Report and Recommendation of the President to the Board of Directors

Program Number: 44060
September 2010

Proposed Multitranche Financing Facility
Republic of Kazakhstan: Small and Medium Enterprise Investment Program

Asian Development Bank
CURRENCY EQUIVALENTS
(as of 8 September 2010)

Currency Unit – tenge (T)
T1.00 = $0.00678
$1.00 = T147.44

ABBREVIATIONS

ADB – Asian Development Bank
ALB – Alliance Bank
Damu – Damu Entrepreneurship Development Fund
EBRD – European Bank for Reconstruction and Development
FAM – facility administration manual
GDP – gross domestic product
KKB – Kazkommertsbank
LCB – local currency bond
MFF – multitranche financing facility
MOE – Ministry of Economic Development and Trade
PFI – participating financial institution
SMEs – small and medium-sized enterprises
TA – technical assistance

NOTE

In this report, “$” refers to US dollars unless otherwise stated.

In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.
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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed multitranche financing facility (MFF) to the Damu Entrepreneurship Development Fund (Damu), guaranteed by the Republic of Kazakhstan, for the Small and Medium Enterprise Investment Program. The MFF is proposed to help Damu—through participating financial institutions (PFIs)—address the unmet demand for longer-term, fixed-rate, local currency denominated credit by small and medium-sized enterprises (SMEs),\(^1\) and thereby address a key constraint to the development of SMEs.

II. THE INVESTMENT PROGRAM

A. Rationale

2. **Limited small and medium-sized enterprises’ contribution to gross domestic product.** The SME sector, which is primarily focused on trade (37%) and services (30%), has not kept pace with general developments in the economy (Table 1).\(^2\) SMEs’ contribution to gross domestic product decreased from 18% in 2005 to 14% in 2009, while the contribution of large enterprises (which are principally involved in the oil and minerals sector) continues to grow. Kazakhstan’s highly concentrated economy and dependence on oil exports poses a potential threat to economic growth given the volatility of the international oil markets. During the global financial crisis, oil prices plummeted from $150 per barrel to $35 per barrel, resulting in a severe economic impact. To support sustained economic growth, economic diversification—including a larger role for SMEs—is a key government priority.\(^3\)

<table>
<thead>
<tr>
<th>% Share</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMEs</td>
<td>18.1</td>
<td>17.1</td>
<td>17.6</td>
<td>12.9</td>
<td>14.2</td>
</tr>
<tr>
<td>1. Small enterprises</td>
<td>14.1</td>
<td>13.1</td>
<td>14.0</td>
<td>9.7</td>
<td>11.2</td>
</tr>
<tr>
<td>2. Medium-sized enterprises</td>
<td>4.1</td>
<td>4.0</td>
<td>3.6</td>
<td>3.2</td>
<td>3.0</td>
</tr>
<tr>
<td>Large enterprises</td>
<td>81.9</td>
<td>82.9</td>
<td>82.4</td>
<td>87.1</td>
<td>85.8</td>
</tr>
</tbody>
</table>

GDP = gross domestic product, SMEs = small and medium-sized enterprises.
Note: Figures exclude farms; small enterprises include individuals (sole proprietorships).
Sources: International Monetary Fund (GDP), Statistical Agency of the Republic of Kazakhstan (SMEs)

3. **Decreasing small and medium-sized enterprises’ access to finance.** Prior to 2002, commercial banks were reluctant to lend to SMEs, which are usually considered high-risk based on lack of collateral and unreliable financial statements. Most SME investment was financed by internal resources. Starting in 2002, based on access to external credit markets, Kazakh commercial banks dramatically increased their lending to the SME sector.\(^4\) However, starting in mid-2007, access to the international interbank and bond markets became difficult and ended in late 2008 with the onset of the global financial crisis. This severely impacted the liquidity of Kazakh banks, resulted in a decline in the availability of domestic credit, and created a debt crisis that exposed deep-seated problems within the Kazakh banking sector. The proportion of nonperforming

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\(^1\) The Law on Private Entrepreneurship (31 January 2006) defines small enterprises as enterprises with no more than 50 employees and not more than $500,000 in average annual assets, and medium-sized enterprises as enterprises with not more than 250 employees or not more than $3 million average annual net assets.


\(^4\) Kazakh banks relied on short-term debt from the international interbank market to fund their growth since the domestic deposit base is small (30% of gross domestic product). While deposits are growing, this is due largely to inflows from public sector entities.
loans grew to about 30% from only 3% in 2007. Several banks defaulted on their borrowings and had to restructure their debts. Lending to SMEs declined from a high of $5.3 billion during the second quarter of 2007 to $1.2 billion in the third quarter of 2009. Under the Kazakhstan Anti-Crisis Plan, the Government of Kazakhstan introduced measures to strengthen the banking sector, including providing subsidized credit lines to selected banks for SME lending.\(^5\)

4. Damu, a wholly owned subsidiary of the Samruk-Kazyna National Wealth Fund (100% owned by the government) implements these credit lines. This support, along with other government actions, led to significantly increased liquidity in the system.\(^6\) Nevertheless, SMEs' access to longer-term credit for investment purposes is limited. The current estimated demand for such financing is around $2.8 billion, and will increase as the economy improves (footnote 2).

