



Report and Recommendation of the President to the Board of Directors

Project Number: 49076-005
October 2016

Proposed Loan and Administration of Technical Assistance Grant Damu Entrepreneurship Development Fund Supporting Resilience of Micro, Small, and Medium- Sized Enterprises Finance Project (Guaranteed by the Republic of Kazakhstan)

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 30 September 2016)

Currency unit	–	tenge (T)
T1.00	=	\$0.00296
\$1.00	=	T338.42

ABBREVIATIONS

ADB	–	Asian Development Bank
ACF	–	Asian Credit Fund
BCC	–	Bank CenterCredit
BOA	–	Bank of Astana
CAGR	–	compound annual growth rate
Damu	–	Damu Entrepreneurship Development Fund
ESMS	–	environmental and social management system
GDP	–	gross domestic product
MFF	–	multitranches financing facility
MSMEs	–	micro, small, and medium-sized enterprises
NBK	–	National Bank of Kazakhstan
PAM	–	project administration manual
PFI	–	participating financial institution
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

NOTE

In this report, “\$” refers to US dollars.

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PROJECT AT A GLANCE

1. Basic Data		Project Number: 49076-005	
Project Name	Supporting Resilience of Micro, Small, and Medium-Sized Enterprises Finance Project	Department /Division	CWRD/CWPF
Country Borrower	Kazakhstan Damu Entrepreneurship Development Fund	Executing Agency	DAMU Entrepreneurship Development Fund
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		200.50
		Total	200.50
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Client relations, network, and partnership development to partnership driver of change	Effective gender mainstreaming (EGM)	✓
Partnerships (PAR)	Institutional development Organizational development Bilateral institutions (not client government) Official cofinancing		
Private sector development (PSD)	Promotion of private sector investment		
5. Poverty and SDG Targeting		Location Impact	
Project directly targets poverty and SDGs	No	Nation-wide	High
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: FI Involuntary Resettlement: FI-C Indigenous Peoples: FI-C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		200.50	
Sovereign Project loan: Ordinary capital resources		200.00	
Sovereign Capacity development technical assistance: Financial Sector Development Partnership Special Fund		0.50	
Cofinancing		0.00	
None		0.00	
Counterpart		40.00	
Beneficiaries		40.00	
Total		240.50	
9. Effective Development Cooperation			
Use of country procurement systems		No	
Use of country public financial management systems		No	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to Damu Entrepreneurship Development Fund (Damu), to be guaranteed by the Republic of Kazakhstan, for the Supporting Resilience of Micro, Small, and Medium-Sized Enterprises (MSMEs) Finance Project. The report also describes the proposed administration of technical assistance (TA) to be provided by the Financial Sector Development Partnership Special Fund¹ for Strengthening Micro, Small, and Medium-Sized Enterprise Finance, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.²

2. The proposed financial intermediation loan will provide local currency credit to sustain operations of and employment by MSMEs during the current economic slowdown. The TA will strengthen credit origination and management of selected participating financial institutions (PFIs) to better serve MSMEs.³

II. THE PROJECT

A. Rationale

3. Kazakhstan's economy significantly depends on hydrocarbons, which in 2015 represented 25% of its gross domestic product (GDP) and more than 70% of export revenues. While GDP growth was robust at an average 10.2% per annum during 2000–2007, economic performance has been volatile since the 2008 global financial crisis. The economy rebounded with an average GDP growth of 6.5% (2010–2013) but then declined to 4.2% (2014), dropped sharply to 1.2% in 2015, and is expected to remain subdued at 0.1% in 2016.⁴ The slowdown is a result of a sharp drop in hydrocarbon revenues, the recession in the Russian Federation, and weakening demand from Kazakhstan's main trading partners. The reduction in foreign exchange income in 2015 prompted the central bank to move to a floating exchange rate regime. From 2014 to mid-2016, the tenge lost 55.8% of its value against the US dollar⁵ and, despite price controls and a restrictive monetary policy, inflation nearly doubled to 13.6% at the end of 2015, from 7.4% at the end of 2014.⁶ Improving MSMEs' productivity, and the resilience of microenterprises as a source of income for the low-income population, is essential to boost the non-oil economy and reduce macroeconomic volatility.

4. While the cities of Astana and Almaty and the Atyrau region generated 42% of value addition in 2015, 86% of Kazakhstan's 17.5 million residents live in rural districts and regional towns. Agriculture represents 24% of employment. In 2015, the rural poverty head count of 4.7% exceeded the urban poverty head count of 1.4%, indicating that the rural population is primarily engaged in low-productivity agriculture and trapped in low-wage jobs. Support of the rural economy is essential to sustain income for low-income families and create demand for

¹ Financing partner: the Government of Luxembourg.

² The design and monitoring framework is in Appendix 1.

