

ASIAN DEVELOPMENT BANK

TAR: AZE 38110

TECHNICAL ASSISTANCE
(Financed by the Japan Special Fund)

TO THE

REPUBLIC OF AZERBAIJAN

FOR

**DEVELOPING COLLATERAL FRAMEWORK
AND MICROFINANCE REGULATIONS**

December 2004

CURRENCY EQUIVALENTS

(as of 1 December 2004)

| | | |
|---------------|---|------------------------|
| Currency Unit | – | Azerbaijan manat (AZM) |
| AZM1.00 | – | \$0.0002 |
| \$1.00 | – | AZM 4,910 |

ABBREVIATIONS

| | | |
|------|---|----------------------------------|
| ADB | – | Asian Development Bank |
| GDP | – | gross domestic product |
| MFI | – | microfinance institution |
| MOED | – | Ministry of Economic Development |
| NBA | – | National Bank of Azerbaijan |
| TA | – | technical assistance |
| TOR | – | terms of reference |

TECHNICAL ASSISTANCE CLASSIFICATION

| | | |
|---------------------------------|---|---|
| Targeting Classification | – | General intervention |
| Sector | – | Finance |
| Subsector | – | Finance sector development, microfinance |
| Theme | – | Private sector development |
| Subthemes | – | Policy, institutional, and legal regulatory reforms |

NOTE

In this report, "\$" refers to US dollars.

This report was prepared by S. Shrestha with contributions from G. Atay and B. Wilkinson.

I. INTRODUCTION

1. In February 2004, the Government of Azerbaijan requested technical assistance (TA) to develop a collateral framework and microfinance regulations. During the Asian Development Bank's (ADB's) Fact-Finding and Appraisal missions for the proposed Micro and Rural Finance Project, an understanding was reached with the Government on the TA's objective, scope, and implementation arrangements.¹ The TA framework is in Appendix 1.

II. ISSUES

2. Azerbaijan's financial sector is at an early stage of development. With 43 commercial banks and combined assets of \$1 billion—equivalent to 14.5% of gross domestic product (GDP)—the banking system dominates the financial sector. Despite the decline in their market share, the two state-owned commercial banks, the International Bank of Azerbaijan and the United Universal Bank, account for 57% of total assets, 47% of total loans, and 69% of deposits. The financial sector also includes a number of nonbank credit organizations, AgrarKredit,² 11 microfinance institutions (MFIs), 3 business lenders, 28 credit unions, 30 pawnshops, 27 insurance companies, and 3 leasing companies. The securities market consists largely of government securities. The volume of outstanding Treasury bills has decreased rapidly in recent years and currently amounts to \$28 million. Stock market capitalization is only 0.1% of GDP and trading activity is virtually nonexistent.

3. The combination of liberal entry requirements and lax prudential regulation led to the collapse of a large number of banks during the first half of the 1990s. As a result, many people lost their life savings. The spillover effect of the Russian and Turkish banking crises in 1998 and 2001, respectively, further weakened the banking system. Despite recent increases, bank deposits are equivalent to only 8% of GDP and credit outstanding amounts to 10% of GDP. Bank borrowing and lending are mostly short term, with few deposits and loans having maturities greater than 1 year. Interest rates have remained high despite falling inflation.

4. Since the late 1990s, the Government has undertaken a number of measures to stabilize and strengthen the banking system. The regulatory and supervisory framework has been strengthened considerably. Nonperforming loans peaked at 62.0% of outstanding loans in 1999, but had been reduced to 8% by early 2004. The International Bank of Azerbaijan and the United Universal Bank have undergone significant restructuring in preparation for privatization. To promote consolidation, the National Bank of Azerbaijan (NBA) has recently raised the minimum capital requirement for banks from \$2.5 million to \$3.5 million effective January 2005, and to \$5 million effective January 2006.

