



# Report and Recommendation of the President to the Board of Directors

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Project Number: 47905  
June 2013

## Proposed Senior Loan AccessBank Azerbaijan for Promoting Rural Financial Inclusion (Azerbaijan)

This is an abbreviated version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communication Policy 2011.

Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 12 June 2013)

Currency unit	–	Azerbaijan manat (AZN)
AZN1.00	–	\$1.2750
\$1.00	–	AZN0.7843

## ABBREVIATIONS

ABA	–	AccessBank Azerbaijan
ADB	–	Asian Development Bank
AMH	–	Access Microfinance Holding Aktiengesellschaft
BOD	–	board of directors
BOM	–	board of management
CAGR	–	compound annual growth rate
CBAR	–	Central Bank of Azerbaijan
EBRD	–	European Bank for Reconstruction and Development
ESMS	–	environmental and social management system
GDP	–	gross domestic product
GLP	–	gross loan portfolio
IFC	–	International Finance Corporation
IFI	–	international financial institution
MSME	–	micro, small, and medium-sized enterprise
NPL	–	nonperforming loan
SMEs	–	small and medium-sized enterprises

## NOTES

- (i) The fiscal year (FY) of AccessBank Azerbaijan ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2013 ends on 31 December 2013. Fiscal year-end (FYE) denotes the end of the fiscal year on 31 December.
- (ii) In this report, “\$” refers to US dollars.

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## CONTENTS

	Page
PROJECT AT A GLANCE	
I. THE PROPOSAL	1
II. THE FINANCIAL INTERMEDIARY	1
A. Investment Identification and Description	1
B. Business Overview and Strategy	2
C. Ownership, Management, and Governance	3
D. Financial Performance	4
III. THE PROPOSED ADB ASSISTANCE	5
A. The Assistance	5
B. Implementation Arrangements	5
C. Value Added by ADB Assistance	6
D. Risks	6
IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT	7
A. Development Impact, Outcome, and Outputs	7
B. Alignment with ADB Strategy and Operations	8
V. POLICY COMPLIANCE	9
A. Safeguards and Social Dimensions	9
B. Anticorruption Policy	10
C. Investment Limitations	10
D. Assurances	10
VI. RECOMMENDATION	10
APPENDIXES	
1. Design and Monitoring Framework	11

## PROJECT AT A GLANCE

<b>1. Project Name:</b> AccessBank Azerbaijan, Promoting Rural Financial Inclusion <b>2. Project Number:</b> 47905																				
<b>3. Country:</b> Azerbaijan		<b>4. Department/Division:</b> Private Sector Operations Department Financial Institutions Division																		
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<b>14. Aid Effectiveness:</b> Not applicable																				

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed senior loan of \$50,000,000 to AccessBank Azerbaijan (ABA) for Promoting Rural Financial Inclusion in Azerbaijan.<sup>1</sup>

## II. THE FINANCIAL INTERMEDIARY

### A. Investment Identification and Description

2. After the collapse of the Soviet Union, exposure to macroeconomic shocks and financial crises has undermined public confidence in Azerbaijan's banking system. Private credit to gross domestic product (GDP) has averaged 16% since 2008, indicating a depth of financial intermediation far below other middle-income peers.<sup>2</sup> Access to financial services is low in Azerbaijan, and is highly concentrated in the capital (Baku) where 88% of bank lending is extended. Azerbaijan's regions,<sup>3</sup> which account for 78% of the population, lag far behind the capital in access to finance, receiving only 12% of bank lending.<sup>4</sup> Compared with emerging markets in Eastern Europe, the efficiency and stability of financial intermediation are low, as witnessed by high lending–deposit rate spreads and high default in 2008 and 2009. Supporting outreach of financial services to the regions and improving stability of the finance sector will have major qualitative impacts on the economy and people by stimulating rural income and employment. This will also support critical risk and income diversification away from the dominant and volatile energy sector.

3. Although rural economic activity contributes less than 10% to GDP, it supports 75% of the population and 38% of employment. The quality of growth is particularly significant in rural areas, as it provides major benefits for low-income families and stimulates demand for goods and services produced by micro, small, and medium-sized enterprises (MSMEs), which represent the bulk of activities in secondary towns and rural districts.<sup>5</sup> The government has recognized that it needs to stimulate value additive activities outside the oil and gas sector, particularly in the regions. Stimulating economic activity and income generation in the regions has become a government priority, and it is pursuing rural investments in infrastructure, agriculture, and agribusiness.<sup>6</sup>

4. MSMEs in Azerbaijan are a critical contributor to income and employment with 42% of the labor force being employed by small and medium-sized enterprises (SMEs), and many more individuals operating as micro-entrepreneurs. However, MSMEs and farmers have consistently lacked access to finance because traditional security-based lending practices have not been able to accommodate the informal information available or address the lack of available collateral. The senior loan to ABA, Azerbaijan's market leader in MSME finance with a strong and growing footprint in the regions, supports access to business finance in the regions by extending funding for onlending to MSMEs that focus their business in areas outside the capital.