³ The project is included in Asian Development Bank (ADB). 2015. *Country Operations Business Plan: Kazakhstan, 2016–2018*. Manila. ADB provided project preparatory TA for Micro, Small, and Medium-Sized Enterprise Development (TA 8918-KAZ). The project is aligned with the priorities identified under ADB. 2012. *Country Partnership Strategy: Kazakhstan, 2012–2016*. Manila.

⁴ ADB. 2016. *Asian Development Outlook, 2016*. Manila.

⁵ From T188 = \$1 to T337 = \$1.

⁶ ADB provided countercyclical support of \$1 billion to mitigate the adverse impact of the macro shocks described. ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Kazakhstan for Countercyclical Support*. Manila.

goods and services provided by MSMEs, including farmers. However, agricultural productivity is hampered by low standards of quality and inadequate infrastructure. Financial service coverage in rural areas is inadequate—only 48% of rural adults have a bank account.⁷

5. In 2015, Kazakhstan had 1.1 million MSMEs, of which 930,000 were sole proprietorships, 176,000 small enterprises, and 2,900 medium-sized enterprises.⁸ Sole proprietors employed 49% of MSME labor, followed by small (39%) and medium-sized (12%) enterprises. MSMEs contributed 26% of GDP and 32% to employment. While sole proprietorships display low productivity with an annual output per worker of \$3,170 equivalent in 2015, their significance in providing subsistence income especially in rural areas highlights their importance as social protection for low-income households. With an annual output per worker of \$27,000, small and medium-sized enterprises (SMEs) are important for employment and income-generation.

6. A World Economic Forum business survey identified corruption, inadequate skills, and poor access to finance as major obstacles to competitiveness. The performance of the banking system is undermined by corruption, bureaucracy, related-party transactions, poor corporate governance, and imprudent lending, as witnessed by the very poor asset quality of banks.⁹ Limited access to finance is a key obstacle to stronger productivity by MSMEs.¹⁰

7. While MSMEs contributed 26% to GDP in 2015, loans to MSMEs represented only 9.8% of GDP. Especially micro and small enterprises have insufficient documentation, credit history, and property titles to satisfy bank requirements. The banks' lending policies do not focus enough on estimated business cash flows when assessing borrowers' creditworthiness. The high cost of originating loans and the recent history of poor credit underwriting led to high perceived risk in lending to small businesses and to high lending rates that make borrowers' investments unattractive.¹¹ Only 19% of MSMEs have received a bank loan, so most fund their investments through retained earnings, and borrowings from family and friends (footnote 9).

8. The performance of the finance sector mirrors that of the economy. Economic shocks, poor credit underwriting, and currency devaluations have hurt the performance and stability of the banks and eroded public confidence. In 2011–2013, the loan book expressed in dollar terms grew by a compound annual growth rate (CAGR) of 10.9%, medium-sized loans surged at a CAGR of 119.0%, and deposits grew at a moderate CAGR of 7.7%. In this period, profitability improved from a negative return on assets to a positive one of 1.8%, and capital adequacy modestly improved to 18.7%. Asset quality, however, remained extremely poor and the nonperforming loans ratio exceeded 30% in 2013. While banks' nonperforming loans ratio reportedly improved to 8% in 2015 as a result of write-offs and massive transfers to special purpose vehicles, doubts about the banks' asset valuation practices suggest that the reported improvement of asset quality is overstated and that asset quality may drop again under the

⁷ World Bank. Financial Inclusion Databank/Global Findex.

<http://datatopics.worldbank.org/financialinclusion/country/kazakhstan> (accessed 30 March 2016).

⁸ Source: National Statistical Office. The government classifies enterprises by the number of workers and by income. In 2016, microenterprises have an annual income up to \$184,000 equivalent or up to 15 employees; small businesses have less than 100 employees and up to \$1.8 million annual income; and medium-sized businesses have less than 250 employees and up to \$18.4 million annual income.

⁹ Sector Assessment (Summary): Finance (accessible from the list of linked documents in Appendix 2).

¹⁰ World Bank and International Finance Corporation. 2014. *Enterprise Surveys: Kazakhstan Country Profile 2013*. Washington DC; World Economic Forum. 2014. *The Global Competitiveness Report, 2015–2016*. Geneva; and World Bank. 2016. *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. Washington DC.

¹¹ Bank annual lending rates in tenge range from 14% to 25%, and those in foreign currency range from 5% to 12%.

current economic decline.¹²

9. The sharp devaluation of the tenge against the dollar (footnote 5) seriously affected the solvency and profitability of some banks, including systemically important banks. Expressed in dollar terms, bank loans contracted by a CAGR of 27.3%, and loans to micro and small enterprises declined by a CAGR of 14.7% during 2014–2015. As a result, the banking system's depth, expressed by the ratio of private sector credit to GDP, remained at a low 38% in 2015.

