I. Introduction and Context

Country Context

Turkey’s macroeconomic policies and structural reforms over the past decade have yielded robust economic growth, while recent sovereign rating revisions reflect a favorable outlook. Real GDP increased by 68 percent between 2001 and 2011. Growth resumed rapidly after the 2008-2009 global crisis, growing at 9 percent in 2010, 8.5 percent in 2011 and 2.9 percent in the second quarter of 2012. Public sector primary balance averaged about 2.9 percent of GDP over 2004-2011 and gross public debt as a percentage of GDP fell from 73.4 percent in 2002 to 39 percent in 2011, in spite of a moderate increase during the 2008-2009 global crisis. Inflation came down from a high of around 70 percent in 2001 to around 10 percent in 2011 and was 7.8 percent as of October 2012. On the back of strong reserve build up, improvements in the country’s prospects were also signaled by upgrades post-2008 and outlook revisions by all the main credit rating agencies. In September 2011, S&P raised Turkey’s local-currency rating by one notch to BBB-. In June 2012, Moody’s upgraded Turkey’s sovereign credit rating to Ba1 with positive outlook, and in November 2012 Fitch upgraded Turkey’s sovereign debt rating to investment grade status with stable outlook, reflecting
the country’s moderate and declining government debt burden, a sound banking system, favorable medium-term growth prospects and a relatively wealthy and diverse economy.

Sectoral and Institutional Context

Small and Medium Enterprises (SMEs) play an important role in the Turkish economy, but face significant access to finance issues. SMEs in Turkey represent 99 percent of all enterprises, 78 percent of employment, 52 percent of wages, and were responsible for 60 percent of total exports in 2011. However, Turkish SMEs are growing more slowly than both large enterprises in Turkey and SMEs in comparator countries. Access to finance is perceived as the single most severe obstacle to growth by SMEs according to the 2008 enterprise survey conducted by the World Bank. Their share in total credit declined in the aftermath of the global crisis by about 5 percentage points to little over 20 percent in 2009, but recovered to 23 percent as of 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 Turkish banking sector has proven resilient to the effects of the global credit crisis, but its limited access to long-term finance prevents maturity matching for corporate lending in general and SMEs in particular. Despite a relatively large number and variety of non-bank financial institutions, banks still represent 86 percent of the Turkish financial sector. The system remains highly-capitalized (CAR of 16.5 percent as of June 2012) and profitable (ROA and ROE of 2.4 percent and 19.8 percent, respectively), with a significant improvement in asset quality (NPL ratio of 2.5 percent in June 2012, after reaching 5.0 percent in 2009). Nevertheless, maturity mismatches prevents banks from offering long-term lending. As of September 2012, nearly 90 percent of bank deposits, which constitute about two thirds of total non-equity liabilities, had a maturity of less than three months. This is mirrored in the funding to the corporate sector, and particularly to SMEs, which is short-term and hinders competitiveness. Access to long term funding for SMEs is even more constrained due to their inability to meet tighter credit standards (higher interest rates, increased requests for collateral, etc.) and because of the small presence of non-bank funding, such as public start-up funds, business angel networks, microfinance facilities, venture capital, private equity funds etc.

The fairly well developed leasing and factoring sectors in Turkey can provide attractive alternatives to bank loans for SMEs, but are still small relative to banks. Leasing enables the use of capital equipment in particular for new/young enterprises without credit track record and with limited possibilities to provide collateral, while factoring’s key virtue is that underwriting is based on the risk of the receivables (i.e. the buyer) rather than the risk of the seller, being particularly well suited for financing obligations of buyers who are more creditworthy than the sellers themselves. Currently, 36 leasing companies operate in Turkey with a leasing portfolio estimated at 7.9 percent of GDP in 2011. The portfolio is concentrated mainly on machinery and equipment. The new leasing law which was enacted in December 2012 opened up the space for new kinds of leasing services such as operational leasing, subleasing, software leasing, sale and lease back. Factoring represents 1.1 percent of Turkey’s financial system, with 76 factoring companies. The sector provides fund 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.).

During the past ten years, the World Bank has provided 11 credit lines to Turkish banks, amounting to some US$4 billion in commitments. These projects have focused on providing financing to exporters (4 projects - EFILs, US$1.75 billion), SMEs (2 projects, US$1.2 billion), and energy sector enterprises (2 projects, US$1.1 billion) – for details please see PCN attachment. The World
Bank has made direct loans to state and private banks—with the Turkish Treasury providing guarantees—who then on-lend the funds to enterprises either directly or through subsidiary Participating Financial Institutions (PFIs). The funds are on-lent to enterprises at market determined rates with maturities averaging 4-5 years, and go to finance working capital, investment and equipment leasing needs. In most cases, the main development objective of these projects has specifically centered on the goal of providing medium and long term finance to enterprises in these sectors.

