

ASIAN DEVELOPMENT BANK

TAR: AZE 36149

TECHNICAL ASSISTANCE

TO THE

REPUBLIC OF AZERBAIJAN

FOR

MICROFINANCE SECTOR DEVELOPMENT

April 2003

CURRENCY EQUIVALENTS

(as of 3 April 2003)

Currency Unit	–	Azerbaijan (AZM)
AZM1.00	=	\$0.000204
\$1.00	=	AZM4,907

ABBREVIATIONS

ADB	–	Asian Development Bank
ANB	–	Azerbaijan National Bank
CU	–	credit union
GDP	–	gross domestic product
IDP	–	internal displaced person
MED	–	Ministry of Economic Development
MFI	–	microfinance institution
MSE	–	micro and small enterprise
NGO	–	nongovernment organization
TA	–	technical assistance

NOTE

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

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I. INTRODUCTION

1. The Government of Azerbaijan requested technical assistance (TA) from the Asian Development Bank (ADB) for the development of the microfinance sector. In response, ADB proposed a TA project to prepare a diagnostic assessment of the microfinance sector and a development strategy to serve as a basis for improvements in the policy, legal, regulatory and institutional framework of the microfinance sector. ADB has reached an understanding with the Government on the objectives, scope, terms of reference, cost estimates, financing plan, and implementation arrangements for the TA.¹ The TA framework is in Appendix 1.

II. ISSUES

2. **The Context.** Since 1995, Azerbaijan has managed to pursue macroeconomic stabilization and structural reforms that have yielded good results. On a positive note, real gross domestic product (GDP) growth has been strong, and there has been a significant degree of economic and monetary stability. However, the benefits of economic growth have not trickled down to the poor or raised the living standards for most of the population. This is largely because of lack of diversification of production base. The production of the oil sector contributed only 1% to employment generation even though it accounts for 62% of the increase in GDP over the last 5 years. Census data (1999) estimates unemployment rate to be about 16%. Based on an absolute poverty line of AZM120,000 (about \$25) per capita per month, poverty incidence is reported to be 49%. Adding to the ranks of the poor are the large numbers of refugees and internally displaced persons (IDPs), estimated to be about 12% of the population.

3. Recognizing these issues, the Government has taken a few important initiatives. Notable is the land reforms that have helped redistribute 1.3 million hectares of land to rural residents. Developing agriculture remains crucial for economic and regional development, as about 40% of the workforce is employed in this sector. Improved accessibility of finance at competitive rates will also promote the development of micro and small enterprises (MSEs) that are generally conducive to generating employment.

4. The Government's 2002 Poverty Reduction Program aims to provide an enabling environment for the growth of income-generating opportunities and improvement in the living conditions of the rural population, especially of the refugees and IDPs. To achieve this objective, the Government calls for (i) expanding the banking network by establishing financial institutions in the regions and (ii) creating conditions for the development of microfinance institutions (MFIs) to provide loans to individuals and MSE.

5. **Overview of Microfinance and Rural Credit.** In Azerbaijan the outreach of MFIs is limited. The operating MFI are largely managed by international nongovernment organizations (NGOs) and serve barely 20,000 borrowers. Consequently, the poor and micro-borrowers have virtually no access to credit and demand for rural credit is not met adequately. Many MFIs provide credit to refugees and IDPs, and offer loans for start-up enterprises normally entailing a high risk of default. They depend on aid agency funds for onlending and are structured to subsidize the high cost of credit administration. While the MFIs have a good record of repayment, they will remain financially unsustainable unless they are transformed into formal financial institutions and allowed to generate their own sources of financing.

¹ The TA first appeared in *ADB Business Opportunities* in December 2002.

6. **Credit Unions.** Previous efforts to form credit unions (CUs) have not been successful. Of 128 CUs formed under provisional regulations, only 28 are operating with a total loan portfolio of only AZM3.2 billion (\$631,000). Recently, a new law on CUs has been adopted. A restrictive feature of the law is the lack of an enabling provision that would allow CUs to accept deposits. This provision has constrained the development of CUs as effective financial intermediaries and lending is mainly financed from equity contributions or grant financing from foreign donors. The CUs have evolved merely as external fund disbursing agents. Even this role has been constrained by the imposition of a high capital adequacy ratio of 25%. The development of CUs as effective rural financial intermediaries is unlikely unless legislation is amended. Regulatory provisions should also be strengthened to ensure the financial soundness of CUs.