10. In 2015, banks were moderately capitalized, with a total capital adequacy ratio of 15.9%. While exceeding the regulatory minimum of 7.5%, banking system solvency remains highly susceptible to the volatile economy and unresolved asset quality issues. The stress tests carried out by the International Monetary Fund in the context of the financial sector assessment program conducted in early 2014 showed that the capital of many banks would not be able to sufficiently absorb shocks of the magnitude witnessed in 2014 and in 2015.¹³ The significant volume of nonperforming loans will require write-offs and loan loss provisions over an extended period, and low net interest margins will limit banks' ability to generate additional capital through retained earnings. Additional capital will likely be needed to meet Basel III requirements, which are being phased in by the National Bank of Kazakhstan (NBK) from 2015 to 2019.

11. High exchange rate volatility resulted in a surge of deposit dollarization from 35% (2010) to 70% (2015), while local currency loans represented 66% of loans in 2015. This led to substantial open foreign currency positions. Banks' lending in local currency was constrained by the NBK's monetary policy and measures to counter currency speculation. In 2014 and 2015, the NBK provided cross-currency swaps up to 12 months. Tenge funding is essential to help reduce currency-related risks of financial institutions and their borrowers.

12. **Government's strategy.** Recognizing their significance for employment, innovation, and non-oil economic growth, the government is supporting MSMEs. The national development strategy Kazakhstan 2050 targets to increase the contribution of SMEs to GDP to 50% by 2020. The Roadmap for Business 2020, Employment Roadmap 2020, and the State Program of Industrial and Innovative Development (2015–2019) contain measures for MSME support.¹⁴ Lack of access to finance is identified as a key constraint to MSME growth. The government has in place several programs to support SME finance along with development partners.¹⁵ Those programs are implemented through Damu, a government-owned agency mandated to provide loans and guarantees to MSMEs via financial intermediaries on commercial and concessional terms.¹⁶

13. **ADB's value addition.** The project will provide loans for MSMEs and support financial inclusion, especially outside the two major cities, by providing funds for working capital and investment loans. Access to finance for businesses owned by women is encouraged through agreed lending targets and gender policies. To meet these objectives, the Asian Development Bank (ADB) carefully selected PFIs that (i) have a significant regional footprint, (ii) have top

¹² "Nonperforming loans" should be interpreted with caution: rescheduled loans are not reported as nonperforming loans.

¹³ International Monetary Fund. 2014. *Financial Sector Assessment Program, Kazakhstan*. Washington, DC.

¹⁴ Government of Kazakhstan. 2012. *Kazakhstan–2050 Strategy*. Astana; Government of Kazakhstan. 2015. *Roadmap for Business–2020*. Astana; Government of Kazakhstan. 2014. *State Program of Industrial and Innovative Development of the Republic of Kazakhstan, 2015–2019*. Astana; and Government of Kazakhstan. 2014. *Employment Roadmap 2020*. Astana.

¹⁵ Development Coordination (accessible from the list of linked documents in Appendix 2).

¹⁶ Loans to financial institutions represented around 70% of Damu's T355.3 billion assets in 2015.

management commitment to service MSMEs, and (iii) have or are willing to put in place innovative lending processes to improve lending efficiency. Critical elements of the ADB package are (i) the provision of local currency loans to address foreign exchange risks of PFIs and its borrowers, (ii) partnership with suitable PFIs that compete in servicing MSMEs through different approaches, and (iii) TA to strengthen the PFIs' credit risk management and their product offerings for MSMEs.

14. **ADB sector experience and assistance program.** Prior to the 2008 crisis, ADB had provided nonsovereign loans and partial credit guarantees to four banks.¹⁷ Since 2010, it provided sovereign loans through a multitranche financing facility (MFF) for SMEs via banks in an aggregate amount of \$500 million equivalent.¹⁸ The facility is expected to close in 2017. While a countercyclical support facility in 2015 helped mitigate the economic shock, the project design reflects the need for extended support to the private sector (footnote 9). Lessons from the MFF are embedded in the design of this project. First, while the MFF provided local currency to mitigate dollarization of loans to the banks and their customers, the swap instruments had to be originated and repaid in bullet payments that were inadequate to match PFI funding needs. ADB will now provide tenge through NBK, allowing periodic withdrawals through separate repo transactions that fit PFI funding needs.¹⁹ Second, the project will also cover low-income microenterprise borrowers through the participation of microfinance organizations and TA to support PFIs in servicing microenterprises. Third, a larger number of PFIs, the flexibility to include additional PFIs during project implementation, and allocation of funds based on actual disbursement performance will stimulate PFI competition. Finally, a longer implementation period provides flexibility to accommodate demand fluctuation in a volatile environment.

15. **Development partner coordination.** The European Bank for Reconstruction and Development, the International Finance Corporation, the United States Agency for International Development, and the World Bank support MSMEs through (i) business development services, (ii) assistance in introducing credit scoring and improving lending technology, (iii) cluster development, and (iv) loans and equity investments in banks. ADB is coordinating with these partners and focuses on mitigating currency risk and improving PFIs' service outreach to MSMEs (footnote 15).