5. However, the impact of these and future reforms in terms of improving financial intermediation will be limited unless the fundamental weaknesses in the collateral framework are addressed. Key weaknesses are the inconsistencies in the provisions of the Civil Code and the Pledge Law.³ For example, the Pledge Law requires all pledges where the lender does not take physical possession to be registered, whereas the Civil Code only requires this for mortgages. Discrepancies are also apparent in the level of description required for pledged property. The Civil Code refers to a movable property register, but no such register exists. The

¹ The TA first appeared in *ADB Business Opportunities* (Internet Edition) on June 1, 2004.

² AgrarKredit is a state-owned institution specializing in rural finance. It has a limited license for lending services and acts as an implementing agency for a number of projects financed by donor agencies.

³ European Bank for Reconstruction and Development, 2002. *Analysis of the Current Secured Transactions Legal Regime in Azerbaijan*, Secured Transactions Project.

absence of a centralized collateral registry for either movable or immovable property reduces transparency and increases transaction costs. Debt enforcement is weak, in part because of legal inconsistencies and in part due to the lack of well-trained judges. An additional impediment is the lack of public awareness about collateral matters. Combined, these weaknesses significantly increase the cost of credit.

6. The 2004 Law on Mortgage Registration was drafted with support from the European Bank for Reconstruction and Development. The law makes general provisions for state registration of immovable property and of collateral origination, transfer, and invalidation. However, further assistance is required for the implementation of the law. This will entail drafting implementing regulations and procedures, establishing a collateral registry, and providing related training. The Government has requested ADB assistance for strengthening debt enforcement and for the establishment an effective collateral registration system.

7. The 11 MFIs in operation in Azerbaijan have a total of 34 branches covering 42 of the country's 66 rural districts. They provide loans for small and microenterprises, farming, livestock, agribusiness, trading, and services in amounts ranging from \$100 to \$10,000. As of September 2004, the 11 MFIs had 39,897 active borrowers and a total outstanding loan portfolio of \$13.9 million. Portfolio at risk over 30 days is low at about 1% of outstanding loans. Of the 11 MFIs, 6 have incomes that exceed operating costs. However coverage is still extremely low and microfinance reaches only 5.9% of an estimated 670,000 rural households.

8. A key impediment to the development of MFIs in Azerbaijan is the absence of an effective legal and regulatory framework. MFIs are currently governed by the Law on Banks and Banking Activity, which requires them to register with the Ministry of Justice as limited liability companies, and to be licensed by NBA. The registration and licensing processes are cumbersome and costly. The licensing regulation prohibits MFIs from collecting any form of savings and from borrowing from other local sources, making them fully dependent on donor funds. In addition, the regulatory oversight of MFIs is weak. The quarterly reports submitted by MFIs to NBA are used mostly for statistical purposes and to ensure that MFIs do not mobilize savings.

9. At the Government's request, ADB has helped prepare a draft Law on Microfinance.⁴ The draft law makes a number of recommendations, including allowing MFIs to mobilize savings and simplifying registration and licensing procedures. The draft law is under review by NBA, and is expected to be submitted to Parliament in mid-2005. The next important step is to improve the regulatory and supervisory framework. This will entail drafting implementing regulations, establishing reporting requirements, and training NBA staff for effective on-site and off-site supervision of MFIs.

10. A number of donors have contributed to the development of MFIs in Azerbaijan. The United States Agency for International Development and a number of nongovernmental organizations, including Adventist Development and Relief Agency Credit, World Vision, the Foundation for International Community Assistance, and Agricultural Cooperative Development International and Volunteers in Overseas Cooperative Assistance, have provided lines of credit to their partner MFIs in Azerbaijan, along with grant assistance for capacity building. However, assistance to develop the regulatory and supervisory framework has not yet been provided.

⁴ ADB. 2003. *Technical Assistance to Azerbaijan for Microfinance Sector Development*. Manila.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

11. The goal of the advisory TA is to promote the development and outreach of commercial banks and MFIs in Azerbaijan. The objectives are to: (i) create an effective collateral and debt enforcement framework, and (ii) improve the regulatory and supervisory framework for MFIs. Outputs will include: (i) an improved legal structure for collateral and debt enforcement, (ii) a centralized collateral registry framework, (iii) an increase in public awareness about collateral issues, (iv) MFI regulations that are in line with international best practice, and (v) a framework for effective supervision and compliance with MFI regulations.

