# PROJECT INFORMATION DOCUMENT (PID)
# APPRAISAL STAGE

Report No.: PIDA948

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| **Project Name** | TR Third Access to Finance for SMEs (SME III) (P130864) |
| **Region** | EUROPE AND CENTRAL ASIA |
| **Country** | Turkey |
| **Sector(s)** | SME Finance (100%) |
| **Theme(s)** | Micro, Small and Medium Enterprise support (100%) |
| **Lending Instrument** | Financial Intermediary Loan |
| **Project ID** | P130864 |
| **Borrower(s)** | T.C. Ziraat Bankasi A.S. (Ziraat Bank) |
| **Implementing Agency** | T.C. Ziraat Bankasi A.S. (Ziraat Bank) |
| **Environmental Category** | F-Financial Intermediary Assessment |
| **Date PID Prepared/Updated** | 18-Apr-2013 |
| **Date PID Approved/Disclosed** | 18-Apr-2013 |
| **Estimated Date of Appraisal Completion** | 15-Apr-2013 |
| **Estimated Date of Board Approval** | 26-Jun-2013 |
| **Decision** | |

## I. Project Context

### Country Context

Turkey is an upper middle-income country and the 18th largest economy in the world, with a Gross Domestic Product (GDP) of US$786.3 billion in 2012. Private consumption accounts for more than 70 percent of GDP, and it is the main driver of economic growth, while exports make up only 26.4 percent of GDP. Domestic savings are very low (about 14 percent of GDP), and thus economic growth is largely financed by external inflows, most of which are of a short-term nature and thus increase the risk of volatility. The economy is based on services that constitute 56 percent of total economic activity, while industrial production makes up about a quarter of the total economy. The share of the agricultural sector in the economy, which has declined during Turkey's rapid urbanization, accounted for 8 percent of GDP in 2012.

Turkey's development over the past decade is a story of notable turnaround thanks to successfully implemented structural reforms and sound macroeconomic management. Reforms include strong fiscal management, reforms in the social security system, strengthening of banking supervision, and shifting to a flexible exchange regime with an independent central bank responsible for inflation targeting. These reforms yielded results. The financial sector remained profitable and highly capitalized. Despite the global crisis of 2008-09, the Turkish economy expanded by an average of 5.2 percent during the 2002-12 period. During the same period, per capita income more than tripled

reaching US$10,504 in 2012; inflation declined to single-digit levels; and the EU-defined public debt-to-GDP ratio eased from 74 percent in 2002 to 36.1 percent in 2012.

Although Turkey was hit hard by the global crisis and its GDP shrank by 4.8 percent in 2009, the country bounced back quickly. The economy expanded by 9.2 and 8.8 percent, respectively, in 2010 and 2011. However the strong recovery in economic growth was driven mostly by domestic demand linked to high credit growth and coupled with higher energy prices. As a result, Turkey suffered a significant worsening of external balances and a rise in inflation. The ratio of the current account deficit to GDP widened from 6.2 in 2010 to 9.7 percent in 2011, while net energy imports increased to 6.1 in 2011 from 4.7 percent of GDP in 2010. Consumer prices increased by 10.4 percent in 2011, well above the Central Bank's target of 5.5 percent. In response to increasing imbalances, the Central Bank has been taking a range of measures to tighten monetary policy since mid-2011, thus increasing funding costs.

On the back of a soft landing and significant economic rebalancing, Fitch ratings has upgraded Turkey to investment grade, but external financing remains a concern. The economy has been slowing down since the last quarter of 2011. In 2012, GDP expanded by 2.2 percent year-on-year, down from 2011's 8.8 percent as a result of the slowdown in domestic demand. The current account deficit eased to 6 percent of GDP, from 9.7 in 2011, while inflation came down to a historic low 6.2 percent at the end of 2012. The main driver of the improvement in the current account deficit in 2012 was real export growth, attributable to export diversification and facilitated by significant nominal currency depreciation against the US dollar in 2011. Foreign direct investments and other long-term inflows accounted for 50 percent of financing in 2012. Given the global uncertainties, Turkey's external financing remains its key weakness, and the financing quality remains a concern in the short-run.

**Sectoral and institutional Context**



The Turkish financial sector has experienced significant growth over the past decade, but is dominated by banks and lacks the depth one would expect given the size of the economy. Financial markets increased almost fivefold, from TL464 billion in 2003 to TL2,152 billion in September 2012. Despite such growth, total financial system assets amounted to just 147 percent of GDP in 2011, whereas Brazil's and Thailand's stood at about 250, South Korea's at 325, and Malaysia's and South Africa's at 450 percent. Bank assets dominate the financial sector, representing about 94 percent of GDP. Banking sector credit and deposits account for 58 and 56 percent of GDP, respectively.