B. Impact and Outcome

16. The impact will be a sustained contribution of MSMEs to Kazakhstan's GDP, which is aligned with the government's objectives of supporting entrepreneurship and the contribution of MSMEs to the non-oil economy and employment under a challenging macro environment. The outcome will be that a sustainable provision of loans to MSMEs is maintained.

¹⁷ Alliance Bank (2006, \$100 million partial credit guarantee and \$50 million loan); Bank CenterCredit (2007, T6 billion loan); BTA Bank (2006, \$75 million loan); and Kazkommertsbank (2007, \$100 million partial credit guarantee). The loans to BTA Bank and Alliance were restructured and partly written off.

¹⁸ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Multitranche Financing Facility to the Republic of Kazakhstan for the Small and Medium Enterprise Investment Program*. Manila.

¹⁹ The NBK liquidity facility will take the form of a repo agreement between NBK and ADB documented under a TBMA/ISMA Global Master Repurchase Agreement. As part of ADB's Borrowing Program for 2016, the Board authorized ADB to source local currency to fund loans through cross-currency swap transactions and transactions of a similar nature. The repo facility with NBK has been structured to replicate the features of a swap, and therefore is considered in accordance with the Board's authorization. Local Currency Funding for ADB's Loan (accessible from the list of linked documents in Appendix 2).

C. Outputs

17. The project comprises the following outputs:
- (i) **Sustained financial inclusion.** The project will fund local currency loans through PFIs to provide working capital to MSMEs, enable productive investments by MSMEs, and incentivize lending to women entrepreneurs and regions outside Astana and Almaty.²⁰ The PFIs will aim to fund at least (a) \$50 million equivalent to women-owned businesses, with a third of the total number of subborrowers being women; and (b) \$120 million equivalent to eligible subborrowers outside the cities of Astana and Almaty.
 - (ii) **Improved efficiency of PFIs' lending to MSMEs.** The project will provide TA to improve credit risk management and efficiency of selected PFIs, and to expand financing opportunities for MSMEs.

D. Investment and Financing Plans

18. The project is estimated to cost \$240 million equivalent. The government has requested a loan of T72 billion (equivalent to \$200 million) from ADB's ordinary capital resources to help finance the project. ADB will provide tenge through an innovative funding facility with the NBK, under which NBK and ADB will execute repo transactions as required to accommodate the PFIs' demand for funding to MSMEs (footnote 19). Damu will be the borrower of the loan, which will be guaranteed by the Republic of Kazakhstan. The final maturity date of the loan will match the termination date of the NBK's liquidity facility. The loan will have (i) an interest rate equal to the sum of ADB's cost of funding²¹ and the contractual spread for sovereign guaranteed loans; (ii) a commitment charge of 0.15% per year on committed and undisbursed amounts commencing 60 calendar days after the date of the loan agreement; and (iii) such other terms and conditions set forth in the draft loan, guarantee, and project agreements. The loan tenor will be 36 months.

Table 1: Financing Plan

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Ordinary capital resources (loan)	200.0	83.3
Subborrowers (through equity contribution)	40.0	16.7
Total	240.0	100.0

Note: Every \$1.00 of an Asian Development Bank subloan is expected to mobilize, on average, an additional \$0.20 of business investment on the assumption that the participating financial institutions (PFIs) will require eligible borrowers to provide on average 16.7% of a subproject's cost with equity. PFIs will have discretion to determine the subborrower equity contributions based on the nature of the credit risk. Although not part of the PFIs' disbursements to subborrowers, the National Bank of Kazakhstan requires the PFIs to hold \$0.075 of capital for each \$1.000 they onlend under the project. The equity capital and loan loss reserves are the first defenses against any subborrower payment defaults and ensure that the PFIs are incentivized to lend to creditworthy clients.

Sources: Asian Development Bank estimates, Damu Entrepreneurship Development Fund, and PFIs.

19. Damu will relend the ADB loan proceeds to qualified PFIs that meet agreed selection criteria, and pursuant to subsidiary loan agreements entered into by Damu and each PFI, on terms and conditions satisfactory to ADB. Each PFI will use the loan proceeds to finance subloans up to \$3 million equivalent to eligible MSMEs for investment and working capital

²⁰ The cumulative amount of financing provided to MSMEs is likely to exceed the ADB loan amount because the PFIs will utilize repaid subloan amounts to fund additional eligible subloans until the final maturity date of the Damu loans extended to PFIs.