7. **The Commercial Banking Sector.** The Azeri banking sector is dominated by the state-owned International Bank of Azerbaijan, which is the best positioned bank with a very high share of the deposit and credit market. The remaining commercial banks are small and owned by different corporate groups. These banks are unable to mobilize significant amounts of deposits, and perform limited financial intermediation role in the rural economy. With a high level of nonperforming loans, it is unlikely that commercial banks will direct their lending operations to rural/micro lending which is perceived to be highly risky. The new Microfinance Bank² recently established and capitalized by the European Bank for Reconstruction and Development, the International Finance Corporation, Black Sea Trade and Development Bank, and LFS Financial Systems³ is expected to become an important player in small and medium-size enterprise lending. However, its average loan size is significantly higher than that of MFIs and loans require full collateralization. This bank is not expected to cater to the poor client base of MFIs and will be a normal commercial bank focusing on small and medium-size enterprises.

8. **Absence of a Microfinance Strategy.** The development of microenterprises as incorporated in the Government's 2002 poverty reduction program is the most promising way of providing the poor with economic opportunities for increased income and employment. While the Government's poverty reduction program considers microfinance as an effective instrument in reducing poverty and creating economic opportunities, a comprehensive rural microfinance development strategy remains to be developed.

9. There is no clear legal definition of microfinance in Azerbaijan. Policy is restrictive; deposit taking by MFIs and CUs is prohibited. The legal and regulatory framework is inadequate to support the development of a financially viable system based on local financial intermediation. There are no formal financial institutions that can mobilize deposits and lend them to enterprises and individuals in rural areas. As a result, only a small range of financial services is available to support income-generating activities and microenterprise development. Development of sustainable MFI is difficult without an appropriate microfinance strategy that would dictate the type and nature of operations of MFIs and other possible institutions, capacity building requirements, enabling legislation, and accompanying regulations.

10. **Restrictive Legal and Regulatory Framework.** In view of the weakness in the banking sector and the prevailing high level of nonperforming loans, policy makers and bank regulators have focused on ensuring the safety and soundness of the banking sector. Creation of an environment for effective rural financial intermediation has traditionally received low priority. The legal regulatory framework for MFI is non-existent. The only provision issued is "On Granting License to Credit Organizations and their Branches and on Organization of their Operations" as an addendum to Regulations No. 1 of the central bank, dated 9 November 1996. The special license issued is for conducting limited banking operations. MFIs and CUs are not mandated to

attract deposits. Legislation should establish the legal character of MFIs, regulatory provisions to set standards of operations, eligibility to take deposits based on the scale of operations, and the manner of transforming MFIs into formal banking institutions.

11. Unless CUs are allowed to generate resources through deposits, their role as self-help organizations providing a range of financial services to members cannot be realized. Legal provisions that would allow CUs to mobilize deposits should be accompanied by institution-building measures to ensure that depositors are protected and sound credit operations are attained.

12. Regulations and supervision for the microfinance sector are new in most countries. In Azerbaijan, where new institutional forms of microfinance are being established, experience in supervision is limited. The passage of appropriate legislation and promulgation of regulatory provisions should be accompanied by capacity building for the regulatory body.

13. **Microfinance Sector Strategy and Its Action Plan.** Given the issues facing the rural and microfinance sector, the Government is keen to develop a microfinance policy and strategy including a review of the sector, the limitations on deposit services, business opportunities for and constraints on the poor, as well as weaknesses in the business climate and administrative barriers. Besides a diagnostic assessment of the demand of microborrowers and MSEs for financial services, there is need to study the feasibility of MFIs operating in rural areas, and to develop a rural finance strategy to determine the appropriate forms that could attract investors, depositors, and creditors.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

14. The goal of the TA is to reduce poverty through broadening and deepening of the outreach of MFIs. The purpose is to create a microfinance development strategy that provide a sound policy, institutional, legal, and regulatory environment for micro and rural finance institutions to permit them to offer a wide range of financial services in a sustainable manner. This goal is in line with the strategic objective of ADB's assistance to Azerbaijan and addresses one of the strategic focuses of the program, which is assistance to agriculture and rural development activities.

15. The expected TA outputs are as follows:

- (i) prepare a microfinance and rural finance development strategy based on a diagnostic assessment of MFIs and the rural financial sector;
- (ii) provide recommendations to develop laws and regulations for MFIs and CUs and to enable the establishment of possible new institutional forms;
- (iii) develop approaches to supervision and regulation of MFIs and CUs; and
- (iv) identify a possible follow-up project to further promote the growth of MFIs and the rural financial sector.