5. **Government measures to develop small and medium-sized enterprises.** The government recognizes that a prosperous SME sector is key for the country’s long-term economic growth. The sector is a major creator of employment and innovation, and is traditionally more responsive and adaptable than are larger enterprises.\(^7\) A number of government initiatives have been undertaken in recent years to address the barriers faced by SMEs. State programs including the *Business Roadmap 2020* (footnote 3) provide the general policy framework. The goal is to diversify the production base and give prominence to development of the SME sector, in particular its expansion and diversification. In turn, developing the SME sector plays an important role in reducing poverty by generating income and employment.

6. Damu, which was established by the government in 1997 to stimulate the development of small business enterprises and ensure better use of public funds allocated to these enterprises, plays an important role in SME development by implementing the government’s access to credit programs for SMEs. Over the years, Damu's range of programs has evolved from direct lending to indirect lending through banks. From 1997 through 2009, Damu directly financed 2,878 small business projects in the amount of T33.3 billion (2% of all loans extended to small businesses in Kazakhstan). Damu’s financial programs for SMEs are now delivered mostly through subsidized loans to selected partner banks, which are used to fund onlending to SMEs.

7. In recognition of the increasing demand for SME finance and decreasing availability based on current market conditions,\(^8\) the Ministry of Economic Development and Trade (MOE), which oversees SME development, and Damu, in consultation with key stakeholders, adopted a results-based SME Access to Finance Action Plan, 2010–2015. The plan seeks to ensure that SMEs have sustainable access to necessary short-term working capital and medium-term finance through a $3 billion investment program. It also includes a policy framework that addresses constraints to such access as well as sets forth key guiding principles (footnote 2).

8. **Asian Development Bank (ADB) support for small and medium-sized enterprises.** Since 2006, ADB has been supporting SME development through direct loans and partial credit

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5. The government provided $1.9 billion in subsidized credit to 16 banks to be used for restructuring existing SMEs loans or for making new loans to SMEs.

6. Short-term liquidity in the system is currently estimated at $12.5 billion and short-term deposit rates are less than 1% per annum.


8. Kazakhstan has an underdeveloped deposit market. The average tenor of deposits is less than a year and banks have difficulties raising medium- to long-term capital at desirable rates. This has resulted in a deficiency of medium- to long-term credit to banks’ borrowers, especially SME borrowers. The global financial crisis exacerbated this. Prior to the crisis, banks’ external debts were mostly US dollar-denominated. The currency exposure was passed on to SMEs, most of which lacked foreign currency earnings and the ability to hedge this exposure. During the crisis, the US dollar appreciated by more than 20% against the tenge, resulting in a heavy burden on SMEs. Many SMEs were unable to service their US dollar debt and had to file for bankruptcy. In addition, most SMEs have insufficient retained earnings to expand their businesses, modernize, or upgrade key assets using their own funds. Working capital is also insufficient.
guarantees to four banks. However, as a result of the financial crisis, two of these banks (Alliance Bank [ALB] and BTA Bank) declared a moratorium on their principal payments and requested restructuring of outstanding debt. The restructuring of ALB has been completed, while that of BTA Bank is expected to be finished later this year. ADB is exploring future nonsovereign support and new secured lending products combined with tighter loan portfolio monitoring to address potential risks.

9 Innovative program design. Because of the poor health of the banking sector, it is difficult for ADB to provide traditional nonsovereign credit line and guarantee operations to support SMEs in Kazakhstan. ADB, however, remains committed to providing such support. For example, ADB’s 2009 Countercyclical Support Program helped the government to fund post-crisis SME credit support operations. At the request of the government, ADB looked at a number of options to provide continued support over the medium term through its sovereign operations. The government requested flexibility in lending products as the health of the finance sector improves, and asked that these products help to mitigate currency, interest, and tenor mismatch issues. Damu also requested assistance in improving its efficiency and effectiveness to enable it to raise external financing over the longer term.

10 In response, ADB developed the investment program, which is consistent with ADB’s overall strategy for Kazakhstan and reflects lessons learned. The investment program is designed as an MFF, under which a series of local currency loans and other financing products will be provided over the medium term. The MFF enables flexibility as it will allow ADB to provide different forms of support (direct loans or guarantees) to Damu to help it fund its lending to PFIs. The MFF also enables ADB to enter into a multiyear partnership with Damu (and possible cofinancing partners) while creating stability and credibility at the level of the financing plan. To reflect lessons learned, the investment program envisions a series of medium-term, fixed-rate, local currency loans to Damu that will be used to fund back-to-back subloans to PFIs for onlending to SMEs. By providing such loans, ADB will directly address currency, interest rate, and tenor mismatch risks. Experience has shown that these financial risks have been a significant cause of stress for SMEs and their banks.

