

**REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
BOARD OF DIRECTORS
ON A
PROPOSED LOAN
AND TECHNICAL ASSISTANCE GRANT
TO THE REPUBLIC OF UZBEKISTAN
FOR THE
SMALL AND MICROFINANCE
DEVELOPMENT PROJECT**

November 2002

CURRENCY EQUIVALENTS

(as of 14 November 2002)

Currency Unit	–	sum
Sum1.00	=	\$0.00114
\$1.00	=	Sum880.55

ABBREVIATIONS

ABW	–	Association of Business Women
ADB	–	Asian Development Bank
BSLD	–	Banking Supervision and Licensing Division
CADR	–	capital adequacy ratio
CBU	–	Central Bank of Uzbekistan
COS	–	country operational strategy
EBRD	–	European Bank for Reconstruction and Development
FAO	–	Food and Agriculture Organization
FCSDCU	–	Financial Company for the Support and Development of Credit Unions
FSDA	–	Financial Sector Development Agency
GDP	–	gross domestic product
IAS	–	International Accounting Standards
IMF	–	International Monetary Fund
ISA	–	International Standards of Auditing
JECF	–	Japan-Europe Cooperation Fund
MFI	–	microfinance institution
MOF	–	Ministry of Finance
MSEs	–	micro and small enterprises
NACU	–	National Association of Credit Unions
NGO	–	nongovernment organization
NPL	–	nonperforming loan
PCB	–	participating commercial bank
PPTA	–	project preparatory technical assistance
SCUs	–	savings and credit unions
SMDP	–	Small and Microfinance Development Project
SMEs	–	small and medium enterprises
SMP	–	Staff Monitored Program
SOE	–	statement of expenditure
SSTA	–	small-scale technical assistance
TA	–	technical assistance
UNDP	–	United Nations Development Programme
USAID	–	United States Agency for International Development
WHO	–	World Health Organization
WOCCU	–	World Council of Credit Unions

NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

This report was prepared by a team consisting of R. Narasimham (Team Leader) and A. Chi.

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LOAN AND PROJECT SUMMARY

Borrower	Republic of Uzbekistan
Classification	Poverty Intervention. Thematic: Economic Growth, Gender Development
Environment Assessment	Category C. Environmental impacts were reviewed, and no significant adverse environmental impacts were identified.
Project Description	<p>The Small and Microfinance Development Project (SMDP) seeks to create a viable and sustainable institutional framework for the effective delivery of financial services, particularly to poor, low-income households, and small and microenterprises. For this purpose, the SMDP promotes (i) the development of an operationally sustainable system of savings and credit unions (SCUs) to deliver microfinance services through efficient intermediation in an enabling policy, regulatory, and supervisory framework; and (ii) enhanced institutional capacity of commercial banks for efficient financial intermediation through outreach in the delivery of financial services to households, and to micro and small enterprises to complement the role envisaged for SCUs. The Asian Development Bank (ADB) loan of \$20 million will finance the requirements of small and micro borrowers by building SCUs as viable institutions and by strengthening commercial banks' delivery outreach. ADB's proposed advisory technical assistance (TA) of \$400,000, being processed simultaneously with the Project, will strengthen the Central Bank of Uzbekistan's (CBU) institutional capacity for prudential regulation and supervision of SCUs.</p>
Rationale	<p>In January 2002, Uzbekistan entered into a Staff Monitored Program (SMP) with the International Monetary Fund (IMF). This program envisages exchange rate liberalization and unification over the medium term as well other structural adjustment reforms across sectors. Among others, this would involve the restructuring and privatization of state-owned enterprises, which would result in retrenchments and layoffs. The unemployment resulting thereof would cause economic and social distress. To generate new income and employment opportunities to mitigate adverse social impacts, during the transition period, the Government has launched initiatives to promote the development of micro and small business finance programs. Micro and small enterprises (MSEs) have the potential for generating employment throughout the country. Uzbekistan has a strong potential competitive advantage in the development of these two subsectors given the country's non-extreme climate, abundant natural resources, and</p>

educated human resources. There are strong complementarities between these two subsectors owing to backward and forward linkages. Integration of these two subsectors' financing needs will add considerable value.

Uzbekistan has a small and underdeveloped financial sector lacking in diversity due to repressive financial sector policies in the past. There were no formal and legally incorporated microfinance institutions. The demand for financial services from households and from MSEs could not be met by the available supply. This was attributable to the banking system's low financial penetration and constraints in terms of liquidity and institutional capability for the delivery of MSE business support services.

An effective and well-funded financial system, which mobilizes savings and provides the poor with financial support to set up opportunities for income generation, is critical to support Uzbekistan's transition and reduce poverty. The Government, under the IMF's SMP, has also begun addressing the structural impediments, which hitherto restricted the growth of the financial sector.

The Government, through policy dialogue with and inputs from ADB, has developed a holistic approach to improve the access and outreach of microfinance delivery on a sustainable basis. This approach encompasses (i) creation of an enabling environment through a prudential legal and regulatory framework for microfinance institutions; (ii) creation and financing of SCUs to provide a range of financial services including mobilization of savings deposits from and make microfinance loans to their members on a sustainable basis; and (iii) developing the institutional capacities of designated commercial banks for efficient financial intermediation by provision of financial and institutional support to the country's micro and small business sectors. Cumulatively, the banks and the SCUs will be able to increase savings mobilization and improve financial intermediation and thereby help meet the unmet demand for credit and other financial services from households, micro and small enterprises. The roles of the SCUs and the banks will complement and mutually reinforce each other.

Objectives

The overall goal of the SMDP is to create a viable and sustainable institutional framework and mechanism for effective delivery of financial services, particularly to poor, low-income households, and small and microenterprises.

The proposed loan will help mobilize domestic savings and improve financial intermediation to promote economic growth and reduce poverty. To support the financing of MSE sector requirements of the country, the SMDP advocates the development of broad and sustainable delivery mechanisms for MSE.

The Project has three major elements:

- (i) development of an effective regulatory and institutional framework for SCUs;
- (ii) financial support for setting up an institutionally and financially sustainable network of 20 SCUs in accordance with the Law on Credit Unions, supervised and regulated prudentially by CBU; and
- (iii) credit line to commercial banks to enable them to onlend to household, microenterprises, and SCUs.

These three elements reinforce each other and are designed to develop an effective and well-funded financial system that mobilizes savings and provides the poor with financial support to set up opportunities for income generation.

Cost Estimates

The total cost of the Project is estimated at \$50 million equivalent.

Component	Foreign Exchange	Local Currency	Total Cost
SCU	4.2	15.7	19.9
Commercial banks	12.0	18.1	30.1
Total	16.2	33.8	50.0

Financing Plan

ADB's \$20 million financing will cover a foreign exchange cost of \$16.2 million and a local currency cost of \$3.8 million equivalent. ADB's financing will cover \$5.0 million equivalent for the SCU component and \$15.0 million equivalent for the commercial bank component. The Government will finance \$2.5 million equivalent in local currency costs of the SCU component. The SCU members will finance \$12.4 million of the SCU component, also in local currency. The participating commercial banks (PCBs) will finance \$7.6 million equivalent and their sub-borrowers will finance \$7.5 million equivalent.

Loan Amount and Terms	A loan of \$20 million from ADB's ordinary capital resources will be provided under ADB's LIBOR-based lending facility. The loan will have a 20-year term including a grace period of 5 years, an interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.75% per annum, a front-end fee of 1.0%, and such other terms and conditions set forth in the Loan Agreement.
Allocation and Relending Terms	The Government of Uzbekistan will bear the foreign exchange risk and relend the loan funds to (i) the participating commercial banks (PCBs) in local currency at real positive market interest rates, for a period of 15 years, including a grace period of 3 years (ii) the SCUs through subordinated loans in local currency with a maturity of up to 10 years including 5 years grace period for repayment of the principal and 3 years grace period for the interest. The SCUs will make micro loans to sub-borrowers for durations initially up to a maximum of 6 months in the range of up to \$1,000, with individual subloans not exceeding 15% of the SCUs' capital. The PCBs will make small loans in the range of \$1,000-\$10,000, up to a maximum of 3 years' duration. The SCUs and the designated commercial banks will create revolving funds from repaid subloans to make new subloans, which should not exceed 75% of the total of a subproject's cost to new sub-borrowers within the Project's overall time frame.
Period of Utilization	The Project will be implemented over a 7 period from the time the loan becomes effective. The closing date for submission of subloan applications, and approval and authorization for withdrawal applications from the loan, will be within 7 years of the date of loan effectiveness, i.e., by 30 June 2010. The closing date for disbursements will be by 31 December 2010.
Estimated Project Completion Date	30 June 2010
Implementation Arrangements	<p>The Financial Sector Development Agency (FSDA) will be the Executing Agency for the entire Project, and will assume responsibility for reporting to ADB. CBU's Banking Supervision and Licensing Division will be the executing agency for ADB's TA to CBU for strengthening CBU's supervision of SCUs. Asaka Bank and Pakhta Bank will be the executing agencies for the credit line component and will also report to FSDA for onward reporting to ADB.</p> <p>A steering committee comprising members from the Department for External Economic Relations and Foreign Investments of the Cabinet of Ministers, the Ministry of Finance, CBU, and the PCBs will be established to oversee the implementation of the loan. FSDA will, however, be primarily responsible for reporting to ADB.</p>

Executing Agencies	FSDA, Asaka Bank, and Pakhta Bank
Procurement	ADB's <i>Guidelines for Procurement</i> will be followed for procurement of vehicles, equipment, and other goods for CBU, and FSDA. All procurements will be made from ADB's member countries. Procurements will be conducted transparently and in conformity with ADB's anticorruption policy.
Consulting Services	A total of 13.6 person-months of international consulting services will be engaged by FSDA to provide institutional capacity-building assistance to SCUs. The recruitment of consultants under the loan will be in accordance with ADB's <i>Guidelines on the Use of Consultants</i> .
Project Benefits and Beneficiaries	The SCU component of the Project will cover over 77,000 members by the 5 th year and over 100,000 members by the 7 th year of project implementation. The component will mobilize domestic members' savings worth \$12.4 million equivalent by the 7 th year. One third of the SCUs' members will be from the poor, and in 5 out of 20 SCUs, at least 50% of the members will be women. SCU members' incomes are expected to rise by at least 50% by year 7. The Project's nonquantifiable benefits will include (i) the development of a modern financial savings and credit system with points of service that extend the outreach and benefits to isolated communities; (ii) increased competition in the provision of financial services to promote efficiency of service delivery; (iii) the creation of an independent, market-based organization to act as a service provider to SCUs; and (iv) the creation of supervisory unit within CBU for the regulation and supervision of SCUs. The commercial banks' onlending will benefit micro and small enterprises in meeting their demand for credit. It will also enhance banks' institutional capacities for improved financial intermediation in a more competitive enabling environment. Credit to micro and small enterprises will facilitate their growth. This will generate additional employment in this sector, which could absorb some of the unemployment created by the country's structural reforms.

Risks and Assumptions

The Project's main risks are (i) ineffective implementation of the SCU law and its regulations, (ii) delays or problems in the establishment of SCUs, (iii) operational and financial risks of SCUs, and (iv) risks of commercial banks' downscaling into microfinance.

All these risks will be addressed by mitigating measures. ADB's TA to CBU to supervise and regulate SCUs prudentially will help to implement the Law on Credit Unions and regulations effectively thereby helping to mitigate (i) above. ADB's already approved small-scale TA¹ for pilot testing of SCUs, USAID's TAs and FSDA's role under the loan will help SCUs mitigate risks in (ii) above. SCUs' operational and financial risks referred to in (iii) above can be mitigated by ADB's subordinated debt to SCUs, and by the training and institutional capacity building to be provided to SCUs initially by FSDA and later by the National Association of Credit Unions (NACU) to be formed voluntarily by the SCUs. The Government's use of loan funds to enable FSDA to provide institutional capacity support to SCUs will also help to mitigate these risks in (iii) above. NACU can also help in mitigating the risk in (i) above by representing SCUs' interests effectively before regulatory authorities, and in (ii) above by using its knowledge base to provide technical and managerial support to nascent SCUs. Careful selection of commercial banks with some experience in microfinance can help mitigate commercial banks' risks referred in (iv) above.

¹ ADB. 2001. *Technical Assistance to the Republic of Uzbekistan for the Pilot Testing of Savings and Credit Unions*. Manila.

Technical Assistance

TA will be provided to CBU to strengthen its institutional capacity to supervise and regulate the nascent SCUs on a prudential basis and in accordance with the requirements of the Law on Credit Unions. The TA will (i) enhance CBU's SCU supervision capabilities and design appropriate systems for supervision monitoring and reporting of SCUs solvency, liquidity, and profitability; (ii) determine the circumstances under which CBU as the central bank may act as a temporary lender of last resort to address SCUs' temporary liquidity problems; (iii) develop within CBU an early-warning management information system to enable the central bank's intervention when required to avert any SCU's financial crisis; and (iv) facilitate understanding by CBU staff on microfinance sector policy and performance issues. The TA will be implemented over a 12-month period between February 2003 and February 2004. It will need 24 person-months of consultancy comprising 9 person-months of international consultancy and 15 person-months of domestic consultancy. A firm of international consultants under the TA will be engaged in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the selection of domestic consultants. The total cost of the TA is estimated at \$520,000 equivalent of which \$400,000 equivalent will be financed by ADB on a grant basis.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Republic of Uzbekistan for the Small and Microfinance Development Project (SMDP). The report also describes proposed technical assistance (TA) to the Central Bank of Uzbekistan (CBU) for developing prudential regulation and supervision of savings and credit unions (SCUs); and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, will approve the TA.

II. INTRODUCTION

2. The Government requested the Asian Development Bank (ADB) for assistance for the SMDP to develop a viable and sustainable micro and small enterprise (MSE) finance delivery system that should help reduce poverty by allowing use of credit to develop businesses and generate self-income opportunities. The Project aims to support the establishment of SCUs; enhance the capacities of selected commercial banks; and provide financial services to poor, low-income households and MSEs. Microfinance¹ is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor, low-income households, and their microenterprises. The SMDP was developed with the support of ADB's project preparatory TA,² a small-scale TA³ that helped develop the SCU component, and an advisory TA⁴ that helped analyze the operational and financial status of participating commercial banks (PCBs) and develop PCBs' capacities in credit appraisal. The development of alternate channels of MSE finance including establishment of SCUs as well as strengthening PCBs' capacities to intermediate microfinance will help improve delivery of financial services for the poor and women. This intervention is timely, given that Uzbekistan needs to develop a social safety mechanism as the economic restructuring process gains momentum and as its impact penetrates across the population over the medium term. Loan appraisal was conducted between 26 September and 4 October 2002.⁵ The Project Framework is in Appendix 1.

III. SECTOR PERFORMANCE, PROBLEMS, AND OPPORTUNITIES

A. Macroeconomic Context

3. Traditionally, pursuing conservative and inward-looking policies, Uzbekistan's macroeconomic management focused on containing internal and external imbalances without imposing hard budget constraints on state enterprises. Economic management was complicated by exchange, pricing, and production controls and by several other administrative and regulatory controls as well as directed subsidized and government-guaranteed flow of credit to state enterprises. When the inherent contradictions in this approach surfaced in 1996 with losses in international reserves, the Government reintroduced multiple exchange rates supported by exchange and trade restrictions. In turn, this triggered real exchange rate appreciation, larger deficits for the public sector as a whole, a worsening international liquidity position, and higher foreign borrowing. The effects of this policy mix were not fully evident in the official statistics,

¹ As defined in ADB's *Microfinance Development Strategy*.

² ADB. 1999. *Technical Assistance to the Republic of Uzbekistan for Rural Savings and Credit Unions*. Manila. ADB was the first aid agency participating in policy reforms in Uzbekistan's microfinance sector.

³ ADB. 2001. *Technical Assistance to the Republic of Uzbekistan for the Pilot Testing of Rural Savings and Credit Unions*. Manila.

⁴ ADB. 1999. *Technical Assistance to the Republic of Uzbekistan for Strengthening the Banking Sector*. Manila.

⁵ The Loan processing team comprised (i) R. Narasimham, Senior Portfolio Management Specialist/Team Leader, Governance, Finance and Trade Division (ECGF); (ii) A. Chi, Financial Economist, ECGF; (iii) A. Bauer, Senior Poverty Reduction Specialist, Poverty Reduction and Social Development Division; and (iv) C. Gautrot, Counsel, Office of the General Counsel.

although they showed up in alternative indicators estimated by the International Monetary Fund (IMF).

4. Against this backdrop, the Government entered into an IMF Staff Monitored Program (SMP) in January 2002. The SMP aims to accelerate Uzbekistan's transition to a market economy, while maintaining macroeconomic stability. The centerpiece of this economic reform package was the requirement of unification of exchange rates and lifting of exchange restrictions to facilitate a move to current account convertibility.

5. Progress in implementation of the SMP has been mixed. Macroeconomic management has benefited from the tight fiscal policy stance although aberration to it has occurred because of wage increases. To reinforce the fiscal position, the Government tightened monetary policy in 2002 supported by a set of policy measures including adjustments in the CBU refinancing rate, initial steps toward cessation of directed credits from CBU, and efforts initiated by a few larger commercial banks to implement the banking sector reform package announced in 2001. Progress in liberalization of the exchange market has been lower than expected. Although the adjustment to align the official rate and the black market rate have persisted, the continued reliance on ad hoc monetary interventions to stabilize the exchange rate, introduction of new formal and informal controls to foreign exchange access, and the slow pace of alignment have prevented the reduction in the spread between the official and black market rates to 20%—a June 2002 target agreed upon between IMF and government authorities. Simultaneously, while the number and rates of tariffs were lowered in June 2002, reversals in trade policy reduced the effectivity of these steps. Of concern are (i) the introduction of an import surcharge on nonfood consumer goods by legal entities payable in convertible currency, (ii) a new special tariff regime for shuttle traders, and (iii) reimposition of tariffs on some previously exempt items. These trade restrictions have a bearing on the exchange regime. On conclusion of its review of the SMP in September 2002, the IMF mission left a list of "prior actions" with the Government that include correction of the above policy reversals. Some of these slippages are being addressed.

6. Economic prospects for Uzbekistan in the near and medium term remain tight. The Government's reluctance to pursue a swifter timetable for current account convertibility is driven by its concerns regarding the level of currency depreciation, which in turn will aggravate inflationary pressures, disrupt fiscal stability, and destabilize the banking system. The share of external debt to gross domestic product (GDP) rose to 41% at the official exchange rate in 2001. It is likely that the debt ratios will rise sharply immediately following exchange rate unification before improving to more sustainable levels, provided cautious borrowing policies are maintained. These developments, as well as the economic restructuring and its impact on employment are expected to adversely impact vulnerable sections of society. In anticipation of this, the Government has requested assistance from aid agencies to develop alternate channels of funding for small and medium enterprises (SMEs) and MSEs to promote employment, while supporting vulnerable groups to meet both their investment and consumption requirements.

B. Sector Description and Performance

7. Uzbekistan is planning to further open up its economy and launch economic restructuring that will involve privatization and/or closure of state enterprises, resulting in retrenchments and layoffs. This is likely to aggravate the social and economic distress of vulnerable groups. At present, almost 30.8% of the population is poor (in some oblast the proportion of poor exceeds 50%), and 70% of the poor live in rural areas. Besides continued efforts to promote higher and sustainable economic growth, the Government has been promoting SMEs and MSEs and has in place a social security program. As of July 2002, Uzbekistan had (i) 168,600 microenterprises, which employ up

to 10 persons in industry and 5 persons in services,⁶ and (ii) 70,000 registered small enterprises, which employ up to 20 persons in agriculture and construction, 40 persons in industry, and 10 persons in services.⁷ In addition, there are a number of informal and unregistered MSEs. These enterprises, given their role in employment generation and poverty reduction, are receiving strategic significance as the economic hardship grows with the deepening of structural reforms. So far, the banks have been the major source of MSE financing delivery (paras. 13-15), followed by nongovernment organizations (NGOs). With ADB support, the Government is now encouraging the development of SCUs and strengthening PCBs' capacities to cater to the high credit requirements of vulnerable groups.