B. Methodology and Key Activities

1. Create an Effective Collateral and Debt Enforcement Framework

12. This will entail the following activities:

- (i) Review the existing legal structure for collateral and debt enforcement, identify weaknesses and inconsistencies, and recommend amendments,
- (ii) Develop detailed recommendations for establishing and operationalizing a centralized public registry for fixed and movable collateral,
- (iii) Draft operating procedures and manuals for the collateral registry,
- (iv) Develop and conduct a training program for judges on effective enforcement of collateral rules, and
- (v) Conduct a public awareness program on collateral issues.

2. Improve the Regulatory and Supervisory Framework for MFIs

13. This will entail the following activities:

- (i) Develop detailed implementing regulations for the new Law on Microfinance,
- (ii) Develop on-site and off-site supervision processes for MFIs,
- (iii) Draft internal manuals for NBA, and compliance guidelines for MFIs,
- (iv) Design and conduct training on new regulations and on supervision for MFIs and the NBA, and
- (v) Complete a round of quarterly reports and analysis to ensure timely and complete reporting.

C. Cost and Financing

14. The total cost of the TA is estimated at \$1.0 million equivalent, of which \$697,000 is the foreign exchange cost and \$303,000 equivalent is the local currency cost. The Government has requested ADB to finance the entire foreign exchange cost of \$697,000 and \$103,000 equivalent of the local currency cost for a total of \$800,000. The TA will be financed by ADB on a grant basis by the Japan Special Fund, funded by the Government of Japan. The Government will finance the balance of the local currency cost of \$200,000 equivalent by providing office space and logistical support, workshop facilities, and counterpart staff. Detailed cost estimates are in Appendix 2.

D. Implementation Arrangements

15. The TA will be implemented over a period of 18 months, starting in February 2005 and ending in August 2006. The Ministry of Economic Development (MOED) will be the executing agency and implementing agency for the collateral component. NBA will be the implementing agency for the MFI regulation and supervision component. A project steering committee consisting of representatives from MOED, NBA, and ADB will be established to facilitate project coordination.

16. The TA will require 22 person-months of international consulting services and 24 person-months of local consulting services. The international consultants will include: (i) a collateral legal and regulatory expert/team leader (7 person-months), (ii) a collateral registry system expert (4 person-months), (iii) a MFI legal and regulatory expert (7 person-months), and (iv) an institutional development and training expert (4 person-months). Domestic consultants will include: (i) a collateral expert (8 person-months), (ii) a MFI expert (7 person-months), and (iii) a training expert (9 person-months). The team leader will be responsible for coordinating the inputs of all the consultants and for consolidating all TA reports. The consultants will be engaged by ADB in accordance with its *Guidelines on the Use of Consultants by the Asian Development Bank and Its Borrowers* and other arrangements satisfactory to ADB for the engagement of domestic consultants. All procurement under the TA will be in accordance with ADB's *Guidelines for Procurement*. The international consultants will facilitate the selection of domestic consultants. Detailed terms of reference are in Appendix 3.

17. The consultants will submit: (i) an inception report 3 weeks after TA commencement, (ii) progress reports on a quarterly basis, (iii) draft final reports 3 weeks prior to TA completion, and (iv) a final report 2 weeks after receiving comments from ADB, MOED, and NBA.