11 For the tranche 1 loan, ADB will raise local currency through cross-currency swaps with international bank counterparties. ADB has been able to leverage its relationships with international banks and utilize its AAA rating to extend the tenor and lower the pricing of cross-currency swaps. For subsequent tranches, ADB will work with MOE and Damu on the issuance of local currency bonds (LCBs) by ADB or, with an ADB guarantee, by Damu. Issuance of LCBs will help develop the local capital market by providing local investors with the opportunity to diversify their investment portfolios; introduce international best practice standards; help develop a local corporate bond yield curve and establish pricing benchmarks for other issuers; and advance the process of mobilizing and channeling domestic savings into longer-term investments.

12 Donor coordination. The European Bank for Reconstruction and Development (EBRD) actively supports SMEs in Kazakhstan. EBRD programs fund international advisers who provide

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9 ADB loans and guarantees without sovereign guarantee for SME lending have been provided to Alliance Bank (2006, $100 million partial credit guarantee and $50 million loan, the latter of which was recently restructured); Bank CenterCredit (2007, T6 billion loan funded by a private placement of a tenge-linked offshore bond); BTA Bank (2006, $75 million loan that was recently restructured); and Kazkommertsbank (2007, $100 million partial credit guarantee).
10 Development Coordination, footnote 2 (Appendix 2).
12 Financial Analysis (Appendix 2).
13 ADB has received all necessary government approvals for the issuance of LCBs. However, MOE requested ADB to defer the issuance of LCBs until the second tranche.
capacity building and training for SMEs and support to rural SMEs to improve their operations, enter new markets, and gain access to financing. The United States Agency for International Development has supported programs that have provided extensive training on business and consulting essentials to mostly start-up entrepreneurs and nongovernment organization business service providers. EBRD has extended several credit lines to commercial banks to fund lending to SMEs. The projects are sometimes supported by technical assistance (TA) to help banks introduce a credit scoring methodology and improve their SME lending policies. The World Bank has provided Kazakhstan with the Second Agricultural Post-Privatization Project ($96.1 million), which has a component for promoting sustainable rural microfinance. The International Finance Corporation promotes SME development through its debt and equity investments in banks that provide loans to SMEs. ADB coordinated closely with other development partners in preparing the investment program and MFF.

B. Impact and Outcome

13. Impact. The investment program and the MFF will promote sustained job creation and economic growth. The design and monitoring framework is attached as Appendix 1.

14. Outcome. The investment program and MFF will help ensure that viable SME borrowers have increased access to medium-term credit on a sustainable basis (Appendix 1).

C. Outputs

15. The investment program and MFF include three outputs:

(i) medium-term financing for viable SMEs for expansion and modernization,
(ii) improved effectiveness and efficiency of Damu, and
(iii) improved financial sector outreach with a focus on SMEs controlled by women (women entrepreneurs).

D. Investment and Financing Plan

16. Investment program. The overall investment program of $2.9 billion is designed to help address the financing needs of SMEs over the medium term (Table 2). The investment program is consistent with ADB’s latest country strategy for Kazakhstan, which supports sustainable economic growth through private sector development, including support for SME development. Loans under the proposed MFF will help meet the growing demand by SMEs for medium-term, local currency credit and will finance subprojects for the production of and trade in goods and services for both investment and working capital purposes.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($) Equivalent in Local Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium-term financing for viable SMEs</td>
<td>2,800,000,000</td>
</tr>
<tr>
<td>Improved effectiveness and efficiency of Damu</td>
<td>50,000,000</td>
</tr>
<tr>
<td>Improved financial outreach, with a focus on women entrepreneurs</td>
<td>50,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,900,000,000</strong></td>
</tr>
</tbody>
</table>

Damu = Damu Entrepreneurship Development Fund, SMEs = small and medium-sized enterprises.
Source: Damu Entrepreneurship Development Fund estimates.

14 The recipients of EBRD’s loans and SME credit lines were ATF Bank, Bank CenterCredit, Kazkommertsbank, Kaspi Bank, and Tsesna Bank.
15 Additional information on related donor activities is contained in Development Coordination (Appendix 2).
17. **Financing plan.** Damu has requested an MFF of the local currency equivalent of $500 million to help finance part of the investment program (Table 3). The MFF will be structured into three or four tranches, all of which will be sovereign guaranteed. The first tranche amounts to the local currency equivalent of $150 million. Tranche 2 is estimated at $150 million, local currency equivalent. Tranches 3 and 4 are estimated at $100 million, local currency equivalent. Financing under tranches 2, 3, and 4 may vary depending on the demand for market-based credit by viable SMEs as market conditions improve; the availability of external credit for Kazakh financial institutions; and the interest of such institutions in participating in the facility. Financing will also depend on the availability of ADB resources; it is subject to Damu’s submission of related periodic financing requests, execution of the related loan agreements for each tranche, and fulfillment of conditions and undertakings set forth in the framework financing agreement.