8. NGOs' Role in MSE Financing. NGOs have been providing microfinance credit, but in the absence of a legal or regulatory framework to govern microfinance operations of NGOs. As of 30 June 2002, Uzbekistan had 619 registered NGOs. Of these, 19 were engaged in microfinance activities. The Association of Business Women (ABW) is the principal provider of microfinance credit. Some NGOs have launched pilot microfinance programs in the poorest provinces (including Kashkadariya, Karakalpakstan, and Namangan), which are supported by the United Nations Development Programme (UNDP) and Mercy Corps, an international NGO. These programs, however, have reached less than 3,000 beneficiaries. NGOs face difficulties mobilizing funding, as their access to formal credit is weak and they have not tapped personal savings. Most NGOs operate without an adequate capital base, proper management structure, or audited financial statements. With limited branch and membership size, total disbursements by the 19 NGOs during 2001 amounted to less than \$500,000 equivalent. The subloan sizes of NGOs have been small. For example, ABW's Navoi branch's maximum loan size was Sum600,000, and other NGOs with less funding capacity had loan sizes between Sum50,000 and Sum180,000. The track record of loan recovery is good, largely because of informal groups and localized kinship among the members. Under the SMDP, NGOs will establish SCUs in line with stipulated norms and criteria, and will be eligible for credit from the PCBs for onlending to their clients/members. The NGOs will help improve PCBs' outreach to clients and will help to meet their own funding requirements.

9. SCUs. In 1997, ABW set up, on a pilot basis, five informal organizations in Uzbekistan resembling credit unions, which benefited from training provided by the World Council of Credit Unions (WOCCU). These credit unions operate on the basis of own funds mobilized by modest levels of membership fees, ownership shares, and retained earnings. In the absence of a legal and regulatory framework, they operate in an ad hoc manner and service only a small number of clients. Over the last 2 years, ADB has helped support the development of an enabling legal and regulatory framework for SCUs (Appendix 2). This involved enactment of the Law on Credit Unions on 4 April 2002, and development of implementing rules and regulations for SCUs, and supervision, and procedural manuals. The Law and its accompanying regulations require SCUs to be adequately capitalized to remain solvent.⁸ The regulations also require SCUs to maintain certain prudential financial ratios.⁹ CBU has received license applications from 12 SCUs, and so far it has issued licenses to three.¹⁰ The rest will be registered as soon as they fulfill membership and capital requirements. The ADB's small-scale TA (footnote 3) has helped operationalize the three licensed

⁶ This definition includes, but is not limited to, individual, household, and family-owned and -run enterprises.

⁷ Ministry of Macro Economics and Statistics. 2002. *Basic Indicators of Social and Economic Development*. Uzbekistan.

⁸ The regulations require SCUs incorporated in Tashkent to have a minimum paid-in equity of \$20,000 equivalent, and those incorporated outside Tashkent to have a minimum paid-in equity of \$10,000 equivalent, to be contributed in cash as a condition for registration.

⁹ These are (i) capital adequacy ratio of not less than 15%, (ii) liquidity ratio (i.e., ratio of liquid assets to demand liabilities of less than 30 days) of not less than 20%, (iii) loan concentration ratio (of lending to any single borrower or group of borrowers) not to exceed 25% of capital, (iv) noncollateralized lending not to exceed 10% of capital, and (v) investment in Government bonds not to exceed 25% of capital.

¹⁰ Licenses have been issued to the SCUs in Samarkand, Bukhara, and Navoi. The SCUs in Jizzak and Namangan are expected to be issued licenses before 31 December 2002.

SCUs. Experts have verified the efficacy of the newly enacted Law on Credit Unions as well as supportive regulations and operational procedures. The establishment of SCUs will enable the creation of new and dedicated member-owned microfinance institutions (MFIs) that should be financially sustainable and to have the potential to efficiently intermediate members' savings within a local area.

10. **Banking Sector.** Currently, there are 24 state-owned and 14 private banks. Banks serve as a major conduit of financial intermediation, while the capital market remains small. There has been limited progress toward the development of alternate channels of funding. The performance of the banking system over the years has been affected by the Government's intervention in the sector and its emphasis on directed credit, supported by guarantees to fulfill planned targets. This obviated the need for rigorous credit analysis, creating a serious moral hazard and prevented banks from catering to the needs of private and MSE financing requirements. The government-guaranteed loans on the books of the banks have rendered it difficult to assess the real state of the banking system. Official statistics estimate nonperforming loans (NPLs) to be less than 5%, keeping in view the supportive government guarantees on loans. However, unofficial reports suggest that, with declining profitability and exchange rate depreciation, the enterprise sector is facing severe financial difficulty, and NPLs could be above 50%. Corroborating this evidence is the growing distress of the enterprise sector, whose profitability is declining as the exchange rate is depreciating and competitive forces are growing. The Government is examining mechanisms and options for resolutions of NPLs and is undertaking preparatory work to restructure and privatize banks. Commercial banks have adopted International Accounting Standards (IAS) and have had their audits conducted according to International Standards of Auditing (ISA). A loan classification system has been adopted to determine banks' portfolio quality on the basis of collectibility of loans. At the same time, CBU has taken steps to strengthen its prudential regulation and supervision of banks.

C. Analysis of Key Problems and Opportunities

11. **Unmet Demand for Micro and Small Business Credit.** Neither Uzbekistan's financial sector nor its NGO sector has been able to meet the country's demand for MSE financing. Based on conservative estimates, the annual demand for MSE credit is in the range of \$154 million–\$245 million. In view of this large and growing demand, the Government requested ADB to provide a credit line of \$15.0 million and the European Bank for Reconstruction and Development's (EBRD) to provide a credit line of \$40 million. Both these credit lines will to be channeled through commercial banks.

12. **Funding Constraints Impeding NGOs' Role in MSE Credit.** The geographical and social impact of NGOs has been limited, based on severe funding constraints. NGOs have relied on external grant assistance to fund their lending activities, since access to bank credit has been an issue based on the absence of a legal and regulatory framework for authorizing and registering NGO (even though they have been providing credit) and their lending activities. A draft resolution was submitted to the Cabinet of Ministers in March 2002 formally recognizing NGOs as nonbank financial institutions and providing them with tax-exempt status and licenses to operate as such.

13. **Financing for MSEs by Banks.** Currently, the total of bank MSE lending is close to \$289.6 million equivalent, which is higher than lending intermediated by NGOs. Banks in Uzbekistan have a good record of lending for SME and MSE financing but their potential in this area is affected by their weak resource mobilization. Bank deposits fell from 60% in 1991 to 15% in 2001 due to lack of public confidence in the banking system, negative real interest rates on bank deposits, restrictions on cash withdrawals from bank accounts, and the power of tax authorities to search and seize customers' bank balances. To ease these problems, CBU has issued a set of

resolutions that (i) allow banks to pay and charge market-determined interest rates on deposits and loans,¹¹ (ii) allow withdrawal of cash from bank accounts,¹² and (iii) remove tax authorities' powers of search and seizure of bank deposits without a court order. A resolution has also been issued to stop directed lending supported by sovereign guarantees.

14. Recognizing the significant and potential competitive advantage of commercial banks, given their reach and branch network, the Government is encouraging development of banks' institutional capacity to improve confidence in banks, while removing structural impediments banks face, which will help deposit mobilization and improve the delivery of MSE financing services. The reduction in government intervention and directed credits will free bank funds for MSE lending. CBU's loan classification system for banks on the basis of collectibility (and not collateral) will encourage banks to make rational credit decisions on projects' future cash flows, which is helpful for micro lending. The Presidential Decree of March 2000 allows banks to set aside 25% of their profits (on a tax deductible basis) to create a fund to assist MSEs and SMEs. In addition, banks are also now allowed to charge market interest rates (over CBU's refinancing rate) for loans made from their own funds. The Government has also facilitated training of bank staff in the appraisal of micro credit and loans to small enterprises without collateral.¹³ These measures will enhance public confidence in the banking system and improve its financial intermediation, particularly to the MSE sector.

15. Banks are the most appropriate vehicles for MSE financing delivery in Uzbekistan considering the high microcredit demand,¹⁴ potential delivery capabilities, and high recovery rates.¹⁵ High recovery rates are attributable to (i) rigorous credit analysis, (ii) independent credit decisions, and (iii) micro and small credits being mainly working capital loans with maturities under 1 year. The results of banks' microcredit operations also reveal that banks' recoveries on noncollateralized microlending was higher than on collateralized lending to large state-owned enterprises.

16. **SCU Development.** As an alternate to banks, the Government has realized the necessity for the creation of new, prudentially regulated MFIs that can supply a full range of financial services to meet community requirements through extended outreach. SCUs have played a critical role as MFIs in several countries.¹⁶ SCUs better serve the local clientele within regional or geographical parameters, giving them an edge in financial services outreach. SCUs also play a critical role in social mobilization, fostering a community/group approach that allows better access to the credit history of clients and generates pressure for credit recovery. SCUs seek a diversified base for their deposits and lending activities. By diversifying their funding and portfolio, SCUs reduce the risks of loan and deposit concentration and are less prone to economic gyrations.

17. ADB's proposed SMDP will focus on providing financial services to MSEs in a commercially and financially viable manner and will endeavor to reduce poverty. ADB recognizes the necessity

¹¹ Interest rates on deposits have been around 35%. Uzbekistan's official inflation rate, judged by its official consumer price index, was 26.4%. CBU's refinancing rate is 34.5% per annum (from 1 January 2002). This indicates that real interest rates are positive. Meanwhile, the banks' lending rates, which are market determined, range between 36% and 45%. Banks' commercial microfinance lending rates are also in this range.

¹² As per Government Resolution No. 23 dated 25 January 2002 and another in August 2002.

¹³ Such training has been facilitated under the TA grant of \$5 million from the Japan-Europe Cooperation Fund (JECF) being administered by EBRD.

¹⁴ Asaka Bank and Pakhta Bank reported that 75% and 100% respectively of their micro and small loans during 2001 were for amounts between \$1,000-10,000 equivalent.

¹⁵ Asaka Bank reported recoveries of 100% for micro loans and 88% for small loans in 2001 while Pakhta Bank reported recoveries of 100% for micro loans and 89% for small loans.

¹⁶ E.g., Ecuador, Guatemala, Kyrgyz Republic, and Philippines.

for an appropriate legal, policy, and regulatory framework for MFIs as a foundation for the growth of this sector.

D. Government's Strategy and Policy Dialogue

18. Uzbekistan has adopted an inward-looking economic strategy with a more gradual and cautious approach to economic liberalization than its neighbors, with the objective of safeguarding vulnerable groups. Recognizing the contribution of SMEs and MSEs to GDP, employment, and poverty reduction, the Government has emphasized development of SMEs and MSEs to ensure that adequate self-income generating opportunities are created by improving accessibility to credit at the individual, household, and MSE levels. To promote development of MSEs, the Government is now strengthening MSE financing delivery mechanisms through the provision of credit lines and capacity building of banks to effectively intermediate credit to MSEs, and has developed alternate channels of MSE financing. In the context of later, the decision to allow SCUs to be set up through the introduction of the Law on Credit Unions is a milestone in this direction. Policy dialogue conducted between the Government and ADB has helped the Government to address impediments to a viable and sustainable environment for MFIs (Appendix 2).

E. ADB's Country and Sector Strategy

19. This Project is fully consistent with ADB's country operational strategy (COS) for Uzbekistan,¹⁷ which stresses the need to support reforms of the financial and enterprise sectors, and effective financial intermediation to improve access to credit by the country's agricultural and MSEs sectors. The COS recognizes the importance of broadening and deepening the outreach of MSE financing, which has bearing on both the enterprise and financial sectors. In this context, the COS recognizes the necessity of developing institutions for sustainable microfinance delivery and identifies SCUs as a vehicle for such a process. It supports assistance to improve banks' and other institutions' credit appraisal skills, and to improve prudential regulation of financial institutions. The SMDP encompasses all the above areas and is consistent with ADB's Microfinance Development Strategy,¹⁸ which underscores the need for selectivity regarding the modality of assistance and an emphasis on right eligibility criteria of SCUs (Appendix 2).

F. External Assistance

20. In the past, external assistance to Uzbekistan for MSE financing has been relatively limited, largely because of the lack of an appropriate legal, regulatory, and policy framework and of suitable institutions for MSE financing. However, recently a number of aid agencies including EBRD, the Japan Fund of Economic Cooperation, UNDP, the United States Agency for International Development (USAID), and the Mercy Corps have been active in the sector (Appendix 3). EBRD approved a loan of \$40 million in May 2002 whose first tranche of \$20 million is being channeled through six banks in conjunction with a \$5 million grant from the Japan-Europe Cooperation Fund (JECF). In May 2002, USAID provided a grant of \$463,000 to support SCU equity financing, staff training, and equipment. Adopting a more holistic approach, ADB's loan, along with its advisory TA, will support the introduction of some fundamental policy, legal, and regulatory changes to the MSE sector as a precondition for the provision of a credit line and further TA support for SCUs. In designing the SMDP, ADB coordinated closely with EBRD, USAID, and the Mercy Corps, all of which endorsed and recognized the complementarity of ADB's intervention in this sector. ADB's credit line to PCBs benefits from the training provided to bank staff under the JECF grant. USAID will provide another TA grant of \$2.2 million, which will reinforce ADB's SCU

¹⁷ ADB. 2000. *Country Operational Strategy: Uzbekistan*. Manila.

¹⁸ The strategy focuses on (i) creating a policy environment conducive to microfinance, (ii) developing financial infrastructure, (iii) building viable institutions, and (iv) supporting social intermediation and pro-poor innovations.

component by assisting SCUs' institutional capacity building, development of business plans for SCUs, and establishment of a voluntary national association of credit unions (NACU).

G. Lessons Learned

21. The SMDP, being the first microfinance project in Uzbekistan, has no precedents to incorporate country-specific lessons. However, ADB has gained substantial lessons from experiences in other transitional economies including its operations in the Central Asian republics and other countries that have faced conditions and circumstances similar to Uzbekistan. Most relevant of these are ADB's project experiences in Cambodia, Kyrgyz Republic, and Mongolia (Appendix 4). In all three countries, ADB projects have provided a credit line for relending to new MFIs (similar to SCUs) to be established by NGOs, and, in case of the Kyrgyz Republic, to SCUs. However, ADB loans for MFIs and SCUs, proceeded without an enabling legal and regulatory framework, although these projects did include provisions for the preparation and introduction of a framework. The absence of such a legal and regulatory framework creates complexities. In some instances, there was unsustainable growth of undercapitalized institutions without appropriate prudential safeguards and managerial capacities. Also, the central banks lacked understanding of their role in regulation and supervision of MFIs/SCUs and often delegated their powers fully to another agency whose regulatory experience and capacities were limited. As a consequence, there were delays in loan commitments and disbursements, and/or MFIs/SCUs operating without adequate safeguards faced operational risks. In some cases, this resulted in a high attrition rate of SCUs that had to be declared insolvent. In ADB's Employment Generation Project in Mongolia, the PCBs did not have an adequate track record of microfinance lending; had limited outreach capabilities; and had subloan ceilings of \$5,000, for which there was little demand.

22. Drawing from these lessons, the SMDP has required up-front introduction of legislation, and regulations imposing stipulated capital and other requirements on SCUs. This Project was processed only after (i) the Law on Credit Unions was enacted, (ii) CBU's regulatory and supervisory powers were codified in the Law, (iii) three SCUs were established and their pilot testing completed under the small-scale TA in accordance with the SCU Law, and (iv) an effective demand assessment was concluded for MSE credits. CBU has been entrusted with adequate powers to supervise and regulate SCUs prudentially, and ADB's advisory TA to CBU will enhance capabilities of staff to supervise these entities. Furthermore, Uzbekistan PCBs were selected after rigorous analysis of their track records. Appropriate subloan sizes were established after careful empirical demand analysis.

IV. THE PROPOSED PROJECT

A. Objectives

23. The primary goal of the Project¹⁹ is to create a viable and sustainable institutional framework and mechanism for effective delivery of financial services, particularly to the poor, women, low-income households, and MSEs. To support the large MSE financing requirements of the country, the Project will focus on (i) development of an effective legal, regulatory, and institutional framework for SCUs; (ii) establishment of a financially sustainable network of at least 20 SCUs during its implementation period, which will serve to provide a role model for further growth of the SCU sector; and (iii) improvement of PCBs' financial intermediation to ensure better access to poor individuals, households, MSEs, and SCUs.

¹⁹ The Project Framework is presented in Appendix 1.

B. Components and Outputs

24. **Development of an Effective Legal, Regulatory and Institutional Framework for SCUs.**

This component of the Project will provide support to do the following:

- (i) Develop institutional capacities of the Financial Sector Development Agency (FSDA) (para. 43) to operationalize SCUs through development of business plans as well as corporate and financial matters, and train of staff to ensure that the management and administration of SCUs is in line with good practices. FSDA will receive financial support of \$2.46 million from the Government and \$1.26 million from the ADB loan proceeds. During the project implementation, FSDA will (i) provide SCUs with managerial and technical support; (ii) assist SCUs in adopting good corporate governance practices, developing institutional and financial sustainability, and encouraging target orientation; (iii) undertake training of SCUs in different areas; (iv) assist SCUs in familiarizing themselves with legal statutes in Uzbekistan and in adopting international experiences and best practices; and (v) provide other assistance to SCUs in meeting their initial statutory requirements. FSDA will regularly report on the development of SCUs. The Ministry of Finance (MOF) and CBU will jointly assess whether SCUs qualify for subordinated debt, in accordance with the stipulated criteria.
- (ii) Develop capacities of CBU through provision of TA grant assistance of \$400,000 to strengthen SCUs' prudential supervision and regulation (paras. 55-56). CBU's Banking Supervision and Licensing Division (BSLD) will be responsible for the prudential supervision and regulation of SCUs. It will monitor the SCUs' capital adequacy ratios, loan concentration ratios, and compliance with other requirements of the loan.

25. **Financial Support to SCUs.** This component will support the establishment of SCUs by providing ADB's loan to finance subordinated debt of \$2 million to 20 SCUs at up to \$100,000 per SCU. This subordinated debt to be issued by MOF will carry a positive real interest rate and a maturity period up to 10 years (with repayment beginning in installments after the 5th year). As a cushion for the nascent SCUs' liquidity, the subordinated debt will carry a grace period for interest payments by the SCUs for the first 3 years of their incorporation, after which they will be required to pay the 3 years' interest cumulatively. Subordinated debt will serve as quasi equity and will help contribute to strengthening the capital of the SCUs. To facilitate ownership among SCU members, the Project will encourage SCUs to mobilize their own resources from members, as is required under the Law, to augment ADB and government financing for the Project.

26. The Government will set up a committee comprising representatives from MOF, CBU, FSDA, and Asaka Bank to determine SCUs' eligibility for subordinated debt and their access to other funds under the ADB loan. To qualify for subordinated debt, the SCUs will need to meet specific criteria including the requirements that (i) they meet the minimum statutory share capital requirement (specified under the Law on Credit Unions and its regulations) in cash at the time of registration, (ii) they secure a license, (iii) their loan delinquency rate does not exceed 5% between the date of their registration and the date of their application for subordinated debt, (iv) there is 100% provisioning for loan losses delinquent for more than 1 year, (v) there is 35% loan loss provision for loans delinquent under 12 months, and (vi) they have adopted a sound credit policy in line with prudential requirements. The maximum subordinated debt that can be provided to an individual SCU will not be higher than \$100,000 equivalent or the sum of the SCU's statutory fund and savings mobilized from members on the date of application for subordinated debt, whichever is lower. CBU will closely monitor the financial condition of SCUs.

27. **Credit Line to PCBs.** This component will provide for a credit line to the designated PCBs for onlending to individuals, households, and MSEs. The cost of this component is \$30.1 million equivalent, which ADB will partly finance through a loan of \$15.0 million; the balance of \$15.1 million equivalent will be financed by the PCBs themselves and their sub-borrowers. The PCBs will provide subloan sizes in the range of \$1,000-10,000 for periods of up to 3 years (paras. 30 and 41). Interest rates will be commercially determined. The Government will relend ADB funds to the PCBs for 15 years including 3 years' grace period for principal amounts. Where appropriate, the PCBs can lend to SCUs and NGOs, acceptable to ADB, as intermediaries for their lending.²⁰ The involvement of NGOs and SCUs in the PCBs' intermediation process will help the PCBs to be introduced to new sub-borrowers, while supporting the requirements of SCUs and NGOs that have better and deeper outreach. This process will help improve access of funding for NGOs/SCUs and increase commercial banks' availability of long-term funds for onlending for MSEs.

