I. Project Context

Country Context

Turkey is the 17th largest economy in the World, with a GDP of US$772 billion in 2011. Private consumption accounts for more than 70 percent of GDP and it is the main driver of the economic growth while exports only make up 23 percent of GDP. Domestic savings are very low (14.5 percent of GDP) and thus economic growth is dependent on external financing, most of which is of a short-term nature thus increasing the risk of volatility. The economy is based on services which constitute 55 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 has been declining as Turkey has been urbanizing rapidly; and it accounted for 8 percent of GDP in 2011.

Turkey’s development over the past decade is a story of notable turnaround thanks to successfully implemented structural reforms and sound macroeconomic management following the 2001 banking crisis. Reforms include strong fiscal consolidation, strengthening banking supervision, reforming the social security system and a shift to the flexible exchange regime with an independent central bank that is responsible for inflation targeting. These reforms yielded results in the years after 2001. The financial sector remained profitable and highly capitalized. Despite the global crisis of 2008-2009, the Turkish economy expanded by an average of 5.5 percent during the 2002-2011 period. During the same period, per capita income more than tripled and reached US $10,444 in 2011; inflation declined to single digit levels and the gross public debt to GDP ratio
eased from 73.4 percent in 2002 to 42.2 percent to 2011.

Turkey was hit hard by the global crisis with its GDP shrinking by 4.8 percent in 2009, but bounced back quickly, much faster than other countries in the region. The economy expanded by 9.2 percent and 8.5 percent respectively in 2010 and 2011. However the strong recovery in economic growth was mostly domestic demand driven, linked to high credit growth, and coupled with higher energy prices, it caused a significant worsening in external balances and a rise in inflation. As a result the current account deficit to GDP ratio widened from 6.4 in 2010 to 10.0 percent in 2011 while net energy imports increased to 6.2 percent of GDP in 2011 from 4.6 percent of GDP in 2010. Consumer prices increased by 10.5 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 tightening policy measures since mid-2011 thus increasing funding costs.

On the back of a soft landing and significant economic rebalancing, Fitch rating 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 the first nine months of 2012, GDP expanded by 2.6% over the same period of last year, down from 2011’s 8.5% as a result of the slowdown in domestic demand. 2012 GDP growth is expected to be reported at around 3 percent and the current account deficit is expected to ease to 7.1 percent of GDP, from 10 percent in 2011, while inflation has come down to 6.4 percent in November 2012. Nevertheless, Turkey’s external financing remains its key weakness and the financing quality remains a concern. The main driver of the improvement in the current account deficit this year has been real export growth, driven by export diversification and facilitated by a significant nominal currency depreciation against the US Dollar. FDI and other long-term inflows only accounted for 20 percent of financing as of October 2012.

II. Sectoral and Institutional Context

The reforms undertaken after the 2001 crisis allowed the Turkish financial system to come through the global financial crisis relatively unscathed. Supportive measures taken by the Turkish authorities, rapid rebound in capital inflows and economic activity also played role in the Turkish banking sector withstanding the impact of the global crisis. In recent years, additional capital buffers built and strengthened banking regulation and supervision, has led to the emergence of a more resilient, stable and profitable banking sector. The system has historically relied mostly on a stable domestic deposit base for funding and remains liquid. The Turkish Banking system remains highly-capitalized (Capital Adequacy Ratio or CAR of 16.5% as of October 2012) and profitable (Return On Assets or ROA and Return On Equity or ROE of 1.53% and 13.8%, respectively), with a significant improvement in asset quality (Non-Performing Loan ratio of 2.9% in June 2012, after reaching 5.0% in 2009). Turkey successfully implemented the BASEL II requirements which were expected to cause a decline in capital adequacy ratios because of the increased risk weights. However, even after this, Turkey still has the second highest capital adequacy ratio among G-20 countries after Indonesia.

The financial sector is expected to be a continued source of macroeconomic strength, but remains shallow. The largest share in the financial sector belongs to the banking sector with 87.9 percent. Banking sector assets increased from 63 percent of GDP in 2005 to 93 percent as of September 2012. This ratio is quite low when compared to EU-27 average of 354 percent and shows the growth potential of the Turkish Banking sector. In spite of the significant growth during the last decade Turkey’s domestic financial system still lacks depth and breadth for an economy of Turkey’s size, with total banking sector credit accounting for 58 percent, and deposits for 56 percent of GDP.
Following an expansion in bank lending after 2009, credit growth started to slow down in the third quarter of 2011 in line with the economic rebalancing and slow down in the economy. Credit growth decelerated from 29.9 percent in December 2011 to 14.3 percent in September 2012 due to the monetary and prudential tightening measures taken by authorities. Uncertainties regarding the global growth outlook and problems in the EU economy adversely affected domestic economic activity in the third quarter of 2012, thus weakening production and investments and bringing about a relatively faster deceleration in business loans and especially in the loans to small and medium sized enterprises (SMEs).

SME Sector Context:

SMEs play a very important role in the Turkish economy owing to their crucial role in generating income and employment. The last Investment Climate Assessment—From Crisis to Private Sector Led Growth (May 2010)—found that there are strong indications that SMEs are disproportionately burdened by business regulations, face severe access to finance constraints, and seem to lack the ability to adopt and use the knowledge needed to make them and, ultimately, the entire Turkish economy more competitive internationally. SMEs play an important role for the economic development of Turkey since 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, 59 percent of exports yet only receive 22.8 percent of total loans. The Turkish government has committed itself to a significant array of programs aimed at making industrial SMEs more competitive, more capable of applying modern technologies to improve production processes, and more effective exporters. One of the major priority areas for SME policies has been access to finance.