<table>
<thead>
<tr>
<th>Source</th>
<th>Total ($ million)</th>
<th>Local Currency Equivalent</th>
<th>Share (%) of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB(^a)</td>
<td>500</td>
<td></td>
<td>18</td>
</tr>
<tr>
<td>Other sources of financing not administered by ADB (estimated cofinancing based on estimated SME demand and availability)</td>
<td>100</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Other international financial institutions</td>
<td>400</td>
<td></td>
<td>14</td>
</tr>
<tr>
<td>Government resources(^b)</td>
<td>800</td>
<td></td>
<td>28</td>
</tr>
<tr>
<td>Private financial institutions(^c)</td>
<td>1,000</td>
<td></td>
<td>36</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,800</strong></td>
<td></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

\(^a\) Lent to Damu Entrepreneurship Development Fund for onlending to participating financing institutions, and then by participating financing institutions to SMEs.

\(^b\) Through subsidized lending program to enterprises engaged in priority sectors.

\(^c\) Represents funding coming from short-term and other deposits and equity.

Source: Damu Entrepreneurship Development Fund estimates.

18. The tranche 1 loan will be financed from ADB’s ordinary capital resources and guaranteed by the Republic of Kazakhstan. The loan will be denominated in local currency (tenge) and will have a term up to 7 years.\(^{17}\) The withdrawal and repayment schedule will match that of the subloans made by Damu to PFIs. The interest rate charged will be the sum of ADB’s cost of raising back-to-back, fixed rate tenge wholesale funding through the international cross-currency swap markets\(^{18}\) and the contractual spread for a sovereign guaranteed loan. Damu will make subloans to PFIs that meet the selection criteria agreed to by ADB.\(^{19}\) Damu will add a margin of up to 1.00% per annum to cover its administrative costs, and a guarantee fee payable to the government for the sovereign guarantee. Each PFI will use its subloan to fund market-based, fixed-rate tenge loans, leases, and other forms of credit to SMEs for investment (acquisition of fixed assets), working capital and/or other purposes pursuant to a newly created Damu Market-Based

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\(^{17}\) Framework Financing Agreement and Periodic Financing Request for Tranche 1 (Appendix 2) have been negotiated. Their signing by the government is being delayed due to the need on the part of the government to complete intergovernmental procedures and to obtain requisite signing authorizations. Signing is expected after the Board approval date.

\(^{18}\) Or from such other markets as ADB may need to tap into to raise effective fixed-rate tenge at the time of a loan withdrawal because of an unforeseen disruption in the international cross-currency swap market or other similar event.

\(^{19}\) Para. 24 and Financial Analysis (Appendix 2).

\(^{20}\) Since Damu is not taking the credit risk of the SME borrowers, PFIs will independently determine the creditworthiness of the SMEs and ascertain the commercial terms and conditions of loans consistent with international best practices for lending to SMEs.
SME Loan Program. Subprojects will be required to comply with Kazakh labor, environmental, health, safety, and social laws and regulations, as well as ADB’s safeguards policies (ADB’s Safeguard Policy Statement [2009, Chapter D, para. 29]). After approval of the proposed MFF by ADB’s Board of Directors, other development partners and commercial lenders may complement ADB’s financing to assist Kazakhstan to develop its SME sector over the medium term through cofinancing to be administered by ADB. The amounts of the cofinancing so administered by ADB will be deducted from the total MFF amount approved by the Board. Such cofinancing may be provided as grants, loans, guarantees, or through other cofinancing products, and may take the form of joint or parallel financing. ADB’s administration of such cofinancing from time to time will be reported to the Board for information annually.

E. Implementation Arrangements

19. Damu will be the executing agency for the MFF. Implementing agencies will be Damu and the PFIs. Damu has a clear mandate to facilitate greater access to credit by SMEs and has demonstrated its capacity to monitor and supervise loans to banks for onlending to SMEs (footnote 12). Damu has 16 regional offices (one in each oblast) and good outreach to potential SME borrowers. Damu will designate a project management team, headed by a project director, who will report to the Damu chairperson. The implementation arrangements are summarized in Table 4 and described in more detail in the facility administration manual (FAM).