²¹ 50% of the base interest rate published by the NBK as of the date of execution of the repo transaction, not less than 7% per annum, repriced quarterly.

purposes. For microfinance organizations, the maximum subloan size will be determined by the regulations of the NBK.²²

E. Implementation Arrangements

20. Damu will be the executing agency responsible for the administration and disbursement of the proceeds of the ADB loan. Qualified PFIs will be the implementing agencies.²³ A project management unit at Damu will administer the project, provide progress reports, oversee PFIs' compliance with ADB loan and project agreements, and manage any issues in coordination with ADB and the PFIs. The PFIs are expected to report the utilization of funds through loans to qualified MSMEs, covering the first and recurrent uses of funds until final maturity of the Damu subsidiary loans to PFIs. The implementation arrangements are summarized in Table 2 and described in detail in the project administration manual (PAM).²⁴

21. Given the volume of trade flows with non-ADB members and the relatively small size of individual transactions, a waiver to allow MSMEs to procure goods, works, and consulting services from non-ADB member countries is requested from the ADB Board of Directors.²⁵

Table 2: Implementation Arrangements

Aspects	Arrangements
Implementation period	January 2017–June 2019
Estimated completion date	30 June 2019
Estimated loan closing date	30 June 2019
Management	
(i) Executing agency	Damu Entrepreneurship Development Fund
(ii) Implementing agencies	Qualified PFIs: Asian Credit Fund (microfinance organization), Bank of Astana, Bank CenterCredit, Bank Kassa Nova, Bereke (microfinance organization), KazMicroFinance (microfinance organization), and Nurbank ^a
Retroactive financing	Up to 20% of the loan amount can be used to finance eligible subloans made by PFIs on or after the approval of the project by the ADB Board of Directors and prior to the loan effectiveness date, but no earlier than 12 months before the signing date of the loan agreement.
Disbursement	The loan proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and arrangements agreed between the government and ADB, including a minimum drawdown amount of \$20 million.

ADB = Asian Development Bank, PFI = participating financial institution.

^a Additional PFIs could be considered during project implementation, provided they meet the eligibility criteria for the project and appropriate financial, safeguard, and integrity due diligence is conducted on each candidate.

Source: Asian Development Bank.

III. TECHNICAL ASSISTANCE

22. Capacity development TA for Strengthening MSME Finance will help improve the credit risk management of selected PFIs and expand financing opportunities for MSMEs. ADB will engage with Damu and selected PFIs in providing customized solutions to upgrade PFIs' credit

²² At the end of 2015, this was 8,000 times the monthly calculation index (set annually in the Budget Law), i.e., T17 million (equivalent to \$46,000).

²³ A description of the PFIs preliminarily selected for the project is included in the Financial Analysis (accessible from the list of linked documents in Appendix 2).

²⁴ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

²⁵ The ADB Board of Directors must approve the waiver by a vote representing not less than two-thirds of the total voting power of the members of the Board. The Board approved a similar waiver for the ongoing MFF that is supporting SME financing in Kazakhstan (see footnote 18).

origination and management, and efficiency of service outreach to MSMEs.²⁶ The TA output will be improved capacities of the PFIs to better serve MSMEs. To improve the sustainability of ADB's credit line, the TA will assist the PFIs in the following areas: (i) institutional development—including market analysis, organizational set up, introduction of new lending techniques, and product development and testing—to support banks in downscaling their lending operations to the smaller segments and development of new products for microfinance organizations; (ii) greater efficiency of the lending process and management of corporate governance and risk issues; and (iii) improvement of internal audit functions. Given the limited TA resources, and to increase the impact of the intervention, the support will be provided individually to a limited number of PFIs, which have confirmed management commitment to introduce innovations that are scalable and can demonstrate improvements in reaching to the target groups (smaller businesses, rural areas, women entrepreneurs).

23. The TA is estimated to cost \$1 million, of which \$500,000 will be financed on a grant basis by the Financial Sector Development Partnership Special Fund (footnote 1) and administered by ADB. The PFIs will fund no less than 35% of each individual TA cost. The TA will be implemented over 30 months. ADB will be the executing agency for the TA, with the Central and West Asia Department acting as the focal point.

IV. DUE DILIGENCE

A. Economic and Financial

24. Sustaining access to finance in a volatile macroeconomic environment positively affects MSMEs' ability to maintain their operations, selectively invest in productive technologies, and grow their businesses to reach economies of scale, thereby contributing to economic stability, diversification away from the oil economy, and preservation of jobs.

25. ADB and Damu selected four banks and three microfinance organizations as PFIs whose business strategies and performance provide a good fit with the project objectives. Most PFIs have significant MSME lending operations in the regions outside Almaty and Astana, i.e., more than half of their loan books. Bank CenterCredit (BCC), a leading lender to SMEs with a very strong branch network, serves more than 2,500 small enterprise borrowers with an average loan size of \$80,000. ADB is familiar with BCC through the MFF since 2012. BCC displays a reasonable financial performance, and acceptable risk profiles and corporate governance. Bank Kassa Nova, recently transformed from a microfinance organization into a bank that retains a strong microbusiness focus, serves more than 3,100 clients for an average loan size of \$30,000 equivalent. Bank of Astana (BOA) and Nurbank are smaller banks that recently began to target the MSME segment. BOA has 370 MSME clients, with an average loan size of \$90,000. Nurbank has 800 SMEs as borrowers with an average loan size of \$51,000. Nurbank and BOA have managements that display strong commitment to expanding the MSME business.²⁷ The participating microfinance organizations—KazMicroFinance, Asian Credit Fund (ACF), and Bereke—lend almost exclusively in rural areas and work well with women borrowers. KazMicroFinance has over 151,000 borrowers with an average loan size of \$682. ACF serves 15,000 borrowers with an average loan size of \$375. Bereke has 4,215 borrowers with an average loan size of \$945. Competition between lenders that use different strategies and distribution channels benefit the financing of small businesses.