28. Asaka Bank and Pakhta Bank were selected as PCBs on the basis of their (i) overall financial condition, judged by solvency, profitability, and liquidity; (ii) transparency in financial disclosure; and (iii) outreach and proven record in MSE financing delivery. As a condition for participation, Asaka Bank and Pakhta Bank have agreed to (i) separate their MSE activities as independent profit centers; (ii) fund at least one half of their MSE lending from deposits raised from micro, small, and medium enterprises; (iii) maintain separate credit appraisal methodologies for micro lending based on future cash flow analysis, rather than insisting on cash collateral;²¹ (iv) employ appropriate software for (iii); (v) train staff adequately for (iii) and (iv), and (vi) provide adequate staff incentive schemes for microfinance operations.

29. To ensure their financial soundness, PCBs will be required to maintain (i) a minimum capital adequacy ratio of 12%, (ii) a minimum return on assets of 1%, and (iii) a maximum loan to deposit ratio of 100%. In addition, PCBs will be required to maintain sound and transparent internal control, internal audit, and corporate governance practices. The PCBs will prepare internal control manuals and will ensure internal audit departments' compliance with the practices stated in the manuals. From 2003, PCBs will also start preparing quarterly financial results. PCBs will be required to provide data on the number of women who will be beneficiaries of their subloans under ADB's loan. In addition to these requirements, PCBs are obligated to adhere to environmental regulations (paras. 64 and 65). Other banks meeting ADB's selection criteria may be considered for later participation.

C. Special Features

30. **Use of Banks and SCUs as Parallel and Complementary Microfinance Delivery Channels.** The high potential demand for credit from MSEs (para. 11), coupled with the lack of other MFIs, underscores the need for continued reliance on banks for MSE financing, while promoting SCU development to serve as a parallel conduit. Empirical evidence suggests that commercial banks' intervention in microfinance, albeit limited (in relation to demand), has been reasonably successful (para. 15). Moreover, both the SCU and commercial bank components

²⁰ To qualify for lending, the SCUs must meet CBU prudential regulations and the NGOs must have (i) at least 3 years' experience in providing micro credit to its members in cash, (ii) loan losses of less than 4%, (iii) at least 20 members, (iv) demonstrated their success in micro lending, and (v) registered with the Government as a local NGO.

²¹ While the SMDP will not require banks to lend without cash collateral (thereby creating a moral hazard), the project does encourage banks to instead seek group guarantees, hypothecation of assets, or other noncash collateral. In doing so, the SMDP will encourage banks to move away from directed lending, while simultaneously seeking to meet credit demands from the MSE sector with more appropriate security.

complement and mutually reinforce each other. The SCUs will make individual subloans not exceeding 15% of their capital for durations initially up to 6 months to meet the demand for the credit needs of their members. The PCBs will make subloans in the range of \$1,000-10,000 for durations up to 3 years. The subloan range limits of PCBs provide SCUs with the opportunity to fully service the requirements in the range of subloan sizes of up to \$1,000. This will facilitate a seamless continuum in the range of financial services for different users. This approach will allow extension of the benefits of SCUs' micro lending to a larger segment of the population, while keeping the nascent SCUs' loan concentration risks under control.

31. SCUs' initial loans to members will be short term (up to 6 months), to test the financial viability of sub-borrowers to repay. This will also help to ensure that SCUs' credit committees obtain suitable experience before approving loans of longer durations, which may impinge on SCUs' liquidity.

32. The subloan size and duration for PCBs were established to focus on those sub-borrowers whose financing requirements are higher than those of the SCUs' clients and the SCUs' capacity to finance them. Many of such sub-borrowers' activities support those of the SCUs' clients through forward and backward linkages. The subloan sizes for PCBs are also designed to cover the financing needs of those SMEs that are lower than the requirements of SMEs being met separately under ADB's Small and Medium Enterprise Project.²²

33. By design, the proposed Project will ensure credit delivery to different end users without impinging on either the SCUs' or PCBs' prudent lending practices. The project design allows banks to lend to SCUs for the latter's onward lending to their clients. Further, SCUs' transaction costs for micro lending in remote regions are expected to be lower than those of the commercial banks, whose accessibility to remote regions is limited. These features of the project design promote synergies between the banks' and SCUs' operations.²³

34. **Developing a Role for NGOs in Microfinance.** The Project will develop the role for NGOs in microfinance by encouraging them to establish SCUs and by supporting their capacity building in MSE financing, while encouraging PCBs to use SCUs and other NGOs as intermediaries in the delivery of microfinance. SCUs will be governed by the Law on Credit Unions and will be supervised prudentially by CBU with reference to their solvency, liquidity, profitability, and financial and corporate governance. This will be particularly helpful to some NGOs, particularly those that have successfully assisted women entrepreneurs within certain geographical parameters. By helping to establish and nurture SCUs, this Project will create new institutions combining the benefits of NGOs and security of well-regulated formal financial institutions. The loan will help establish and fund SCUs through subordinated debt, and ADB's advisory TA to CBU (paras. 55-56) will help CBU's prudential supervision of SCUs. USAID's TA will support development of business plans for SCUs and their capacity building. Doing so could exploit the synergies of lower transaction costs that NGOs and SCUs could enjoy through their local geographic network, coupled with bank funding.

²² ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Uzbekistan for Small and Medium Enterprise Development Project*. Manila.

²³ Pakhta Bank and Asaka Bank have, in the past, made loans, albeit of amounts not exceeding \$100,000 at a time, to NGOs such as ABW's Samarkand Chapter without collateral but on the basis of group guarantee of its members; and have reported fully recovery. Lending by banks to incorporated and prudentially regulated and supervised SCUs should therefore also be possible. The Project is not seeking sovereign guarantees for bank lending to SCUs or NGOs, as that would constitute another moral hazard.

D. Cost Estimates

35. The total cost of the Project is estimated at \$50 million equivalent, comprising \$16.2 million in foreign exchange and \$33.8 million equivalent in local currency (Table 1). The total project cost of \$50 million equivalent comprises \$19.9 million equivalent for the SCU component (consisting of a foreign exchange cost of \$4.2 million and a local currency cost of \$15.7 million equivalent) and \$30.1 million equivalent for the commercial banks (consisting of a foreign exchange cost of \$12.0 million and a local currency cost of \$18.1 million equivalent).

Table 1: Detailed Project Costs
(\$ '000)

Component	Foreign Exchange	Local Currency	Total Cost
1. SCU Component			
(i) SCU Establishment	1,268.50	13,161.50	14,430.00
(ii) Institutional Capacity Building	1,260.00	2,204.10	3,464.10
(iii) Contingencies, Front-End Fee, and Interest During Implementation	1,637.50	363.00	2,000.50
Subtotal Cost (1)	4,166.00	15,728.60	19,894.60
2. Commercial Bank Component	12,000.00	18,105.40	30,105.40
Total Cost	16,166.00	33,834.00	50,000.00

E. Financing Plan

36. The Government of Uzbekistan has requested a loan of \$20 million from ADB's ordinary capital resources to help finance the Project. The loan will have a 20-year term, including a grace period of 5 years; an interest rate to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a commitment charge of 0.75% per annum; a front-end fee of 1% which ADB will deduct from the loan and pay itself; and such other terms and conditions as set out in the draft Loan and Project Agreements. The Government of Uzbekistan has provided ADB with (i) the reasons for its decision to borrow under ADB's LIBOR-based lending facility, and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any communication or advice from ADB.

37. ADB will finance a total of \$20 million, at 40% of the total project cost. ADB's \$20 million equivalent financing will cover a foreign exchange cost of \$16.2 million and a local currency cost of \$3.8 million equivalent (Table 2). ADB's financing will cover \$5.0 million equivalent (consisting \$4.2 million in foreign exchange and \$0.8 million equivalent in local currency) for the support of SCUs and \$15.0 million equivalent for the commercial banks (consisting of \$12.0 million in foreign exchange and \$3.0 million equivalent in local currency). The Government will finance \$2.5 million equivalent in local currency costs of the SCU component. The SCU members will finance \$12.4 million equivalent of the SCU component in local currency. The PCBs will finance \$7.6 million equivalent, and their sub-borrowers will finance \$7.5 million equivalent.

**Table 2: Detailed Financing Plan
(\$ '000)**

Component	Foreign Exchange	Local Currency	Total Cost
1. SCU Component			
(i) ADB Loan			
(a) Subordinated Debt	1,166.00	834.00	2,000.00
(b) Institutional Capacity Building	1,260.00	0.00	1,260.00
Contingencies, Front-End Fee, and Interest During Implementation	1,740.00	0.00	1,740.00
Total ADB Financing for SCU Component	4,166.00	834.00	5,000.00
(ii) Government (Capacity Building)	0.00	2,464.60	2,464.60
(iii) SCU Members	0.00	12,430.00	12,430.00
Subtotal (1)	4,166.00	15,728.60	19,894.60
2. Commercial Bank Component			
(i) ADB Loan	12,000.00	3,000.00	15,000.00
(ii) Commercial Banks	0.00	7,552.70	7,552.70
(iii) Sub-borrowers	0.00	7,552.70	7,552.70
Subtotal (2)	12,000.00	18,105.40	30,105.40
Total Financing	16,166.00	33,834.00	50,000.00

F. Implementation Arrangements

38. **Relending and Onlending Terms.** The Government of Uzbekistan will be the Borrower of the loan and will bear the exchange risk. A steering group comprising representatives from MOF, the Cabinet of Ministers, and CBU will be established for this purpose.

39. For the loan's commercial bank component, the Government will relend the loan funds in local currency to the PCBs (for the time being, Asaka Bank and Pakhta Bank) for 15-year periods including grace periods of 3 years, under subsidiary loan agreements (SLAs) with these banks. The interest rate charged will be market-determined, positive in real terms, acceptable to ADB,²⁴ and in accordance with CBU's monetary policy. MOF will allocate the proceeds of the loan funds to the PCBs in accordance with their credit line allocation agreed to under the loan. For this purpose, MOF will open special imprest accounts with CBU to facilitate disbursements to the commercial banks.

40. For the loan's SCU component, MOF will designate Asaka Bank as its agent. For this purpose, MOF will open a special account with Asaka Bank to facilitate disbursements of

²⁴ At a reasonable margin over CBU's refinancing rate.

subordinated debt to the SCUs. The credit risk on such subordinated debt will be borne by MOF. Asaka Bank's role as the agent of the MOF for the SCU component will not conflict with its role as a PCB for the Project's other component. For determining the eligibility of the SCUs to loan funds, a committee comprising members of MOF, CBU, FSDA, and Asaka Bank will review each SCU's application and decide accordingly. A special separate foreign exchange account will be maintained by MOF with CBU for \$1.26 million for use by FSDA.

41. The SCUs and the PCBs will charge market-based interest rates that take into account their cost of funds, administrative costs, risk premium for absent or inadequate collateral, and other factors. Onlending by SCUs will be for amounts under \$1,000 for periods initially of up to 6 months. Onlending by commercial banks will be for amounts between \$1,000 and \$10,000 for periods of up to 3 years. Onlending by banks and SCUs from ADB's loan funds will not be subjected to any interest rate ceiling. In no case should any subloan extended by an SCU exceed 75% of the total of a subproject's cost. Likewise, no individual subloan extended by a commercial bank in the range of \$1000–10,000 should exceed 75% of the total cost of the subproject being financed. In addition, subprojects being financed by the banks will be required to meet the two additional criteria (i) subprojects must have a debt service coverage ratio of not less than 1.25 times, and (ii) subprojects' return on assets' ratio should not be less than 12%. Subprojects involving the processing of narcotics, spirits, tobacco, and radioactive materials or which are environmentally hazardous (paras. 64-65) will not be funded under the loan. Both the SCUs and the PCBs will disburse their subloans to their sub-borrowers in cash if so needed by their sub-borrowers.

42. SCUs and the PCBs will establish and maintain revolving funds to allow proceeds from repayments of SCU loans to be used to support additional lending activities similar to those under the Project. The individual SCUs will also establish and maintain similar revolving funds to use proceeds from repayment of subloans by members.

43. **Project Management—Overall Project and TA Implementation.** FSDA²⁵ will be the executing agency for the overall Project and will assume responsibility for reporting to ADB on the SCU and commercial bank components. FSDA will establish a special project management unit (PMU) to implement this Project. The Director of FSDA will be designated as the Manager of the PMU. Under the proposed Project, FSDA will hire 2 international advisors and 12 domestic staff to assist in providing training to nascent SCUs (Appendix 5). It is recommended that this unit be ultimately transferred to NACU, which will be voluntarily formed by the credit unions in Uzbekistan.²⁶The Government will finance the funding requirements of FSDA to enhance its capacity to implement this Project.

44. A steering committee comprising members from the Department for External Economic Relations and Foreign Investments of the Cabinet of Ministers, MOF, CBU, and the PCBs will be established to oversee the implementation of the loan. The 20 individual SCUs to be established under the loan will be the implementing agencies for this component. Each SCU will set up its management council, credit and audit committees, and administrative staff on a voluntary basis from its members. The SCUs will use model SCU bylaws and policies developed by CBU, the standard SCU chart of accounts, and financial statements with guidance from CBU. SCUs will

²⁵ FSDA is a legal entity with a charter capital of Sum60 million and staff strength of 10. Its charter was fully subscribed by CBU. It was constituted by a Presidential Decree in August 1999 to be the implementing agency for the World Bank's Financial Institution Building Project. Under the World Bank's loan, FSDA coordinated (i) technical assistance to five commercial banks for business planning, accounting and management information system (MIS) reform, credit approval, analysis, and monitoring; (ii) assistance to CBU in payments and settlements systems, bank security, and legal affairs; and (iii) assistance to MOF's Bank Privatization and Asset Restructuring Agency. FSDA handled these functions objectively and diligently to the satisfaction of the World Bank.

²⁶ The NACU will be formed and funded by the credit unions themselves with a USAID grant augmenting members' funding.

provide savings and credit services to their members. They will undertake all credit analysis concerning individual member loans and will have the final authority for loan approvals.

45. Pakhta Bank and Asaka Bank will be executing agencies for the loan's commercial bank component. These banks which began their microcredit operations in 2000 and have maintained excellent track records since (Supplementary Appendix A). Their past and projected financial performance fully meets ADB's selection criteria. These banks have agreed to ADB's requirements for streamlining their microcredit operations to keep them sustainable on a long-term basis.

46. **Implementation Period.** The Project will be implemented over a 7-year period from the time the loan becomes effective. The closing date for submission of subloan applications, and for approval and authorization for withdrawal applications from the loan, will be within 7 years of the date of loan effectiveness. The closing date for disbursements will be 7.5 years from the date of loan effectiveness. The implementation period for this Project is longer than for normal development finance institution loans because it involves the establishment of SCUs.

47. **Procurement.** The procurement of equipment and other goods for CBU and FSDA will be carried out in accordance with the provisions of ADB's *Guidelines for Procurement*. For contracts below \$50,000 equivalent, including items such as computers, printers and photocopiers that are locally available, prior agreement with ADB for direct purchase procedures will be required. The procurement of goods and services to be financed by subloans will (i) be from member countries of ADB; (ii) be of reasonable price, given time of delivery, quality, and efficiency; and (iii) follow a procedure appropriate to the circumstances.

48. **Consulting Services.** From the loan funds, FSDA will hire an international firm to provide two international consultants for a total of 13.6 person-months. One consultant will be a savings and credit union institution development specialist who will provide 5 person-months of consulting service. The other consultant will be an SCU corporate, statutory, and financial specialist; this consultant will also serve as the team leader and provide a total of 8.6 person-months of consultancy (Appendix 5). The international consultants will be fielded over a 12-month period after loan effectiveness, between May 2003 and April 2004. The international consultants will be recruited in accordance with ADB's *Guidelines on the Use of Consultants*, using ADB's quality and cost-based selection (QCBS) method.

49. **Disbursements.** All disbursements under the ADB loan will be carried out in accordance with the procedures in ADB's *Loan Disbursement Handbook*. Four imprest accounts will be opened by MOF with CBU for disbursements under the loan. The limit of an imprest account will be 6 months' estimated project expenditure or 10% of loan size, whichever is lower, as is stated in ADB's *Loan Disbursement Handbook*. ADB's statement of expenditure (SOE) procedures will be utilized for reimbursement of expenditures for eligible items from the imprest account. A limit of \$50,000 will be established for use of the SOE procedures. ADB will disburse funds based on actual payments made by SCUs and PCBs. The Executing Agencies will submit requests to ADB for replenishment of balances in imprest accounts when required. The evidence of such payments will become the basis of SOE operations. ADB will assess the accounting systems of the Executing Agencies 6 months after loan effectiveness to satisfy itself of the appropriateness of the special disbursement procedures. In compliance with ADB's SOE procedures, ADB review missions will test check SOE transactions on a random sampling basis.

50. **Accounting, Auditing, and Reporting.** A separate set of project accounts acceptable to ADB will be maintained by FSDA and Asaka Bank. They will reveal the total expenditures by categories of different components of the project. These accounts will record (i) amounts provided to individual SCUs, and (ii) amounts spent by FSDA. These accounts will be audited by auditors

acceptable to ADB, and English copies of the accounts and audit reports will be furnished to ADB within 6 months of the completion of each financial year. Each of the 20 SCUs will be required to maintain accounts comprising balance sheets, income statements, and funds flow statements in accordance with the requirements of the SCU Law. These will be audited by auditors acceptable to ADB, and English copies of the accounts and audit reports will be submitted to ADB within 6 months of the completion of each financial year. Delays in submission of audited financial statements may result in the suspension of loan disbursements by ADB.

51. The PCBs will maintain separate project accounts for the funds spent under the Project and will have such accounts audited by auditors acceptable to ADB. They will be submitted to ADB within 6 months of the close of each financial year. In addition, PCBs will also furnish to ADB their annual audited financial statements comprising balance sheet, income statement, and funds flow statement. The PCBs' accounts will be maintained in accordance with IAS and audited in accordance with ISA. All submissions by the PCBs to ADB will also be in English. ADB has advised the Government of its stringent requirements on timely submission of audited project accounts and financial statements and that noncompliance will result in suspension of loan disbursements.

52. FSDA will report to ADB the progress of the Project's implementation. FSDA will prepare and submit to ADB quarterly progress reports on project implementation in such form that ADB may request. During the 2004 midterm review of the project, financial projections for the PCBs and SCUs for the next 5 years will be submitted and updated annually. Within 3 months of project completion FSDA will prepare and furnish to ADB a project completion report detailing project implementation; project costs; loan recoveries; financial condition of the PCBs and SCUs; and BSLD and other details that ADB may consider necessary.

53. **Project Performance, Monitoring and Evaluation.** Project benefit monitoring and evaluation will be carried out by FSDA in accordance with the guidelines specified in ADB's *Handbook on Benefit Monitoring and Evaluation*. The Project framework will be used to monitor the overall progress and benefits. FSDA will submit to ADB a brief monitoring and evaluation report on project benefits at the end of each project year. Monitoring by FSDA will also include the efficacy of (i) the training provided to the poor and women; and (ii) the savings and lending products developed for the poor and women. PCBs will be required to report to ADB on the percentage and numbers of women beneficiaries from their subloans provided under the ADB loan.

54. **Project Reviews.** A comprehensive review of the Project will be carried out jointly by ADB, MOF, CBU and FSDA in mid-2004. This review will focus on the policy, institutional, administrative, organizational, technical, social and financial aspects of the Project and its continuing viability. The review will, among other things, assess the overall performance of the Project and the need for changes in its design. It will examine progress in microfinance reforms and compliance with the Loan and Project Agreements. It will consider complementary measures to enhance poverty impact during operations. The review will include the progress in the development of the network, and the relending and onlending terms and conditions, and will make recommendations, if any, for changes in Project design and implementation arrangements.

V. TECHNICAL ASSISTANCE

55. Sound development of SCUs in Uzbekistan requires an adequate legal and regulatory environment conducive to financially viable operations of SCUs. Given the nascent nature of the SCU industry, it is imperative to have an effective system of supervision for building strong fundamentals in SCUs for successful operation to minimize the risks of bankruptcy. BSLD in CBU has been created to be responsible for regulation and supervision of the SCUs. The TA is aimed at strengthening the capacity of BSLD to effectively regulate, supervise, and monitor the newly

created SCUs' operations and management to ensure sound development and to better withstand challenges and crises. The TA will (i) enhance CBU's SCU supervision capabilities and design appropriate systems for monitoring and reporting of SCUs' solvency, liquidity, and profitability; (ii) determine the circumstances under which CBU as the central bank may act as a temporary lender of last resort to address SCUs' temporary liquidity problems; (iii) develop within CBU an early-warning management information system to enable the central bank's intermediation when required to avert any SCU financial crisis; and (iv) facilitate understanding among CBU staff of microfinance sector policy and performance issues.