IV. THE PRESIDENT'S DECISION

18. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$800,000 on a grant basis to the Government of Azerbaijan for Developing Collateral Framework and Microfinance Regulations, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

| Design Summary | Performance Indicators/Targets | Monitoring Mechanisms | Assumptions and Risks |
|---|--|--|--|
| <p>Goal The development and improved outreach of commercial banks and microfinance institutions (MFI)</p> | <p>Significant increase in financial intermediation by 2008</p> <p>Significant decline in cost of funds by 2008</p> | <p>Reports from National Bank of Azerbaijan (NBA), commercial banks and MFIs</p> <p>Country reports from ADB and IMF</p> | |
| <p>Purpose</p> <p>An effective collateral and debt enforcement framework created</p> <p>The regulatory and supervisory framework for MFIs improved</p> | <p>Basic framework for registry of movable and immovable collateral in place by end-2006</p> <p>Improvement in banks' debt recovery rate by end-2006</p> <p>MFI regulations in line with international best practices issued by NBA by end-2005</p> <p>Quarterly reports from NBA based on complete, timely and reliable information from MFIs starting end-2006</p> <p>Improvement in MFIs' compliance with regulatory requirements by end-2006</p> | <p>NBA and commercial bank reports</p> <p>Ministry of Economic Development (MOED) Report</p> <p>ADB TA completion report</p> | <p>Macroeconomic and financial stability (A)</p> <p>MFI Law is passed by Parliament by early 2005 (A)</p> <p>There may not be consistent application of laws and regulations related to MFIs and banks (R)</p> |
| <p>Outputs</p> <p>Improved legal framework for collateral and debt enforcement</p> <p>Centralized collateral registry</p> <p>Improved public awareness about collateral issues</p> | <p>Detailed legal amendments drafted and presented to Government by end-2005</p> <p>Detailed practical guideline for establishing the centralized collateral prepared by early 2006</p> <p>Training for judges conducted by early 2006</p> <p>Comprehensive public awareness and information dissemination program designed and conducted by mid-2006</p> | <p>NBA and MOED reports</p> <p>Bank and MFI reports</p> <p>Consultant reports</p> <p>Review Mission</p> | <p>All banks, MFIs and client groups consulted (A)</p> <p>Parliament approves recommended legal and regulatory changes (A)</p> <p>Significant number of trained staff leave NBA (R)</p> |

Continued on next page

| Design Summary | Performance Indicators/Targets | Monitoring Mechanisms | Assumptions and Risks |
|--|---|---|--|
| <p>MFI regulation in line with international best practice</p> <p>Effective supervision and compliance with MFI regulation</p> | <p>Detailed implementing regulations prepared by end-2005</p> <p>Off-site and onsite supervisory framework developed by end-2005</p> <p>Training for supervision staff in NBA and MFIs conducted by early 2006</p> | | |
| <p>Activities</p> <p>Develop implementing regulations for MFIs</p> <p>Develop supervision processes and reporting requirements for MFIs</p> <p>Design and conduct NBA and MFI training sessions on regulation/supervision structure</p> <p>Review existing legal structure for collateral and debt enforcement</p> <p>Draft amendments to legislation to enhance collateral registration and realization</p> <p>Conduct training program for judges on effective debt enforcement</p> <p>Conduct public awareness program on collateral and debt issues</p> | <p>Implementing regulations to govern operation of MFIs prepared</p> <p>Guidelines for onsite and offsite supervision prepared</p> <p>Training completed</p> <p>Managers of trained staff provide feedback confirming on-the-job use of training materials</p> <p>Commentary on issues with law, implementation of existing law</p> <p>Draft amendments to legislation to improve debt enforcement capacity, use of collateral</p> <p>Training completed</p> <p>Information materials prepared and disseminated</p> | <p>TA reports</p> <p>Review Mission</p> | <p>NBA reviews and formalizes arrangements in a timely manner (A)</p> <p>Processes tested with MFIs to ensure effective implementation (A)</p> <p>Training is properly designed and targeted (A)</p> <p>MOED reviews and formalizes arrangements in a timely manner (A)</p> <p>Training is effective (A)</p> <p>Materials are not appropriately targeted (R)</p> |

Continued on next page

| Design Summary | Performance Indicators/Targets | Monitoring Mechanisms | Assumptions and Risks |
|---|--------------------------------|--|---|
| Inputs | | | |
| International Consultants (collateral legal and regulatory expert, collateral registry expert, MFI expert, and training specialist, 22 person-months total) | \$535,000 | Review Mission Regular communication with executing and implementing agencies | Qualified consultants are not available (R) |
| Domestic Consultants (collateral expert, MFI expert, and training specialist, 24 person-months total) | \$25,000 | | |
| Training and workshop | \$25,000 | | |
| Public awareness and information dissemination | \$28,000 | | |