<table>
<thead>
<tr>
<th>Aspects</th>
<th>Arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMEs’ access to finance action plan</td>
<td>Damu in coordination with the Ministry of Economic Development and Trade and other key stakeholders</td>
</tr>
<tr>
<td>Program management</td>
<td>Damu, through a program management team, and PFIs</td>
</tr>
<tr>
<td>Loan disbursement</td>
<td>Damu and PFIs. Loan proceeds will be disbursed in accordance with ADB’s Loan Disbursement Handbook (2010, as amended from time to time), and arrangements agreed to between Damu, PFIs and ADB due to the need for ADB to fund each withdrawal on a back-to-back basis.</td>
</tr>
</tbody>
</table>

### Table 4: Implementation Arrangements

<table>
<thead>
<tr>
<th>Aspects</th>
<th>Arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMEs’ access to finance action plan</td>
<td>Damu in coordination with the Ministry of Economic Development and Trade and other key stakeholders</td>
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<td>Program management</td>
<td>Damu, through a program management team, and PFIs</td>
</tr>
<tr>
<td>Loan disbursement</td>
<td>Damu and PFIs. Loan proceeds will be disbursed in accordance with ADB’s Loan Disbursement Handbook (2010, as amended from time to time), and arrangements agreed to between Damu, PFIs and ADB due to the need for ADB to fund each withdrawal on a back-to-back basis.</td>
</tr>
</tbody>
</table>

ADB = Asian Development Bank, Damu = Damu Entrepreneurship Development Fund, PFI = participating financial institution, SMEs = small and medium-sized enterprises.


20. Since many SMEs will be importing goods, works, and consulting services from or are engaged in trade (para. 2) with both ADB and non-ADB member countries, including the Russian Federation, a request for Board approval is being made pursuant to Article 14(ix) of the Agreement Establishing the Asian Development Bank (the Charter), to approve procurement from non-ADB member countries in appropriate circumstances. Board approval on this issue is being requested with respect to procurement by SME borrowers using loan proceeds under the investment

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21. PFIs will undertake on a best efforts basis that (i) funds received be used only to provide credit to qualifying SMEs within 12 months of receiving the funds; (ii) at least 50% of the subloan proceeds be used for investment purposes; and (iii) at least 40% of the funds be lent to SMEs located outside of the cities of Almaty and Astana. No SME or group of related SMEs may borrow more than $3 million under the program.


24. ADB. 1966. Agreement Establishing the Asian Development Bank. Manila (Article 14[ix]) provides: “The proceeds of any loan, investment or other financing undertaken in the ordinary operations of the Bank or with Special Funds established by the Bank pursuant to paragraph 1(i) of Article 19, shall be used only for procurement of goods and services produced in member countries, except in any case in which the Board of Directors, by a vote of Directors representing not less than two thirds of the total voting power of the members, determines to permit procurement in a non-member country or of goods and services produced in a non-member country in special circumstances making such procurement appropriate, as in the case of a non-member country in which a significant amount of financing has been provided to the Bank.”
program. This request reflects the market-based nature of the investment program, trade agreements, and SME demand and procurement history.

21. To strengthen Damu’s efficiency and effectiveness in supporting SMEs, advisory TA is proposed for tranche 1. The TA will help Damu to implement and roll out its new market-based SME lending program. The TA cost is estimated at $720,000, of which ADB will finance $650,000 as a grant from its Technical Assistance Special Fund (TASF-IV). Damu will provide the balance of $70,000 through in-kind contributions. ADB will engage consultants in accordance with the Guidelines on the Use of Consultants (2010, as amended from time to time) to be contracted either as individual consultants or through a firm using the biodata technical proposal. The TA is expected to commence in the first quarter of 2011 and be completed by the second quarter of 2012. Implementation of the TA is detailed in the FAM.

III. DUE DILIGENCE

22. ADB’s initial due diligence indicates that the MFF and the tranche 1 loan project are financially viable, economically sustainable, socially desirable, and legally permissible subject to compliance with the following criteria.

A. Economic and Financial

23. Due diligence was performed on Damu and three banks (ALB, Bank CenterCredit, and Kazkommertsbank [KKB]) that expressed interest in participating in Damu’s new market-based SME lending program funded by the tranche 1 loan. Although due diligence revealed that two of the banks did not meet all (but only most) of the eligibility criteria (Table 5) set forth in para. 8 of Operations Manual Section D6, they may participate in tranche 1 based on their agreement to implement measures to meet these criteria under time-bound action plans acceptable to ADB.26

24. Under the agreed selection criteria with Damu, to participate in tranche 1, each financial institution must (i) comply with capital adequacy requirements and other prudential requirements established by the Agency for Regulation of Financial Markets or have an agreed action plan to become fully compliant; (ii) have been profitable for their most recently completed fiscal year, or have an agreed action plan to achieve profitability; (iii) have a nonperforming loan ratio of less than 10% or have an agreed action plan to reduce it to that level; (iv) have a credit rating of at least B– by a credit rating agency or equivalent rating acceptable to ADB; (v) have corporate, financial, and management practices acceptable to ADB; and (vi) have satisfactorily completed ADB’s integrity due diligence checklists.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Capital Adequacy</th>
<th>Prudential Limits</th>
<th>Profitability</th>
<th>NPL &lt;10%</th>
<th>Credit Rating</th>
<th>C, F, and M Practices</th>
<th>Integrity Due Diligence</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALB</td>
<td>Yes (AP)</td>
<td>No (AP)</td>
<td>No</td>
<td>No (~80%)</td>
<td>B-/B3/B-</td>
<td>Acceptable</td>
<td>Satisfactory</td>
</tr>
<tr>
<td>BCC</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>B/Ba3/BBB-</td>
<td>Acceptable</td>
<td>Satisfactory</td>
</tr>
<tr>
<td>KKB</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No (~20%)</td>
<td>B-/B/Ba3</td>
<td>Acceptable</td>
<td>Satisfactory</td>
</tr>
</tbody>
</table>

ALB = Alliance Bank; AP = action plan; BCC = Bank CenterCredit; C, F, and M = corporate, financial, and management practices; KKB = Kazkommertsbank; NPL = nonperforming loan.


