

**ASIAN DEVELOPMENT BANK**

**TAR: OTH 36026**

**TECHNICAL ASSISTANCE**

**FOR**

**RURAL FINANCE IN CENTRAL ASIA**

**December 2002**

## ABBREVIATIONS

ADB	–	Asian Development Bank
CAR	–	Central Asian republics
MFI	–	microfinance institution
MSE	–	micro and small enterprise
NGO	–	nongovernment organization
RETA	–	regional technical assistance
SCU	–	savings and credit union
SFI	–	small financial institution
SME	–	small and medium enterprises
TA	–	technical assistance

## NOTE

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

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## I. INTRODUCTION

1. The overall goal of the proposed technical assistance (TA) is to promote viable and sustainable rural financial systems in the Central Asian republics (CARs). This goal will be achieved by developing approaches and modalities for efficient intermediation of rural financial resources specifically by (i) diagnosing the current state of rural financial systems, identifying constraints and issues and potential approaches and institutional mechanisms for delivering financial services; (ii) examining approaches through which the banking system can deliver services more effectively, while considering viable, alternative institutional mechanisms that have served well in other countries; and (iii) discussing approaches, modalities and best practices for efficient intermediation in delivering rural financial services at the international, national, and regional levels. The TA will bring together rural finance experts and market participants, as well as other stakeholders, to encourage the debate on issues facing rural financial systems, as well as disseminate recommendations. The TA will draw on the Asian Development Bank (ADB's) and other aid agencies' existing policy and country work in rural financial markets. The TA<sup>1</sup> framework is in Appendix 1.

## II. ISSUES

2. Since 1991, the newly market-oriented financial systems in CARs have been preoccupied with laying the basic foundations of a commercial banking system. CARs have seen a great deal of bank insolvency and restructuring due to excessive exposure to irresponsible state lending and poor regulations and governance. Initially in the transition period, governments used the banking systems to continue financial support for agricultural and other targeted enterprises, without regard to the financial consequences on the banks involved. As a result, the banking system, including the state-owned agricultural banks, ended up burdened with an excessive amount of nonperforming loans. As most of these institutions were shut down across the region, bank lending to purely agricultural enterprises has come to a virtual halt.

3. The financial sectors of CARs<sup>2</sup> have now stabilized, yet remain underdeveloped. Critical sectors of the economy have only limited access to formal financial services. For instance, the financial system underserves the rural sector that employs from 34-53% of CARs' populations, with agricultural production contributing from 9% to 72% of gross domestic product (Appendix 2 shows key indicators for the rural/agricultural sectors for all CARs). In the transition, the CARs have (i) dismantled rigid, state-controlled systems of agricultural production; (ii) encouraged substantial and growing participation of private farmers, herders, and households; and (iii) subsidized directed credit to rural and agriculture systems as well as small and medium enterprises (SMEs) and the micro and small enterprises (MSEs) through special state-driven programs.

4. The CARs have launched several initiatives to provide credit to the rural and agriculture sectors as well as to SMEs and MSEs. Evidence suggests that the poorest segment of the rural and agriculture sectors remains predominantly underserved by both the banks and alternate mechanisms that are either ineffective or at a rudimentary stage of development. Varied issues and constraints face the rural financial market intermediation process.

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<sup>1</sup> The TA first appeared in *ADB Business Opportunities* in August 2002.

<sup>2</sup> Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan.

5. **Status of Alternate Channels of Delivery.** In CARs, financial intermediation related to rural and agriculture sectors takes place through the banking system. The cost of credit remains high due in large part to operational inefficiencies and poor governance of financial institutions. Banks have either channeled, directed subsidized credit or rediscounted money targeted to agriculture or SMEs, mainly funded by aid agencies. None of these initiatives represents a sustainable funding mechanism. Bankers, on their own account, are reluctant to reach out beyond the larger corporate customers in the largest cities and leave poorer, rural clientele without access to banking services. Furthermore, banks are not equipped to deal with the natural risk of lending to primarily agricultural enterprises. Capacity building in credit/risk management, product design and pricing, and marketing remains an acute need.

6. CAR rural enterprises are in many cases organized around households or otherwise fall into the category of MSE or SME. Rural households are often engaged in a combination of agricultural and nonagricultural income-generating activities, that when evaluated together, provide a bankable mix of cash flow sources. Rural microfinance institutions (MFIs), therefore, have a key role to play in providing services. In other parts of developing Asia and in Latin America, MFIs have often been provided unsecured or semi-secured retail credit by banks, with some degree of success. The challenge for CARs' commercial banks is to create the right mix of products and services for the new rural MSEs and SMEs, delivered through the right organization structure and channels and administered by an effective governance regime.