The reforms undertaken after the 2001 crisis allowed the Turkish banking system to come through the global financial crisis relatively unscathed, although credit growth has recently deteriorated. Supportive measures taken by the Turkish authorities and a rapid rebound in capital inflows and economic activity also played a role in the Turkish banking sector's ability to withstand the impact of the global crisis. In recent years, additional capital buffers and strengthened banking regulation and supervision have led to the emergence of a more resilient, stable and profitable banking sector. The Turkish banking system remains highly capitalized (a Capital Adequacy Ratio -CAR- of 17.4 percent as of November 2012) and profitable a (Return On Assets -ROA- and a Return On Equity -ROE- of 1.71 and 14.6 percent, respectively), with a significant improvement in asset quality (a Non-Performing Loan ratio -NPL- of 2.9 in November 2012, after reaching 5 percent in 2009). Nevertheless, credit growth decelerated from 29.9 percent in 2011 to 14.7 in November 2012 due to

the authorities' monetary and prudential tightening measures, as well as uncertainties over the global growth outlook and the Eurozone in particular. The deceleration was more visible in the Small and Medium Enterprise (SME) sector.

The maturity of the banking sector's liabilities continues to be short-term in nature. The banking system is funded mostly by relatively well diversified and stable customer deposits, backing more than 57 percent of total assets. However, as of September 2012, only 4.6 percent of the deposits were due to mature after one year, and the average maturity oscillated at around 76 days. With the system's loan to deposit ratio increasing since 2009 by 25p.p. to reach 106 percent in November 2012, banks have drawn on balance sheet liquidity and wholesale funding from abroad (with total assets to foreign liabilities standing at 15 percent, relatively low by regional standards). However, longer term sources of foreign debt, such as syndications and securitizations, remain limited and constitute only 21 percent of the total. In addition, following the Banking Regulation and Supervision Agency's (BRSA) authorization in 2010, banks commenced issuing domestic bank bonds with tenures ranging between 6 to 18 months. Nevertheless, only 1.6 percent of the total assets are funded by Turkish lira bonds, while the weighted average of the maturity remains under one year. As the volume becomes more significant, it is expected that domestic issuance will help diversify the Turkish banks' funding base significantly.

Leasing remains underdeveloped, despite its potential as a key alternative funding source for the corporate sector and SMEs in particular. Leasing allows SMEs access to income-producing assets without a significant base for collateral, and can play a critical role in their inclusion in the formal financial system. There are 31 leasing companies in Turkey, operating under the supervision of BRSA. There are four Participation Banks and 11 Investment and Development Banks that are also allowed to offer leasing. The sector is relatively concentrated with 10 companies capturing over 80 percent of total lending volume in 2011. The leading leasing companies are typically subsidiaries of the larger domestic banks, gaining wider access to SMEs through the parent bank branch network and comprehensive client information. Nevertheless, Turkey ranks below most European countries with respect to leasing penetration, with a rate of just 0.54 percent of annual leasing volume to GDP. The lease financed investments as a percentage of the total (excluding dwellings) is below 3 percent, while the average in Europe is 12. Although the leasing sector is the largest financial segment after banking (capturing 42 percent of the non-bank financial sector), its assets correspond to less than 1 percent of total financial sector assets. A survey conducted by the European Commission in 2011 shows that only 19 percent of SMEs in Turkey used leasing in 2011, well below the EU27 average of 37 percent.

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The largest users of leasing are SMEs and the average term stands at 3 years. The most leased type of equipment is construction and textile, and the average contract size is approximately US $355,000. Following continuous volume growth between 2002 and 2006 of around 50 percent, the sector contracted substantially as a result of the global financial crisis in 2008-09, before starting to recover again in 2010. This contraction reflected lower demand for investment finance (with the banking sector shifting to working capital), but also the industry's focus on SMEs that were hit the hardest. The average transaction size grew substantially, highlighting the shift away from SMEs. Post-crisis recovery has been strong, with 45 and 53 percent volume growth in 2010 and 2011, respectively, but the sector is still far below the record volumes of 2007. The NPL rate has been recovering since 2010, but is still above the 2007 levels standing at 8.3 percent in 2012.

The Parliament enacted a new Leasing, Factoring, and Financing Companies Law in November

2012 that is expected to spur growth in the sector. The new law was supported by the World Bank Competitiveness and Savings Development Policy Operation (DPO). It provides a strong legal framework and aims to introduce new leasing instruments beyond the existing financial leasing (namely operational leasing, sub-leasing, software leasing, and sell and lease back). In addition, the new law envisages the establishment of a registry that will cover leasing contracts and leased movable assets to protect lessors' rights; removes some operational barriers to facilitate leasing transactions; and aims to ensure equal treatment for Turkish and foreign leasing companies. The new law is expected to help the non-bank financial institutions sector to grow and improve SME's access to finance. The Leasing Association (FIDER) is expecting an average annual growth of 19 percent in the next 5 years.