Recognizing the importance of continually strengthening its financial sector interventions, the World Bank has recently engaged the Turkish Treasury and other IFIs in an impact evaluation exercise of Lines of Credit. Existing IEG Reviews of ICRs for the EFIL I, II and III series rate outcomes as Satisfactory, Highly Satisfactory and Highly Satisfactory respectively (the SME I ICR is currently under preparation). In addition, the 2011 study “EFIL and SME Credit line project: an assessment of outcomes” conducted a survey of final borrowers, some 400 EFIL and SME beneficiaries and 200 control firms. It concluded that they were successful in targeting the medium-to long-term working capital and investment finance needs of exporters and SMEs. A high proportion of SMEs in particular, cited the availability of longer-term financing as the key benefit of participation, and expressed overall high satisfaction with the credit lines. The latest impact evaluation under discussion with the Turkish Treasury and other IFIs is being designed in parallel to the proposed line of credit.

Relationship to CAS

The proposed project is fully in line with Turkey’s Country Partnership Strategy (CPS). The 2012-2015 CPS specifically calls for improving SMEs’ access to longer-term funding and an enhanced capacity of intermediaries to lend under longer maturities profiles.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The main Project Development Objective (PDO) is to enhance access to medium and long term finance for SMEs.

Key Results (From PCN)

PDO indicators will be developed in close coordination with the Impact Evaluation exercise. In addition to the quality of the portfolio financed under the project, they will include, but will not be limited to changes in the SME lending portfolio profile of PFIs (such as the maturity of subloans) and changes in the client profile of PFIs (such as the number of SMEs).

III. Preliminary Description

Concept Description

The proposed lending instrument is a US$300 million wholesale investment loan to Ziraat Bank, which will be intermediated through private retail banks. The wholesale credit line, guaranteed by the Turkish government (for a guarantee fee), will be intermediated by Ziraat Bank, which in turn will on-lend funds through Participating Financial Intermediaries (PFIs), which can be commercial banks and leasing companies. The selected PFIs will in turn make sub-loans to private SMEs, the final beneficiaries of the credit line. For the purpose of this project, in line with Government policy, SMEs will be defined as firms employing fewer than 250 people and having annual turnover of less than TL 40 million. The PFIs will assume the credit risk of the sub-borrowers who will be selected
based on agreed selection criteria. In accordance with the requirements of OP 8.30 (currently being updated), credit would be extended on market terms to avoid any distortion. Ziraat Bank has set up a PIU to manage the project including the selection of PFIs, monitoring and reporting.

With a view to broaden the impact of the IBRD financing, the team is in discussions with the authorities to incorporate in the project design the following features, which are not included in existing lines of credit:

- Leverage Bank resources by instituting minimum project co-financing requirements. This will increase the amount of funding available to SME clients during the lifetime of the project. Current discussions focus on whether co-financing will take place at the level of the wholesaler or the PFIs, and on what the minimum co-finance percentage should be. Both decisions are critical, as there is a potential trade off between increased outreach at the expense of higher cost and shorter maturity for the ultimate beneficiary, as IBRD low-cost long-term funding is blended with other resources. In addition, co-financing at the PFI level may pose significant monitoring challenges. The appropriate level of co-financing will be finalized during project preparation.

- Require the use of project reflows to be channeled for similar purposes under similar conditions for an additional cycle under the wholesale model. Under this practices, Ziraat would re-intermediate the reflows under the project through PFIs to SMEs for the same purposes. In order to ensure the reflows are processed at least once by Ziraat Bank, the Bank team would require Ziraat Bank management to certify the same in writing.

Ziraat Bank was selected as a wholesaler by the government for its geographic coverage and 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 the SMEs in all regions of Turkey thanks to a strong branch presence and focus on the SME sector. Additional criteria for selecting Ziraat Bank included the bank’s financial soundness, 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.

IV. Safeguard Policies that might apply

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V. Tentative financing
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### VI. Contact point

#### World Bank

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#### Borrower/Client/Recipient

Name: T.C. Ziraat Bankasi A.S. (Ziraat Bank)  
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Email:

#### Implementing Agencies

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