7. Many nongovernment organizations (NGOs) have ventured into rural areas, but these institutions often have a problematic ownership structure and mixed set of missions, some purely social. There are interesting lending programs in every CAR. Most of the programs will have difficulty transforming themselves into sustainable, full-service financial institutions. Yet they are filling a need for credit in underserved rural areas. Approaches ought to be developed to ensure the sustainability of this channel of financing, drawing on the experience of the best-run programs that have been or will be transformed into formal financial institution, and which can offer a meaningful level of services in rural areas (e.g., XAC Fund, now XAC Bank in Mongolia).

8. Small financial institutions (SFIs), like savings and credit unions (SCUs), can play a vital role in filling the rural financial service vacuum. ADB's recent experiences in the Kyrgyz Republic and Mongolia show that SCUs are popular, but require substantial and prolonged TA programming, including social intermediation, to ensure that both the SCUs and their support systems are set up and operate properly. Still, decades of experience with SCUs in Latin America and more recent experience in Asia demonstrate that if run on clear business principles, SCUs can achieve considerable outreach<sup>3</sup> and serve the economically active poor.

9. The development of rural financial markets can be catalyzed by promoting new and innovative financial products that have served other markets well. These products include insurance and reinsurance, which deal with natural and other kinds of risk, and equipment leasing. These products and businesses require the adoption of a conducive legal and regulatory framework; the financial institutions themselves require capacity building so as to manage the new and different kinds of risk.

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<sup>3</sup> In 2000, the amount of credit provided by savings and credit unions in Latin America reached \$2 billion, compared with \$800 million provided by microfinance institutions. Source: *Safe Money*, 2000, published jointly by Inter-American Development Bank and World Council of Credit Unions.

10. **Legal and Regulatory Environment.** On the policy side, one major constraint to the development of rural finance is lack of an explicit framework for financial sector development that considers at all times the needs of the rural economy and rural population. One constraint is the lack of laws governing insurance, which renders the CARs, each with a large agriculture sector, fully exposed to natural risk. As for the regulatory side, capacity building remains the major challenge.

11. In many CARs, the legal and regulatory approach is to draft laws specifically for MFIs on one hand, and SCUs on the other, and to consider regulation needs separately for each. Commercial banking laws and regulations, for better or for worse, are considered separately from those that govern SFIs. In most CARs, regulations governing the operations of SFIs are inadequate, and resources and capacity to effectively regulate SFIs are insufficient.

12. Mindful of the system and moral hazard risks and given many bank failures and the low level of public trust in banks, regulators are reluctant to allow deposit taking by SFIs. The concern with system risk is understandable, but it impedes mobilization of deposits. SFIs tend, therefore, to overemphasize their only product, credit, when rural dwellers have a more fundamental need for deposit and payment services. Even though limited amounts of credit are available in rural areas, no real financial intermediation is taking place. Aside from deposit insurance, which was recently introduced in Kazakhstan, CAR regulators have few strategies for increasing the level of deposits.

13. **Role of the Central Bank and Government.** Central banks often play two roles. The first and essential role is that of guardian of the public's trust in financial institutions that are classified as deposit-taking institutions, which the central bank regulates and supervises. The other role is that of promoter of new kinds of financial institutions. Given their lack of skills, often regulators in CARs struggle to play the former role effectively. To date, governments and central banks have received a great deal of policy advice and technical support from the aid community in developing of SFIs. Though most of this advice is well-intentioned, it has often been uncoordinated and delivered ineffectively. The aid agencies' record notwithstanding, it is clearly the responsibility of CAR governments and central banks to develop their financial sectors to serve the needs of urban and rural dwellers, SMEs as well as and micro entrepreneurs. CAR policymakers have received advice and expertise but the challenge is to sift through the information, determine what has worked and why, and design coherent long-term strategies that are politically supportable.

14. Corporate governance remains weak, with managers relatively free to operate without due regard for acceptable risk, efficiency, or profitability benchmarks. In more developed countries, the public debt and equity markets serve to impose discipline on managers even when board members do not act decisively. In CARs, with market discipline entirely absent and boards of directors unassertive or otherwise unprepared, regulators become the only effective check on management. Regulators rarely act until an institution has failed or is on the brink of failure. In the absence of fully functioning market mechanisms, governments and the aid agencies that support them have a responsibility to vigorously promote principles of operational efficiency, good corporate governance, and transparency.

