SMEs in the local financial system</p>	Satisfactory	<p>ADB's assistance in Azerbaijan has further encouraged the government's efforts to privatize all state-controlled banks, which have controlled the banking industry since its declaration as an independent state from the former Soviet Union. Such state ownership had been reduced from 54% in 2006 to 38% in 2008.</p> <p>The government, through the National Bank of Azerbaijan, has earmarked state funds for local banks to be onlent to SME businesses.</p>
<p>1.7. Wider demonstration of new standards. Contributes to raised standards in the financial sector or in subborrower industries and sectors in corporate governance, transparency, and stakeholder relations</p>	Satisfactory	<p>IFC and Kazimir Investment Caspian Fund have a 17.5% and 10.0% stake, respectively, in AGBank. These institutions currently hold one board seat each in AGBank's five-member supervisory board and influence AGBank's corporate governance, transparency, and stakeholder relations.</p> <p>In 2007, AGBank established a risk management department and signed a 1-year cooperation agreement with IFC aimed at increasing its risk management effectiveness. An expert from Germany was hired as a consultant to establish AGBank's risk management system and to develop a working plan for the risk management department.</p>

Indicators	Ratings ^a	Justifications
<p>2. Participant Banks and Subborrower Impacts 2.1. Skills with wider impact potential. Contributes</p> <ul style="list-style-type: none"> (i) to improved SME credit approach at all stages in the participant bank(s) in ways that will be replicated by other providers of SME finance and banking service; and (ii) via the participating bank(s) to improved subborrower skills in operation of their businesses, e.g., via good appraisal, and monitoring by the bank(s) 	<p>Excellent</p>	<p>In October 1998, AGBank signed a development program contract with the European Bank for Reconstruction and Development to restructure AGBank's organizational and banking procedures to fall in line with international standards while maintaining its adaptation to local markets.</p> <p>AGBank, in cooperation with KfW, is developing a credit scoring and grading system that incorporates sound risk management principles. The development and planned implementation in all branches will facilitate the timely and efficient processing of SME loan applications. The said system is an industry standard and is expected to go live in March 2010.</p> <p>The specific software purchased by AGBank offers integrated support on a single platform to banks that provide services to corporate and professional clients. It includes coverage of corporate credit, correspondent banking and cash management, payments, treasury services, and trade finance. AGBank expects to improve its credit operations as soon as the new system goes live.</p> <p>AGBank plans to improve its operations further in 2010 by implementing automation of its data warehousing.</p>

Indicators	Ratings ^a	Justifications
<p>2.2. Demonstration and new standards-setting potential. Demonstrates potential through improved and achieved standards in corporate governance, transparency, stakeholder relations, and Environmental, Social, Health, and Safety (ESHS) spheres</p>	Excellent	<p>PricewaterhouseCoopers has been the auditor of AGBank since 2000. Financial statements are prepared and reported according to International Financial Reporting Standards.</p> <p>The corporate governance policy of AGBank was based on guidelines and policies promulgated by the National Bank of Azerbaijan. Upon IFC's 17.5% equity investment in AGBank, IFC launched the Corporate Governance Project to improve practices at Azerbaijan's joint-stock companies and banks, helping them enhance operations and increase their ability to attract financing and investment. After 2 years of collaboration, AGBank has raised its charter and bylaws to international best practice standards and has significantly improved the composition and performance of its supervisory board. AGBank is also making progress with internal audit and risk management functions and is establishing dividend and disclosure policies.^c</p>
Overall Rating	Satisfactory	

ADB = Asian Development Bank, IFC = International Finance Corporation, IFI = international finance institution, SMEs = small and medium-sized enterprises.

^a Ratings scale: excellent, satisfactory, partly satisfactory, and unsatisfactory. The rating is not an arithmetic mean of the individual indicator ratings, which have no fixed weights. Consider already manifest actual impact (positive or negative) and the potential impact and risk to its realization.