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<sup>1</sup> The design and monitoring framework is in Appendix 1.

<sup>2</sup> World Bank. 2012. *Benchmarking Financial Systems around the World, Country Comparisons*. Washington, DC.

<sup>3</sup> In this report, "regions" refers to areas outside the capital city Baku.

<sup>4</sup> Central Bank of Azerbaijan, *Monthly Bulletin*. December 2012.

<sup>5</sup> Most Azerbaijani enterprises range in the micro and small size category. Only a few are medium-sized, according to the European Union threshold for large enterprises above 250 employees and business turnover of greater than AZN50 million equivalent. Azerbaijan is part of the European Union neighborhood region.

<sup>6</sup> The key elements of the government's strategy were presented during the Azerbaijan 2020: The Vision of the Future conference held on 3 December 2012 in Baku under the auspices of the President of Azerbaijan.

5. In 2005, the Asian Development Bank (ADB) provided a nonsovereign loan of \$4 million to ABA for onlending, predominantly to microenterprises.<sup>7</sup> ABA has fully repaid this loan, which ADB rated *successful*.<sup>8</sup> ABA is also a participant in ADB's Trade Finance Program. In June 2012, ADB entered into discussions with ABA's senior management to broaden the existing relationship, and designed a loan targeted to support MSMEs in the country's regions. The proposed loan aims to build on the success of the first intervention with ABA and strengthen its contribution to rural financial inclusion, providing finance to private farms and businesses in regional towns and villages. ABA currently conducts half of its lending business in the regions and is therefore considered a good candidate for ADB funding given its existing footprint in the regions and its rural staffing and branch expansion plans. This will strengthen ABA's regional platform to target and service MSMEs.

6. ABA was established as a greenfield bank serving low-income customers. Access Microfinance Holding Aktiengesellschaft (AMH), one of ABA's core shareholders, has successfully tested this business model in a number of low and lower-middle income economies in Central Asia and Africa. ABA's international financial institution (IFI) investors share a long-term vision of building a strong profitable bank, and exercise influence in promoting internal and external governance best practices. High-quality selection and training of staff and management, strong internal rules for integrity and responsibility toward their customers, no tolerance for abuse, and resources to handle crises that may adversely affect a greenfield bank in its buildup period are the essential components of their successful greenfield bank business model.

7. ABA has set high governance standards in Azerbaijan's banking industry, driven by the quality and principles of its shareholders, strong board oversight, and outstanding asset quality and client responsiveness. With a Fitch rating of BB+, it is the best internationally rated bank in Azerbaijan. ABA received three consecutive Euromoney awards from 2010 to 2012 as the best bank in Azerbaijan. The Consultative Group to Assist the Poor's Smart Campaign evaluation in 2011 rated ABA outstanding for fairness and responsibility with its customers. The proposed loan will improve rural financial inclusion in Azerbaijan, and provide ADB with entry into a relationship with AMH to promote financial inclusion in other challenging developing member country markets where it has a presence, including Tajikistan and potentially Myanmar in the future.

## **B. Business Overview and Strategy**

8. ABA, the eighth largest bank in Azerbaijan, had assets of AZN515 million (\$656 million) and a market share of 3.3% of loans and 2.2% of deposits at FYE2012. It has a strong franchise among MSMEs, which represent 91% of total loans and a moderate exposure to retail clients (9% of loans), which includes mortgages and staff loans. Its unique strength lies in its capability to analyze undocumented business cash flows and provide loans to very small business customers through its branch and loan officer network, hence filling the market gap where traditional lenders are not active. Originally focused on Baku, ABA has diversified its portfolio by expanding its loan book in the regions, thereby reducing the concentration risk to the increasingly competitive Baku market. Regional loans now represent 50% of total loans. Moreover, ABA plans to strengthen services to MSMEs outside Baku through an additional 18 regional branches by the end of 2017, and grow its regional loan book to 55% of total loans. ABA's loan book increased by 34% in 2012, and the first 4 months of 2013 indicate 30% growth

<sup>7</sup> ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Assistance to Private Banks and Leasing Companies in Azerbaijan*. Manila.