SMEs continue to face significant access to finance issues despite their important role in the Turkish economy. SMEs are estimated to account for 99 percent of all enterprises, 78 percent of employment, 55 percent of value added, 65 percent of sales, 50 percent of investments, and 59 percent of exports. The last Investment Climate Assessment -From Crisis to Private Sector Led Growth (May 2010)- found strong indications that SMEs face disproportionately severe access to finance constraints. Lack of cash flow based financing and high collateral requirements further constrain access to finance to SMEs. Overall, they receive only 23 percent of total loans, and are growing more slowly than both large enterprises in Turkey and SMEs in comparator countries. Their share in total credit declined in the aftermath of the global crisis by about 5p.p. to a little over 20 percent in 2009, but recovered to 23 percent by mid-2012 as the economy rebounded. The sharp decline demonstrates how SMEs are among the first and most affected casualties of a financing crunch.

The World Bank has been working through various channels to support SMEs and develop the availability of long-term finance in Turkey. Over the past ten years, the World Bank has provided 11 credit lines, amounting to some US$4 billion in commitments. These projects have focused on exporters, SMEs, and energy sector enterprises. In most cases, the main development objective has been to provide medium and long-term finance. Reviews of Implementation Completion Reports by the Independent Evaluation Group rate outcomes above Satisfactory, and the 2011 study "EFIL and SME Credit Line Projects: An Assessment of Outcomes" concluded that the projects were successful in targeting the medium- to long-term working capital and investment finance needs of exporters and SMEs. The study was based on a survey of final borrowers, some 400 EFIL and SME project beneficiaries, and 200 control firms. Such lines of credit act as a bridge until financial infrastructure constraints are lifted and alternative sources of long-term finance are in place, which can be a long-term process. Recently, the World Bank work in Turkey has produced a Corporate Bond report, supported the drafting of new rules under the new Capital Markets Law, and produced a Mutual Fund and Pension Funds report to support regulators and market players in strengthening Turkey's non-bank financial sector. The World Bank is also providing support to Turkey's treasury to lengthen the yield curve of government bonds.

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## II. Project Development Objectives

The Project Development Objective (PDO) is to improve access to medium and long-term finance for small and medium enterprises through lease financing.

## III. Project Description

### Component Name

A credit line to Ziraat to be on-lent for intermediation through PFIs to SMEs

## IV. Financing *(in USD Million)*

| For Loans/Credits/Others | Amount |
|---|---|
| Borrower | 75.00 |
| International Bank for Reconstruction and Development | 300.00 |
| Total | 375.00 |

## V. Implementation

Ziraat Bank (the Borrower) will be responsible for implementation of the project and was selected based on its experience with SMEs and the World Bank. Ziraat Bank, a public sector bank with a lending portfolio of about US$40 billion, has extensive experience in offering credit to SMEs in all regions of Turkey, based on its strong branch presence and focus on the SME sector. Additional criteria for selecting Ziraat Bank included the bank's financial soundness, the performance of its credit portfolio, and its good performance as one of the Borrowers in the ongoing SME II credit line project financed by the World Bank.

The Project Implementation Unit (PIU) at Ziraat Bank is staffed with capable and qualified personnel for the implementation of the project and an action plan has been agreed upon with Ziraat Bank to bring implementation arrangements to a satisfactory level by effectiveness. The PIU will operate under the overall supervision of a Deputy General Manager. Its responsibilities will include: (i) selection of and on-lending to PFIs; (ii) monitoring of PFIs to ensure compliance with project criteria; (iii) responsibility for adherence to all fiduciary and safeguard requirements of the World Bank for final borrowers; and (iv) monitoring and evaluation based on key project development indicators.

PFIs will be selected by Ziraat Bank (subject to the World Bank's no objection) based on their financial health, as well as their capacity to implement sub-projects. The eligibility criteria for PFIs' creditworthiness and internal operating practices and procedures will be determined by the World Bank in close collaboration with Ziraat Bank. Ziraat Bank takes the credit risk of PFIs and therefore has a strong incentive to carefully assess their financial health and operational capabilities. The PFI selection is also subject to a no-objection process by the Bank team, while Subsidiary Loan Agreement covenants between Ziraat Bank and PFIs require compliance with local regulations thereby supporting continued financial health. PFIs in turn make sub-loans to any SMEs based on eligibility criteria, terms and conditions agreed with the Bank. Each PFI will be allocated maximum US$60 million. If PFIs do not effectively implement the project, their allocation can be re-allocated to other PFIs.

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## VI. Safeguard Policies (including public consultation)

| Safeguard Policies Triggered by the Project | Yes | No |
|---|---|---|
| Environmental Assessment OP/BP 4.01 | × | |
| Natural Habitats OP/BP 4.04 | | × |
| Forests OP/BP 4.36 | | × |
| Pest Management OP 4.09 | | × |
| Physical Cultural Resources OP/BP 4.11 | | × |
| Indigenous Peoples OP/BP 4.10 | | × |
| Involuntary Resettlement OP/BP 4.12 | | × |

| | | |
|---|---|---|
| Safety of Dams OP/BP 4.37 | | × |
| Projects on International Waterways OP/BP 7.50 | | × |
| Projects in Disputed Areas OP/BP 7.60 | | × |

## VII. Contact point

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