²⁶ Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

²⁷ Financial Analysis (accessible from the list of linked documents in Appendix 2).

26. ADB carried out due diligence on each PFI and was satisfied with their ability to assess the creditworthiness of each MSME subloan and determine the commercial terms of the subloan based on their risk profile.²⁸ Damu's capabilities to manage the borrowed funds and comply with monitoring and reporting requirements are considered appropriate, as shown under previous ADB projects, and will be further enhanced with additional Damu staff to monitor the implementation of the project. Financial due diligence indicated that, within the given high-risk-country environment, the PFIs are exposed to significant risks, given their modest capital adequacy, poor asset quality, and weak profitability. To mitigate these risks, ADB will closely monitor compliance of PFIs with the eligibility criteria in each disbursement and throughout implementation.²⁹ Additional PFIs that satisfy agreed eligibility criteria may participate.

B. Governance

27. ADB's Anticorruption Policy (1998, as amended to date) and requirements on financial management, reporting and auditing, and environmental and social safeguards were explained to and discussed with Damu and the PFIs. The specific policy requirements and supplementary measures are described in the PAM (footnote 24).

28. ADB's financial management and integrity due diligence on Damu and each PFI indicate moderate risks. Damu's capabilities are considered adequate. However, as a government-owned institution, Damu's independence is somewhat affected by the direct influence of higher government authorities. Integrity due diligence on Damu and the PFIs included the identification of ultimate beneficial ownership and presence of politically exposed persons, which was suitably disclosed, and any issues were managed to ADB's satisfaction.³⁰ All PFIs meet ADB's anti-money-laundering due diligence requirements. The PFIs' boards of directors and management boards are composed of experienced professionals. Internal controls are generally well established, including independent internal audit units that carry out risk-based audits and report directly to the supervisory boards.³¹ All banks have credit risk functions independent from credit origination. All PFIs are regulated by the NBK and prepare annual financial statements in accordance with International Financial Reporting Standards, audited by reputable audit firms.

C. Poverty and Social

29. The country's strong economic growth between 2010 and 2013 has reduced the poverty rate to 2.8% (2014) and the unemployment rate to 5% (2015).³² However, the rural poverty rate remains significant at 4.9%, and the current macroeconomic instability will potentially increase

²⁸ NBK has established as a condition for providing tenge liquidity for this project that the maximum onlending rate to small and medium-sized subborrowers be not above the sum of (i) half the NBK's policy rate or 7%, whichever is higher; and (ii) 8%. As of September 2016, this limit would be 15%, which is in line with market practices. This limit does not apply to lending done by microfinance organizations, which cannot provide loans over \$50,000.

²⁹ Key selection criteria for PFIs are (i) compliance with NBK's prudential regulations, adequate asset quality, and profitability; (ii) business strategies for and track record of serving MSMEs; (iii) presence of an environmental and social management system that complies with ADB's requirements and national laws, and appointment of designated staff to screen prospective subprojects; and (iv) preparation of complete financial statements in accordance with International Financial Reporting Standards, externally audited based on International Standards of Auditing. Financial Analysis and Project Administration Manual (accessible from the list of linked documents in Appendix 2).

³⁰ Integrity due diligence identified politically exposed people in the ownership structure and management board of Kassa Nova Bank. ADB's integrity due diligence has classified the risks as low.

³¹ ACF (microfinance organization) has a lower internal audit capacity and relies on the support of an internal audit team from Kompanion, a Mercy Corps subsidiary based in the Kyrgyz Republic.

³² National Statistics Office of Kazakhstan.

poverty. Farmers and MSMEs, especially in the regions, will provide a buffer to such impacts by providing subsistence income and employment.³³

30. At 68%, women's labor force participation is below that of men (78%). Women also represent a higher share of the unemployed (57% in 2015).³⁴ An ADB survey carried out in 2015 found that 58% of surveyed microenterprises owned by women had annual sales of up to \$10,000, and focused on services (34%), trade (33%), and manufacturing (20%), mainly in food and garments. This highlights the significance of microfinance for female entrepreneurs. Encouraging women entrepreneurship helps broaden the base for economic growth and provides employment and income opportunities for women and their families. The project is categorized as *effective gender mainstreaming* because it is expected to contribute to women's empowerment through the actions described in the gender action plan and the targets set in the design and monitoring framework.