56. The total cost of the TA is \$520,000 equivalent, including \$400,000 in foreign exchange cost and \$120,000 equivalent in local currency cost. ADB will provide \$400,000 equivalent on a grant basis from the TA Special Fund to finance the total foreign exchange cost of \$378,000 and a local currency cost of \$22,000 equivalent. The TA will be implemented over a 12-month period between February 2003 and February 2004. It envisages 9 person-months of international and 15 person-months of domestic consultants. An international firm will be selected for this purpose in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for selection of domestic consultants. ADB's QCBS will be used for the selection of consultants under the TA. The detailed scope, terms of reference, cost breakdown, and financing plan are shown in Appendix 6.

VI. PROJECT BENEFITS, IMPACTS, AND RISKS

57. The adoption of a comprehensive approach to the development of microfinance is aimed at maximizing the Project's benefits and impact, and endeavoring to minimize and reduce the potentially significant risks.

A. Benefits

58. **Creation of Viable Microfinance Delivery Institutions–SCUs.** Analysis of the projected financial operations under different assumptions about the SCUs shows them to be viable financial institutions (Appendix 7 and Supplementary Appendix B for the analysis and underlying assumptions). The SCUs are expected to earn positive returns on assets from either the second or third year of their operations (depending on the assumptions). Their solvency, measured by their capital adequacy ratios are expected to reach 10% in the second year of their operations. Total membership in SCUs is expected to reach over 77,000 by the end of the fifth year and over 100,000 at the end of the project implementation period (seventh year). The SCUs are expected to mobilize members' savings worth \$12.4 million and increase their member's income by 50% by the end of the seventh year. The results of a sensitivity analysis show that the SCUs will remain viable even in the case of lower membership growth and lower interest margins. Initially, the loans to the membership will be short term (up to 6 months) and for small amounts to test the financial viability and the discipline of the borrower to repay.

59. **Viable Microfinance Operations of PCBs.** The PCBs should be financially sound in terms of solvency, liquidity and profitability. This will enable their efficient operational outreach during project implementation.

60. **Other Nonquantifiable Benefits.** The Project's nonquantifiable benefits will include (i) development of a modern financial savings and credit system in semiurban areas with points of service that extend the outreach and benefits to more isolated communities; (ii) increased competition in the provision of semiurban and rural financial services to promote efficiency of service delivery; (iii) establishment of an independent, market-based organization to act as a

service provider to SCUs; and (iv) creation of supervisory unit within CBU for the regulation and supervision of SCUs.

B. Project Impact

61. The Project will seek to build legal and formal MFIS in Uzbekistan for the first time. It will also seek to reorient commercial banks' lending policy towards microfinance without attempting to compromise their portfolio quality. The Project will also address overall economic development through (i) reduction of poverty, (ii) gender emancipation, and (iii) environmental protection as discussed below. It will not trigger ADB social safeguard policies relating to indigenous people or involuntary resettlement.

62. **Poverty Focus.** The Project, most importantly, will address poverty in Uzbekistan on a sustainable basis (Appendix 8). The Project is national in scope and has been designed to ensure that at least one third of the SCU members are poor. The Project is therefore classified as a Poverty Intervention Project. The average income for Uzbekistan's first quintile of income distribution is Sum6,472 and that for its second quintile is Sum12,907. For this reason, the SCU membership fee is proposed to be set at not less than Sum10,000, which may be paid in installments to allow wider participation by the poor. Within geographical regions, the Project's focus will be governed by each region's population density, physical infrastructure, economic base, and access to markets. Sensitivity will be exercised in designing loan and savings products to enhance women's participation. Based on a preliminary survey, the principal subsectors to benefit from microfinance under the loan will be (i) smallholder agriculture, (ii) handicraft making, (iii) micro agroprocessing, (iv) custom tailoring, (v) trading, and (vi) other services. While the Project will provide access for financing economic activities in farming and self-employment and other economically productive activities, a significant share of beneficiaries is likely to belong to the lower quintiles of the population. As borrowers can access funds on a noncollateral basis under the Project, it will also benefit those with no property or other collateral. The commercial bank component will also fund the same activities but for loan sizes of \$1,000-10,000. Likewise, the participation of the poor in SCUs will allow them the benefit of a collective group guarantee for future loans, for which they may have little or no collateral. The Project will seek to increase the incomes of SCU members by at least 50% at the end of its seventh year.

63. **Gender.** Empirical evidence from the three SCUs formed so far indicates that the majority of their beneficiaries are women and a significant number are from the low-income strata.²⁷ Over one third of the beneficiaries targeted by the loan are expected to be women, and over 20% of the total loan cost will accrue to women. The Project is therefore also classified as a Gender Development Project (Appendix 8). This Project will mandate as a condition that in at least 5 of the 20 SCUs, a minimum of 50% of members will be women. Many of the women members' individual savings may not be economic in size to maintain in banks, which is why the SCU serves collectively as a useful investment vehicle. PCBs' lending to SCUs and NGOs will enable their onward lending to their members. This will allow the banks to lend, albeit indirectly, to such groups, benefiting from the SCUs and NGOs' lower transaction costs. Likewise, PCBs could provide efficient intermediary services to the deposits of SCUs raised from the poor and women. Further, banks will be required to report to ADB the percentage of women beneficiaries from their subloans under the ADB loan. The Government has taken numerous measures addressing gender policy, including at the local level, most relevant to the implementation of this Project, the creation of women's councils within mahalla committees.

²⁷ The percentage of women members in the three SCUs (to total members) has varied between 50% and 95% in the three SCUs established. The percentage of poor members has varied between 10% and 40%.

64. **Environmental Protection Impact.** The Project is categorized as Environment Category C. The SCUs will likely finance small trading activities, a large share of which will be accounted for by barter in the poor rural areas, animal husbandry, small-scale production (in the \$1,000-\$10,000 funding range) such as tailoring, and bakeries, and agricultural activities on a micro and small scale. Based on the type of activities identified during the rural survey and the scale of lending, it is expected that the environmental effects of such activities will be insignificant.

65. Detailed legislation exists for environmental protection, with enforcement delegated to local authorities. Due consideration for the environmental impact of subprojects will be given during project implementation. The loan will not finance any subproject using toxic or hazardous chemicals or materials whose ban has been recommended by the World Health Organization (WHO) or Food and Agriculture Organization (FAO). ADB will require the PCBs to have the necessary policies and procedures in place to (i) conduct environmental screening of all subprojects based on the list of ineligible subprojects and other environmental criteria during subloan appraisal; and (ii) report on the compliance of qualified projects with environmental laws, government regulations, and ADB's environmental regulations. SCUs financing subprojects for subloans under \$1,000 equivalent will be required to report that their subprojects are not in the environmentally ineligible list, and do not use materials banned by WHO or FAO.

C. Project Risks and Safeguards

66. **Risk of Ineffective Implementation of SCU Law.** While the preparation and adoption of legislation and regulations for SCUs can be relatively easy, their effective implementation and enforcement can be more problematic. Effective implementation on a consistent basis, especially of the regulations, will be essential to ensure the safety and soundness of the licensed SCUs, particularly to protect the savings deposits of their clients by CBU. The provision of the \$400,000 advisory TA to CBU will help CBU implement the SCU Law more effectively. ADB's SSTA has helped to pilot test three SCUs under the new law. In doing so, it determined the efficacy of the Law.

67. **Risk of Delays or Problems in the Establishment of SCUs.** There are also significant risks associated in the establishment of SCUs. While their establishment has occurred successfully in other parts of the world, SCUs are relatively new to Uzbekistan. The SCUs currently may have limited capacity and this will have to be expanded rapidly through intensive training. This is expected to be mitigated in part by FSDA's knowledge base to be built under the loan as well as through ADB's SSTA and USAID's existing and proposed TAs.

68. **Operational and Financial Risks of SCUs.** Credit risk, operation risk, capital risk, and liquidity risks are the fundamental risks associated with SCUs' financial intermediation. Training and other institutional capacity building for SCUs from the USAID TA will help them mitigate their operational, credit, and interest rate risks. Subordinated debt from ADB's loan will help to mitigate SCU's capital liquidity risks. ADB's subordinated debt provides SCUs with an additional capital cushion. To further mitigate nascent SCUs' liquidity risks, SCUs' initial loans will be for 6-month durations. Overall, to mitigate these risks, the Government has undertaken under its legislation to allow SCUs to operate on a sound and independent basis without political interference and without distortions in lending rates or in credit flows.

69. Financial risks to the SCUs and their members may arise if membership is concentrated in groups who derive their income from a single economic sector. Economic shocks or collapse within that sector could have adverse impacts upon the viability of individual members and the SCU as a whole. Effective promotion and training will emphasize awareness of the risks of such membership concentration and the benefits of diversity of members' sources of income. Prudential financial

ratios set for SCUs will also help them to mitigate their financial risks and maintain a sound financial condition. This Project specifically encourages portfolio and funding diversification by SCUs for mitigating this risk.

70. **Risk of Commercial Banks' Microfinance Operations.** Normal commercial credit risks are associated with all of the subloans. Additionally, although the Government is committed to full implementation of management autonomy in financial sector institutions—and this is largely in place with private sector lending—at the local level there remain risks that external interference in lending decisions will result in poor loans. Careful selection of commercial banks having successful experience in microfinance and a strong overall financial condition will help to mitigate this risk. While empirical evidence indicates a higher rate of loan recovery from banks' microfinance operations (compared with their other operations), it is essential that the selected banks' overall financial condition remains satisfactory to enable them to continue their microfinance operations sustainably. For this reason, it is also necessary for the banks' microfinance operations to be treated as separate profit centers. Prudential financial ratios set for the commercial banks will help to maintain their financial soundness.

VII. ASSURANCES

A. Specific Assurances

71. In addition to the standard assurances, the Government and FSDA have given the following assurances, which are incorporated in the legal documents

- (i) The Government will provide required counterpart funding to FSDA in a timely manner for the period of the Project
- (ii) CBU will carry out regular reviews of operations and maintain proper supervision of SCUs
- (iii) The Government will encourage the participation of women in SCU development, establishment, and management. In particular, in at least 5 of the 20 SCUs, at least 50% of the members will be women
- (iv) The Government will assure that SCUs' operations remain autonomous and be free from corruption, both internally and in relation to their dealings with the Government, particularly at the regional and local levels
- (v) To be eligible to borrow from the ADB loan, all SCUs will operate in accordance with prudential and legal norms set out in the Law on Credit Unions
- (vi) The PCBs will comply with the financial eligibility criteria to be agreed to between ADB and the Government requiring their financial soundness
- (vii) The PCBs must have their accounts audited by an independent external auditor acceptable to ADB certifying that the bank is in compliance with the prudential norms in (vi); and complies with sound internal control, internal audit and corporate governance practices
- (viii) The PCBs agree to follow the conditions referred to in para. 28 to maintain the sustainability of their microfinance and small business support operations
- (ix) The Government will ensure that subprojects that are environmentally hazardous; use materials whose ban has been recommended by WHO or FAO; or that process narcotics, arms, tobacco, spirits, or radioactive materials are not financed under the loan.

B. Conditions for Loan Effectiveness

72. The following are the conditions for loan effectiveness (i) execution of the subsidiary loan agreement between the Government and Pakhta Bank, and (ii) execution of the subsidiary loan agreement between the Government and Asaka Bank.

C. Conditions for Disbursement

73. The following condition for disbursement of loan proceeds to each new PCB shall be met: execution of a subsidiary loan agreement with each new PCB.

VIII. RECOMMENDATION

74. I am satisfied that the proposed loan would comply with the Articles of Agreement of 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 loan of \$20,000,000 to the Republic of Uzbekistan for the Small and Microfinance Development Project from ADB's ordinary capital resources with interest to be determined in accordance with ADB's LIBOR-based lending facility; an amortization period of 20 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Project Agreements presented to the Board.

MYOUNG-HO SHIN
Vice-President

15 November 2002

PROJECT FRAMEWORK

Design Summary	Performance Indicators or Targets	Monitoring Mechanisms	Risks and Assumptions
A. Goal			
<p>1. Creation of a viable and sustainable institutional framework and mechanism for effective delivery of financial services, particularly to the poor, low income households, and small and microenterprises.</p>	<ul style="list-style-type: none"> • Creation and operationalization of financially sustainable and prudentially regulated and supervised savings and credit unions (SCUs) to be established under this project • Enhancing, financially and institutionally, the capacities of commercial banks for viable and sustainable microfinance delivery • Having at least 1/3 of SCU members from among the poor • In at least 5 of the 20 SCUs, a minimum of 50% of members must be women. • Members' income should rise by 50% by year 7. 	<ul style="list-style-type: none"> • Benefit monitoring and evaluation report • Annual loan reviews • Statistics from Central Bank of Uzbekistan (CBU) • Comprehensive midterm review after 18 months • Annual reports of commercial banks • Progress reports to be submitted by commercial banks • Project completion report (PCR) Mission • Review of SCUs' members registers to determine poverty level 	<ul style="list-style-type: none"> • Improving macroeconomic environment and political stability • Functional legal and regulatory framework to develop and nurture sound and financially sustainable SCUs • SCUs and commercial banks are allowed to operate independently without political interference or directed credit. • Improved financial disclosure standards in Uzbekistan • Potential demand for microcredit materializes through borrowers' sound and viable business plans.
B. Purpose			
<p>1. Development of an effective legal, regulatory, and institutional framework for SCUs</p> <p>2. Establishment of financially sustainable network of at least 20 SCUs that would serve to provide a role model for further growth of SCU sector</p> <p>3. Improving commercial banks' financial intermediation and access to poor individuals, households, microenterprises, and SCUs</p>	<ul style="list-style-type: none"> • Effective, objective, and consistent implementation of the Law on Credit Unions along with its accompanying regulations • Establish 20 institutionally and financially sustainable SCUs with a total of 80 service points providing access to credit to 100,000 members, and mobilize savings of \$12.4 million by the end of the seventh year. • Increase in deposits raised by banks from households, micro and small enterprises by 100% by year 7 • Full utilization of credit line of \$15.0 million by banks over a 7-year period • SCUs' raising deposits and shares from members up to \$12.4 million over a seven-year period • Commercial banks increase sustainable lending without collateral from MSEs by at least 28.3 million by year 7 	<ul style="list-style-type: none"> • Financial Sector Development Agency's (FSDA) report • Project management unit (PMU) report • Benefit monitoring and evaluation reports • Annual loan reviews • Financial statements of SCUs and commercial banks • CBU's onsite and offsite inspection reports on SCUs and banks • Comprehensive review of project after 18 months • PCR Mission completion of the Project 	<ul style="list-style-type: none"> • SCUs acquire adequate management and leadership skills. • Commercial banks develop appropriate institutional capacities for viable and sustainable microfinance delivery. • CBU develops adequate supervisory skills to monitor and regulate SCUs prudentially. • Improved financial disclosure standards in Uzbekistan • Assumptions regarding complementarities in terms of loan size and duration between the roles of SCUs and commercial banks remain valid throughout the Project, as also linkages between the borrowers from SCUs and commercial banks. • The risk for the potential demand for credit not materializing for banks due to borrowers'

Design Summary	Performance Indicators or Targets	Monitoring Mechanisms	Risks and Assumptions
	<ul style="list-style-type: none"> • SCUs increase sustainable lending to members by \$ 15.0million (in outstanding loans) by year 7 • Building of institutional capacities of SCUs from the USAID grant of \$2.2 million 		<p>institutional weakness can be mitigated by business plan development under JFPR grant.</p> <ul style="list-style-type: none"> • Prudential financial standards established for SCUs will help to maintain their financial soundness to facilitate efficient and sustainable microfinance delivery. • SCUs' liquidity risk will be further mitigated by the credit line that SCUs can obtain from ADB's loan, both directly and the portion lent to SCUs by commercial banks. • SCUs' financial risks can be mitigated by diversifying their funding and portfolio distribution • SCUs' capital risks can be mitigated by the equity to be provided to them from JFPR and subordinated debt from ADB's loan.
			<ul style="list-style-type: none"> • Prudential financial standards established for commercial banks will help to maintain their financial soundness facilitate efficient and sustainable delivery of microfinance.
C. Outputs			
<p>1. Establish an SCU network that is financially sound and institutionally sustainable, meeting the measurable prudential standards stated in the next column.</p>	<ul style="list-style-type: none"> • 100% provisioning for loan losses delinquent for more than 1 year • SCUs' intermediation cost rates must be < 5% • 35% loan loss provision for loans delinquent under 12 months • SCUs' capital adequacy ratio not less than 10% • Loan to deposit ratio not to exceed 80% for SCUs • Loan delinquency rate for loans>30 days<5% of loan portfolio for SCUs • SCUs' liquid assets equal to or greater than 10% of their demand liabilities 	<ul style="list-style-type: none"> • SCUs' financial statements • CBU's onsite and offsite inspection reports • Annual loan reviews • PCR Mission • Benefit monitoring and evaluation report 	<ul style="list-style-type: none"> • SCUs are allowed to operate independently without political interference or directed credit • Supervision function in CBU is well established. • Accounting and audit standards improve in Uzbekistan. • SCU staff acquire requisite skills. • Effective implementation of Credit Union Law and regulations thereto to ensure safety and soundness of SCUs • Risks in conversion of nongovernment organizations (NGO) into SCUs can be mitigated by application of the results of the small-scale

Design Summary	Performance Indicators or Targets	Monitoring Mechanisms	Risks and Assumptions						
			technical assistance (SSTA). <ul style="list-style-type: none"> Assistance to nascent SCUs can also help in the conversion process. Consistent interpretation of the Credit Union Law by CBU 						
2. Expand outreach to and beyond oblast capital, supplying remunerative financial services that meet effective demand from field membership.	<ul style="list-style-type: none"> Reach the following growth parameters by year 7 <table border="1" data-bbox="625 423 1031 594"> <tr> <td>Number of SCUs</td> <td>20</td> </tr> <tr> <td>Total membership (Households)</td> <td>100,000</td> </tr> <tr> <td>Members to total households in Uzbekistan</td> <td>2.18%</td> </tr> </table>	Number of SCUs	20	Total membership (Households)	100,000	Members to total households in Uzbekistan	2.18%	<ul style="list-style-type: none"> Annual loan reviews PCR Mission CBU's onsite and offsite inspection reports of banks/SCUs SCU's financial statements Benefit monitoring and evaluation reports Banks' annual reports 	<ul style="list-style-type: none"> Government allows SCUs to operate independently. SCUs imbibe public confidence based on trust. Supervision function in CBU is well established. Accounting and Audit standard improve in Uzbekistan. Government's flexibility in amendments to SCU Law and operating regulations, if necessary, for effective implementation of technical assistance (TA) SCUs have enough demand for microcredit.
Number of SCUs	20								
Total membership (Households)	100,000								
Members to total households in Uzbekistan	2.18%								
3. Establish enabling legal and regulatory framework for SCU operations.	<ul style="list-style-type: none"> Law on SCUs prepared under project preparatory technical assistance (PPTA) is operational and, if necessary, revised (after testing of pilot SCUs under SSTA) to support their efficient functioning Regulations and operating policies are in place and revised, if necessary. 	<ul style="list-style-type: none"> Annual loan reviews PCR Mission CBU's onsite and offsite inspection reports SCU's financial statements SSTA Inception Mission Benefit monitoring evaluation report 							
4. Establish prudential supervision and regulation infrastructure for SCUs.	<ul style="list-style-type: none"> Creation of an adequately staffed special department in CBU 	<ul style="list-style-type: none"> Annual loan reviews PCR Mission CBU's onsite and offsite inspection reports SCU's financial statements SSTA Inception Mission Benefit monitoring evaluation Report 							
5. Enhance capacity of the FSDA to provide training and institutional capacity building to nascent SCUs	<ul style="list-style-type: none"> FSDA hires adequately qualified personnel in the following disciplines <ol style="list-style-type: none"> accounting; financial management; credit administration; 	<ul style="list-style-type: none"> Annual loan reviews PCR Mission CBU's onsite and offsite inspection reports SCU's financial statements SSTA Inception Mission 	<ul style="list-style-type: none"> Technical and managerial support to SCUs to mitigate SCUs' operational, liquidity, capital, credit and interest rate risks. 						