<sup>8</sup> ADB. 2011. *Extended Annual Review Report: Private Banks and Leasing Companies in Azerbaijan*. Manila.

by FYE2013. Growth in the immediate term is being supported through the establishment of nine additional regional branches during 2013, and the significant opportunities offered by a substantially underserved MSME segment.

9. ABA's gross loan portfolio (GLP) reached AZN414 million (\$525 million) at FYE2012. ABA recently revised its GLP growth target downward to a compound annual growth rate (CAGR) of 13% from 2013 to 2017, based on the anticipated recapitalization of banks. The Central Bank of Azerbaijan (CBAR) increased the minimum capital requirement from AZN10 million to AZN50 million by FYE2013. Competition in banking is expected to intensify, resulting in a more conservative growth trajectory. However, ABA is expected to increase the credit it provides to regional MSMEs at a CAGR of 15% and double by FYE2017, equivalent to an increase of \$256 million.

### **C. Ownership, Management, and Governance**

10. **Ownership.** Established in 2002 as a greenfield microfinance bank, ABA is predominantly owned by IFIs, with Black Sea Trade and Development Bank, the European Bank for Reconstruction and Development (EBRD), the International Finance Corporation (IFC), and KfW each holding 20% of shares. AMH holds 16.5% of shares and Luso Financial Systems holds the remaining 3.5%.

11. **Management.** ABA's board of management (BOM) is chaired by the chief executive officer, and has four additional members: director of finance, director of business banking and risk, director of retail banking and operations, and director of infrastructure. The chief executive officer, a German commercial banker with 17 years of experience in Europe and the Russian Federation, joined ABA in mid-2012. All other members of the BOM are Azerbaijani nationals, have strong academic backgrounds, and most have been with ABA since its establishment in 2002. Three members have moved up from credit officers to their current positions and are intimately familiar with ABA operations. The BOM sets strategic targets for approval by the board of directors (BOD).

12. **Governance Structure.** ABA is governed by a two-tier board structure comprising the BOD and the BOM. The BOD is responsible for overseeing implementation of key policies, approving strategic plans and business targets, and appointing management and monitoring their performance. Black Sea Trade and Development Bank, EBRD, IFC, and KfW nominate four of the five BOD members (including the chairperson), who are currently all senior professionals with international banking experience. The other board member is a German banker, who was ABA's CEO from 2002 to 2006. He was nominated by AMH. Two of the five current BOD members are women.

13. ABA's audit department reports directly to the audit committee and is led by an experienced auditor. The external auditor changes periodically. PricewaterhouseCoopers has conducted audits since 2009. Historically, audit observations have related to addressing fraud identified at branches. To reduce fraud risk and meet the requirements of its growing business, ABA is currently migrating from its legacy banking software to a more advanced core banking system (Temenos 24), which is scheduled to be operational in September 2014. Audit observations have not identified any major accounting, operating, or compliance risks. ABA dismisses staff if fraud is identified and substantiated. In the view of the audit department, ABA management addresses audit issues in a timely manner. ABA's audit function is considered to be well established.

14. The finance and audit departments manage reporting on money laundering. ABA identifies suspicious transactions by scanning information by source of wealth, politically exposed persons, and watch lists. It has established “know your customer” and policies countering money laundering, and reports findings to the CBAR Financial Services Unit.<sup>9</sup>

#### **D. Financial Performance**

15. **Capital adequacy.** ABA’s total capital adequacy (under both Basel I International Financial Reporting Standards [IFRS] and Azerbaijan regulatory definitions) has well exceeded minimum requirements or benchmarks. Throughout the 2008–2009 banking crisis, ABA’s capital adequacy was supported by a no dividend policy (until 2009) and a 3-year income tax holiday for all banks in Azerbaijan, which ended in 2011, allowing a buildup of capital through accumulation of retained earnings. As a result, ABA’s Basel I capital adequacy ratio was maintained at 22.5% or greater from 2008 to 2012, despite ABA’s significant loan growth and dividend payout in FY2012. This comfortable capital position should provide a cushion for additional capital charges for market and operating risk, once CBAR decides to move toward Basel II and III regulatory frameworks.