25 ADB has experience, through its Private Sector Operations Department, working with all three of these banks (footnote 9).
25. ALB and KKB have submitted action plans acceptable to ADB to fulfill eligibility criteria. KKB is the largest bank in Kazakhstan, it is committed to expanding its SME portfolio throughout Kazakhstan, and it has a good management team and a good credit and risk management system. Alliance is one of the larger banks in Kazakhstan, it is also committed to expanding its SME portfolio throughout Kazakhstan, and it has a good management team and good credit and risk management system. Participation of these banks is thus justified. Moreover, since ADB is currently a creditor of ALB, ALB’s participation in the investment program improves its potential to increase its profitability and pay its creditors, at no additional risk to ADB since the loan is sovereign guaranteed. In addition, all of the banks have procedures and systems in place to ensure compliance with ADB safeguards and have a track record in nonsubsidized SME lending.

26. Since the end of 2007, Damu has been wholly owned by Samruk-Kazyna Sovereign Wealth Fund, which holds a majority of seats on Damu’s board of directors, and is being integrated into the structure of the Samruk-Kazyna Sovereign Wealth Fund Group. Damu’s risk management and internal control system is designed to comply with Samruk-Kazyna Sovereign Wealth Fund requirements. In 2009, Damu acquired a new senior management team that appears to be well trained, competent, and dedicated. Because of Damu’s exposure to four banks that are or were being restructured and are now majority owned by Samruk-Kazyna Sovereign Wealth Fund, Damu’s overall financial condition remains weak (footnote 12). Samruk-Kazyna Sovereign Wealth Fund’s strategy supports greater autonomy for Damu, with less dependence on government funding. The MFF provides Damu with its first opportunity to raise external financing, to develop and roll out a new, market-based lending program, and to improve its effectiveness and efficiency to enable it to attract external financing over the longer term.

27. The sustainability of the MFF will be supported by the market-based nature of the lending program, the institutional development of Damu, and implementation of the action plan. Damu will provide ADB with information necessary to monitor ADB’s results framework.

B. Governance

28. A financial management assessment of Damu and PFIs has been conducted. Based on the assessment, Damu’s capabilities and systems are considered sound. However, improvements recommended to ensure the sustainability of the program will be addressed under the TA. ADB reviewed the PFIs’ credit, operational, and counterparty risks and is satisfied with the measures that they have implemented for monitoring and mitigating these risks. ADB and Damu will monitor the PFIs to ensure that loans made to SMEs will finance activities that are consistent with ADB’s Safeguard Policy Statement and other SME loan qualification criteria (footnote 21). Their auditing procedures will meet ADB requirements. A FAM outlining the detailed implementation arrangements for the program will be adhered to throughout implementation (footnote 23). ADB’s Anticorruption Policy (1998, as amended to date) was explained to and discussed with Damu and the PFIs. The specific policy requirements and supplementary measures are described in the FAM.

C. Poverty and Social

29. Based on strong economic growth, Kazakhstan has made rapid progress in poverty reduction. Poverty declined from 39% in 1998 to an estimated 14% in 2008. While data are not yet available for 2009, there is indirect evidence—from the number of persons applying for social assistance—that the crisis has pushed more people into poverty. Although government initiatives have provided part-time employment, this is only a temporary measure. Increased poverty is closely correlated with unemployment and underemployment. SMEs can provide employment opportunities to the poor. Bank credit is an important prerequisite for this goal. SMEs often have few alternatives to bank credit for funding since the volume of private capital in the economy is limited and funding from family members is difficult to raise. Thus, when lines of credit from banks
are not available, SMEs are severely affected. Even if the owners of SMEs are not themselves poor, SMEs’ use of bank credit will enable them to hire more workers, which will help raise employment and indirectly reduce poverty.\textsuperscript{27}

30. While Kazakhstan has a good record in gender equality and related issues, the unemployment rate of women is higher than men (7.9% as compared to 5.3%) (footnote 27). Currently, 33.7% of women are employed by small enterprises and 46.2% by medium-sized and large enterprises. Based on more limited employment opportunities, two-thirds of women become individual entrepreneurs engaged in small trade activities, with limited opportunity for expansion based on limited access to economic resources. For example, only 16% of the loans provided under Damu programs go to women. The investment program is categorized as effective gender mainstreaming because it is expected to promote better monitoring, better outreach, and better access to finance for women entrepreneurs seeking to expand or modernize their businesses.\textsuperscript{28}

D. Safeguards

31. The investment program conforms to ADB’s Safeguard Policy Statement and complies with Kazakh labor, environmental, health, safety, and social laws and regulations. This investment program has been categorized as financial intermediary with respect to environment and social safeguards. It is treated as category C because the subprojects financed under tranche 1 will have minimal or no adverse environmental or social risks. Subprojects that fall under ADB’s environmental and social safeguard categories A and B or that require government environmental assessment clearances will not be eligible for financing under the investment program.