15. The proposed TA aims to review and analyze in depth the current state of rural financial markets in CARs, focusing on issues related to meeting the requirements of micro and small borrowers. The findings will be compared with approaches and modalities that have resulted in improved rural financial services in other parts of the world. The TA will outline frameworks for expanding the range of financial services and giving greater access to those services to as

broad a spectrum of rural society as possible in CARs. Within CARs, rural financial markets are developing more rapidly in some countries (Kazakhstan and Mongolia) than in others (Azerbaijan, Kyrgyz Republic, Tajikistan, Uzbekistan), and experiences in the former may give useful lessons, that can be applied in the latter. ADB's past TA programs at the regional level have been prescriptive and produced general recommendations for national-level programming.<sup>4</sup> The national TA programs have primarily supported individual components, including the promotion of SCUs, village cooperatives, or NGOs engaged in microfinance. The TA will draw on both ADB and other aid agency activities and programs to evaluate the effectiveness of external interventions to date, and to determine next steps that are geared to building sustainable financial institutions that serve the needs of the rural people in CAR.

### III. THE TECHNICAL ASSISTANCE

#### A. Purpose and Output

16. The goal of the TA is to promote the development of sound and viable rural financial markets to make improved financial services widely accessible to rural micro entrepreneurs and SMEs. The TA will support a regional study that will give a comprehensive overview and analysis of the size and structure of rural financial activity in each CAR and related issues. Considering local requirements and conditions, the TA will give advice on efficient alternate approaches and modalities for developing sustainable rural financial systems that serve the requirements of small and micro borrowers. The TA findings and recommendations will be discussed at national and regional levels.

#### B. Methodology and Key Activities

17. The TA will

- (i) carry out diagnostic studies of the current state of rural financial systems for the six targeted CARs, which will identify constraints and issues in the delivery of financial services. The review will examine rural financial markets from the perspectives of the customer/beneficiary, product, institution-regulatory framework, and policy; will define, measure, and evaluate the full spectrum of financial activity—from formal to informal—including the role of commercial banks, SCUs, NGOs, and other nonbank financial institutions;
- (ii) examine ways to use the banking system for more effective service delivery, while considering viable, alternative institutional mechanisms that have served well in other countries;
- (iii) identify specific subsector needs for financial services through case studies of rural finance customers (and potential customers).
- (iv) catalogue aid agency assistance and evaluate its impact on rural finance;
- (v) draw on international, regional, and national best practices in rural financial service delivery to help each CAR to promote the building of strong, sustainable rural financial service providers; and
- (vi) support dialogue with key stakeholders in each country.

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<sup>4</sup> ADB. 2000. *Final Report on Rural Financial Systems Workshop in Central Asia*. Manila. Conducted workshops and collated information on rural finance in the region, which can serve as a foundation on which to build a richer profile of rural financial systems in each of the CARs.

18. A team of international and domestic consultants will conduct an intensive research into the rural financial systems in each CAR at national and regional levels. The result will be six national diagnostic studies, which will be collated to provide a regional overview. The findings will be discussed in national workshops to include key stakeholders, with workshop insights incorporated into the final drafts of the studies. The set of national studies will be the basis for a regionwide analysis of rural financial systems. Selected participants in the national workshops will be invited to participate in a regional workshop, the purpose of which is to arrive at conclusions and recommendations for either national or regional projects to promote rural finance.

### **C. Cost and Financing**

19. The estimated cost of the TA is \$600,000, composed entirely of foreign exchange. The TA will be financed on a grant basis by ADB's TA funding program. Detailed cost estimates and the financing plan are in Appendix 3.

### **D. Implementation Arrangements**

20. The ECGF will implement the TA, with logistical support from ADB's Resident Missions in the CARs; ADB will be the executing agency. The Missions, as well as government agencies with which ADB maintains close contacts in the CARs, will be asked to help coordinate national workshops and the final regional workshop. ADB will review and monitor the implementation of the TA through regular missions and consultant's reports. ADB will organize and participate in the national workshops and the final regional workshop.

21. A team of 17 consultants will be recruited to implement the TA. Five international consultants (16 person-months) will coordinate the work of the domestic consultants (36 person-months). The international consultants will be led by a rural financial systems advisor/team leader (8 person-months), supported by four rural finance country specialists (2 person-months each). Twelve domestic consultants will be fielded, two from each of the six CARs, for 3 months each. The domestic consultants will have a background in economics, finance, and/or banking. All consultants will be selected and recruited in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements for engaging domestic consultants. Outline terms of reference for the international and domestic consultants are in Appendix 4. The TA is expected to start in January 2003 and to be completed in December 2003.