16. **Asset quality.** ABA maintained high asset quality throughout the high growth period due to its rigorous client selection and monitoring process, the high granularity of its loan portfolio, and the substantial proportion of repeat loans (representing 76% of its GLP at FYE2012).<sup>10</sup> The micro, agriculture, SME, mortgage, and consumer loan segments have consistently shown a high portfolio quality with nonperforming loans (NPLs) not exceeding AZN4.8 million (or 1.1% of GLP) throughout 2012.<sup>11</sup> Since 2007, the NPL ratio has never exceeded 1.4% of GLP, whereas the Azerbaijan banking system has historically recorded an NPL ratio of 6%–10%. ABA has implemented a conservative provisioning policy, with provisions exceeding portfolio at risk greater than 30 days by 2.5 to 3.0 times since 2007. The good sector diversification supports the robustness of asset quality, and single and related party exposures are kept at policy levels far below the CBAR prudential minimum.<sup>12</sup>

17. **Earnings.** For FY2012, net income dropped slightly to AZN15.8 million (\$20.1 million), from AZN17.3 million (\$22.1 million) in FY2011, as a result of increasing competition in Baku and the end of the tax holiday for banks. However, return on equity remained sound at 17.6% and return on assets at 3.5%. Net income grew at a CAGR of 35% from 2007 to 2012 and return on equity remained above 35% during 2008–2010, primarily the result of high business growth and the income tax holiday in place from 2009 to 2011. After the 2009 financial crisis, ABA’s net interest margin dropped by about 250 basis points to 19% by FYE2011, before recovering by 70 basis points in FY2012. ABA’s net interest margin is strong by international standards and appropriate given a high cost-to-income ratio, which reached 69.3% in 2012 due to ABA’s personal, intensive, low transaction volume business model. For the coming years, the return on assets is projected to moderate but remain above 2%, reflecting cost increases for the branch expansion and tightening of net interest margin. ABA expects its net profit to grow by 3%

<sup>9</sup> Azerbaijan participates in the Financial Action Task Force (FATF). Its compliance is monitored by MONEYVAL, Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism.

<sup>10</sup> High granularity of a loan portfolio refers to a portfolio that is well diversified across a large number of borrowers with small individual exposures.

<sup>11</sup> In this report, NPLs are defined in line with ADB’s problem loan definition, which is the sum of (i) not impaired loans overdue more than 90 days, (ii) loans classified impaired according to the International Financial Reporting Standards, and (iii) restructured loans within 12 months of the reporting date and not included in (i) and/or (ii).

<sup>12</sup> CBAR prescribes single party exposure limits at 7% of regulatory capital for unsecured and 20% for secured exposures, and related party exposures to legal entities at 10% of total regulatory capital and to individuals at 3%.



annually to the end of 2017 through efficiency gains, while continuing to maintain high portfolio quality, despite the increase in costs associated with regional expansion.

18. **Liquidity and asset–liability management.** Since 2008, ABA has improved its local funding base. Approximately half of its deposits constitute accounts that exceed AZN150,000, and are held by individuals and institutions that tend to be price sensitive. The share of deposits to total funding improved from 14% in 2008 to 49% in 2011. However, in 2012 the ratio dropped to 42% as a result of strong loan growth and an increase in longer-term borrowing from IFIs. Improving the deposit base through cross selling to its MSME customers will be important to provide more stable domestic funding. ABA has a particular strength in mobilizing direct and indirect (through MSME investment funds) IFI funding (including its shareholders), and commercially oriented bilateral and philanthropic investor funding, given its attractive development-oriented business model. However, additional financial support from current shareholders and lenders is constrained by single investment and borrower exposure limits at the respective IFIs. Access to other commercial funding remains limited, as a result of the collapse of funding from European commercial sources since the global financial crisis and the ongoing sovereign debt crisis in Europe. ABA's domestic wholesale funding is insignificant, and the bank has no access to government-subsidized funding programs. However, this has the benefit of ensuring that ABA does not come under political pressure with respect to its lending activities. Until FYE2013, ABA expects loan growth to exceed deposit growth and then to slightly reverse, targeting a share of deposits to total liabilities of 50% by FYE2017.

19. **Sensitivity to market risk.** All banks in Azerbaijan are exposed to market risk arising from the direct foreign currency exposure of their funding. Since 2009, ABA has improved its (unhedged) balance sheet foreign currency gap from 69% to 51% of total regulatory capital. Since most deposits and all IFI borrowings are denominated in foreign currency, ABA matches its foreign currency resources with foreign currency lending. It manages the foreign currency-induced credit risk through a requirement that borrower cash flows need to be twice as high as for local currency denominated loans to ensure debt service capacity under adverse scenarios. In addition, term loans are largely assigned to mortgage and business loans with foreign currency income. In the absence of a liquid swap market, the capital buffer and cautionary debt service arrangements appear appropriate to manage foreign currency-induced credit risk. ABA's interest rate sensitivity, measured by the earlier of contractual repricing or maturity dates, indicates that the gap for below 6-month maturity has substantially reduced since 2011.