D. Safeguards

31. Subprojects will comply with Kazakh labor, environmental, health, safety, and social laws and regulations, as well as safeguard policies in para. 29 of ADB's Safeguard Policy Statement (2009). The project is categorized as *financial intermediary* with respect to environment and as *financial intermediary* (treated as C) for involuntary resettlement and indigenous peoples. Subprojects will not be eligible for ADB financing if they (i) appear on ADB's Prohibited Investment Activities List, or (ii) have involuntary resettlement or indigenous peoples impacts, or are classified as environment category A. As for environment, PFIs may either (i) exclude all projects with environmental impacts that exceed category C,³⁵ or (ii) permit subprojects that are classified B and C. ADB will require PFIs to maintain an environmental and social management system (ESMS) that complies with ADB's requirements and national laws, and have designated staff trained in implementing the ESMS to screen prospective subprojects, as a condition to participate in this project.³⁶ PFIs and Damu will provide to ADB semiannual ESMS monitoring reports during implementation.

E. Risks and Mitigating Measures

32. Major risks and mitigating measures are summarized in Table 3 and described in detail in the risk assessment and risk management plan.³⁷ Some significant risks are related to the volatile economic operating environment and can only be partly mitigated through the project as described. However, ADB's position is protected by the strong credit of the sovereign, which guarantees the loan. The project is categorized as low risk because (i) the size of the loan amount does not exceed \$200 million, (ii) ADB and Damu have adequate mechanisms to oversee the performance of PFIs and experience in supporting MSMEs in Kazakhstan, and (iii) Damu has a solid track record in managing ADB's and other externally funded projects. The integrated benefits and impacts are expected to outweigh the costs.

³³ Summary Poverty Reduction and Social Strategy and Sector Assessment (Summary): Finance (accessible from the list of linked documents in Appendix 2).

³⁴ Kazakhstan ranks 47th out of 145 countries in the Gender Gap Index 2015. World Economic Forum. 2015. *The Global Gender Gap Report, 2015*. Geneva.

³⁵ Applicable to all participating microfinance organizations.

³⁶ Financial Intermediary: Environmental and Social Management System Arrangement (accessible from the list of linked documents in Appendix 2).

³⁷ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

Table 3: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Cumbersome government procedures for approval of the sovereign guarantee for the project cause delays in loan effectiveness.	Ongoing dialogue with borrower and guarantor will speed up the process of approval. The Damu Entrepreneurship Development Fund now has more experience in handling these internal procedures (based on earlier ADB and other development partner projects).
Economic slowdown further reduces demand from micro, small, and medium-sized enterprises for credit and their debt service capacity.	The government is implementing countercyclical support measures to sustain growth and employment, and improve the environment for micro, small, and medium-sized enterprises. Project design allows for longer implementation period, thereby accommodating demand fluctuation. PFIs adjust lending limits and security requirements, and increasingly denominate loans in tenge.
Subdued growth and external demand may further depreciate the tenge and hurt banks' solvency, liquidity, asset quality, and profitability.	The National Bank of Kazakhstan is gradually tightening prudential regulations toward Basel III, which will require additional capital injections by bank shareholders. ADB will closely monitor eligibility of PFIs during disbursement. Loan tenor is limited to 36 months and guaranteed by the government.
PFIs' asset quality deteriorates.	ADB will closely monitor the eligibility of PFIs during disbursement. Technical assistance will support customized efforts of PFIs to improve underwriting and risk management.

ADB = Asian Development Bank, PFI = participating financial institution.

Sources: Asian Development Bank, Damu Entrepreneurship Development Fund, and National Bank of Kazakhstan.

V. ASSURANCES AND CONDITIONS

33. Damu and the PFIs have assured ADB that the implementation of the project shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and loan documents.

34. Damu and the PFIs have agreed with ADB on certain covenants for the project, which are set forth in the loan and project agreements. It is a condition for effectiveness that the Global Master Repurchase Agreement between ADB and the NBK is signed and effective.

VI. RECOMMENDATION

35. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and, acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve

- (i) the loan of T72,000,000,000 to Damu Entrepreneurship Development Fund, to be guaranteed by the Republic of Kazakhstan, for the Supporting Resilience of Micro, Small, and Medium-Sized Enterprises Finance Project, from ADB's ordinary capital resources, with an annual interest rate equal to the sum of ADB's cost of raising tenge funding and the contractual spread for sovereign guaranteed loans; for a term of 36 months; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan, guarantee, and project agreements presented to the Board; and
- (ii) the proposal in para. 21 of this report to permit procurement of goods, works, and services produced in nonmember countries of ADB.