Design Summary	Performance Indicators or Targets	Monitoring Mechanisms	Risks and Assumptions
	<ul style="list-style-type: none"> (iv) SCU promotion and organization; and (v) SCU Law and operational regulations thereunder 	<ul style="list-style-type: none"> • Benefit monitoring evaluation report • Audited financial statements of commercial banks • Progress reports of commercial banks 	
<p>6. Selection of Pakhta and Asaka Bank and other commercial banks that are operationally and financially sound</p>	<ul style="list-style-type: none"> • For commercial banks, establish financial covenants such as capital adequacy ratio of not less than 10%, loan to deposit ratio not higher than 100%, and return on assets ratio of not less than 1%. • For commercial banks, select those banks with a minimum of 56 rural branches and at least \$3.5 million in annual lending in microfinance. 		
D. Inputs			
<p>1. Loan of \$5.0 million for SCU development</p>		<ul style="list-style-type: none"> • Annual loan reviews • Progress reports • PCR Mission 	
<p>2. Credit line of \$15.0 million to the designated banks</p>			
<p>3. Provision of subordinated debt up to \$100,000 per SCU to 20 SCUs from the ADB loan</p>		<ul style="list-style-type: none"> • CBU Banking Supervision Department reports • Annual reviews 	<ul style="list-style-type: none"> • SCUs meet the criteria for registration of a minimum of 50 members and a minimum equity contribution thereof of \$3,000 equivalent

SAVINGS AND CREDIT UNIONS' LEGAL AND REGULATORY FRAMEWORK

1. Uzbekistan's Parliament approved on 4 April 2002 the Law on Credit Unions. The Law, drafted by ADB's project preparatory technical assistance (PPTA) consultants, is comprehensive in scope and transparent to interpretation. The Law sets out savings and credit unions' (SCU) permissible prudential operational, financial and corporate governance safeguards and stipulates SCUs' rights and obligations. It requires every SCUs to be a legal entity, defines SCUs as taxable commercial organizations and protects their operations from political interference. It restricts the powers of SCUs into venturing to risky endeavors such as manufacturing or trading. The Law mandates SCUs' minimum membership at 50 (which includes both individuals as well as legal entities) to ensure a minimum critical mass for membership. It defines the members' ownership and shareholding structures and the statutory regulatory capital for every SCU.

2. The Law allows SCUs to accept deposits from and make loans to its members alone. This is to control SCUs' liquidity and credit risks by the principle of mutuality. The Law lays down the criteria and procedure for registration of SCUs (including information on the members' qualifications and their share subscription) The Law requires every SCU to have as a prerequisite for registration at least 50 members (which may include both individuals and legal entities. None of the individual members should have ever faced any criminal charges. The regulations also require every SCU to be adequately capitalized and be financially prudent. The regulations require SCUs incorporated in Tashkent to have a minimum paid-in equity of \$20,000 equivalent and those incorporated outside Tashkent to have a minimum paid in equity of \$10,000 equivalent to be contributed in cash as a condition for registration. To ensure fairness, the Law provides for any association of persons whose application for the registration of an SCU has been refused, to appeal to court over CBU's refusal if the SCU meets the above basic eligibility criteria.

3. Once established, every SCU is required to adhere to the following financial ratios (i) capital adequacy ratio of not less than 15%, (ii) liquidity ratio (i.e., ratio of liquid assets to demand liabilities of less than 30 days) of not less than 20%, (iii) loan concentration ratio (of lending to any single borrower or group of borrowers) not to exceed 25% of capital, (iv) noncollateralized lending not to exceed 10% of capital, and (v) investment in Government bonds not to exceed 25% of capital .

4. Under the Law, SCUs have to submit audited financial statements. CBU will conduct their onsite and offsite examination, in line with the internationally accepted practices recommended by WOCCU. The Law specifies the powers of SCUs' general meeting of members and of their boards of directors. It requires SCUs to have an odd number of directors not less than five and to meet not less than once a month. To avoid conflict of interest, the Law prohibits any board member from participating in the activities of other credit unions. To maintain a high standard of corporate governance, the Law requires the board to establish an audit committee (whose members should not also be members of the board's management committee) that is to be vested with the responsibility of an SCU's accounts and finances and in ensuring its compliance with its statute and the Law. The Audit Committee is empowered to call for a general meeting of the members to discuss its findings on an SCU's financial condition. This provision ensures transparency in SCUs' financial disclosure and allows early ameliorative action to correct any deterioration in financial condition.

5. Along with the Law, CBU has prepared with support from ADB's PPTA (i) standardized bylaws for SCUs, (ii) rules and regulations for the supervision of SCUs, and (iii) procedure manuals for SCUs. CBU's rules and regulations cover the entire gamut of prudential norms for SCUs drawn from legislation in other countries. These include (i) licensing of SCUs; (ii) credit policies and documentation; (iii) asset classification, loan loss provisions, and interest accruals; (iv) capital adequacy; (v) investment and liquidity policies (including loan concentration limits); (vi) asset-liability management; (vii) internal or external audits, and internal controls; (viii) conflict of interests and unsound business practices; (ix) maintenance of records; (x) sanctions on SCUs by CBU; and (xi) reorganization and voluntary and involuntary liquidation. CBU's procedure manuals cover models for (i) provision for loan loss policy, (ii) liquidity and asset liability management policy, (iii) capital policy, (iv) collection policy, (v) credit policy, (vi) investment policy, and (vii) savings policy.

6. These regulations and model documents reflect the best practices of operational and financial management of SCUs worldwide, adapted to Uzbekistan's context. They were intended as guides to nascent SCUs to enable SCUs to conform to provisions of the Law and to its accompanying regulations.

EXTERNAL ASSISTANCE

1. External assistance to Uzbekistan's micro and small enterprise (MSE) sector finance has been relatively limited, which could be attributed to the lack of an appropriate regulatory and policy framework. The United Nations Development Programme (UNDP) was a pioneer in this area. The UNDP Micro Credit Project in Karakalpakstan began in 1998 with the involvement of the Karakalpakstan branch of the Association of Business Women (ABW).¹ The pilot phase began in Nukus in the town of Kegheili and included approximately 180 households. Credits were extended to groups of 5-7 members for purposes of trade, livestock breeding, small enterprises, services, or consumption. Since inception, the project has exhibited a repayment rate of 97-100%. In addition to Kegheili, it now operates in Chimbai, Akmanghi, and Karauziak towns and serves 763 clients. Women represent 99.4% of the participants. This scheme has an annual lending of \$400,000 equivalent.
2. Asian Development Bank (ADB) has assisted nongovernment organization (NGO)-based microfinance activities through a Japan Fund for Poverty Reduction (JFPR) Grant, "Innovative Poverty Reduction in Karakalpakstan," approved on September 2001 for \$2.4 million. The microfinance component of this grant was \$0.63 million.
3. UNDP and an NGO from the Netherlands have operated a micro credit fund in Bashchasma and Karshi since 1999. It has experienced a 98-99% repayment rate, and currently serves 174 clients. This scheme has an annual lending of \$100,000 equivalent, and the average size loan was approximately \$90 equivalent.
4. The United States Agency for International Development (USAID) approved in December 2001 the Fergana Valley Micro Credit Activity. Under this project, credits from \$50 to \$3,000 equivalent in local currency are being disbursed based on group lending activities. Mercy Corps, a US-based NGO, began micro credit operations in 2001 in the Samarkand and Fergana regions in collaboration with the UK Government's Department for International Development. In April 2002, Mercy Corps disbursed \$230,000 equivalent in local currency loans. The aforesaid programs target groups and individual lending for amounts below \$3,000 equivalent in local currency. Interest rates range between 30-70% with maturity up to 6 months.
5. The European Bank for Reconstruction and Development (EBRD) approved on 28 May 2002 a \$20 million credit line for micro and small enterprises to be channeled through six banks.² A second tranche of a further \$20 million may be released depending on the performance of the banks under the first. EBRD is the first major international financial institution to undertake lending for this sector.
6. The Japan-Europe Cooperation Fund approved a technical assistance (TA) of \$5 million to strengthen the institutional capacities of the commercial banks participating in EBRD's credit line. The TA supports the commercial banks in (i) training specialized lending personnel, (ii) creating efficient micro and small enterprise lending procedures, (iii) building diversified loan portfolios, (iv) establishing transparent and objective decision-making mechanisms, and (v) establishing internal auditing and management information systems. ADB had extensive consultations with EBRD during project processing and both institutions have complementary operations, which are critical for meeting the unmet SMF credit requirements.

¹ This association, which will be incorporated as a legal entity, will be a candidate for conversion into a savings and credit union under the proposed ADB loan.

² These are Pakhta Bank, Hamkor Bank, Ipak Yuli Bank, Uzjilsberbank, Business Bank, and Promstroy Bank.

7. USAID approved on 20 May 2002 a TA grant for \$463,000 to assist savings and credit unions (SCUs). This grant finances (i) domestic training for SCU staff in transparent financial disclosure and corporate governance, holding of board and other statutory meetings, credit, and accounting; (ii) specialized out-of-country training of SCU staff; (iii) office equipment and premises for SCUs; and (iv) equity capital for SCUs. USAID's TA complements ADB's small-scale TA in institutional capacity building. USAID will provide a new TA to Uzbekistan. This TA grant, which will further build on the activities of USAID's earlier grant, will complement the institutional capacity building for SCUs envisaged under the proposed loan.

USAID's new TA grant will support SCUs institutionally in the following areas

- (i) business plan preparation;
- (ii) organization of board and other statutory meetings for SCUs;
- (iii) development of appropriate financial reporting and corporate governance structures;
- (iv) monitoring and analysis of SCUs' financial and operational performance, and tracking their achievement of internationally accepted prudential standards;
- (v) standardizing and harmonizing charts of accounts of SCUs;
- (vi) establishment of savings mobilization programs;
- (vii) domestic and out-of-country training for SCU staff in (i)–(vi) above; and
- (viii) support of SCUs to voluntarily form a National Association of Credit Unions that would provide technical and managerial support.

This TA is expected to commence in January 2003.

LESSONS LEARNED

1. As this is the first microfinance project in Uzbekistan, there are no precedents to incorporate country specific lessons. However, ADB has gained valuable experience in its microfinance operations in other transitional economies, Cambodia, the Kyrgyz Republic and Mongolia which have been incorporated into the design of this project.

2. The Project design draws important lessons from the Rural Credit and Savings Project in Cambodia.¹ The design of the two projects is similar. That project also involved (i) a credit line to the Rural Development Bank of Cambodia for relending to microfinance institutions (MFI) to be established by NGOs and (ii) TA to the Central Bank to better regulate and supervise MFIs. The timing of that loan was probably premature. When the loan became effective, there were no registered and licensed MFIs ready to utilize the loan funds. This was due to delay in the legal and regulatory framework for MFIs. As a result, loan commitments and disbursements were delayed. By contrast, in Uzbekistan, the loan is being processed only after legal and regulatory framework for savings and credit unions (SCU) are in place. Three SCUs are already licensed and more are expected to be licensed by the time the loan becomes effective. By having the SCU regulatory framework in place and pilot testing SCUs before loan approval, the problem of delayed implementation has been mitigated.

3. In the Kyrgyz Republic, ADB's loan was approved amid an incomplete regulatory infrastructure for SCUs,² which did not specify the standards for SCUs' solvency liquidity and profitability. Further, the Central Bank of the Kyrgyz Republic delegated SCUs' supervision and regulation responsibilities to another agency the Financial Company for the Support and Development of Credit Unions (FCSDCU). Owing to the limited regulatory capabilities of FCSDCU, many SCUs lacking adequate capital, sound management and viable business plans were prematurely granted licenses. This resulted in a proliferation of undercapitalized SCUs in the early years, which led to a high attrition rate. Clearly, FCSDCU's limited supervisory capacity could not keep pace with the proliferation of SCUs.

4. By contrast, ADB's loan to Uzbekistan was being processed only after a legal and regulatory framework was in place (i.e., with the enactment of the Law on Credit Unions with its accompanying regulations). Both the Law and regulations incorporate internationally accepted prudential financial benchmarks for SCUs based on World Council of Credit Unions (WOCCU) and Protection to members, Effective financial structure, Asset quality, Rates of return and costs, Liquidity and Signs of Growth (PEARL) formula. To test the efficacy of the Law, ADB's small-scale TA successfully pilot tested 3 SCUs in the country which have since received their licenses. Further, unlike in the Kyrgyz Republic, in Uzbekistan, the Central Bank of Uzbekistan (CBU) will be the prudential supervisor and regulator of SCUs. ADB's advisory TA to CBU will further enhance its regulatory capacity. The project recognizes and builds further on the already existing role of commercial banks in microfinance. ADB is thereby adopting a more holistic approach to the development of microfinance services in Uzbekistan.

5. The Project design also draws lessons from Loan 1290-MON: Employment Generation Project.³ That project also envisaged use of participating commercial banks (PCBs) for the delivery of loans to micro and small enterprises (MSEs). The draft PPAR of that project reported that its employment targets were not met because: (i) the participating commercial banks were not suitable as micro and small credit lenders since their credit officers lacked a clear understanding of cash flow analysis and debt service capabilities of MSEs; (ii) ADB did not

¹ ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Cambodia for the Rural Credit and Savings Project*. Manila.

² Operations began under Temporary Rules for the Regulations of Credit Unions.

³ ADB. 1993. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the Employment Generation Project*. Manila.

rigorously undertake institutional analysis of PCBs whose financial viability was unproven; (iii) loan products of PCBs were not designed to service the poor; (iv) financial institutions' viability and outreach were mutually exclusive; (v) subloan ceiling of \$5,000 equivalent caused implementation delays in terms of subloan disbursements against targets, with subloan disbursements increasing only after subloan ceiling was raised to \$15,000; and (vi) using NGOs as intermediaries to introduce clients to PCBs did not significantly improve the number of loans. By contrast, in Uzbekistan, ADB selected participating commercial banks (PCBs) with a (i) proven track record in microfinance delivery and outreach capabilities and loan recovery, and (ii) with a proven demand for credit in the subloan sizes considered by the project from small and micro enterprises.

6. Overall, in the design of the Uzbekistan project, ADB has ensured that the following conditions necessary for successful microfinance operations were in place (i) a sound legal and regulatory framework for MFI with sound financial standards for their solvency, liquidity and profitability; (ii) trial run of MFIs on a pilot basis working under the legal and regulatory framework; (iii) careful selection of financially viable PCBs with a proven track record in microfinance delivery, outreach capabilities and loan recovery; (iv) careful analysis of demand for credit from micro and small enterprises; and (v) allowing MFIs and PCBs to lend at real positive interest rates without any interest rate ceilings.

TERMS OF REFERENCE FOR CONSULTANTS AND STAFF TO BE ENGAGED UNDER THE LOAN BY THE FINANCIAL SECTOR DEVELOPMENT AGENCY (FSDA)

A. Local Staff

1. The Financial Sector Development Agency (FSDA) will hire 12 local staff at the salary equivalent of \$1,000 per month for 84 months (7 years) during the Project's implementation. This cost is entirely in local currency amounting to \$84,800 and will be met out of the Government's contribution towards project cost. The local staff will have had prior experience in providing support services to savings and credit unions (SCUs) or non-government organizations (NGOs) as well as expert knowledge in SCU Law regulation supervision and operations. Working knowledge of English is preferable, albeit not a precondition for selection.

B. International Consultants

2. From the loan funds, FSDA will hire two international consultants to provide a total of 13.6 person-months of consultancy. One consultant will be an SCU institution development specialist who will provide 5 person-months' consulting service. The other consultant will be an SCU corporate, statutory and financial specialist. This consultant will also serve as the team leader and provide a total of 8.6 person-months of services. The international consultants will be fielded over a 12-month period after loan effectiveness, between May 2003 and April 2004. The international consultants will be recruited in accordance with Asian Development Bank's (ADB's) *Guidelines on the Use of Consultants* using ADB's quality and cost based consultants' selection.

3. The team leader will be an accountant by training and have a fluent working knowledge of Russian. The team leader/SCU corporate, statutory and financial specialist will have had considerable experience in the establishment and/or supervision of SCUs in other countries. The team leader will also have had prior experience in SCUs' accounting, financial disclosure and statutory meetings organization. The SCU institution development specialist will have had considerable experience in the preparation of business plans, establishment of savings' mobilization programs and SCUs' beneficiary needs' analyses.

4. The team leader and SCU Institution Development Specialist will coordinate their activities closely with the team leader for the United States Agency for International Development (USAID) grant. The team and the USAID team will divide their coverage of SCUs regionally. Both the team leader and the SCU Institutions Development Specialist will prepare the necessary manuals and train the local staff of FSDA in their respective disciplines. This should enable the locally hired FSDA staff to continue the training activities after departure of the international consultants.

C. Detailed Terms of Reference for Consultants

1. Team Leader/SCU Corporate and Financial Specialist

5. The team leader's activities will include, but not be limited, to the following:

- (i) organization of board and other statutory meetings;
- (ii) standardization and harmonization of charts of accounts for SCUs;
- (iii) development of appropriate financial reporting and corporate governance structures;
- (iv) monitoring and analyses of SCUs' financial and operational performance and tracking their achievement against internationally accepted standards;
- (v) provision of domestic training to SCUs in above areas and recommendation of out-of-country training;

- (vi) review and development of training programs on the existing statutory requirement for the establishment of SCUs;
- (vii) development of training programs to introduce transparent corporate governance practices, institutional and financial sustainability and target orientation for nascent SCU;
- (viii) development of a training program for SCU on the use of the standard SCU chart of accounts and financial statements;
- (ix) provision of a uniform set of norms embracing internal controls and prudential/operational standards and guidelines for SCU and implement training programs for their implementation;
- (x) preparation of guidelines for SCU's credit analysis for individual loans and implement training programs for its usage, which should reflect international best practices;
- (xi) development of a monitoring system to provide reports of financial conditions, external audit reports, and onsite inspection or examination reports;
- (xii) development of a curriculum and training programs for SCU boards of directors, committees, and staff on the use of model bylaws and policies developed by the Central Bank of Uzbekistan (CBU);
- (xiii) development and implementation of a training program for SCUs in document registration; and
- (xiv) development of eligibility criteria of each SCU to subordinated debt, credit line and institutional strengthening assistance.

2. SCU Institution Development Specialist

6. The SCU Institutional Development Specialist's activities will include, but not be limited, to the following:
- (i) preparation of SCU business plan;
 - (ii) establishment of savings mobilization plan;
 - (iii) analyses of SCU beneficiaries' needs
 - (iv) provision of domestic training of SCUs' staff in above disciplines;
 - (v) preparation of training out-of-country in above disciplines;
 - (vi) development and implementation of a program of workshops for the promotion of SCUs;
 - (vii) assistance in the establishment of 20 SCUs required under the loan activities;
 - (viii) preparation of a training program for FSDA officers and staff on assessing SCU using the eligibility criteria; and
 - (ix) establishment of ongoing development and education programs for SCU board of directors, committee members, and staffs.

D. Reporting Structure

7. Within 1 month of their engagement, the international consultants will prepare an inception report outlining their activities. Three months after the commencement of their activities, the consultants will prepare a midterm report which will be reviewed by ADB, the Government and FSDA. The views of ADB, the Government, and FSDA will be incorporated into the report. Prior to completion of their assignment, the consultants will prepare a draft final report which will again be reviewed by ADB, the Government and FSDA. The Final Report will be prepared after completion of the assignment.

THE TECHNICAL ASSISTANCE

A. Methodology and Key Activities

1. The Asian Development Bank (ADB) will engage a qualified team of consultants in accordance with its *Guidelines on the Use of Consultants*. ADB's quality and cost-based consultant selection procedure will be used. The consultant team will be hired through a firm and will work closely with the officials from the Central Bank of Uzbekistan (CBU), the Financial Sector Development Agency (FSDA), and ADB, and undertake tasks detailed in the terms of reference (TOR) (Part D). The consultants will hold training sessions and organize the out-of-country training trips for a number of CBU staff to be identified later to learn from international experience.