^b AGBank Management Reports

^c IFC. 2009. IFC Helps Azerbaijan's AGBank Raise Corporate Governance to International Standards. IFC Press Release, 5 February 2009. <http://www.ifc.org/ifcext/pressroom/ifcpressroom.nsf/PressRelease?openform&289894F3A5BE913385257554005D3784>

Source: ADB. 2008. *Revised Project Administration Instructions on Extended Annual Review Reports for Non-Sovereign Operations*, Appendix 7. Manila.

SECTOR AND OPERATIONS REVIEW

1. Azerbaijan's local banking system has been less affected by the global financial crisis than have others in Central and Eastern Europe. This is because Azerbaijan domestic banks have limited international financial integration and a low level of foreign borrowings.

2. Azerbaijan's banking system is highly concentrated, with the seven largest banks controlling more than 70% of the system's total assets. The remaining 30% (comprising 39 banks) are relatively fragmented. Concentration of state ownership in the sector is also high, as the system is dominated by the state-controlled International Bank of Azerbaijan, which accounted for about 43% of the banking sector's total assets at year end 2008.¹

3. In 2008, Azerbaijan's total banking system assets grew by 59%, to AZN10.1 billion.

A. Profitability

4. Data from the National Bank of Azerbaijan (NBA) show that profits earned by banks in 2008 (before taxes) amounted to AZN246 million. Although 8 of the 46 banks in Azerbaijan posted losses in 2008 (these banks' assets make up only 2.6% of the total bank assets), aggregate profits still exceeded the 2007 profit before taxes of AZN172.1 million by 42.9%.

5. Table A3.1 shows total banking system income data and selected ratios. Net interest income grew from AZN175.5 million in 2005 to AZN532.7 million in 2008, for a compounded annual growth rate of 44.8%. Net noninterest income grew from AZN93.4 million in 2005 to AZN283.9 million in 2008, for a compounded annual growth rate of 44.9%. The banking system's return on equity leveled at 17%–18% in 2007 and 2008.

Table A3.1: Azerbaijan Banking System Data

Item	2005	2006	2007	2008
Income Statement				
(AZN million)				
Net interest income	175.5	275.0	309.8	532.7
Net noninterest income	93.4	131.9	209.1	283.9
Selected Ratios				
(%)				
Return on equity	15.7	12.8	17.6	17.0
Return on assets	2.2	1.7	2.6	2.2

Source: National Bank of Azerbaijan.

6. The banking sector remained fairly stable in 2009, although its profitability declined moderately, as the downside effects of recent rapid credit growth manifest. Interbank borrowing rates have increased, as local banks began to conserve liquidity to counter the credit crunch. Increased loan loss provisioning (70% in 2008) and various operating costs also adversely affected AGBank's profitability. Conversely, high growth in earning assets for the past 3 years, robust interest margins, and contribution from strong fee- and commission-based income (30%–37% of operating revenues) have helped offset the negative effects of the global financial crisis for most of Azerbaijan's banks.

¹ Moody's Investor Services. 2009. *Banking Systems Outlook – Azerbaijan*. Moscow (June, p. 2).

B. Asset Quality in the Banking Sector

7. The banking sector's loan portfolio increased by 53% to AZN7.2 billion (\$8.9 billion) in 2008. Nonperforming loans relative to total credit increased, as economic growth slowed from the global financial crisis. In particular, the rise in nonperforming short-term loans has been steep, from 3.6% at the end of July 2008 to 6.7% at the end of July 2009. Further increases in nonperforming loans are expected, given the sharp drops in output being recorded across almost all economic sectors. Notwithstanding the rise in nonperforming loans in 2009, there are strong indications that adequate capital levels and the positive earnings of Azerbaijan banks will absorb the nonperforming loan loss of 15% of the total loans.

C. Capital Position of the Banking Sector

8. Table A3.2 shows the capital adequacy ratios in the Azerbaijan banking sector. It is evident that the banking sector remains well capitalized despite the strain brought about by the global financial crisis.

Table A3.2: Capital Adequacy Ratios of Azerbaijan Banking Sector
(%)

2006	2007	2008	As of Second Quarter 2009
18.0	20.0	19.6	19.5

Source: Fitch Ratings.

