

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC4158

Project Name	Frontier Finance (P147183)
Region	EUROPE AND CENTRAL ASIA
Country	Turkey
Sector(s)	SME Finance (100%)
Theme(s)	Micro, Small and Medium Enterprise support (100%)
Lending Instrument	Investment Project Financing
Project ID	P147183
Borrower(s)	Türkiye Sınai Kalkınma Bankası A.Ş. (TSKB)
Implementing Agency	Türkiye Sınai Kalkınma Bankası A.Ş. (TSKB)
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared/ Updated	10-Mar-2014
Date PID Approved/ Disclosed	15-Apr-2014
Estimated Date of Appraisal Completion	25-Apr-2014
Estimated Date of Board Approval	15-Jul-2014
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

1. Turkey's economic development over the past decade has resulted in impressive economic achievements, yet both domestic and external imbalances remain. After a banking crisis in 2001, the country embarked on a concerted path of structural reforms supported by strong fiscal consolidation, strengthened banking supervision, and a shift to a flexible exchange rate regime with an independent central bank responsible for inflation targeting. Per-capita income subsequently almost tripled in less than a decade, and Turkey is now an upper middle-income country with the world's 18th largest economy. While the economy entered an overheating period driven by loose global liquidity conditions, the policy makers achieved a soft-landing and rebalancing of the economy in 2012, resulting in an increase in the country's sovereign rating to investment grade level. Economic growth recovered in 2013, driven by strong domestic demand. The current account deficit reached 7.9 percent of GDP at end 2013, up from 6.2 percent in 2012. In line with this, annual inflation increased to 7.4 percent, exceeding the official target of 5 percent.

2. Turkish financial markets have come under severe pressure following the emergence of corruption allegations against high government officials on December 17th. The lira depreciated by almost 18 percent against the dollar since December 17th, and reached a record low on January 27th. Together with the weakening of the currency since the Fed's tapering message in May 2013, the lira is down almost 29 percent. The main equity price index eased by 16.2 percent following the start of the corruption probe, and the benchmark (2-year) government bond yield surged by 200bps in the same period to 11 percent in January 2014, up from a record low of 4.8 percent in May 2013. Meanwhile, non-residents' holdings of debt securities and equities reduced to US\$104 billion as of January 17th, down from US\$114 billion on December. The Central Bank of the Republic of Turkey (CBRT) delivered a strong tightening and returned to a conventional monetary framework in response to excessive exchange rate volatility and elevated inflation. Following the decision, the lira appreciated by almost 7 percent against the dollar and the average cost of CBRT funding to the banking sector rose by 360bps to 8.4 percent on January 29th.

3. Looking ahead, Turkey may have to settle for a period of modest growth, with external financing and the corporate sector's large foreign exchange position as the main risks. Turkey's external financing needs over the coming five years are high due to a large current account deficit. In addition, the composition of financing remains a critical concern. With higher global interest rates and another round of risk re-pricing making external financing dearer, Turkey may be able to finance a current account deficit of about 6.5 percent of GDP in line with a growth rate of close to 4 percent in the medium term. Meanwhile, inflation is projected to ease towards the official target of 5 percent, helping to limit real exchange rate appreciation. Under a scenario of prolonged political crisis, a corresponding loss of confidence and a sudden stop of capital inflows, Turkey could possibly face a sharp GDP contraction similar to the one during the 2008-2009 global crisis. Continuation of the lira depreciation could also cause severe losses to corporates with large foreign exchange exposures, which in turn could have spill-over effects on the banking sector.

Sectoral and Institutional Context

4. Small and Medium Enterprises (SMEs) play an important role in the Turkish economy, yet face significant access to finance issues and are the first casualties of financing pressures. SMEs are estimated to account for 99.9 percent of all enterprises, 76 percent of employment, 54 percent of investments, and 63 percent of exports. The last Investment Climate Assessment -From Crisis to Private Sector Led Growth (May 2010)- found strong evidence that SMEs face disproportionately severe constraints in accessing finance. Lack of cash flow based financing and high collateral requirements acutely constrain their access to funding. Overall, they receive only 25 percent of total loans and grow slower relative to both large enterprises in Turkey and SMEs in comparison countries. Notably, their share in total credit declined in the aftermath of the global crisis by about 5p.p. to just over 20 percent in 2009, the sharp fall demonstrating how SMEs are among the first and most affected casualties of a financing crunch.