2. The technical assistance (TA) scope will include the following activities:

- (i) develop a conceptual framework for effective implementation, supervision, and monitoring of savings and credit unions (SCU) regulations;
- (ii) review CBU's regulatory framework for credit union supervision, monitoring and risk management system; and recommend a system to monitor and report on SCUs solvency, liquidity, and profitability;
- (iii) formulate comprehensive procedures and draft relevant manuals and guidelines to support supervision and monitoring of SCU liquidity risk management following the best international practices;
- (iv) determine optimum liquidity levels and establish and enforce liquidity and risk management indicators of SCUs supervised by CBU and determine the circumstances under which CBU as the central bank may act as a temporary lender of last resort to address SCUs' temporary liquidity problems;
- (v) improve the financial disclosure, corporate governance, regulatory submissions, and prudential supervision of banks' noncollateralized microfinance portfolios;
- (vi) establish and implement a management information system (MIS) framework for SCU supervision;
- (vii) help CBU to design rescue schemes to mitigate temporary liquidity crises that SCUs may face, and design an early-warning management information system to enable CBU's intervention when required to avert any SCU financial crisis;
- (viii) through appropriate domestic and external training, build the capacity of CBU for supervision and liquidity risk management;
- (ix) review banking laws, the central banking law, and feasible reforms in banking laws taking account of microfinance; and study the appropriateness of the Law on Credit Unions in the context of the country and the policy frameworks;
- (x) explore ways to enhance the leadership and promotional role of CBU to support microfinance, and an independent credit rating process; and identify promotional activities such as pilot testing of projects; and
- (xi) develop sustainable microfinance in the envisaged sequence of financial liberalization, such as deregulation of interest rates; and review barriers to entry in the formal financial system.

3. The funds provided by ADB will finance international and domestic consulting services; resource persons, materials, and other costs for the seminars; equipment; project coordination; overseas training; and other administrative and office requirements. The Government's contribution of \$120,000 equivalent will cover the costs of counterpart staff; office accommodation for international and domestic consultants; local communications and

transportation; interpretation and translation; venue, organization, and administration for workshops; and general administration and others.

B. Cost and Financing

4. The total cost of the TA is \$520,000 equivalent, including \$378,000 in foreign currency cost and \$142,000 equivalent in local currency cost. ADB will provide \$400,000 equivalent on a grant basis from the Technical Assistance Special Fund to finance the total foreign currency cost and \$22,000 equivalent of the local currency cost. The funds provided by ADB will finance the international and domestic consulting services; resource persons, materials, and other costs for the training; equipment; project coordination; and other administrative and office requirements. The Government's contribution of \$120,000 equivalent will cover the costs of counterpart staff; office accommodation for international and domestic consultants; local communications and transportation; interpretation and translation; venue, organization, and administration for training; and general administration. The detailed cost breakdown and financing plan for the TA are shown at the end of this appendix.

C. Implementation Arrangements

5. The Banking Supervision and Licensing Division (BSLD) of CBU will be the Executing Agency for the TA. BSLD will work closely with FSDA. The implementation of the TA is expected to commence in February 2003 and it is expected to be completed in February 2004.

6. For the TA, the services of 9 person-months of international consultants and 15 person-months of domestic consultants will be required. The lead international consultants will have expertise in credit union supervision and operations and will be responsible for coordinating project activities in close collaboration with BSLD; drafting the progress reports on key tasks identified in the TOR; and organizing the trainings, meetings, and consultations. Domestic consultants will have expertise in rural formal/informal finance sector related to the operating environment of the credit unions and be familiar with the government's policy on credit unions, microfinance sector, and economic reform. They will assist in all aspects of the TA as needed, with particular emphasis on the framework of the supervision, regulation, and monitoring role of CBU; management information system (MIS); participating in the workshop, translating, and other tasks as necessary; and otherwise as requested by the lead international consultant. The outline terms of reference for the consultants are attached in the following section. The consulting services will be provided by an international consulting firm, which will provide both international and domestic consultants. The consultants will be selected and engaged in accordance with ADB's *Guidelines on Use of Consultants*. International training persons will also be invited to participate in workshop. The equipment will be procured by the BSLD in accordance with the Bank's *Guidelines for Procurement*. An advance payment facility will be provided for the start-up. The TA will be supervised by the Governance, Finance and Trade Division in close collaboration with BSLD. The technical proposals invited from the shortlisted firms will be in ADB's simplified format.

7. The team leader will submit an inception report, two progress reports, draft final report, and a final report to the Government and ADB. Two tripartite meetings and one review meeting will be held to discuss the status of implementation of the TA and to identify any additional actions that may be needed to meet the objectives of the TA.

8. The TA will be implemented over a 12-month period commencing in February 2003.

D. Outline Terms of Reference for Consultants

1. SCU Supervision and Regulation Specialist/Team Leader (international, 6 person-months)

9. The SCU supervision and regulation specialist will have extensive experiences in all aspects of SCU operations including their supervision. He or she will, in particular, have expertise in preparing policy frameworks for regulation, supervision, and monitoring of SCUs. He or she will hold at least a master's degree in economics, or in a similar discipline; have had at least 10 years of experience in banking/credit union supervision and regulation, preferably in transition economies; and have knowledge of Russian. The consultant's tasks will include the following:

- (i) Assess the current situation in Uzbekistan in the context of developing a policy framework for SCUs with reference to the Law on Credit Unions and its regulations pertaining to fiscal policy, agricultural policy, financial sector policies and reform, direct government assistance and interventions, institutional autonomy and governance, and competition,
- (ii) Review the SCU operating environment including the legal framework of SCU regulation in line with CBU's regulations on bank supervision, regulatory and supervisory mechanism of SCUs (including self-regulatory organization), system of internal controls, auditing and regulatory standards for transparency, the draft Law on Credit Unions, and other relevant legislation;
- (iii) Review the model policies and procedures developed under the project preparatory technical assistance (PPTA) in the areas of credit administration, delinquency control, collections, internal controls, asset/liability management, and savings deposits; and provide recommendations on its adequacy and amendments,
- (iv) Recommend a comprehensive policy and prudential framework to carry out the functions efficiently and effectively in a market-oriented banking system, and assist in implementation,
- (v) Review the role of central banks in supervision of microfinance institutions in microfinance development in other countries, and draw parallels for the Uzbekistan context,
- (vi) Examine the financial standards in Uzbekistan for SCUs against the background of international benchmarks Protection to members, Effective financial structure, Asset quality, Rates of return and costs, Liquidity and Signs of growth (PEARLS) developed by the World Council of Credit Unions,
- (vii) Draft appropriate supervisory procedures for off-site and on-site surveillance of the SCU system, and work closely with the SCU MIS specialist,
- (viii) Review international best practices in the regulation, supervision, and monitoring of SCUs and keep abreast of aid activities and non-government organization (NGO) activities in the area of microcredit and SCUs,
- (ix) Assist CBU in facilitating the implementation of policies, accounting, auditing, and disclosure requirements as required under the regulations; and explore the linkages with the supervision of commercial banks' microfinance activities by BSLD,

- (x) Identify any other issues that have significant impact on the SCU system, and make recommendations for any required modifications,
- (xi) Review the monitoring system developed under the PPTA including reports of financial conditions, external audit reports, and others; and recommend any changes necessary.

10. In addition, the team leader will be responsible for coordinating all approved activities, overseeing tasks of the domestic consultants, submitting all required reports to the Government and ADB, and otherwise seeking to take all reasonable and practicable steps to ensure the successful completion of the TA.

11. Three copies of each of the above reports will be submitted to the Ministry of Finance (MOF) and ADB, in both paper form and electronically. The reports will detail progress toward producing the outputs, completing the activities, and achieving the objectives of the TA, as well as any problems encountered and any substantial changes that may be needed in the work program or the consultants' TOR. In addition, the final report will provide recommendations for future actions by the Government and ADB.

2. SCU Legal Advisor (international, 1 person-month)

12. The SCU legal advisor will have expertise in developing the legal framework for effective regulation and supervision of SCUs and will assist the team leader in drafting recommendations. He or she will have had good experience in advising the authorities in other transition economies on credit unions and/or microfinance laws. The consultant will perform the following specific tasks:

- (i) Review international norms in the SCU legal and regulatory framework, and recommend amendments as necessary based on the best international practices,
- (ii) Work closely with the local law expert in reviewing existing legislation relating to banking operations and the SCU Law,
- (iii) Research legal issues affecting the development of SCUs and their compliance with existing legislation,
- (iv) Draft recommendations on amendments to the existing regulations and bylaws,
- (v) Work closely with the team leader to provide necessary inputs to the reports.

3. SCU MIS Specialist (international, 2 person-months)

13. The SCU MIS specialist will have in-depth familiarity with SCU operations, specifically the reporting requirements. He or she will have had at least 5 years of working experience in assisting credit union supervisory authorities in other countries, preferably developing countries. Working closely with the SCU supervision and regulation specialist, the SCU MIS specialist will be responsible for the following specific tasks

- (i) Review the monitoring system developed under the PPTA; develop the MIS requirements of SCUs to assess their capacity to provide prompt and accurate

information as needed by CBU; and make practical recommendations for improvements,

- (ii) Assess data requirements from the perspective of both CBU and SCU to ensure (a) efficiency in reporting, and (b) transparency in accounting and financial reporting,
- (iii) Devise a simple and cost-effective system of data collection and processing, and incorporate it in an operating manual,
- (iv) Work closely with the domestic MIS specialist in all tasks to transfer the knowledge.

4. SCU Development Advisor (domestic, 8 person-months)

14. The SCU development advisor will have good knowledge of SCU development in Uzbekistan and the rural formal/informal microfinance sector, and will work closely with the SCU supervision and regulation specialist in the performance of all aspects of the TA. The consultant will perform the following specific tasks:

- (i) Assist in reviewing the SCU operating environment including government policies on SCUs, the legal framework, and the regulatory and supervisory mechanism for SCUs,
- (ii) Assist in reviewing the system of internal controls, auditing, and regulatory standards for transparency; the draft Law on Credit Unions; and other areas of relevance,
- (iii) Assist in drafting the reports and manuals,
- (iv) Assist in any other tasks necessary.

5. MIS Specialist (domestic, 7 person-months)

15. The domestic MIS specialist will have expertise in developing software for banking and financial reporting. The consultant will work closely with the international SCU MIS specialist and will perform the following specific tasks:

- (i) Review software needs vis-à-vis the information requirements,
- (ii) Advise on hardware and peripheral needs,
- (iii) Install and test software, including a web site on SCUs in CBU,
- (iv) Train CBU staff and selected SCU staff,
- (v) Prepare a user's manual,
- (vi) Work closely with the international MIS specialist in carrying out the tasks.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	200.0	0.0	200.0
ii. Domestic Consultants	0.0	22.0	22.0
b. International and Local Travel	35.0	0.0	35.0
c. Reports and Communications	18.0	0.0	18.0
2. Equipment	11.0	0.0	11.0
3. Training, Seminars, and Conferences	8.0	0.0	8.0
4. Study Tours	50.0	0.0	50.0
5. Miscellaneous Administration and Support Costs	10.0	0.0	10.0
6. Representative for Contract Negotiations	6.0	0.0	6.0
7. Contingencies	40.0	0.0	40.0
Subtotal (A)	378.0	22.0	400.0
B. Government Financing^b			
1. Office Accommodation and Transport	0.0	30.0	30.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	70.0	70.0
3. Contingency	0.0	20.0	20.0
Subtotal (B)	0.0	120.0	120.0
Total	378.0	142.0	520.0

^a Financed by ADB's Technical Assistance Special Fund.

^b All local currency costs other than those for domestic consultants will be financed by the Government.
Source: ADB estimates.

FINANCIAL PROJECTION OF THE SAVINGS AND CREDIT UNIONS

A. Introduction

1. The financial projections of the savings and credit unions (SCUs) have been made based on a set of assumptions that reflect (i) the SCU operating environment in the country, and (ii) the initial findings from the small-scale technical assistance (TA) on pilot testing of three SCUs in Samarkand, Bukhara, and Namangan regions. As Uzbekistan aims to meet the policy targets of the International Monetary Fund's (IMF) Staff Monitoring Program (SMP) for financial assistance in the near future, the macroeconomic conditions in the country are undergoing dramatic changes, which will impact the operating environment of SCUs as well as their financial viability. Hence, the assumptions that were made during the project preparatory technical assistance (PPTA) stage were closely reviewed during the appraisal mission and amended based on the latest developments on the ground.

2. SCUs are in their early stage of establishment. There is no historical data from which to draw inferences to forecast member loans, deposits, and operating expenses, etc. The projected financial statements are based on credit union operations in other countries, where the World Council of Credit Unions (WOCCU) has provided TA and training, the PPTA's beneficiary needs survey, and government statistics. The pilot programs in the three regions started in May 2002, and their findings so far have been very positive. The experience in these regions shows that there is high demand for SCU services as indicated by high initial membership number and the survey results of the pilot SCU members. However, a more conservative membership growth base than the PPTA financial projections has been used in order to reduce the risk of inflating the results, and the interest rate policies adopted by the pilot SCUs have been used in the financial projections.

3. It was originally planned in the PPTA to establish four SCUs per year; thus there would be 20 SCUs in five years. However, the Central Bank of Uzbekistan (CBU) is planning to grant licenses to 12-14 SCUs during 2002-2003, which makes it desirable for the Project to support the establishment of all of the newly licensed SCUs. The United States Agency for International Development (USAID) is expected to provide cofinancing to support capacity building for the SCUs. Therefore, under the expectation that the technical support to SCUs will be provided by USAID, the financial projections have assumed that 14 SCUs in the first year and 6 in the second year will be established, and the following years will see the growth of the 20 SCUs. Given the uncertain economic conditions, sensitivity analysis was performed under different economic and growth assumptions (section D). The results show that the viability of SCUs remains unchanged in the cases of lower membership growth (half of the base case assumption); however, it remains uncertain in the case of lower interest rate spread combined with lower membership growth.

B. SCU Financial Projections – Key Assumptions

4. Based on the assumptions in Table 1, SCUs will generate a positive net income beginning in year two. The institutional capital-to-total assets ratio will reach close to 10% by the end of the second year, and loan delinquency is assumed to be less than 5% of the total loans outstanding. Funds and liquidity management efforts will keep SCUs liquid, as the liquidity reserve as a percentage of total savings deposits will be maintained above 10%.

5. **Membership.** It is estimated that the organizing efforts prior to actual SCU start-up will produce an initial membership of 250. The experience of the pilot program so far has shown that

the initial membership is likely to be 500 or more. Through continued marketing efforts, at the end of year one, total membership will reach 500. The second year of continued marketing efforts and the opening of points of service should result in an additional 750 members. By the end of the third year, it is estimated that there will be approximately 2,188 members. It is estimated that by year 7, an SCU will have nearly 5,188 members. Total membership in the network of 20 SCUs is estimated to be over 100,000 members (or 2.18% of households) at the end of 7 years of the Project.

6. **Capitalization.** SCUs will be established with an initial start-up capitalization of \$15,000 equivalent in the form of a development grant to cover operational costs.¹ The initial development grant will be used to cover start-up-operating costs. SCUs will also gain access to subordinated debt, which will carry a term of 10 years with a 3-year interest payment grace period, and an interest rate of inflation plus 3%. The subordinated debt is conditional on the SCUs meeting financial performance targets, e.g., loan delinquency less than 5%, an agreed upon institutional capital build-up program, good governance, and internal controls monitored by a regulatory agency. The subordinated debt principal re-payment is expected during the last 5 years to maturity, at which time the accumulated discount factor of 20% per year will be applied. The level of subordinated debt will help ensure that the SCUs have an achievable timeframe to reach an efficient and profitable scale and scope of economies. Furthermore, the subordinated debt will serve as a deposit guarantee fund by increasing the SCU's capital base. Each SCU will have access to up to \$100,000 equivalent in subordinated debt. Based on the projections, a SCU will utilize as much as \$100,000 equivalent by the fourth year to meet expected loan demand.

7. **Institutional Capital.** Institutional capital-to-total assets is projected to reach close to 10% by the second year provided that 98% of net income goes into capital reserves in the first 2 years. Calculation of risk capital according to the Basle Accords leads to risk capital-to-total assets of greater than 12%. With an uncertain Government policy and macroeconomic environment, coupled with an aggressive loan policy and lack of deposit insurance, the greater level of capital adequacy is justified and will contribute to a successful exit strategy and deposit savings mobilization program.

8. **Lending Interest Rates.** Assuming an initial inflation rate of 40% based on unofficial estimates, the annualized 80% lending interest rate translates into a real interest rate of 40%. Prevailing lending rates for informal nongovernment organizations are approximately 96% per annum, while private lender rates are much higher. It is projected that once an SCU is established, rates can be gradually reduced to a spread of 10% over savings and inflation by the fifth year.

9. **Deposits.** Initial member deposits are expected to average \$35 equivalent during year 1. Average savings balances are expected to grow by 20% of the initial balance for the first 2 years as members gain confidence and derive benefits from the SCU. Total savings and shares are expected to grow from \$17,000 equivalent to \$42,000 equivalent by the end of year 2 per SCU. By the end of year 5, total savings is projected to be about \$274,000 equivalent per SCU. Deposit savings-to-total assets are expected to increase from 43% in year 1 to nearly 54% by the end of year 7.

¹ USAID is expected to provide equity grant under its TA.

10. Average deposit balance is roughly based on WOCCU experience worldwide, compared with Uzbekistan per capita gross domestic product (GDP), as well as on the average financial savings of households found in the PPTA's beneficiary needs survey.

11. **Loans.** The SCU loan policy will be aggressive and the income-yielding assets (loans) will be high-risk during early operations because of the policy as well as the lack of a prior history. Net total loans outstanding at the end of year 1 are expected to be \$28,000 equivalent, with a projected loan loss of 5%. By the end of year two, the total net loan portfolio will exceed \$119,000 equivalent with an average loan size of \$191 equivalent. Loan growth projections are based on increased diversification into small business loans and a larger average loan size due to application of repayment capacity analysis and tangible, liquid collateral (an increasing sophistication in credit administration). Fifth year projections show that loans outstanding will grow to more than \$427,000, which will reach \$759,000 equivalent by the seventh year.

12. By the end of year 5, an SCU started in the first year of the Project will have net loans-to-total assets of 94%. Provisions for loan losses are projected to be 5% of total loans outstanding at the end of each year. It is assumed that the collections program will recover 50% of bad debt. The average loan balance was based on WOCCU experience worldwide, Uzbekistan per capita GDP, and average government salaries. Roughly, 60% of per capita GDP, or a debt service ratio of 0.33 on an average salary for a government employee, estimated to be \$480 equivalent per year, leads to an average loan size of US\$159 equivalent.

13. **Liquidity.** Liquidity reserves-to-total savings and share deposits are set a 10% to meet the minimum WOCCU international financial standards.

14. **Net Income.** Net income-to-average assets will be positive from year 2 and grow to over 8% in year 5; this reflects the benefits of economies of scale and scope, and the impact of accumulating zero-cost institutional capital and other capital. This serves to capitalize the SCUs as noted in the increasing institutional capital-to-total assets from 9.1% in year 2 to more than 22% by end of year 5.

15. Operational expenses-to-average assets will decline steadily from 51% in year 1, to 10% in year 5, as the SCU achieves greater scale of economies. The percentage of borrowers to total membership is projected to be 60% in the first year and to fall to 40% at the end of year 7 as the membership gains a growing awareness of the value of financial savings, and the impact of the savings mobilization and marketing programs are felt. But most importantly, this assumption of a falling percentage is a result of increasing confidence that members will have in the safety and soundness of their SCUs. In other words, a greater percentage of the new members will become net savers.

16. **Loan Yields.** Loan yields are expected to average inflation plus 40% per year initially, gradually declining to a real rate of about 15% in the seventh year. The yield on financial investments (commercial bank time deposits) is assumed to be 11% per year based on current average yields of commercial bank time deposits (1-3 months), and no return held on a current account.

17. **Cost of Funds.** The SCU's cost structure for its funds is based on inflation. The return paid on shares is assumed to be inflation plus 15% initially and will fall to inflation plus 5% by year 7. The deposit savings interest rates on fixed time deposits equals inflation plus 12% initially, which falls to inflation plus 5% by year 7. Cost of the subordinated debt to the eligible SCU is set at the inflation rate plus 3% with a 3-year interest payment grace period.

C. SCU Projections Under Base Case Scenario

18. The SCU projections under base case scenario is given in Table 1.

Table 1: SCU Projections: Key Indicators (Base Case)

Indicator	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Membership ^a	7,000	20,500	38,125	59,063	77,109	90,645	100,939
Total Assets	560,000	2,111,843	4,369,287	7,654,683	11,045,991	13,478,043	15,611,726
Total Loans Outstanding	385,000	1,782,891	3,984,488	7,153,959	10,402,358	12,010,205	14,322,060
Total Members' Savings	350,000	1,007,500	2,025,538	3,581,390	5,380,081	7,083,703	8,766,167
Total Institutional Capital ^b	210,000	260,856	983,674	1,948,917	2,600,978	3,115,123	3,622,733
Subordinate Debt	0	840,000	1,340,000	1,820,000	2,000,000	1,720,000	1,320,000
% of Members to Total Household	0.18%	0.50%	0.89%	1.37%	1.75%	2.00%	2.18%

^a Membership is in terms of number of households. Average household size is six people.