### III. THE PROPOSED ADB ASSISTANCE

#### A. The Assistance

20. The proposed ADB assistance comprises a senior, unsecured loan facility of up to \$50 million with a tenor of 5 years. The proceeds will be used exclusively to support ABA's plan to increase lending to MSMEs in the underserved regions outside Baku, including secondary towns and rural districts. The assistance will also provide enhanced access to longer-term finance for the MSME segment, which is critical to support income and employment.<sup>13</sup>

#### B. Implementation Arrangements

21. ABA will be required to provide annual audited financial statements in accordance with International Financial Reporting Standards. It will also provide quarterly financial statements

<sup>13</sup> In this loan, MSMEs are enterprises employing up to 250 staff and reaching an annual business turnover of up to AZN50 million, in line with the definition of the European Union. Subloans will not exceed \$3 million equivalent.

and compliance certificates for agreed covenants. Reporting requirements include (i) status updates for introducing and maintaining the Basel regulatory framework; (ii) updates on governance, safeguards, and social protection compliance; and (iii) updates on ABA's business performance and utilization of the ADB loan. ADB will field review missions at least annually to review and discuss progress with ABA management.

### **C. Value Added by ADB Assistance**

22. ADB's value addition to the project is expected to be the following:

- (i) ADB will provide stable long-term financing that currently cannot be raised from the local market. Azerbaijan's capital markets are nascent, and public confidence in the finance sector is only gradually being restored. Commercial bank funding is not readily available given current market conditions in Europe. IFIs that are funding Azerbaijan banks are now operating within tighter country, sector, and single investment and borrower exposure limits, thereby increasing the need for ADB engagement. More broadly, the loan may contribute to increasing public confidence in the banking system, through the support of this strong and growing bank with significant outreach in underserved areas.
- (ii) The loan will improve financial inclusion, specifically by targeting MSMEs in regions, including rural areas. Secondary towns play an important role as trade and service hubs linking agriculture to national and regional markets. MSMEs have not been well served by the traditional banking system, and ABA has developed specialized lending practices to reach these underserved customers. The ADB loan will support diversification in the regions outside Baku and to non-oil subsectors.
- (iii) Through close on-site monitoring and dialogue with ABA management, ADB will support ABA's adherence to high corporate governance, social, environmental, and fiduciary standards; and enhance risk management.

### **D. Risks**

23. **Challenging operational environment.** The global economic downturn negatively affected the Azerbaijan economy, as evidenced by the decline in oil and gas demand and the associated sharp decline in GDP growth. For banking, depositor confidence further weakened as shown by the sector-wide loan to deposit ratio of 144% as of FYE2011, loan growth slowed, and asset quality deteriorated. Notwithstanding the current period of economic growth, the small domestic economy has a narrow non-oil base, is highly concentrated in Baku, and remains susceptible to deteriorations in the operating environment, which could adversely affect loan portfolio quality and capital adequacy. In response, ABA seeks to diversify its portfolio by targeting regional loans to reach 55% of GLP by FYE2017, and to continue benefiting from its highly granular portfolio, which is diversified across multiple sectors. More than 50% of the loan book is dollar-denominated and neither ABA nor its borrowers have been tested through a sharp devaluation of the local currency. To mitigate devaluation risk, ABA applies a discount on the face amount of the sub-loans issued to its borrowers.

24. **Refinancing risk.** ABA has consistently sourced non-depositor funding to support its asset growth due to the challenges in deposit mobilization in Azerbaijan. However, ABA's long-term access to financial support from shareholders may be constrained by their single investment and borrower exposure limits. Recently, ABA has diversified its borrowing to several

lenders, many of which have long-term investment horizons. To deepen funding sources, ABA has committed to augment its depositor base by increasing its deposit to loan ratio during the term of the ADB loan. In addition, strong funding flows from loan repayments and ABA's long-running relationships with its international creditors will continue to help secure its refinancing requirements.

25. **Capital adequacy.** ABA's capital adequacy could come under pressure as a result of high business growth coupled with material negative macroeconomic or political events. To mitigate this risk, ABA maintains a conservative capital position. ABA's shareholders have also indicated support for ABA's continued growth through moderate dividend payouts and flexibility if higher retained earnings are required. By FYE2017, ABA expects its capital to grow by \$50 million to \$170 million, which should provide adequate room for its business growth.