E. Risks and Mitigating Measures

32. This is a complex program, since the MFF amount is more than $200 million. The potential risks identified will be addressed by mitigating measures in consultation with Damu and MOE. ADB conveyed to Damu and MOE, ADB’s strategy of identifying and mitigating potential risks.\textsuperscript{29} Major risks and mitigating measures are identified in Table 6.

<table>
<thead>
<tr>
<th>Risks</th>
<th>Mitigating Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Downturn in economic activity reduces SMEs’ demand for credit and repayment capacity</td>
<td>Monitoring and dialogue under ADB’s 2009 countercyclical support program to promote prudent macroeconomic policies and countercyclical measures.</td>
</tr>
<tr>
<td>Government subsidized lending programs distort market competition</td>
<td>The investment program will provide market-based financing to SMEs and help address market failures.</td>
</tr>
<tr>
<td>Currency and interest rate mismatch of SME loans provided by Kazakh banks</td>
<td>The investment program will provide medium-term, fixed-rate, tenge-denominated loans to Damu to enable it to provide similar subloans to PFIs to match fund their fixed-rate, tenge-denominated loans and leases to SMEs.</td>
</tr>
<tr>
<td>ADB is unable to raise cost-effective tenge-denominated wholesale funds through cross-currency swaps because of a disruption in the international swap market</td>
<td>ADB has one year to raise and disburse tenge funds to Damu for on-lending to PFIs, which will commit to borrowing from Damu under the investment program at a predetermined ceiling interest rate. PFIs have the option to pay a higher interest rate during this period. ADB can also explore other sources of medium-term tenge, including a local bond issuance.</td>
</tr>
<tr>
<td>Damu is unable to repay loans to ADB.</td>
<td>Loans under the MFF will be guaranteed by the Republic of Kazakhstan</td>
</tr>
<tr>
<td>The financial condition of two PFIs remains weak.</td>
<td>Program eligibility criteria require PFIs to be financially sound or better.</td>
</tr>
</tbody>
</table>

\textsuperscript{27} Summary Poverty Reduction and Social Strategy (Appendix 2).
\textsuperscript{28} Gender Action Plan (Appendix 2).
\textsuperscript{29} Risk Assessment and Risk Management Plan (Appendix 2).
IV. ASSURANCES AND CONDITIONS

33. Damu and the PFIs have assured ADB that implementation of the investment program shall conform to all applicable ADB policies, including those concerning financial intermediation loans, anticorruption measures, safeguards, gender and development, and disbursement. These warranties and representations are described in the FAM and relevant legal documents. Damu has given ADB certain undertakings for the MFF which are contained in the Framework Financing Agreement and Periodic Financing Request for Tranche 1 (footnote 2). Specific covenants agreed by Damu with respect to individual tranches under the MFF will be included in legal agreements for respective tranches.

V. RECOMMENDATION

34. I am satisfied that the proposed multitranche financing facility would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve:

(i) the provision of loans and guarantees under the multitranche financing facility in an aggregate amount not exceeding $500,000,000 from ADB’s ordinary capital resources on such terms and conditions to be determined in accordance with then applicable policies relating to allocation of and eligibility for such resources;

(ii) the administration by ADB of the cofinancing to be provided by development partners and other financing partners in the form of grants, loans, guarantees, and through other cofinancing products as described in para. 18 of this report;

and such other terms and conditions as are substantially in accordance with those set forth in the Framework Financing Agreement presented to the Board, all to Damu for the Small and Medium Enterprise Investment Program.

35. I recommend that the Board approve the proposal set out in para. 20 of this report that goods, works, and consulting services procured from non-ADB member countries are eligible for financing under loans provided to small and medium-sized enterprises (SMEs) in the Republic of Kazakhstan under the Small and Medium Enterprise Investment Program. If the requisite affirmative vote of Directors representing not less than two thirds of the total voting power of ADB’s members, pursuant to Article 14(ix) of the Agreement Establishing the Asian Development Bank, is not obtained for this recommendation and the Board only approves the recommendation in para. 34, then only goods, works, and consulting services procured from ADB member countries will be eligible for financing under loans provided to SMEs under the Small and Medium Enterprise Investment Program.