^b Equity capital SCUs contributed by members plus retained profits thereon.

D. Sensitivity Analysis

19. Given the uncertain economic conditions in the country and nascent operation of SCUs, sensitivity analyses were carried out with the following changes to the basic assumptions while the rest of the other assumptions have been kept unchanged: (a) moderate membership growth so that by the end of year 5 the membership is 2,438 instead of 4,102, (b) lower inflation rate and lower interest margin, and (c) both assumptions (a) and (b) combined. Detailed proforma and financial statements for each scenario can be found in the Supplementary Appendix B.

20. Under scenario (a), the SCUs' net profit is significantly lower than in the base case, although it is still positive from the second year onwards. This is due to the corresponding decrease in financial costs with a decrease in financial income as a result of a reduced amount of interest earned on loans with lower loan demand. Since most of the operational expense is fixed cost, the ratio of operational expense to net average assets is higher than in the base case. The return on assets (net income/average assets) fell significantly to 2.2 from 8.6 in the base case (Table 2). Under the scenario (b), due to dramatically reduced financial income as a result of narrower interest margin and high operations expense as a share of assets while other variables remain constant, the positive net income is not sustainable beyond the fourth year (Table 3). When both lower membership growth and lower interest margin are assumed under the scenario (c), SCUs are moderately profitable in years 3 and 4, but their profits turn negative from the fifth year onwards. Therefore, while moderate membership growth alone would not likely to threaten the viability of SCUs in the medium term, the interest rates need to maintain certain spread in order to generate sufficient income to cover financial and operational expenses (Table 4).

Table 2: SCU Projections: Key Indicators Sensitivity Test (a)

Indicator	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Membership ^a	7,000	17,000	27,000	36,300	45,825	53,869	59,987
Total Assets	560,000	1,855,936	3,360,969	5,255,569	7,130,394	8,097,681	8,671,821
Total Loans Outstanding	385,000	1,457,338	2,805,848	4,382,599	6,459,235	7,248,479	7,915,395
Total Savings and Shares	350,000	836,000	1,430,940	2,193,329	3,197,302	4,209,749	5,209,601
Total Institutional Capital	210,000	178,137	578,228	1,090,162	1,288,948	1,394,029	1,463,174
Subordinate Debt	0	840,000	1,340,000	1,820,000	2,000,000	1,720,000	1,320,000
% of Members to Total Households	0.18%	0.41%	0.63%	0.84%	1.04%	1.19%	1.29%

^aAverage household size is six people.**Table 3: SCU Projections: Key Indicators Sensitivity Test (b)**

Indicator	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Membership ^a	7,000	20,500	38,125	59,063	77,109	90,645	100,939
Total Assets	560,000	1,960,988	3,666,722	5,990,202	8,150,791	9,446,837	10,557,504
Total Loans Outstanding	385,000	1,684,738	3,323,668	5,497,688	7,507,158	8,623,216	9,568,138
Total Savings and Shares	350,000	1,007,500	2,025,538	3,581,390	5,380,081	7,083,703	8,766,167
Total Institutional Capital	210,000	113,019	295,161	528,616	493,981	389,534	299,738
Subordinate Debt	0	840,000	1,340,000	1,820,000	2,000,000	1,720,000	1,320,000
% of Members to Total Households	0.18%	0.50%	0.89%	1.37%	1.75%	2.00%	2.18%

^aAverage household size is six people.**Table 4: SCU Projections: Key Indicators Sensitivity Test (c)**

Indicator	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Membership ^a	7,000	17,000	27,000	36,300	45,825	53,869	59,987
Total Assets	560,000	1,766,000	2,948,625	4,327,422	5,551,277	6,183,349	6,701,201
Total Loans Outstanding	385,000	1,457,338	2,643,791	3,973,714	5,125,922	5,647,124	6,067,491
Total Savings and Shares	350,000	836,000	1,430,940	2,193,329	3,197,302	4,209,749	5,209,601
Total Institutional Capital	210,000	90,000	174,132	290,940	92,705	0	0
Subordinate Debt	0	840,000	1,340,000	1,820,000	2,000,000	1,720,000	1,320,000
% of Members to Total Households	0.18%	0.41%	0.63%	0.84%	1.04%	1.19%	1.29%

^aAverage household size is six people.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY AND OVERALL POVERTY AND SOCIAL ASSESSMENT

I. SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

A. Linkages to the Country Poverty Analysis

<p>Sector identified as a national priority in country poverty analysis?</p> <p>The country poverty analysis is in progress. Support for rural financial institutions is recognized in the Country Strategy Program (CSP) as one of the operational objectives that forms part of the central goal of managing the transition to an economy that relies on market based institutions to lead to a sustainable reduction in poverty.</p>	<p>Sector identified as a national priority in country poverty partnership agreement?</p> <p>No. Poverty partnership agreement not finalized.</p>
<p>Contribution of the sector/subsector to reduce poverty in Uzbekistan</p> <p>By providing a new market-based institution outside the purview of the restrictions that presently constrain the financial sector, based on recently enacted legislation, savings and credit unions (SCUs) offer the prospect of becoming important providers of microfinance services to the bulk of the population, including the poor, who are currently unserved by the banks. SCUs have the advantage over other microfinance institutions of being based primarily on members' own savings and are therefore in a good position to become sustainable after initial external support ceases.</p> <p>Credit provided by the SCUs will directly increase the income of borrowers, many of them women and the poor, raising some of them above the poverty line, and reducing the severity of poverty among others. The micro enterprises started or expanded will also absorb unemployed family labor. Apart from providing credit, the SCUs will provide an attractive outlet for savings, including those of the poor, for intermediation into more productive uses. Much of household savings in Uzbekistan are presently invested unproductively in jewelry, consumer durables, and other inflation-hedges.</p> <p>The small loans component of the project, extended through the banking system, will lead to the setting up and expansion of small enterprises, which will not only directly generate income for the borrowing self-employed entrepreneurs, but also carry the indirect benefit of generating wage employment for others. Finally, loans will also be extended by the banks to nongovernment organizations (NGOs), which will have an even higher proportion of poor borrowers, and many of which lend only to women.</p>	

B. Poverty Analysis
Proposed Classification: Poverty Reduction
Thematic: Gender

A little less than a third of the population live below the poverty line in Uzbekistan, and about 70% of the poor live in rural areas. Women are more at risk of poverty than men, given agricultural underemployment and the reduced wages on which most unskilled rural women depend. Both the poor generally and women are taking advantage of new opportunities in trade, backyard cultivation, and other businesses to supplement household incomes. Considerable unsatisfied demand exists for credit for productive purposes from NGO programs at cost-recovering interest rates, provided the loan size is small enough; ease of access is ensured; and collateral substitutes, such as group or cosigner guarantees are accepted. Several design features are proposed in the SCUs to be set up which are expected to enhance the participation of the poor and women and ensure that more than a third of SCU members are poor, although their share of the population is less than a third. The poor will participate primarily as borrowers initially, and later as savers. A higher proportion still will benefit from the component of the project in which a commercial bank will lend to NGO microfinance institutions (MFIs) for retailing to their members. The borrowers will benefit from the credit support to income generating activities and at the same time, skills development training support proposed for financing through the Japan Fund for Poverty Reduction (JFPR) Project.¹

C. Participation Process

Stakeholder analysis prepared No

Participation strategy: No.

While a formal stakeholder analysis and participation strategy have not been prepared, women's groups such as the Association of Business Women of Uzbekistan have been widely consulted in the design of the Project, building on the experience of the credit unions they have been running on a pilot basis. Extensive discussions were held with the staff and borrowers of the few local and international NGOs already involved in microfinance.

¹ JFPR Project: UZB Sustainable Finance for the Poor in Kashkardarya and Namangan Regions of Uzbekistan.

D. Potential Issues

Subject	Significant, Not Significant, Uncertain, None	Strategy to Address Issues	Output Prepared
Resettlement	None		None
Gender	Significant	Women are expected to play a disproportionately active role in organizing and managing SCUs and to constitute an important part of the membership. Sensitivity will be exercised by SCU management in loan and savings product design so as to enhance women's participation. However no specific targeting is proposed.	None
Affordability	Uncertain	Valuable experience is expected to be gained from the three SCUs that have been set up under the ongoing small-scale technical assistance (SSTA) on "affordability" of the membership share subscription, loan terms, etc.	None
Labor	None		None
Indigenous People	None		None
Other Risks/ Vulnerabilities	Uncertain	Experience gained from the ongoing SSTA, including that relating to design issues to enhance the participation of the poor will be taken into account	None

II. POVERTY AND SOCIAL ASSESSMENT

A. Poverty in Uzbekistan

1. Uzbekistan was one of the poorer republics in the Soviet Union, and poverty increased significantly between 1989 and 1993, although the rise in poverty and inequality was less sharp than in other Central Asian republics. In the decade of the 1990s the quality of life of the majority deteriorated as a result of unemployment, the failure of agricultural wages to keep pace with inflation, wage arrears, and the rising cost (and in many cases lower quality) of education and medical services. Regularly paid pensions, child allowances and other transfers channeled through neighborhood committees have however softened the impact on the extreme poor. The incidence of destitution is therefore modest. Moreover the new openings constituted by household entrepreneurial activities provide an important coping strategy for the reduction of poverty.

B. Extent of Poverty

2. Uzbekistan does not officially recognize the existence of poverty, but conducts a periodic household budget survey, the last of which was conducted for the period April 2000 to March 2001 with improved methodology. It forms the basis of a living standard assessment, whose preliminary and tentative results indicate that 30.8% of the total population is poor.¹ Poverty is predominantly a rural phenomenon, with 70% of the poor living in the rural areas. The extent of overall poverty varies across regions ranging from 58% in Kashkadarya to 6.5% in Tashkent City. The second and third poorest provinces are Namangan (34.5%) and Karakalpakstan (31%).

3. Given the difficulties in measuring consumption, an important part of which comes from own-production in backyard plots,² and the many nonquantifiable components of poverty, many observers rely as much on social perceptions as on food consumption-based poverty lines to estimate the incidence of poverty. A pilot impact assessment of the United Nations Development Programme's (UNDP) microfinance project in Kashkadarya³ found that 44 % of respondents in a rural area, Beshchasma, 45% in an urban area, Karshi City, and 72% in a semiurban area, Bishkent (the Project's three locations) are underprivileged.⁴ Similarly, a participatory poverty assessment of the World Bank found a sharp increase in social stratification, so that according to the perception of respondents, if in Soviet times 80–85%

¹ However, after standardizing for age and gender, and taking into account economies of scale in consumption in larger households, the head count ratio decreases to 23.7% (19% urban, and 26.5% rural). A poverty line based on food consumption of 2100 calories per day was estimated at about Sum4,801 in October 2000 prices. At today's prices the line would lie at about twice this level. Assuming average family size of about six in the rural areas, it would yield a monthly household poverty line income of about Sum60,000 depending on local prices. A more precise estimate would be spurious since reliable figures for the consumer price index do not exist. Inflation is believed by most observers including the International Monetary Fund (IMF) to be twice as high as the official estimates of 28% in 2001. A set of seven contextual indicators to do with such criteria as the ability to afford to eat meat at least once a week, heat a certain amount of space in the winter, and afford the cheapest antibiotics rather than rely on traditional healers places the poverty line a little higher, according to discussions with Arustan Zholdasov, an experienced poverty researcher.

² The survey conducted by the project preparatory technical assistance (PPTA) found that 90% of respondents had backyard plots of average size 0.1 hectare and a further 30% had fields of average size 0.3 hectare.

³ Karshi. *Report on a Pilot Impact Assessment and Monitoring Evaluation Conducted Within a Microcredit Program in Kashkadarya Region*. UNDP Project Office, Uzbekistan.

⁴ The same study found that 87% of all households without any small business enterprise had a monthly income below Sum60,000.

constitute the middle class, today 1–2% constituted the very rich, 3–5 % the rich, 5–10% the well-to-do, 20% the middle class, 40– 80% the poor, and 1–5% the destitute.⁵

C. Government Strategies to Reduce Poverty

4. Apart from the indirect benefits of growth expected to accrue from ongoing macroeconomic and sector reform, the Government's "direct attack" strategy appears to consist essentially of two strands, assistance to small and medium enterprises (SMEs) and social security transfers, which are quite large as a proportion of total household income of the lower quintiles in the income distribution as Table 1 shows. From all accounts, welfare assistance such as the child allowances appears to be well targeted through local level neighborhood, committees, a traditional institution, which has recently been revived. For the poorest of the poor and the destitute who may lack the entrepreneurial and other skills to avail of microfinance and even the energy in some cases (many of the poor are food deficient) transfers are a more appropriate form of assistance. The second strand is assistance to SMEs, primarily through credit. Several extrabudgetary sources of funds have been tapped for this purpose, including in the case of the Business Fund part of the proceeds of privatization. Such programs assist the poor only indirectly through the wage labor they generate. This will also be the case with the small loans component of this Project.

5. However, the project adds a third strand to the "direct attack" approach in the form of microfinance from savings and credit unions (SCUs) and nongovernment organizations (NGOs). Further, the Project will (i) target women in rural areas, where gender disparities are wider; (ii) promote the participation of poor rural women in SCUs; and (iii) develop viable business management skills for poor women in SCUs. Doing so will help to induct women on a sustainable basis for the delivery of financial services.

D. Gender

6. Because the economic hardship that has accompanied the transition has rendered education less affordable, increased unemployment among women, and reduced wages in agriculture on which most unskilled women in the rural areas depend, women and women-headed households are more at risk of poverty than men. Anemia affects 60% of women. Women's participation in the formal political structure has fallen, and traditional gender ideologies have tended to reemerge.

7. Counteracting these trends on the other hand, the shift in the importance of women's economic activities such as backyard cultivation and trade, which this project seeks to reinforce, has strengthened women's authority in the home. Moreover, educated and entrepreneurial women are using their experience to lead Uzbekistan's growing women's NGO movement, including the Association of Business Women (ABW), which has participated in the design of this Project and is already running a number of credit unions informally, which are proving a valuable training ground. Last, the Government has taken numerous measures addressing gender policy, including, at the local level, most relevant to the implementation of this Project, the creation of women's councils within neighborhood committees.

⁵ 1999. *Consultations with the Poor: Participatory Poverty Assessment in Uzbekistan for the World Development Report*. National Synthesis Report. Uzbekistan.

E. Importance of Household Business Income

8. Table 1 is based on a survey of 600 households conducted during the project preparatory technical assistance (PPTA) and indicates the importance of entrepreneurial activities as a source of household income.⁶

Table 1: Sources of Income of Sample Households by Quintile

Quintile	Average (Sum)	Salary as % of Total (%)	Enterprise Income (%)	Agricultural Income (%)	Welfare Income (%)	Pension Income (%)	Other (%)
1 st	6,472	39.50	7.95	9.94	13.47	27.48	2.11
2 nd	12,907	41.19	13.05	5.86	10.81	27.11	1.98
3 rd	19,164	40.33	10.84	7.53	10.94	30.20	0.16
4 th	28,864	37.43	17.17	13.16	7.56	22.12	2.56
5 th	72,091	24.88	17.65	33.06	3.04	9.99	11.38

Source: Project Preparatory Technical Assistance, May 2001, Appendix 16, Beneficiary Needs Analysis.

9. That entrepreneurial and agricultural income from backyard plots can contribute significantly to enhancing well being is indicated also by the impact assessment study referred to in para. 3 in Kashkadariya province where 20% in Karshi City, 61% in Bishkent, and 90% in Beshchasma, of those who had regarded themselves as “underprivileged” earlier, regarded themselves as having moved to the middle level of wealth after receiving loans.⁷

10. The 600 respondents had between them 225 primary businesses (37 % of the sample) and 12 secondary less gainful businesses as shown in Table 2.

Table 2: Distribution of Entrepreneurs by Sectors of Business Activity

Item	Farm	Peasant's Activity	Handicraft Industry	Processing of Agricultural Products	Custom Tailoring	Dwelling Construction and Repair	Freight Services	Other Services	TOTAL
Most Gainful Business	7 3.1%	81 36.0%	2 0.9%	1 0.4%	29 12.9%	14 6.2%	12 5.3%	79 35.1%	225 100.0%
Less Gainful Business		2 16.7%	1 8.3%		4 33.3%			5 41.7%	12 100.0%

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

11. Of the 225 businesses, 48 belong to the lowest quartile and 42 to the second quintile showing that businesses are well distributed across the income distribution. (Table 3).⁸By far the

⁶ Mean household income for the sample at Sum28,942 is clearly an underestimate, as the survey itself demonstrates when it determines mean household expenditure of the sample to be Sum 55,888 (not reproduced here). Household consumption (the relevant criterion for poverty estimation) is no doubt higher still, as is the common experience of surveys in Uzbekistan (and no doubt other countries) in which respondents underestimate income more than expenditure and consumption for tax reasons. Too much reliance should not be placed therefore on the absolute numbers here, but on relative magnitudes. Indeed, to the extent salary, pension and welfare payments are public knowledge, the relative shares of enterprise and agricultural income are almost certainly higher.

⁷ Depending on location, respondents said they now had at least one cow or sheep, and enough land or income to cover daily needs including clothes for the children and money for them to go to college.

⁸ This and subsequent tables taken from the survey done for the PPTA, *Report on the Development Capacities of a Savings and Credit Union System* present the income distribution in quartiles rather than quintiles. However, this does not affect the argument.

most important of the businesses are the cultivation of backyard plots, and "other services." Tailoring is also important, and is predominantly a women's activity, while for men self-employment in building trades as masons and carpenters is important.

Table 3: Distribution of Lower Quartile Entrepreneurs by Sectors of Business Activities

Item	Farm	Peasant's Activity	Handicraft Industry	Processing of Agricultural Products	Custom Tailoring	Dwelling Construction and Repair	Freight Services	Other Services	Total
Distribution for Quintile 1 of Family Income		26 54.2%			5 10.4%	4 8.3%	1 2.1%	12 25.0%	48 100.0%
Distribution for Quartile 2 of Family Income	1	12	1	1	5	3	3	16	42
	2.4%	28.6%	2.4%	2.4%	11.9%	7.1%	7.1%	38.1%	100.0%

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

12. As many as 196 of the respondents had borrowed during the last year (Table 4), although much of the borrowing was to meet household and personal liquidity needs. This is not surprising. At low levels of income households first seek to smoothen consumption over time, and spend money on educational, health, home repair, and other needs, and even pressing social obligations. Clients of UNDP's microfinance projects, most of whom had no cash-producing employment before taking out loans, spent most of the surpluses (after repayment) of the first two loans on family needs, essential household durables, and animals, which can be resold later when cash needs arise (an important coping strategy). It was only in the third loan cycle that clients tended to plough most of their profits back into their enterprises.

13. Most of the borrowing is of a noncommercial nature from friends and relatives, carries no interest, is unsecured, and is open-ended in maturity.

Table 4: Loan Purposes and Sources

Item	Business/ Commerce	Agriculture	For Whole Family	For Own Needs	Total
Total	10 5.1%	5 2.6%	141 71.9%	40 20.4%	196 100.0%
Source of Loan					
Bank			4 100.0%		4 100.0%
Moneylender/Lombard	1 25.0%		2 50.0%	1 25.0%	4 100.0%
Relative/Neighbor/Friend	8 4.3%	5 2.7%	133 72.3%	38 20.7%	184 100.0%
Other Sources	1 25.0%		2 50.0%	1 25.0%	4 100.0%

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

14. Borrowing is not confined to the higher quartiles (Table 5). More than half the 196 loans were in fact taken by the lower two quartiles (70 plus 40), although overwhelmingly again for household and personal needs. However, a few, even among these borrowers had borrowed for their enterprises.

Table 5: Loan Purposes by Income Quartile

Item	Business/ Commerce	Agriculture	For the Whole Family	For Own Needs	TOTAL
Aim of Borrowing for Quartile 1 of Income Distribution	3 4.3%	2 2.9%	53 75.7%	12 20.4%	70 100.0%
Aim of Borrowing for Quartile 2 of Income Distribution	1 2.3%		32 72.7%	11 25.0%	44 100.0%

Source: Survey done for Project Preparatory Technical Assistance.