After being severely underserved in the aftermath of the 2008 global financial crisis, SMEs have been making inroads in gaining access to credit. While the largest proportion of loans (45 percent) is being allocated to corporate clients, SME credit accounts only for 22.8 percent of total banking sector credit (from a low of 21 percent in 2009). Nevertheless, while SMEs are usually in the market for medium- and long-term financing, banks do not usually have adequately structured resources to offer them, mostly as a result of the short-term maturity structure of their liability base, thus leaving SMEs open to severe liquidity and interest rate risk, as evidenced by the events in the aftermath of the global financial crisis when major banks significantly cut their exposures to SMEs in a matter of weeks. In addition, lack of cash flow based financing (especially in the SME segment) and high collateral requirements further constrain access to finance to SMEs.

Market barriers still exist for scaling up financing to EE investments, especially in SMEs. These include; (a) Lack of knowledge among banks and SMEs about EE opportunities, project performance and risks; (b) High transaction costs for small SME EE investments; (c) Financing constraints due to high collateral requirements; (d) Limited institutional capacity in market to identify, prepare bankable EE projects.

The ESCO model has also been unable to gain traction within the Turkish market to date. ESCOs have, in many countries, proven to be an effective way of facilitating EE investments, including in emerging sectors and new technologies. ESCOs can provide a “one stop shop” solution to project owners, allowing them to effectively outsource the project from energy audit and development through implementation and monitoring. In some cases the ESCOs are also able to arrange or
facilitate financing for the project. In order to promote the ESCO market, MENR has in recent years certified some 38 ESCOs under its accreditation program, mostly related to technical training. However, to date, none have undertaken actual ESCO projects and several have indicated they are unlikely to seek accreditation renewal. The only ESCO project reported is with an international ESCO for a large shopping mall in Istanbul. One main reason for this situation is the limitations of ESCO models being promoted in Turkey today, namely the Shared Savings and Guaranteed Savings models. The numerous small local ESCOs do not have sufficient balance sheets to take on the debt under a Shared Savings model, and lack a demonstrated track record and financial means to offer a credible performance guarantee under the Guaranteed Savings model. The slow uptake of ESCO models in Turkey as well as experience from other countries suggest that in order to strengthen the ESCO market in Turkey, it would be important to both broaden the range of ESCO models being promoted in Turkey today, as well as bring in other types of local companies (e.g., leasing firms, equipment suppliers, construction firms) into the ESCO market.

Higher Level Objectives to which the Project Contributes:

The project is consistent with the Country Partnership Strategy (CPS) for the FY12-15 period, approved by the World Bank’s Executive Board on March 27, 2012. The CPS has three main strategic objectives and pillars: Strategic Objective 1 - enhanced competitiveness and employment; Strategic Objective 2 - improved equity and public services; and Strategic Objective 3 - deepened sustainable development. The project will support the Strategic Objectives 1 and 3. EE reduces firm operating costs and infrastructure bottlenecks thus improving their competitiveness. The improvement in the efficiency of energy consumption would also control the growth of demand and import of energy, thus contributing to the improvement in the current account deficit. The project would also enable SMEs to have access to longer term credit. EE has been identified in Turkey’s first National Communication to the United Nations Framework Convention on Climate Change (UNFCCC), the National Climate Change Strategy and Action Plan, and other government programs, as a crucial component for energy security and climate change mitigation in Turkey.

III. Project Development Objectives
The Project Development Objective (PDO) is to improve the efficiency of energy use in small and medium enterprises, by scaling-up commercial bank lending for energy efficiency investments. The global environmental objective is to reduce GHG emissions through the removal of barriers to EE financing in the SME sector.

IV. Project Description
Component Name
Component 1: Energy efficiency investments in SMEs
Component 2: Policy support and TA to GDRE

V. Financing (in USD Million)

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<th>For Loans/Credits/Others</th>
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<td>BORROWER/RECIPIENT</td>
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<td>International Bank for Reconstruction and Development</td>
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<td>Global Environment Facility (GEF)</td>
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<td>Sub-borrower(s)</td>
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VI. Implementation
The project has two major components – Component 1: Energy efficiency investments in SMEs; and Component 2: Policy support and TA to (General Directorate of Renewable Energy) GDRE.

In Component 1, credit lines will be provided to three FIs, Halkbank, VakifBank, and Ziraat Bank to lend for EE improvements in SMEs. The Project has identified target key, energy-intensive SME subsectors and common technical retrofits in each of these subsectors which can be replicated under a streamlined appraisal method. These measures help address the issue of transaction cost. Based on the market assessment conducted during project preparation, and as agreed with the three FIs, target subsectors will include: machinery and equipment, metal products, food and beverage, textiles, trade and services, pulp and paper, and hotels and other commercial buildings—although other sectors will also be eligible for financing. Based on this information, an ESMAP-supported EE screening tool was developed to assist the three FIs conduct initial assessments of potential EE subprojects and determine project eligibility with the agreed criteria while lowering transaction cost for smaller loans.

Further TA will be provided through Component 2 to support ongoing policy dialogue on EE, enhance the enabling environment, and foster broader EE market development in Turkey. Given the vast investment potential and limited size of the credit line, efforts will be made to broaden the market in three main areas, namely: (a) awareness and information dissemination on energy efficiency opportunities and sharing experience from the credit line; (ii) policy and market support for energy efficiency financing and ESCO development; and (iii) institutional support to GDRE to support its EE policy and programs.

VII. Safeguard Policies (including public consultation)

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<th>Safeguard Policies Triggered by the Project</th>
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<tr>
<td>Environmental Assessment OP/BP 4.01</td>
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<td>Forests OP/BP 4.36</td>
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<td>Projects on International Waterways OP/BP 7.50</td>
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<td>Projects in Disputed Areas OP/BP 7.60</td>
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