B. Methodology and Key Activities

16. The TA will

- (i) undertake a rural financial market survey through field interviews of randomly selected residents in selected regions to evaluate the demand for financial services in the regions;
- (ii) produce a diagnostic assessment of MFIs to assess their outreach, operational procedures, and financial sustainability;
- (iii) study a sample of existing CUs to evaluate the nature of financial operations and determine capacity-building requirements;
- (iv) provide policy makers with background on the international experience on regulation of MFIs, with special emphasis on the role of central bank in microfinance;
- (v) examine the existing Azeri laws and prudential regulations governing MFIs, CUs, and other forms of rural nonbank financial institutions, and discuss amendments to strengthen them;
- (vi) assess the operation of the regulatory agency and deliver a capacity-building program to strengthen supervisory capacity; and
- (vii) develop inputs and insights for a concept paper on a proposed follow-up project to promote the growth of the sector.

C. Cost and Financing

17. The estimated total cost of the TA is \$500,000 equivalent, comprising \$297,000 in foreign exchange and \$203,000 equivalent in local currency. The Government has requested ADB to finance the entire foreign exchange cost of \$297,000 and \$103,000 equivalent of the local currency costs. The TA will be financed on a grant basis from ADB's TA funding program. Detailed cost estimates and a financing plan are in Appendix 2.

D. Implementation Arrangements

18. The Ministry of Economic Development (MED) will be the Executing Agency for the TA. An Interagency Coordination Committee will be established to coordinate and ensure the participation of different stakeholders. The committee, comprising the National Bank of Azerbaijan, MED, NGO Association, Credit Union Association, aid agencies, and other stakeholders, will meet with ADB and the consultants at least three times (inception, mid review, and final meeting). The chairman of the committee will be nominated by the Government. MED will provide the necessary office support, counterpart staff, transportation, and other services to the consultants. ADB will review and monitor the implementation of the TA through missions and consultants' reports.

19. At the beginning of the project a brainstorming meeting with all relevant stakeholders will be held to discuss problems and obstacles to the development of the sector. The preliminary findings of the diagnostic assessment of MFIs and the rural financial sector will be discussed in a workshop to include key stakeholders. The views and opinions of the participants, where appropriate, will be incorporated into the diagnostic assessment. Using the findings of the diagnostic approach, the consultants will produce a microfinance and rural finance development strategy.

20. ADB will assemble a team of individual consultants (detailed terms of reference are in Appendix 3) to implement the TA. The international consultants (9 person-months) will include a rural/microfinance specialist and a regulatory/supervision specialist. Three domestic consultants with microfinance experience will be engaged for 28 person-months. The consultants will be selected and recruited in accordance with ADB's *Guidelines on the Use of Consultants*. Consultants will submit (i) inception reports 3 weeks after the start of their services; (ii) interim progress reports at appropriate stages of TA implementation; (iii) draft final reports before the conclusion of the contract; and (iv) final reports 2 weeks after incorporating comments of the MED and ADB. The TA is expected to begin in June 2003 and to be completed in June 2004.

IV. THE PRESIDENT'S DECISION

21. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$400,000 on a grant basis to the Government of the Republic of Azerbaijan for Microfinance Sector Development, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Goal Reduce poverty	Poverty incidence indicators	Project completion report ADB missions	Government commitment to develop sustainable microfinance sector as part of the poverty reduction program continues. Stable political and macroeconomic environment.
Purpose Provide a sound policy, institutional, legal, and regulatory environment for micro and rural finance institutions to permit them to offer a wide range of financial services in a sustainable manner.	MFI outreach indicators	Project completion report ADB missions	Government commitment to implement a sound microfinance sector strategy, develop/ strengthen microfinance institutions, and amend existing legal and regulatory framework exists.
Outputs Microfinance development strategy Recommendations to draft appropriate legislation and set of revised, updated regulations governing operations of MFIs and Credit Unions (CUs) Program design to build institutional capacity to properly supervise MFIs, CUs	Draft laws and regulations to establish/ strengthen institutions providing microfinance services Amendments to the relevant laws and regulations proposed Adequate procedures established to carry out active supervision of MFIs, CUs, and other	Quarterly reports and project completion report Ministry of Economic Development (MED) reports, ADB missions Consultants' reports	Government acceptance of the proposed strategy, including legal, regulatory, and institutional requirements Aid agencies to clearly delineate areas where assistance will be provided and to avoid overlapping TAs.