D. Corporate Governance

9. Corporate governance remains a challenge in Azerbaijan. In October 2009, Fitch Ratings reported that Azerbaijan banks remained relatively weak in implementing corporate governance due to a lack of independent and experienced risk management, the high level of government influence on the operations of the country's biggest bank, high balance sheet concentrations, and a significant share of foreign currency assets and liabilities.² However, the entry of international financial institutions in Azerbaijan has significantly influenced the adoption of effective corporate governance at Azerbaijan banks. The International Finance Corporation, in its effort to upgrade the sector's risk management system, has extended technical assistance to its investee banks.

E. New Banking Regulations

10. In July 2007, NBA increased banks' minimum capital requirement to \$10 million to consolidate the sector. By the end of 2008, nearly all Azerbaijan banks met the minimum capital requirement.

11. In early 2008, several banks were borrowing heavily overseas—relative to their balance sheets—and using the proceeds to expand their market share aggressively. In the middle of 2008, some began to experience a liquidity squeeze due to the closure of global financial markets, a problem exacerbated in the first quarter of 2009 by corporate and retail funding outflow. To support overall sector liquidity, NBA, during the fourth quarter of 2008 to the first

² Fitch Ratings. 2009. *Azerbaijani Banks: Back Down to Earth*. New York (5 October 2009, p. 2).

quarter of 2009, reduced obligatory reserve requirements from 12.0% to a record low of 0.5%. It also supported a legislative initiative in May 2009 to increase the level of retail deposit insurance coverage by five-fold, to AZN30,000 (about \$37,000). NBA also acted to reduce volatility of the Azerbaijan manat, helping reduce depositor nervousness and support bank asset quality in light of the significant levels of foreign currency lending. All of these actions demonstrated NBA's commitment to supporting the Azerbaijan banking sector.

12. In November 2008, Azerbaijan President Ilham Aliyev endorsed legislation that exempted banks from paying taxes on their profits for 3 years if they use the money to increase their statutory capital. This is a clear effort on the government's part to strengthen the capital base of its banking sector.

COMPARATIVE FINANCIAL STATEMENTS

Table A4.1: Comparative Balance Sheets
(AZN'000)

Balance Sheet	2005	2006	2007	2008	Third Quarter 2009
A. Assets					
Cash and cash equivalents	12,670	15,056	24,305	31,584	26,799
Mandatory cash balances with the NBAR	1,858	3,664	4,626	3,627	286
Due from other banks	3,473	3,841	2,043	3,657	2,728
Loans and advances to customers	33,230	53,331	107,866	148,609	171,913
Investment securities available for sale	135	4,082	386	363	573
Investment securities held to maturity	2,698	0	0	0	0
Investment in associates	144	302	296	415	564
Premises and equipment	3,849	6,433	9,402	15,895	16,566
Computer software and licenses	179	210	275	305	288
Deferred income tax asset	43	0	0	0	0
Current income tax prepayment	0	0	375	4	0
Other financial assets	0	0	233	7	430
Other assets	324	387	6,971	2,322	2,588
Subtotal (A)	58,603	87,306	156,778	206,788	222,735
B. Liabilities					
Due to other banks	301	272	12,902	11,725	15,710
Customer accounts	43,865	57,442	96,115	125,402	120,241
Debt securities in issue	583	553	3,295	3,283	3,029
Borrowings from government and international financial institutions	6,143	14,563	24,601	32,652	41,433
Subordinate deposit	0	0	0	0	4,018
Deferred income tax liability	0	347	275	328	417
Current income tax liability	337	395	0	0	0
Other financial liabilities	0	0	774	2,823	5,580
Other liabilities	71	244	472	438	579
Subtotal (B)	51,300	73,816	138,434	176,651	191,007
C. Equity					
Share capital	5,800	9,000	12,000	15,000	15,000
Share premium	0	0	0	6,860	6,860
Other reserves	0	1,438	1,481	1,433	1,464
Retained earnings	1,503	3,052	4,863	6,844	8,404
Subtotal (C)	7,303	13,490	18,344	30,137	31,728
Total	58,603	87,306	156,778	206,788	222,735

AZN = Azerbaijan Manat, NBAR = National Bank of Azerbaijan Republic
Source: Audited Financial Statements.