Stephen Groff
Vice-President

5 October 2016

DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned With			
The impact will be a sustained contribution of MSMEs to Kazakhstan's GDP, which is aligned with the government's objectives of supporting entrepreneurship and the contribution of MSMEs to the non-oil economy and employment under a challenging macro environment. ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome Sustainable provision of loans to MSMEs maintained	By December 2020: a. PFIs' outstanding loans to MSMEs increased by 20% (2015 baseline: ^b T410 billion) b. PFIs' outstanding loans to MSMEs outside of Almaty and Astana cities increased by 20% (2015 baseline: ^b T224 billion) c. PFIs' number of MSME borrowers increased by 20% (2015 baseline: ^b 178,312) d. PFIs' net nonperforming loan ratios ^c remained less than or equal to 25% of total regulatory capital (2015 baseline: below 25%) e. Commercial banks' CAR ^d met or exceeded minimum requirement of 10% (2015 baseline: minimum of 7.5%) f. Microfinance organizations' capital ratio ^e met or exceeded 15%	a–d. Damu's monitoring reports a–f. PFIs' monitoring reports and audited financial statements	Economic slowdown further reduces demand from MSMEs for credit and their debt service capacity. Subdued growth and external demand may further depreciate the tenge and hurt banks' solvency, liquidity, asset quality, and profitability. PFIs' asset quality deteriorates.
Outputs 1. Financial inclusion sustained	By June 2019: ^f 1a. At least 5,500 micro borrowers, of whom at least 50% are women, reached by microfinance organizations (2015 baseline: 0) 1b. At least 1,000 small and medium-sized borrowers, of whom at least 33% are women, reached by commercial banks (2015 baseline: 0) 1c. Volume of ADB-funded loans to MSMEs issued by PFIs is at least \$200 million equivalent (2015 baseline: 0), of which at least \$50 million are to women subborrowers, and \$120 million to	1a–c. Damu's and PFIs' monitoring reports	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
2. Efficiency of PFIs' lending to MSMEs improved	<p>subborrowers located outside of Almaty or Astana cities (2015 baseline: 0)</p> <p>2a. Selected PFIs have improved credit underwriting policies and procedures in place (2015 baseline: not applicable)</p> <p>2b. Staff of Damu's and PFIs' small and medium-sized enterprise departments trained on gender analysis (2015 baseline: not applicable)</p>	2a–b. Consultants' monitoring reports, Damu monitoring reports, ADB's mission back-to-office reports, and other reports	
<p>Key Activities with Milestones</p> <p>1. Financial inclusion sustained</p> <p>1.1. PFIs onlend to MSMEs (beginning Q1 2017, continuous until Q2 2019).</p> <p>1.2. Damu and PFIs implement outreach and other support activities to target groups (women entrepreneurs, lending outside the larger cities) (beginning Q1 2017, continuous until Q2 2019).</p> <p>1.3. PFIs provide monthly reports to Damu and quarterly and semiannual reports to ADB, including disbursements, financial performance of the PFI, safeguards, and development effectiveness results (continuous beginning Q2 2017 until end of project).</p> <p>1.4. Damu provides quarterly reports to ADB (continuous beginning Q1 2017 until end of project).</p> <p>2. Efficiency of PFIs lending to MSMEs improved</p> <p>2.1. Recruit consultants and finalize TA agreements with PFIs (by Q1 2017).</p> <p>2.2. PFIs participate in customized advisory programs to develop and improve lending to MSMEs (beginning Q2 2017).</p> <p>2.3. Consultants provide business advice to PFIs on MSMEs lending technology (by Q2 2019).</p> <p>Project Management Activities</p> <p>Prepare periodical reports, including gender action plan and environmental and social management system monitoring reports.</p> <p>Periodical audit review and review missions that monitor executing agency and PFIs' performance.</p> <p>Inputs</p> <p>Asian Development Bank: \$200 million (ordinary capital resources loan)</p> <p>Financial Sector Development Partnership Special Fund: \$500,000 (capacity development TA)</p> <p>Assumptions for Partner Financing</p> <p>Not applicable</p>			

ADB = Asian Development Bank; CAR = capital adequacy ratio; Damu = Damu Entrepreneurship Development Fund; GDP = gross domestic product; MSMEs = micro, small, and medium-sized enterprises; PFI = participating financial institution; Q = quarter; TA = technical assistance.

^a Government of Kazakhstan. 2014. *State Program of Industrial and Innovative Development of the Republic of Kazakhstan for 2015–2019*. Astana; and Government of Kazakhstan. 2015. *Update to Business Roadmap 2020*. Astana.

^b Baselines considering identified PFIs at the time of loan approval. Baselines to be updated if new institutions participate in the project at a later stage.

^c Ratio of net nonperforming loans to total regulatory capital, defined as loans overdue more than 90 days, less loan loss reserves as a percentage of regulatory capital, based on data reported in PFIs' compliance certificates to ADB.

^d Defined as total regulatory capital to total risk-weighted assets.

^e Defined as equity to total assets.

^f These indicators refer to MSME loans funded with ADB loan proceeds.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=49076-005-3>

1. Loan Agreement
2. Guarantee Agreement
3. Project Agreement
4. Sector Assessment (Summary): Finance
5. Project Administration Manual
6. Contribution to the ADB Results Framework
7. Development Coordination
8. Attached Technical Assistance
9. Financial Analysis
10. Country Economic Indicators
11. Summary Poverty Reduction and Social Strategy
12. Gender Action Plan
13. Financial Intermediary: Environmental and Social Management System Arrangement
14. Risk Assessment and Risk Management Plan

Supplementary Document

15. Local Currency Funding for ADB's Loan