Haruhiko Kuroda
President

8 September 2010
## DESIGN AND MONITORING FRAMEWORK FOR THE INVESTMENT PROGRAM

<table>
<thead>
<tr>
<th>Design Summary</th>
<th>Performance Targets and Indicators</th>
<th>Data Sources and Reporting Mechanisms</th>
<th>Assumptions and Risks</th>
</tr>
</thead>
</table>
| **Impact**     | Sustained job creation and economic growth | Increase in the SME sector’s contribution to gross domestic product from T2,683 billion in 2009 to T5,000 billion in 2014  
SME sector employment increases from 2.088 million in 2009 to 3.500 million in 2014 | Government statistics  
Damu statistics disaggregated by gender | Assumptions  
Macroeconomic stability  
Strong government commitment for reforms  
Global economy recovers from financial crisis  
Increased aggregate SME lending and leasing results in increased aggregate output of SMEs |
| **Outcome**    | SMEs have increased access to medium-term credit on a sustainable basis. | SME loan accounts opened by PFIs increases from 116,556 in 2009 to 145,249 million in 2014  
Outstanding SME loans increase from T1,708 billion in 2009 to T2,129 billion in 2014 | Government statistics  
PFI reports  
Damu reports | Assumptions  
Adequate demand for SME credit on market terms by SME borrowers  
PFIs have sufficient risk-taking capacity and willingness to deliver medium-term credit to SMEs in a sustainable manner.  
Government implements measures to improve other SME and finance sector distortions |
| **Outputs**    | 1. Medium-term financing to SMEs | Number of SME loans disbursed by PFIs increases from 23,338 in 2009 to 29,083 in 2014  
Number of women entrepreneur borrowers under Damu programs increases from 16% of loans to 21% in 2014 | Damu reports  
PFI compliance reports to Damu  
PFI annual reports | Assumptions  
PFIs provide financing to SMEs at market interest rates  
SMEs use funds under the investment program to expand their businesses |
|                | 2. Improved effectiveness and efficiency of Damu | Damu receives a credit rating. | Risk  
Higher-than-expected delinquency rate on SME loans and leases |
### Design Summary

<table>
<thead>
<tr>
<th>Performance Targets and Indicators</th>
<th>Data Sources and Reporting Mechanisms</th>
<th>Assumptions and Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sex-disaggregated data on the following indicators available in Damu GIS: number of borrowers, loan accounts opened, and new jobs created; amount of loan; purpose of loan; business sector of borrowers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>More women are participating in Damu training (baseline to be collected as part of GAP).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Activities with Milestones

1. Preparation of tranche 2 project by Damu in coordination with ADB (starting March 2011)
2. Draft PFR for tranche 2 project submitted by Damu (September 2011)
3. Damu submits signed PFR, as endorsed by the Ministry of Finance for tranche 2 project to ADB (October 2011)
4. Tranche 2 loan agreement signed by Damu and ADB (October 2011)
5. Tranche 2 guarantee agreement signed by the government and ADB (October 2011)
6. Damu signs subloan agreements with PFIs (October 2011)
7. ADB enters in transactions (possibly local bond issuance) to fund withdrawal request from Damu matched by a matching drawdown withdrawal request from PFIs (October 2011). Additional transactions and withdrawals will take place as other PFIs sign subloan agreements.
8. PFIs make loans, leases, and credit lines to SMEs using funds from Damu borrowed from ADB (October 2011 through October 2012)
9. Subsequent tranche projects prepared by mid-2012 and mid-2013, PFRs approved by ADB, where projects involve loans, sovereign guarantees provided, transactions entered into to fund local currency loans, etc. (2012–2014)

#### Inputs

<table>
<thead>
<tr>
<th>ADB OCR loans</th>
<th>$500 million MFF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cofinancers</td>
<td>$100 million</td>
</tr>
<tr>
<td>Participating financial institutions</td>
<td>$1.4 billion</td>
</tr>
<tr>
<td>Government</td>
<td>$800 million</td>
</tr>
<tr>
<td>Total</td>
<td>$2.8 billion</td>
</tr>
</tbody>
</table>

ADB = Asian Development Bank, Damu = Damu Entrepreneurship Development Fund, GAP = gender action plan, GIS = geographic information system, MFF = multitranche financing facility, OCR = ordinary capital resources, PFI = participating financial institution, PFR = periodic financing request, SMEs = small and medium-sized enterprises.

LIST OF LINKED DOCUMENTS
http://www.adb.org/Documents/RRPs/?id=44060-01-3

1. Framework Financing Agreement and Periodic Financing Request for Tranche 1
2. Sector Assessment (Summary): Finance: Small and Medium-Sized Enterprises Finance and Leasing
3. Facility Administration Manual
4. Project Classification Summary
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Financial Analysis
8. Economic Analysis
9. Country Economic Indicators
10. Summary Poverty Reduction and Social Strategy
11. Gender Action Plan
12. Risk Assessment and Risk Management Plan