5. The Turkish financial sector lacks the depth one would expect given the size of the economy, and a bank dominated system offers limited access to alternative means of finance. Financial markets increased almost six fold, from TL461 billion in 2003 to about TL2,779 billion in December 2013. Despite such growth, total financial system assets amounted to just 158 percent of GDP in 2012, whereas emerging market economies average stood at about 190, and newly industrialized Asian economies at 611. Banks represent 86 percent of the financial sector and about 97 percent of GDP (with banking sector credit and deposits at 53 and 54 percent of GDP, respectively). The banking system remains highly-capitalized (CAR of 15.3 percent as of December 2013) and profitable (ROA

and ROE of 1.6 percent and 14.2 percent, respectively), with a significant improvement in asset quality (NPL ratio of 2.7 percent in December 2013, after reaching 5 percent in 2009). Nevertheless, maturity mismatches prevent banks from offering long-term lending to the corporate sector, and particularly to SMEs, which is mostly below 3 years. Characteristically, the maturity mismatch of banks becomes acute beyond the 3 months, with the liquidity gap being the widest for loans of 1 to 5 years. Access to funding for SMEs is even more constrained due to their inability to meet tighter credit standards and because of the small presence of non-bank funding. Among the non-bank financial sector, 39 percent represents leasing, 35 factoring, 23 finance companies, and 3 percent accounts for asset management companies.

6. Islamic finance and factoring can provide attractive alternatives to mainstream bank loans to SMEs. Shariah compliant finance is based on the principles of risk-sharing and asset backing (a component of trade) rather than risk-transfer (as seen in conventional banking) – see Annex 3 for more details, including structures to be followed under the proposed Loan. The sector focuses mainly on SMEs and, in the case of Turkey, it can help widen and deepen access to finance by including parts of the population open only to Sharia compliant instruments. Notably, participation banking emerged stronger after the 2001 crisis and the 2008/09 global financial crisis. In factoring, the enterprise sells its receivables in the form of an invoice to the factor that makes a partial advance of the purchase price of the receivable amount. As such, factoring can be an important cash management tool and source of working capital. Factoring is particularly important for SMEs, as it takes advantage of the characteristics of value chain production by advancing funds to smaller firms that sell goods to larger more creditworthy organizations. The sector provides funds mostly to SMEs and to commercial institutions searching for alternative finance sources due to lending constraints in the banking sector (maturities, interest rates, collateral requirements, etc.). Both participation banks and factoring companies are regulated by the Banking Regulation and Supervision Agency (BRSA).

7. Nevertheless, Islamic finance and factoring are still small contributors relative to mainstream banks, and can benefit from access to longer-term financing. There are currently four participation banks with a market share of only 5 percent of the total banking sector. The sector is well capitalized and profitable (CAR of 14.1 percent, and ROA and ROE of 1.3 and 14 percent, respectively), and enjoys high asset quality (NPL ratio of 3.4 percent) as of December 2013. Factoring, on the other hand, represents only 1 percent of Turkey's financial system, with a total of 79 factoring companies. The sector is also well capitalized and profitable (CAR of 18.5 percent, and ROA and ROE of 9.1 and 48.8 percent, respectively), with high asset quality (NPL ratio of 4.8 percent). Factoring receivables account for US\$9 billion, with a total annual turnover of US\$43 billion. The factoring volume is dominated by domestic business at 82 percent, pointing to a big gap and potential in exports that demands longer maturities by nature. Both sectors would value the security of access to longer term funding, just as SMEs would benefit from longer tenors in Islamic finance instruments and higher volumes of international factoring.

8. The Government has been taking significant steps to increase the role of such frontier finance, in many instances with the support of the World Bank. The “Leasing, Factoring, and Financing Companies” Law was passed in 2012, supported by the World Bank's “Competitiveness and Savings” Development Policy Operation (DPO, P127787), while a parallel World Bank line of credit (SME III, P130864) focused exclusively on supporting lease finance. The government has been working on secondary legislation that will also be supported by the “Sustaining Shared Growth” DPO (P146322) under preparation. The Law provides a stronger legal framework for factoring by introducing international standards and definitions, strengthened capital requirements,

related party lending rules, enhanced accounting standards and transparency, as well as a centralized factoring billing system. In addition, the new credit bureau reform envisaged the establishment of a new credit registry that became fully operational in July 2013. The new credit bureau, established under the Bankers Association, aims to improve the depth of credit information, with non-bank financial intermediaries also being members and providing information. Overall, it is expected to help the non-bank financial institutions to grow and improve SME's access to finance. Finally, the government has announced its aim to raise the share of the Islamic finance sector to 15 percent by 2023. It passed a new sukuk law on June 2013 that is set to bolster the growth of Turkey's Islamic capital market, and plans for two state-owned banks to start Islamic operations in 2014.

9. The World Bank has been working through various channels to support SMEs, with TSKB being a key player and valuable partner in these efforts. Over the past ten years, the World Bank has provided 12 credit lines, amounting to over US\$4 billion in commitments. TSKB has been a key partner of the World Bank through five lines of credit and as the only private Investment and Development bank in Turkey (see Section C and Annex 4). Overall, the 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 and the projects have operated through the banking sector. 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 report to support regulators and market players in strengthening Turkey's non-bank financial sector.

10. The World Bank has also begun initiatives to specifically support Islamic finance, recently launching the Global Islamic Finance Center (GIFC) in Istanbul with the Government's support. This followed the establishment of the Islamic Finance Working Group (IFWG) in 2009, which formed partnerships with key stakeholders in the Islamic finance industry and focused on: (i) strengthening the legal, regulatory and institutional foundations for Islamic finance; and (ii) knowledge sharing and capacity building. The GIFC was established in 2013 with financial support from the Government of Turkey and other Turkish donors (based on an initial USD2.5 million trust fund). It is located in the premises of Borsa Istanbul and aims to contribute to the development of Islamic finance globally, through research, training and advisory services to World Bank clients.