COST ESTIMATES AND FINANCING PLAN
(\$'000)

| Item | Foreign Exchange | Local Currency | Total Cost |
|--|---------------------|-------------------|-----------------|
| A. Asian Development Bank (ADB) Financing^a | | | |
| 1. Consultants | | | |
| a. Remuneration and Per Diem | | | |
| i. International Consultants | 535.00 | 0.00 | 535.00 |
| ii. Domestic Consultants | 0.00 | 25.00 | 25.00 |
| b. International and Local Travel | 60.00 | 3.00 | 63.00 |
| 2. Reports and Communication | 12.00 | 12.00 | 24.00 |
| 3. Public Awareness Program ^b | 5.00 | 23.00 | 28.00 |
| 4. Training ^c | 4.00 | 16.00 | 20.00 |
| 5. Workshops ^d | 1.00 | 4.00 | 5.00 |
| 6. Contingencies | 80.00 | 20.00 | 100.00 |
| Subtotal (A) | 697.00 | 103.00 | 800.00 |
| B. Government Financing | | | |
| 1. Office Accommodation and Transport | 0.00 | 80.00 | 80.00 |
| 2. Remuneration and Per Diem of Counterpart Staff | 0.00 | 80.00 | 80.00 |
| 3. Training/ Seminar/ Workshop Arrangements | 0.00 | 20.00 | 20.00 |
| 4. Other | 0.00 | 20.00 | 20.00 |
| Subtotal (B) | 0.00 | 200.00 | 200.00 |
| Total | 697.00 | 303.00 | 1,000.00 |

^a Financed by the Japan Special Fund funded by the Government of Japan.

^b Information on collateral issues will be widely disseminated through the distribution of educational materials and by organizing community gatherings.

^c This includes training for judges on collateral legislation, and training for the National Bank of Azerbaijan and Microfinance Institutions on new regulations and supervision.

^d Stakeholder workshops will be conducted as needed to manage the reform process.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. The purpose of the technical assistance (TA) is to (i) improve the legal framework and procedures for collateral registration and enforcement, and (ii) develop a regulatory and supervisory framework conducive to the development of microfinance institutions (MFIs). The TA will be implemented over a period of 18 months. The selection of international and domestic consultants will be conducted in accordance with Asian Development Bank *Guidelines on the Use of Consultants* and other arrangements satisfactory for the selection of consultants.

A. International Consultants

1. Collateral Legal and Regulatory Expert/Team Leader (7 person-months)

2. The collateral expert will have at least 10 years of experience in collateral legislation and regulation and a solid understanding of the mechanics of collateral registries. Relevant experience in transition economies is highly desirable.

3. The consultant's terms of reference (TOR) will include, but not be limited, to the following:

- (i) Review the Law on Collateral, the Pledge Law, the Civil Code, the Bankruptcy Code, the Law on Mortgage, and other pertinent laws and regulations for movable and immovable collateral. Review sample loan and collateral agreements and court rulings on collateral. Based on the review, recommend specific amendments and develop an overall strategy for addressing legal, regulatory, and institutional constraints.
- (ii) Make specific recommendations for quick and inexpensive enforcement of collateral.
- (iii) Work closely with the collateral registry expert and the international and local training experts to design and conduct a training program for judges and bailiffs on effective debt enforcement.
- (iv) Work closely with the collateral registry system expert and the international and local training experts to design an awareness program to improve public understanding of collateral legislation, and registration and enforcement procedures.
- (v) Supervise and coordinate the inputs of other team members to ensure that TA outputs are delivered in a satisfactory and timely manner.
- (vi) Coordinate with the Government and with other development partners.
- (vii) Consolidate all TA reports.