26. **Loan portfolio growth.** ABA has conservatively estimated its loan portfolio to grow at a CAGR of 13% during 2013–2017, while loans in the regions are expected to grow at a CAGR of 15%. During 2013, ABA's loan growth will remain high at 30%, reflecting opportunities in the MSME market and the focus on regional expansion. Repeat borrowers represent 76% of ABA's current loan portfolio and have successfully gone through earlier borrowing cycles. ABA has put in place adequate processes, staffing plans, and information technology systems to support the business targets until FYE2017. The regional branch expansion from 19 at FYE2012 to 28 at FYE2013 and an additional 3–5 branches annually from 2014 to 2016 will provide ABA with a stronger platform for growth. ABA staff are well prepared for the expansion, including the rollout of a new core banking information technology system.

27. **Sustainability of asset quality and internal controls.** ABA's asset quality metrics are favorable with an NPL ratio of 1.15% in 2012, down from 1.4% in 2011, well below the average NPL ratio of the country's SME segment of 10%. However, asset quality may be adversely affected by its planned portfolio expansion in the next 5 years. ABA standardized the credit underwriting (using rigorous analysis of client cash flows to determine debt service repayment capacity) and approval process through the extensive training of field officers and close monitoring by experienced senior loan officers. Further, ABA has implemented a strong performance-based pay scheme for loan officers, where pay is adjusted monthly based on each loan officer's portfolio performance. This approach supports timely collections of any outstanding loan amounts.

#### IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

##### A. Development Impact, Outcome, and Outputs

28. **Impact.** The impacts are (i) increased availability of bank credit to the regional non-oil economy, and (ii) expansion of private banking services in Azerbaijan's regions. This will be reflected by an increase in the private credit-to-GDP ratio, and increased private credit to regions outside Baku. Also expected is an increased contribution of MSMEs to Azerbaijan's economic output and employment. However, these impacts currently cannot be measured accurately in the absence of public information on these metrics.

29. **Outcome.** The outcome is growth of MSMEs financed by a sustainable ABA, fulfilling its core mandate of prudently serving more MSMEs and their diverse business needs in Azerbaijan. ABA is expected to set an example for other banks in deepening its outreach to rural areas, while retaining good asset quality and funding private agricultural activity with employment and income benefits for the business owners and their staff.

30. **Outputs.** The outputs are that ABA will improve its service outreach to MSMEs in the regions, and diversify its credit risk exposure by reducing concentration in Baku. ABA will ensure that adequate investment is made in human resources, processes, and branch infrastructure in the regions. Providing capital to MSMEs, including farms, will strengthen their role as an important source of employment, especially in poverty-stricken rural areas. Emphasizing lending based on MSME cash flows, expanding into remote areas, and providing term finance will help serve the regional economy and diversify ABA's risk and income profile.

## **B. Alignment with ADB Strategy and Operations**

### **1. Consistency with Strategy 2020 and Country Strategy**

31. Under Strategy 2020, ADB aims to strengthen its support for the finance sector by supporting the development of financial infrastructure, institutions, and products and services; and by promoting inclusive growth.<sup>14</sup> Through such initiatives, ADB will encourage channeling of savings into productive investments. The building of inclusive financial systems will be supported through ABA's emphasis on funding regions where productivity is low, and the potential for employment and income generation is high. The loan will help ABA to reach rural MSMEs, and is consistent with government efforts to promote growth in these areas, particularly to diversify economic growth in private non-oil activities. Strategy 2020's target for poverty reduction through private sector development will be supported via ABA's emphasis on activities in the regions where poverty vulnerability is highest.

32. An ADB financial sector assessment<sup>15</sup> and an evaluation of ADB's assistance to Azerbaijan<sup>16</sup> were completed in 2012. A country partnership strategy is currently being prepared. The reports all highlight the importance of developing private and financial institutions, and the need for intensified financial intermediation. More diversified financial services away from Baku and oil will capture essential qualitative growth opportunities in neglected regions and sectors, and encourage sound risk management. The reports highlight that agriculture and SMEs have inadequate access to financial services, and that lending support via financial institutions presents the greatest opportunity for ADB's private sector operations. The global financial crisis highlighted the importance of resilient banking systems to protect against adverse impacts on populations.