Relationship to CAS

11. The project is consistent with and supports the Country Partnership Strategy (CPS) for the FY12-15 period, endorsed by the World Bank's Executive Board on March 27, 2012. The CPS has three main strategic objectives and pillars: (i) enhanced competitiveness and employment; (ii) improved equity and public services; and (iii) deepened sustainable development. The project supports the strategic objectives of enhancing competitiveness and employment. The project is also complimentary to other private and financial sector initiatives, including: (i) the Competitiveness and Savings DPO that supported the new leasing law; (ii) Financial Sector Development TA that aims to support the development of the non-bank financial sector; and, (iii) ongoing lines of credit operations (EFIL IV, SME III and SME Energy Efficiency) that aim to provide medium to long-

term finance to SMEs and exporters. In particular the proposed operation is a natural continuation of SME III (P130864) that focused exclusively on leasing as a venue to alternative finance for SMEs.

12. The project is also consistent with the Government's latest SME Strategy and Action Plan, as well as the tenth National Development Plan (NDP). Access to finance was one of the five strategic areas under the 2011-13 SME Strategy, and a key provision of the 2007-13 NDP. The new five-year NDP was adopted by the Government of Turkey and presented to Parliament in July 2013 and covers the period 2014 to 2018. The new NDP includes actions and provisions on improving SME's access to bank loans, venture capital, and capital markets under the "Entrepreneurship and SMEs" and the "Financial Markets" sections.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

13. The Project Development Objective (PDO) is to improve access to longer term finance for small and medium enterprises through Islamic finance and international factoring.

Key Results (From PCN)

14. PDO indicators will be developed during project preparation, but are expected to include the following: (i) Ratio of the average maturity of Islamic finance sub-loans financed under the project, over the Islamic finance PFIs' average maturity of SME portfolio; (ii) Ratio of international factoring sub-finance in the factoring portfolio financed under the project, over the factoring PFIs' equivalent metric of the factoring portfolio not financed under the project; and (iii) Number of SME beneficiaries financed by PFIs under the project.

15. Key intermediate indicators and additional indicators, monitored for analytical purposes and aimed to help improve SME related policies and projects will also be developed.

III. Preliminary Description

Concept Description

16. Two project components will provide US\$250 million to be intermediated by TSKB through participation banks and factoring companies targeting SMEs. Component 1 will focus on Islamic finance and Component 2 will focus on factoring. The credit line, guaranteed by the Turkish government, will be intermediated by TSKB, which will be the Borrower and implementing agency for this project. TSKB will in turn on-lend funds through PFIs, which can be participation banks and factoring companies. TSKB will select PFIs pursuant to criteria agreed between TSKB and the World Bank, and subject to no objection by the World Bank. The selected PFIs will in turn make sub-finance to private SMEs, the final beneficiaries of the credit line. The PFIs will assume the credit risk of the sub-borrowers who will be selected based on agreed upon selection criteria. TSKB will have exposure only to the selected PFIs and will assume the credit risk for lending funds to PFIs. There will be no sectoral restrictions and credit will be extended on market terms to avoid any distortion. In the case of Islamic finance (see Annex 3 for details), preliminary talks point to a Wakala structure –an agency contract under which the participation bank finances the SME on behalf of TSKB. The participation bank acts as an agent for TSKB, investing on its behalf and offering a guarantee (a Kafalah agreement) to pay back TSKB in case the SME fails to repay its obligations. Nevertheless, the option of a Murabaha structure is also a possibility – the transfer of funds from TSKB to the PFI is achieved through commodity based buy and sell transactions. Any accepted structure will have to be in accordance to the PFI's Sharia board approval.

17. Project preparation will include detailed definition of eligibility criteria, and terms and conditions: (i) the Loan terms and conditions between the World Bank and TSKB; (ii) the eligibility criteria for the PFIs that will be financed by TSKB, and the terms and conditions of subsidiary loans between TSKB and PFIs; (iii) the eligibility criteria for the SMEs that will be financed by PFIs, and terms and conditions of sub-finance between PFIs and SMEs.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01	x		
Natural Habitats OP/BP 4.04		x	
Forests OP/BP 4.36		x	
Pest Management OP 4.09		x	
Physical Cultural Resources OP/BP 4.11	x		
Indigenous Peoples OP/BP 4.10		x	
Involuntary Resettlement OP/BP 4.12		x	
Safety of Dams OP/BP 4.37		x	
Projects on International Waterways OP/BP 7.50		x	
Projects in Disputed Areas OP/BP 7.60		x	

V. Financing (in USD Million)

Total Project Cost:	250.00	Total Bank Financing:	250.00
Financing Gap:	0.00		
Financing Source			Amount
Borrower			0.00
International Bank for Reconstruction and Development			250.00
Total			250.00

VI. Contact point

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