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Identification of a possible follow-up project	financial institutions MFI supervision unit fully staffed and trained according to plan		
Activities Survey of MFIs and CUs Diagnostic assessment of rural financial institutions Review of the relevant legal and regulatory framework Review of international experience in regulating MFIs Workshops Consultations and meetings		Reports and project completion report ADB missions Consultants' reports	Timely recruitment of consultants

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank (ADB) Financing ^a			
Financing			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	217.00		217.00
ii. Domestic Consultants		60.00	60.00
b. International Travel	25.00		25.00
c. Rural Financial Market Survey		12.00	12.00
d. Workshop	25.00	5.00	30.00
e. Local Travel and per Diem		5.00	5.00
f. Translation and Publication		15.00	15.00
2. Contingencies	30.00	6.00	36.00
Subtotal (A)	297.00	103.00	400.00
B. Government Financing			
1. Remuneration and Per Diem of Counterpart Staff		48.00	48.00
2. Office Accommodation		41.00	41.00
3. Contingencies		11.00	11.00
Subtotal (B)		100.00	100.00
Total	297.00	203.00	500.00

^a Financed on a grant basis from ADB's TA funding program.
Source: ADB estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. International Experts

1. A team of two international specialists will be recruited to conduct the diagnostic assessment of the rural/microfinance sector, identify a strategy to promote the sector, examine legal and regulatory issues, and provide assistance to build institutional capacity. The two international specialists will provide consulting services for 9 person-months, as follows:

1. Rural/Microfinance Specialist (7 person-months)

2. The rural/microfinance expert will have an advanced degree in finance, banking, or related fields at least 10 years experience in microfinance, cooperatives, and rural/cooperative banking experience in countries in transition. The expert will carry out the following tasks:

- (i) Serve as team leader of the technical assistance (TA) project.
- (ii) Participate in the Interagency Coordination Committee.
- (iii) Create an agenda for the initial brainstorming meeting and moderate the seminar.
- (iv) Carry out a rural financial market survey by conducting field interviews of randomly selected residents in selected regions to determine economic profile, demand for savings and credit services, and sources and cost of credit. In consultation with the Executing Agency, the consultant will choose three regions that could support the feasible operation of local financial institutions.
- (v) Carry out a survey of MFIs to assess outreach, operational procedures, and financial sustainability. Examine plans to transform MFIs into formal banking institutions and determine the assistance required in transformation.
- (vi) Study a sample of existing CUs to evaluate the nature of their financial operations. Determine capacity-building requirements to improve the soundness of operations.
- (vii) Identify other appropriate institutional forms, including second-tier organizations, to encourage effective rural financial intermediation. Study the feasibility of establishing specialized financial institutions in regions where the rural market survey was carried out. Determine the appropriate institutional form, availability of investors, and the feasibility of savings and credit operation. Identify the required legal, regulatory, and institutional capacity-building requirements.
- (viii) Prepare a microfinance development strategy based on the rural financial market survey and the diagnostic assessment of the microfinance sector.
- (ix) Design and supervise the workshop where the preliminary project findings and recommendations will be discussed and presented to key stakeholders.

2. Regulation/Supervision Specialist (2 person-months)

3. The regulation/supervision specialist will have an advanced degree in finance, banking, or related fields. The specialist will have at least 10 years experience in both legal and regulatory aspects and supervision of banks, quasi banks, and nonbanks engaged in microfinance. Recent consulting experience related to legal aspects and supervision of MFIs and CUs preferably in a transition economy is essential. The specialist will carry out the following tasks:

- (i) Examine existing laws and draft proposed legislation to support the development and/or strengthening of MFIs, CUs, and other institutional forms identified.
- (ii) Review existing prudential regulations and propose required regulatory provisions.
- (iii) Analyze the operation of the regulatory agency in off-site and on-site procedures and propose improvement.
- (iv) Prepare a capacity-building program to strengthen the supervisory capacity of the regulatory body in the field of MFI and CU.

B. Domestic Consultants (28 person-months)

4. Under the direction of the rural/microfinance specialist, two domestic microfinance consultant (12 person-months each) will carry out the following tasks:

- (i) Provide logistic support to the team.
- (ii) Carry out field interviews for the rural financial market survey and analyze data collected.
- (iii) Carry out a survey of existing MFIs to determine outreach and financial sustainability.
- (iv) Study the operation of a sample of existing CUs.
- (v) Carry out other activities as may be required.

5. The domestic regulatory/supervision consultant will have experience with legal and regulatory aspects. Under the direction of the international supervision specialist, the domestic supervision consultant (4 person- months) will carry out these tasks:

- (i) Assist in examining existing laws and making recommendations to amend existing legislation.
- (ii) Assist in reviewing existing prudential regulations and propose required regulatory provisions.
- (iii) Assist in preparing a capacity building program for the regulatory agency.
- (iv) Carry out other activities as may be required.