2. Collateral Registry System Expert (4 person-months)

4. The consultant will have at least 7 years of experience in developing collateral registry systems and a strong background in collateral laws and regulations. Relevant experience in transition economies is highly desirable.

5. The consultant's TOR will include, but not be limited, to the following:

- (i) Prepare a detailed design for a centralized public registration system for immovable and movable collateral, including equipment, software, staffing, and training needs.

- (ii) Draft operating procedures and operating manuals, set up the fee structure to ensure a self-sustaining operation, and determine budget and other institutional requirements.
- (iii) Assess possible private or joint private-public sector participation in setting up, funding, and operating the public register.
- (iv) Provide inputs for the collateral training and public awareness programs.

3. Institutional Development and Training Specialist (4 person-months)

6. The specialist will have a strong background in training in collateral laws and regulations. The expert must have a proven track record in designing training and public awareness programs on financial laws and regulations.

7. The specialist's TOR will include, but not be limited, to the following:

- (i) Work closely with the collateral legal expert and the collateral registry system expert to prepare the operating manuals, forms, and a users' guide for the centralized collateral registry.
- (ii) Supervise the local training consultant in designing training manuals and in conducting training and awareness programs.
- (iii) Design and conduct a training program for judges and bailiffs on debt enforcement.
- (iv) Identify additional training needs, if any, and conduct relevant training programs.

4. MFI Legal and Regulatory Expert (7 person-months)

8. The expert will have a strong background in all aspects of MFI operations, and will have at least 7 years of experience in developing regulatory and supervisory frameworks for MFIs. Relevant experience in transition economies is highly desirable.

9. The TOR will include, but not be limited, to the following:

- (i) Draft implementing regulations for the new Microfinance Law, review taxation of MFIs, and develop prudential norms and reporting requirements.
- (ii) Develop corporate governance and internal control guidelines for MFIs.
- (iii) Develop and conduct training for MFIs on compliance with the new MFI Law and regulations, corporate governance guidelines, and reporting requirements.
- (iv) Design and conduct training for National Bank of Azerbaijan (NBA) staff for on-site and off-site supervision of MFIs.
- (v) Design and conduct training for NBA staff on risk management principles of MFIs, including internal controls and audits.

B. Domestic Consultants

1. Collateral Expert (8 person-months)

10. The collateral expert will be a lawyer with at least 3 years of relevant work experience. The expert must be fluent in English.

11. The TOR will include, but not be limited, to the following:

- (i) Translate and summarize laws and regulations pertinent to collateral, highlighting key features and weaknesses.

- (ii) Assist the international collateral experts in all aspects of the design of the centralized collateral registry and the development of implementation procedures.
- (iii) Draft necessary forms, users' guides, and manuals under the supervision of the international collateral expert.
- (iv) Consult with stakeholders to identify key problems related to debt enforcement and suggest possible solutions.
- (v) Provide input into the design and conduct of workshops and training for the collateral component of the TA.

2. Training Expert (9 person-months)

12. The expert must have an adequate background in collateral-related issues and a strong track record in conducting training, particularly at the community level. Fluency in English is required.

13. The TOR will include, but not be limited, to the following:

- (i) Hold community meetings in both urban and rural areas to assess borrowers' concerns and training needs.
- (ii) Consult with banks to identify the concerns from the lenders perspective.
- (iii) Based on (i) and (ii), and under the supervision of the international collateral expert, design both the overall strategy and a detailed training program to ensure maximum outreach and impact.
- (iv) Prepare training materials, conduct training sessions, advise on methods for disseminating information to the public, and suggest follow-up activities.

3. MFI Expert (7 person-months)

14. The expert will have a strong background in all aspects of MFI operations and at least 3 years of industry experience. The expert must be fluent in English.

15. The TOR will include, but not be limited, to the following:

- (i) Provide background information to the international MFI expert on MFI laws, regulations, taxation, industry trends, and other impediments to the further development of MFIs.
- (ii) Provide input into the preparation of implementing regulations and corporate governance guidelines.
- (iii) Assist the international consultant in the design and conduct of training.