## **IV. THE PRESIDENT'S DECISION**

22. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$600,000 on a grant basis for Rural Finance in Central Asia, and hereby reports this action to the Board.

### TECHNICAL ASSISTANCE FRAMEWORK

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p><b>Goal</b> Develop sound and viable rural financial markets</p>	<p>Capacity to plan projects and programs to fit into comprehensive strategy at country level</p> <p>Regional network to share experiences that inform national policy</p> <p>Projects and programs that are based on empirical research and proven best practices</p>	<p>Consultative group meetings and Asian Development Bank (ADB) missions</p>	<p>Government commitment to develop market economy continues.</p> <p>A stable macroeconomic environment exists.</p>
<p><b>Purpose</b> Increase stakeholders' knowledge of rural financial markets so that policies and strategies to develop them are more effective</p>	<p>Detailed understanding by key stakeholders in each Central Asian republic (CAR) of critical rural finance development issues and situation in their own country</p> <p>Individual CAR experiences in developing rural financial markets shared among regional counterparts</p> <p>Experience with the rest of developing Asia and other parts of the world shared and understood by all project participants</p>	<p>ADB missions</p>	<p>Rural areas remain significant contributors to CARs' economies.</p> <p>Government commitment to financial sector development in general and rural financial market development in particular continues.</p> <p>Aid coordination exists. Policymakers identified through regional technical assistance (RETA) are able to retain positions of stature.</p> <p>Policymakers are motivated to carry out recommended activities.</p>
<p><b>Outputs</b> Comprehensive study of national and regional rural financial markets, which provides foundation for programming</p>	<p>National diagnostic study prepared for each CAR Project opportunities identified in individual CARs that conform to unique national conditions</p>	<p>ADB missions</p>	<p>Consultants are capable of organizing a large body of information into concise, usable form.</p> <p>Participants selected to participate in national and</p>

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
activities to strengthen rural financial markets in CARs	Regional project opportunities that build on successful national, regional, and international experiences		regional workshops are qualified and committed, and provide useful feedback.
<b>Activities</b> Research National workshops Consultations and meetings Regional workshop	Consulting services  Technical assistance budgeted as follows:  \$600,000	Consulting team and ADB personnel	Studies are comprehensive and recommendations are practical.

## KEY INDICATORS

Country	Agriculture Sector as % of GDP <sup>a</sup>	Rural Population as % of Total Population <sup>b</sup>	Agricultural Labor as % of Total Employment <sup>c</sup>	% of Population in Poverty <sup>d</sup>	% of Rural Population in Poverty <sup>e</sup>
Azerbaijan	17	48	41	68	-
Kazakhstan	9	44	34	32	34
Kyrgyz Republic	38	66	53	52	56
Mongolia	26	43	48	36	33
Tajikistan	24	72	64	83	-
Uzbekistan	35	63	34	22	-

GDP = gross domestic product.

<sup>a</sup> Asian Development Bank (ADB). 2002. *Key Indicators of Developing Asia and Pacific Countries*. Manila; page 57. All figures are for 2001.

<sup>b</sup> Ibid., page 52. All figures are for 2001.

<sup>c</sup> Ibid., Country Tables. Percentage is calculated as total agricultural employment divided by total employment.

<sup>d</sup> Ibid., page 40. Azerbaijan, 1995; Kazakhstan and Kyrgyz Republic, 2000; Mongolia, 1998; Tajikistan, 1999; Uzbekistan, 1996.

<sup>e</sup> Ibid., page 40. Figures for Azerbaijan, Tajikistan, and Uzbekistan not available.

**COST ESTIMATES AND FINANCING PLAN**  
(\$)

<b>Item</b>	<b>Total Cost</b>
<b>A. Asian Development Bank Financing</b>	
1. International Consultants	
a. Remuneration and Per Diem	400,000
b. International Travel	35,000
2. Domestic Consultant	
a. Remuneration	36,000
3. Translation and Communication	7,500
4. Final Regional Workshop	35,000
5. Conference <sup>a</sup>	25,000
<b>Subtotal (A)</b>	<b>538,500</b>
<b>B. Contingencies</b>	<b>61,500</b>
<b>Total</b>	<b>600,000</b>

<sup>a</sup> Contribution to World Bank Microfinance Conference (to be held in April 2003, in Almaty, Kazakhstan).  
Source: Asian Development Bank estimates.

## OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

### A. International Consultants

1. Five international specialists will provide consulting services for 16 person-months.

#### 1. Rural Financial Systems Advisor/Team Leader (8 person-months)

2. The rural financial systems advisor will be the team leader. This consultant will have at least 15 years' experience advising governments in designing policies related to rural finance. Significant experience with microfinance institutions and/or with savings and credit cooperatives is also essential, as is regional experience. At the start of the technical assistance (TA), the consultant will travel to Manila for extensive consultations with staff of ECGF, and to gather information related to rural financial markets in Central Asian republics (CARs). The consultant will

- (i) thoroughly review the academic and other specialist literature related to rural finance topics that are relevant to Central Asia (including material related to the experience of other developing countries), and create an annotated bibliography of the available specialist literature;
- (ii) develop a framework for the national diagnostic studies in close consultation with the international experts assigned to each of the CARs;
- (iii) prepare survey and/or other evaluation tools the consulting team will use to gather quantitative and qualitative data related to rural financial markets and rural economic activity;
- (iv) prepare a matrix of aid agency programs related to rural finance by country and by program or project theme, with inputs provided by the other international experts. Analyze the strategic and regional programming strategy of other aid agencies working in Central Asia, and make a catalog of rural finance interventions that highlights successful examples of rural finance institution building in the region;
- (v) assist in organizing the national diagnostic workshops to discuss preliminary findings of the diagnostic studies. Participate in the national diagnostic workshops to ensure a consistent approach to soliciting input from stakeholders and thorough coverage of all cross-cutting issues;
- (vi) edit the national diagnostic studies for inclusion in a final report;
- (vii) create an agenda for the final regional seminar, and moderate the seminar;
- (viii) prepare a comprehensive final report on rural finance in CARs that outlines the national and regional strategies for developing rural financial markets, with focus on the requirements of micro and small borrowers and programming options; and
- (ix) act as a rural finance country specialist in one CAR.

## 2. Rural Finance Country Specialists (8 person-months)

3. There will be four rural finance country specialists, each for 2 person-months to work. The specialists will have at least 10 years' experience working with rural financial institutions, and significant policy and/or research experience. Experience in working with microfinance institutions or savings and credit unions, or both, in CARs is essential. A rural finance country specialist will be assigned to at least one CAR, but one country specialist will be assigned to cover two countries simultaneously. The team leader performs the tasks of the country specialist in one CAR. The rural finance country specialists will be responsible for preparing a diagnostic study of rural finance in their assigned CAR. Each consultant will

- (i) examine the available literature on financial markets, rural finance, microfinance, the agriculture sector, and rural economy in the assigned CAR; in addition, catalog the recent project and program activities of the aid community that are related to rural finance;
- (ii) research including via survey (if no recent studies or surveys are available) rural financial markets and rural economic activity; using surveys and field research, look at the nature and extent of informal activity, including informal lending, as well as productive or service-related activities; also examine formal agricultural and business activity;
- (iii) review the activities of financial institutions, particularly banks, serving rural areas: define a range of financial products offered in rural areas, evaluate whether the supply of products/services fits local needs, highlight supply shortfalls and potential marketing opportunities, analyze the capacity of local financial service providers to meet demand; analyze the capacity of these organizations to manage risk, and evaluate their prospects for financial growth and geographic expansion;
- (iv) review the performance of nonbank financial institutions, including nongovernment organizations and small financial institutions in serving the rural markets; determine if worthwhile urban-based programs may be adapted to serve rural areas;
- (v) examine the role of government agencies in regulating, supervising, and promoting of rural financial institutions, and outline ways to strengthen or improve the legal and regulatory environment;
- (vi) identify rural regions and economic subsectors in rural areas that are underserved and analyze the reasons why they may have been neglected;
- (vii) from the foregoing, recommend ways to promote efficient rural financial markets, and strong, sustainable rural financial institutions that can better serve the rural economies in CARs;
- (viii) for a wide spectrum of stakeholders organize a national workshop, in which the preliminary findings and recommendations of the rural financial system diagnostic study will be presented and discussed;

- (ix) revise and edit the diagnostic studies, incorporating where necessary useful feedback from the national workshop; and
- (x) identify key people with significant knowledge of the rural finance situation in each CAR who can lead in building more efficient rural finance systems and stronger rural finance institutions, and nominate three candidates to participate in the regional workshop.

**B. Domestic Consultants (36 person-months)**

4. Two consultants from each of the six CARs (Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Uzbekistan) will join the rural finance country specialist to form a country diagnostic team. Consultants from each country will be retained for 3 months each, totaling 36 person-months. The domestic consultants will have significant experience working with international projects, ideally, related to rural finance or banking and finance. Consultants must be fluent in the local language and English. The consultants will work under the direction of the international consultants, and assist as needed in gathering information and drafting sections of the diagnostic studies.