### **2. Consistency with Sector Strategy and Relevant ADB Operations**

33. Financial sector development is a key focus of ADB assistance as set out in ADB's Private Sector Development Strategy<sup>17</sup> and Enhanced Poverty Reduction Strategy,<sup>18</sup> which note economic growth, stimulated by private sector investment, as a key contributing factor in reducing poverty. These strategies also note the importance of generating jobs, with private sector employment being the major source of income for workers and their families. The Private Sector Development Strategy emphasizes ADB's role in strengthening finance sectors in its developing member countries. It provides that SME beneficiaries of financial intermediation are important employers and providers of income to contribute to poverty reduction. Support of financial intermediaries is important to instill confidence and rehabilitate the finance sector in

<sup>14</sup> ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

<sup>15</sup> ADB 2012. *Azerbaijan: Financial Sector Assessment*. Manila.

<sup>16</sup> ADB. 2012. *Azerbaijan: Validation of the Final Review of Country Operations, 2000–2011*. Manila.

<sup>17</sup> ADB. 2000. *Private Sector Development Strategy*. Manila.

<sup>18</sup> ADB. 2004. *Enhancing the Fight Against Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

countries affected by macroeconomic shocks and financial crises. The loan is consistent with ADB's financial sector operational plan and the 2007 report of the Working Group on Rural Poverty, which underscores the importance of rural finance and promotes financial inclusion of underserved poor households, farmers, and SMEs.<sup>19</sup>

34. ADB plays an important role in supporting deepening of services in Azerbaijan's finance sector. Since 2005, ADB has provided nonsovereign loans of \$45 million to banks, comprising (i) \$15 million in total senior loans to ABA, Azerigas Bank, and Bank Respublika; (ii) a \$20 million subordinated loan to IBA; and (iii) a \$10 million subordinated loan to Bank Respublika. ABA, Bank of Baku, Bank Respublika, and Demir Bank also benefit from ADB's Trade Finance Program, with an approved total exposure limit of \$17.5 million. The proposed loan would be ADB's second loan to ABA, building on the success of the previous loan, and specifically targeting MSMEs in the regions where access to finance is most limited.

## **V. POLICY COMPLIANCE**

### **A. Safeguards and Social Dimensions**

35. In compliance with ADB's Safeguard Policy Statement (2009), ADB's senior loan is classified category FI based on potential impacts on the environment, and category FI treated as C for impacts on involuntary resettlement and indigenous peoples. Subloans classified as environment category A and social safeguards categories A and B will not be financed under ADB's senior loan. The potential environment and social impacts of subloans, the risks associated with ABA's existing and likely future portfolio, and ABA's commitment and capacity for environmental and social management were assessed. The existing environmental and social management system (ESMS) established by ABA and agreed modifications requested by ADB are deemed adequate to comply with ADB's Safeguard Policy Statement. ABA will ensure that investments using ADB funds do not involve business activities on the ADB prohibited investment activities list. ABA will enhance its existing ESMS to implement modifications agreed with ADB before the first disbursement of the loan. The ESMS will provide for ABA compliance with applicable national safeguard requirements on environment, health, and safety; and safeguard requirements of its international financing partners such as ADB, EBRD, and IFC. The ESMS also provides for ABA compliance with national labor laws and measures required by international core labor standards in accordance with ADB's Social Protection Strategy.<sup>20</sup>

36. ADB has made significant efforts during its due diligence to assess ABA's commitment and capacity for promoting gender equity, and to ensure that gender inclusiveness is an integral feature of this transaction. Women comprise 35% of ABA staff and represent 24% of senior and middle management; ABA's human resource policies are based on equal opportunities. ABA also targets female customers as an important business segment, and ABA's commercial policies and practices support equal opportunities for women to access services and markets. This is demonstrated by recent statistics, where ABA had 34,000 female borrowers in 2012 (up from 26,000 in 2009), representing about 27% of overall borrowers. ABA has taken proactive steps to promote a gender-inclusive ethos, which is likely to generate significant benefits for female customers. As such, this transaction is classified SGE (some gender elements) under ADB's guidelines.<sup>21</sup> ABA's reporting requirements to ADB include reporting on subloans by gender; ADB will monitor progress in supporting female borrowers.

<sup>19</sup> ADB. 2007. *Rural Poverty Reduction and Inclusive Growth: Report of the Working Group on Rural Poverty*. Manila.

<sup>20</sup> ADB. 2001. *Social Protection*. Manila.

<sup>21</sup> ADB. 2012. *Guidelines for Gender Mainstreaming Categories of ADB Projects*. Manila.