F. Demand for Credit from the Poor

15. Indeed, the experience of the few NGO programs and the credit unions run by ABW is that there is considerable demand for credit from poor borrowers. A breakdown by borrowing purpose is available for UNDP's projects in Kashkadarya and Karakalpakstan (Table 6).

Table 6: Borrowing Purposes in UNDP's Microfinance Projects (%)

Business Type	Kashkadarya			Karakalpakstan Four Rural Districts Covered by the NGO Daulet
	Beshchasma (Rural)	Bishkent (Semiurban)	Karshi City (Urban)	
Small Production	3	1	2	16.5
Poultry Farming	7		1	0.2
Cattle Breeding	28	10	4	7.4
Sheep Breeding	NA	NA	NA	22.4
Trading	57	72	81	52.8
Services	5	17	13	0.7

NA=not applicable.

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

16. The major borrowing purpose is trading, which is predominantly a women's activity. Distribution networks are relatively underdeveloped in Uzbekistan as in many other former transitional economies, in which trading was regarded as an "unproductive" activity and did not even enter the system of national accounts. Other reasons for the relative underdevelopment of trading are the large share of transactions still accounted for by barter in the poorer rural areas, the high share of consumption accounted for by own-production, and the refusal of the banks to lend for trading. Thus, trading affords a particular opportunity to credit unions and other microfinance programs to help lift the poor out of poverty as the economy commercializes.

17. Other borrowing purposes are animal husbandry (sheep and cattle rearing and poultry) and small-scale manufacturing (including simple food processing such as candy making, bakeries, as well as sewing).⁹ A potentially important borrowing purpose is cultivation of backyard plots, as well as agriculture by registered private farmers with long-term leases and by laborers on collective farms who manage to obtain plots on lease for a few months while the land is idle from the main cotton or wheat crop. In locations near urban areas, a great deal of

⁹ In the Ferghana valley a demand for milk, and therefore for mature cows, is emerging with a new plant being set up by Nestle's which will collect 100 tons of milk a day through 150 collection centers.

cash-crop cultivation takes place on backyard plots (and not just wheat for home consumption) of vegetables, potatoes, onions, and garlic. However the existing NGO programs will have to introduce lump-sum repayment loans to encourage more borrowing for agriculture, as the SCUs propose to do.

18. The existing level of loans outstanding for the four main NGO programs is the equivalent of about \$250,000, with an estimated further \$15,000 equivalent lent out by about a dozen credit unions run by ABW. Average loan size outstanding was about Sum60,000 for the NGOs and about double that for the credit unions. A very rough estimate of total loan demand from NGOs and SCUs alone is estimated at \$40-60 million.¹⁰

G. Existing Microfinance Providers

1. Credit Unions run by the Association of Business Women

19. ABW is one of the most active women's organizations in Uzbekistan; it aims to improve the condition of women, especially those living in rural areas, and in the long run attain gender equality through the provision of legal, gender, business and vocational education. It has 14 branches in the oblasts and extensive contacts with external agencies, which have assisted a variety of training programs. In 1997, ABW set up five informal microfinance institutions resembling credit unions on a pilot basis after training provided by the World Council of Credit Unions (WOCCU). Many of the remaining branches set up SCUs in 2001 as the new Credit Union Law (finally passed in April 2002) reached an advanced stage of acceptance.

Table 7: Some Informal MFIs Similar to Savings and Credit Unions Run by the ABW

Item	Navoi	Sirdarya	Tashkent	Fergana
No. of Members/ Borrowers	71/11	105/13	NA/19	45/NA
Total Amount of Loans Outstanding	5,98,000	800,000	650,000	2,26,000
Range of Loan Size	10,000-600,000	50,000-150,000	50,000-450,000	50,000-450,000
Rate	8-10%	8%	8%	3%
Collateral Margin	120%	120%	125%	
Duration of Loan	Up to 5 months	Up to 3 months	Up to 3 months	Up to 6 months
Type of Security	Group guarantee	Group guarantee	Group guarantee	Group guarantee

NA=not applicable.

Source: ABW and field visits

20. A few of the informal MFIs (Table 7) were visited briefly by the mission. It was ascertained during discussion (conventional financial statements were not available) that the funds base consisted entirely of own funds (i.e., ownership shares and ploughed-back surpluses) and in some cases, as the new legislation recognizing SCUs neared maturity, savings from members. Apart from a membership fee of Sum500–Sum1000, the main source of funds in most cases was subscription to shares on which dividends are paid (except in one

¹⁰ The basis for the upper limit is about one-fifth of total households, or approximately 5 million households, borrowing an average of Sum90,000 each, which is the average of loans outstanding from NGOs and credit unions. The lower bound estimate is based on the PPTA which projects total lending by the 20 project assisted credit unions alone as \$38 million equivalent at a household penetration ratio of 5% and average loan size of about \$150 equivalent.

case).¹¹ Share prices range from Sum1,000–Sum10,000, but some informal MFI organizations similar to SCUs allow members to buy multiple shares (up to the maximum, in the case of the MFI at Navoi, of 10 shares of Sum 5000 each, or Sum50,000). Members are allowed, however, only one vote irrespective of shareholding).

21. The rate of interest on savings is the same as the dividend. The Navoi MFI had attracted a single deposit as large as Sum830,000 and total savings of Sum 5 million, although it was very much an exception in this respect. Its aggressive fund mobilization policy was matched by a maximum loan size of Sum600,000, and a rate of interest on loans of as high as 10% a month, although its usual rate was the general rate set by all MFIs, or 8%. Unlike the banks, these rates are fully cost recovering, including the cost of inflation, and yield a surplus for expansion. The modal dividend rate was 4% a month, with the range being 3-5 % (the maximum being Navoi MFI again).

22. The MFIs have varying policy on utilization of the rest of interest income, only some of them retaining 1% to cover operational costs, since in most cases the work of the chairperson and accountant is entirely voluntary. Loan duration is short (up to 6 months). The MFIs varied in orientation towards coverage of the poor, minimum loan size, number of rural members, etc. Only one MFI, Bukhara, generally regarded as one of the best managed, had loans overdue, from three borrowers, with slim prospects of recovery. Jewelry is often retained as collateral in addition to the use of group guarantees.

23. There is a social and governance aspect to an MFI quite apart from the purely financial, in the sense of efficacy through the control of resources it gives members, and the chance it gives them to exercise democratic procedure in the selection of office bearers, and in observing the principle of one-woman-one-vote. In this respect ABW in general, and the SCUs in particular, are an important part of the process of the emergence and strengthening of civil society in Uzbekistan.

2. NGO Credit

24. Although fewer in number, NGOs have much larger loan portfolios (the existing SCUs have only a few borrowers each, since they are confined at present to members of ABW). Since 1999, UNDP has been undertaking pilot microfinance projects in two of the three poorest provinces, Kashkadariya and Karakalpakstan, with funds sourced from an NGO from Netherlands and the Soros Foundation, through local NGOs (ABW in Kashkadarya, with about 1000 borrowers, and Daulet and ABW in Karakalpakstan, with about 1000 borrowers each). UNDP also has a microfinance training center in Nukus, Karakalpakstan.

25. An international NGO, Mercy Corps has been implementing microfinance in Namangan, the second poorest province, for less than a year, and has about 2000 borrowers. It has grown much faster than the UNDP projects, partly because of the higher density of population in Ferghana valley but also because it pays a great deal of attention to training both borrowers and staff members. It intends to expand eventually to the rest of the Ferghana valley, along with a second international NGO, which has just commenced operations in Andijan, also in the Ferghana valley. Mercy Corps is seeking external assistance to expand operations in

¹¹ The Samarkhand MFI does not pay a dividend at all, and was exceptional in charging only 3% on loans. Members explained that at 8% charged by all the other SCUs, they would not be able to compete with the banks. The potential for a small degree of competition with the rate charged by banks on special subsidized loan programs was an issue raised by other SCUs too, but would be minimized by initiating activities in parts of the oblast where the banks had not penetrated.

Namangan and to commence a new microfinance project in another poor province, Surkhandariya.

26. The NGOs have smaller minimum (Sum20,000-50,000), maximum (Sum120,000-180,000), and average loans sizes (half) than the SCUs, although they are all planning to increase loan size eventually to about Sum0.5 million to prepare borrowers to graduate to the banks. As with the SCUs, loan duration is 2-6 months.¹² The interest rates are generally lower,¹³ partly because shareholding members and depositors in the SCUs do not have to be paid dividend and interest. However they are still cost recovering, including the cost of inflation, and yield a surplus for expansion. The methodology followed is the traditional Grameen Bank group lending model, except in Kashkadariya, which has switched to so called "solidarity" group, lending through one common loan (instead of separate individual loans to group members) and to slightly smaller groups of 3-5 members. The project also allows male membership, but would like to restrict it to 40%. The membership of the other projects is entirely female). The major difference with the SCUs is that the NGOs do not depend on savings or even encourage them yet until they are formalized.

27. The basic problem constraining rapid expansion of NGO microfinance is the lack of legal authority for NGOs to lend (although they are being allowed to do so informally for the time being). A draft cabinet resolution has been submitted to the Government jointly by the stakeholders, and is reported to be under consideration, which would formally recognize NGOs as nonbank financial institutions (NBFIs) and give them tax exempt status, as well as exempt them from regulations relating to interest rates and collateral. The crucial dispensation that they require however is to be allowed to make cash loans (at present only the European Bank for Reconstruction and Development (EBRD) project has been exempted up to the limit of \$5000).

H. Problems in Small Lending by the Banks

28. The banks make very few small loans to self-employed entrepreneurs, as Table A7.4 shows (only 4 of 196 loans were from the banks). In Uzbekistan, as in many other transitional economies, the use of the banking system as a passive conduit for directed credit, has precluded banks making a large volume of micro and small loans. Banks' role as tax collection agents, coupled with restrictions on the withdrawal of cash from bank accounts limited their meaningful intervention in microfinance.

29. It was only in 2000 that the banks were allowed to extend half the amount of a maximum loan the equivalent of \$5000, in cash, on condition of its repayment in 1.5 years.¹⁴ The only exception to this rule is an EBRD project with Japan-Europe Cooperation Fund (JECF) technical assistance (TA) under which 3 participating banks have commenced lending with their own funds until the proposed loan of \$20 million is released. Under EBRD's project the cash limit is 100% of loans up to \$5000 (currently Sum3.5 million at the official exchange rate).¹⁵ Most importantly, subloans under EBRD's credit line were not subjected to any interest rate ceilings.

¹² Mercy Corps is planning to increase loan duration to facilitate repayment for the larger loans that will be required for the purchase of mature cows.

¹³ Except for Mercy Corps', which charges 4.5% a month on a flat rather than declining balance basis, which virtually doubles the effective interest rate.

¹⁴ The relevant regulation 902 of the Ministry of Justice of February 2000 applied only to self-employed entrepreneurs including peasant farms, which were registered but not established as legal entities, and specifically excluded "trade and mediator activities." In the case of the legal entities a similar regulation, 903 allowed a maximum loan size of \$10,000 equivalent.

¹⁵ The official exchange rate of about Sum700 to the US dollar, which is closer to the purchasing power parity of the sum than the market exchange rate of about Sum1,400 to the US dollar in May 2002, would appear to be logical rate to use in comparing loan sizes in the current project over time and with projects in other countries.

SCUs and participating commercial banks (PCBs) under the present Project have been granted similar powers.

30. The smallest loans the banks generally make are of Sum0.5 million, with loans of less than Sum1 million being uncommon. Most of these loans are under made under special programs in which the banks receive special extrabudgetary funds at a subsidized rate¹⁶ or obtain tax benefits.¹⁷ Interest rates varied but were subject to a ceiling of 1.5 times the refinancing rate (in the case of loans made on behalf of the Business Fund, they are made at half the refinancing rate). The EBRD loan was the first exception to this past practice. The number of borrowers in line for these loans at negative real rates of interest far exceeds the supply of loan funds, and widespread anecdotal evidence suggests that rationing takes place through corruption, political influence, and the high transaction cost of the paperwork involved.¹⁸

I. Proposed Solutions in the Project

31. The present Project, through its component to make small loans from \$1,000 to \$10,000 equivalent through a commercial bank, seeks to overcome these problems in several ways. First, subloans granted by the PCBs will not be subjected to interest rate ceilings. Most important, the component will benefit from the TA in the form of consultants (provided under the JECF grant) who will work in the field with loan officers, training them in small loan project appraisal using profitability and cash flow methods, rather than merely relying on collateral. Loan officers will be trained to be proactive, and to go out into the field and locate creditworthy borrowers. The objective is to help build institutional capacity for improved credit decisionmaking and prudent monitoring and supervision subsequently. Special small loan units will be set up in each participating bank branch where the loan officer will appear before the credit committee along with the borrower to help present the loan proposal. Banks will treat their microfinance lending as separate profit centers and not insist on cash collaterals. An objective of the component will be to demonstrate that small lending can be a profitable activity for the banks, so that they are encouraged to take it on through their own resources. Thus, the branch micro and small enterprise finance unit will be treated as an autonomous profit center. The participating commercial bank will also make bulk loans to NGO MFIs who will retail them as at present, also without any interest rate ceilings.

J. Savings

32. Of the 600 respondents surveyed, 19% had bank accounts, although most of these were opened in Soviet times to take advantage of indexing. However the indexation is insufficient to compensate for inflation, and withdrawals are difficult. The mean deposit account balance is Sum18,000.

33. A slightly higher proportion of the sample, 23%, save outside the banks (Table 8).

¹⁶ The main funds are the Business Fund of the State Property Committee, the Employment Promotion Fund of the Ministry of Labor, and the Fund for Support for Peasant and Private Farms (from the Association of Support to Peasant and Private Farms). In 2000, the amounts allocated by these funds for small and microfinance (SME) were Sum1 billion, 2 billion, and 200 million respectively. The amounts may since have gone up considerably.

¹⁷ Banks are allowed to use up to 25% of their profits on SME lending (i.e., the additional cost to the bank is the amount of profit utilized net of what taxes on them would have been).

¹⁸ These amounted from 10–50% of the loan amount according to two respondents interviewed, including the cost of notarizing documents relating to collateral, the cost of insurance, etc.

Table 8: Savings Outside the Banks

Item	Yes	No	N/A	TOTAL
Total	136 22.7%	454 75.7%	10 1.7%	600 100.0%
RESIDENCE:				
Urban	36 19.8%	146 80.2%		182 100.0%
Rural	100 23.9%	308 73.7%	10 2.4%	418 100.0%
SEX OF RESPONDENT:				
Male	91 26.4%	248 71.9%	6 1.7%	345 100.0%
Female	45 17.6%	206 80.8%	4 1.6%	255 100.0%
OCCUPATION OF RESPONDENT:				
Employees	75 26.8%	201 71.8%	4 1.4%	280 100.0%
Private non-agro business	21 36.2%	37 63.8%		58 100.0%
Farmers	4 14.3%	24 85.7%		28 100.0%
Pensioners, disabled	22 14.2%	128 82.6%	5 3.2%	155 100.0%
Unemployed	6 25.0%	18 75.0%		24 100.0%
Other/idle	8 14.5%	46 83.6%	1 1.8%	55 100.0%

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

34. Significantly, as many as 43 of these 136 savers belonged to the lower two deciles, quartiles 1 and 2, saving Sum2,717 and Sum4,717 respectively, every month (Table 9). Mean savings out of the banks are Sum10,793 a month.

Table 9: Approximate Amounts Saved Every Month by Income Quartiles

Item	Mean	100-1500	2000-2500	3000-4000	5000	6000-60000	N/A	Refuse	TOTAL
TOTAL	10 793	20 14.8%	17 12.6%	18 13.3%	28 20.7%	18 13.3%	25 18.5%	9 6.7%	135 100.0%
FAMILY EXPENDITURES:									
Quartile 1	2 717	3 18.8%	3 18.8%	3 18.8%	3 18.8%		4 25.0%		16 100.0%
Quartile 2	4 771	4 15.4%	4 15.4%	5 19.2%	6 23.1%	5 19.2%	1 3.8%	1 3.8%	26 100.0%
Quartile 3	3 397	6 15.0%	6 15.0%	7 17.5%	9 22.5%	1 2.5%	8 20.0%	3 7.5%	40 100.0%
Quartile 4	23 458	7 13.2%	4 7.5%	3 5.7%	10 18.9%	12 22.6%	12 22.6%	5 9.4%	53 100.0%

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

35. Middle-income families save chiefly in cash, and the monthly amount of savings is about Sum5,000. Well-off families purchase livestock, an investment mode that is unaffordable to medium-income families (Table 10). All farmers and most businesspersons invest in livestock. The self-employed save mostly in cash, as many of them are engaged in trade and need money at hand.

Table 10: Nonbank Savings by Employment Status

Item	Savings in Soums	Purchase Jewelry	Consumer Durables	Purchase Property	Buy Livestock	Other	TOTAL
TOTAL	83 61,0%	5 3,7%	8 5,9%	1 0,7%	56 41,2%	4 2,9%	136 100,0%
OCCUPATION OF RESPONDENT:							
Employees	47 62,7%	3 4,0%	5 6,7%	1 1,3%	27 36,0%	2 2,7%	75 100,0%
Private non-agro business	11 52,4%		2 9,5%		10 47,6%	1 4,8%	21 100,0%
Farmers	1 25,0%	1 25,0%			4 100,0%		4 100,0%
Pensioners, disabled	14 63,6%	1 4,5%	1 4,5%		11 50,0%		22 100,0%
Unemployed	5 83,3%				1 16,7%		6 100,0%
Other idle	5 62,5%				3 37,5%	1 12,5%	8 100,0%

Source: Survey done for Project Preparatory Technical Assistance. See footnote 8.

K. Design Features to Maximize Participation of the Poor in Project Credit Unions

36. Since credit unions are essentially self-financing organizations, it is important to ensure the optimal balance between net borrower and net saver members.¹⁹ Membership is proposed to set at Sum10,000. This would appear to be low enough to ensure that at least about a third of the membership are poor. To make it easier for them to join, the draft regulations allow poor members to subscribe to their membership share subscriptions in installments. Valuable experience will be gained on this and other matters through the three pilot SCUs being set up under the small-scale technical assistance (SSTA).

37. Based on the discussion above of the extent of savings of the poor as revealed by the survey, the poor are not likely initially to subscribe to a major share of the various savings products the SCUs will introduce. Savings will come initially from better off members, many of who may remain net savers, such as employees and pensioners who receive a regular income but do not run an enterprise and need an attractive outlet for their savings (in respect of the various attributes of yield, liquidity, safety, and convenience on which SCUs are expected to have an advantage over the banks). Most of the poor members are likely however to become borrowers.

38. To make it easier for them to do so (as also for women), the SCUs will have to fix minimum loan size at an appropriately low level (while extending at the same time larger loans to nonpoor members), and in addition, develop loan products with suitably long maturities so that the monthly repayment burden is minimized. Second, "social" collateral in the shape of group lending (where group members are jointly and severally responsible for their members' repayments) will have to be relied on in cases where borrowers cannot offer the security of jewelry, carpets, or consumer durables. (Group lending may in any case have to be resorted to in order to minimize the administrative costs of loan disbursal and collection). Cosigner arrangements by guarantors who possess collateral or savings with the SCU are also envisaged.

39. Further, it may be desirable to secure the involvement of neighborhood committees, which might be able to take responsibility for loans through the moral suasion they can exercise on account of the social security transfers routed through them. Finally, it should be possible to recruit poor members in relatively large blocks through factories, collective farms, and markets. The SCUs will be setting up an average of four branches within the oblast, so that it should be possible to resort to geographic targeting and penetrate the rural districts where the majority of the poor live.

L. Indicators for Targeting, Monitoring, and Evaluation

40. There will be no formal targeting of individuals among the poor, who will be relied upon to self-select themselves as members by suitable adjustments of loan size and duration. Nor will targets be laid down for women members, although it is expected they will form an important part of the membership.

41. However, there will be monitoring and evaluation of variables such as

- (i) the proportion of poor members and women in an SCU;
- (ii) the nature of their participation as savers and borrowers, and the amounts saved and borrowed; and

¹⁹ Deposits to total assets are expected to grow to 70-80%.

- (iii) the extent to which members' incomes go up, family labor is absorbed, and/or wage employment is created.

42. Proxy indicators for poverty may have to be developed such as the condition of the house, ownership of assets, etc. Baseline sample surveys will be undertaken.