Table A4.2: Comparative Financial Statements
(AZN'000)

Income Statement	2005	2006	2007	2008	Third Quarter 2009
Interest Income	5,696	8,819	15,295	27,180	22,832
Interest Expense	(2,303)	(3,653)	(6,913)	(13,259)	(11,034)
Net Interest Income	3,393	5,166	8,382	13,921	11,798
Provision for impairment due from other banks	7	46	(30)	0	(120)
Porvision for loan impairment	(495)	(878)	(1,409)	(5,402)	(3,542)
Net Interest Income after Provision for Loan Impairment	2,905	4,334	6,943	8,519	8,137
Fee and commission income	2,885	3,422	4,754	7,665	5,686
Fee and commission expense	(776)	(983)	(1,682)	(2,687)	(3,509)
Gains less losses from trading in foreign currencies	281	554	1,104	1,865	35
losses	(242)	52	(5)	38	1,899
Other operating income	98	86	29	161	18
Adminstrative and other operating expenses	(2,906)	(4,060)	(6,689)	(10,627)	(8,306)
Share of profit of associates	(6)	8	(6)	52	49
Profit before Tax	2,239	3,413	4,448	4,986	4,009
Income tax expense	(569)	(783)	(1,031)	(1,110)	(80)
Profit for the year	1,670	2,630	3,417	3,876	3,929

AZN = Azerbaijan Manat

Source: Audited Financial Statements.

REEVALUATION OF RETURN ON INVESTED CAPITAL AND WEIGHTED AVERAGE COST OF CAPITAL

A. Cost of Equity

Formula: US Treasury Bill (5 years) + US Equity Premium + Inflation Country + Country Macro Spread + Liquidity Risk Premium

where Inflation Country is the difference between Inflation_{US} and Inflation_{AZ}

Liquidity Risk Premium is derived from Key Variables in Estimating the Cost of Capital (Ibbotson & Associates) (Table A5)

Table A5:

Size Premium			
Decile	Market Capitalization of Smallest Company (\$ million)	Market Capitalization of Largest Company (in million \$)	Size Premium (Return in Excess of CAPM)
Mid-Cap, 3–5	1,947.240	7,777.183	0.97%
Low-Cap, 6–8	627.017	1,946.588	1.76%
Micro-Cap, 9–10	2.247	626.955	3.88%
Breakdown of Deciles 1–10			
1- Largest	16,848.063	371,187.368	-0.36%
2	7,847.424	16,820.566	0.65%
3	4,098.254	7,777.183	0.81%
4	2,861.655	4,085.184	1.03%
5	1,947.240	2,848.771	1.45%
6	1,379.267	1,946.588	1.67%
7	977.912	1,378.476	1.62%
8	627.017	976.624	2.28%
9	314.912	626.955	2.70%
10–Smallest	2.247	314.433	6.27%
Breakdown of the tenth Decile			
10a	173.664	314.433	4.35%
10b	2.247	173.439	9.68%

US Treasury Bill (5 years) :	2.06%
US Equity Premium :	7.50%
Inflation (United States) :	3.85%
Inflation (Azerbaijan) :	20.80%
Country Macro Spread :	1.16% Spread on 5-year Russian sovereign credit default swaps, August 2008
Liquidity Risk Premium :	2.70%

Market Capitalization :	37.5
Decile :	314.912 2.70%
Cost of Equity :	30.37%

B. Weighted Average Cost of Capital**WACC**

Formula:

$$\left\{ \left(\frac{MV_e}{MV_e + MV_d} \times \text{Cost of Equity} \right) + \left(\frac{MV_d}{MV_e + MV_d} \times \text{Cost of Debt} \right) \right\} \times (1 - \text{Tax})$$

Market Value of Firm's Equity ^a :	AZN30.1 million	(<i>MV_e</i>)
Market Value of Firm's Debt ^a :	AZN176.7 million	(<i>MV_d</i>)
Cost of Debt :	7.20%	
Tax Rate :	22.00%	
Weighted Average Cost of Capital	9.22%	

^a Figures were based on balance sheet.
Market Value¹²