## **B. Anticorruption Policy**

37. ABA was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

## **C. Investment Limitations**

38. The proposed senior loan is within the medium-term country, industry, group, and single investment exposure limits for nonsovereign investments.

## **D. Assurances**

39. Consistent with the Agreement Establishing the Asian Development Bank<sup>22</sup> the Government of Azerbaijan will be requested to confirm that it has no objection to the proposed assistance to ABA. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the ADB Board of Directors.

## **VI. RECOMMENDATION**

40. I am satisfied that the proposed senior 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 the senior loan of \$50,000,000 to AccessBank Azerbaijan for Promoting Rural Financial Inclusion in Azerbaijan from ADB's ordinary capital resources, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Bindu N. Lohani  
Vice President

26 June 2013

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<sup>22</sup> ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

## DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
<b>Impacts</b> Increased availability of bank credit to the non-oil economy  Expansion of private banking services in Azerbaijan's regions	Commercial bank credit to non-oil GDP increased from 42% (2012) to >50% (2020)  Commercial bank credit in regions outside the capital Baku increased from 12% (2012) to >20% (2020)	CBAR reports	<b>Assumption</b> CBAR gradually enhances risk-based supervision  <b>Risks</b> Political risks Volatility of oil subsector Fiscal risks Currency risk
<b>Outcome</b> Growth of MSMEs financed by a sustainable ABA	Net cash flows (inflation adjusted) increased for at least 30% of MSME clients from 2015 to 2019 <sup>a</sup>  ABA ROAA remains above 2% (2012–2019) compared with 3.3% (2011)  ABA deposits to total liabilities reaches 50% by 2019  ABA NPL ratio maintained at <3% (2012–2019)  ABA cost to income ratio maintained at <80% (2012–2019) <sup>b</sup>  Number of ABA MSME borrowers with up to 100 employees increased from 16,000 (2012) <sup>c</sup> to 20,000 (2019)  ABA's ratio of repeat MSME clients maintained at >60% from 2013 onward <sup>d</sup>  ABA total MSME loans increased from \$463 million (Dec 2012) to >\$700 million (2019)  Number of MSME borrowers increased from 95,000 (2012) to	Audited financial statements  Development effectiveness monitoring reports	<b>Assumptions</b> ABA well supervised by its supervisory board and ensures good governance  Increased competition decreases ABA's profitability  <b>Risks</b> Volatility of oil subsector  Fiscal risks  Currency risk

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
	130,000 (2017)  Number of female borrowers increased from 34,000 (2012) to 51,000 (2017)		
<b>Outputs</b> ABA's banking services to regional MSMEs expanded	Number of branches outside Baku increased from 19 (2012) to 40 (2017)  At least \$200 million in additional MSME loans provided in the regions by 2017 from \$260 million in 2012  ABA regional loan portfolio increased from 49% of GLP (2012) to >54% (2017)  Number of MSME borrowers outside Baku increased from 65,000 (2012) to 100,000 (2017)  ESMS meets ADB safeguard requirements	ABA annual reports  Audited financial statements  Development effectiveness monitoring reports  ABA ESMS report	<b>Assumption</b> Management carries out business as planned; recruits and trains staff in regions  <b>Risks</b> Foreign currency-induced credit risk  Loan default risk
<b>Activities with Milestones</b> 1. ABA business plan revised (December 2014) 2. ABA funding to MSMEs in regions (2013 onward) 3. Monitoring and semiannual review missions			<b>Inputs</b>  Senior loan  ADB: \$50 million

ABA = AccessBank Azerbaijan; ADB = Asian Development Bank; CBAR = Central Bank of Azerbaijan; ESMS = environmental and social management system; GDP = gross domestic product; GLP = gross loan portfolio; MSMEs = micro, small, and medium-sized enterprises; NPL = nonperforming loan; ROAA = return on average assets.

<sup>a</sup> This is a proxy indicator for growth of the MSMEs. Generation of this information depends on available data.

<sup>b</sup> The high cost to income ratio is reflective of the labor-intensive nature of ABA's business; with frequent visits to clients.

<sup>c</sup> In 2012, ABA clients included 14,923 microenterprises (with up to 10 employees, including sole proprietorships), 797 small enterprises with 11–30 employees, 171 enterprises with 31–50 employees, and 117 enterprises with 51–100 employees.

<sup>d</sup> This is also a proxy indicator for the quality of ABA's services, which have a high proportion of repeat clients. Generation of this information depends on available technical assistance grants for sampling the information.

Sources: ABA and Asian Development Bank.