MICROFINANCE DEVELOPMENT IN UZBEKISTAN

TECHNICAL NOTE

March 2007

This work is a World Bank’s contribution to the preparation of the Welfare Improvement Strategy of the Government of Uzbekistan

Document of the World Bank
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Executive Summary

A. Challenges to Microfinance Development

While there are numerous aspects to the environment that are positive for microfinance development, there are also challenges. In some cases, these simply involve some fine-tuning of existing approaches and practices. In other cases, this has to do with impediments that constrain capacity, opportunities and delivery of micro-credit, and may serve to keep micro-credit limited in impact as a tool of poverty reduction and economic growth.

The microfinance market is deeply under-served through licensed or registered institutions, which adds to the cycle of informality in financial transactions despite government efforts to capture this market. Given that Uzbekistan had only about $15 million in outstanding loans from credit unions and microfinance organizations in late 2006, equivalent to less than $1 per capita, this suggests that the potential market is deeply under-served. With an estimated $171 million in bank loans to households and small enterprises, the gross loan figure averages of $7 per capita, or 1.2 percent of GDP. Despite recent increases in bank loans for households and SMEs, this still represents a very low figure relative to the needs of small enterprises and households in the economy.

Based strictly on credit union membership data from other regions of the world and the lowest per member loan figures, Uzbekistan has a micro-credit gap of more than $40 million when compared to the least served markets, nearly $60 million when compared with very low penetration levels, and nearly $250 million when compared with average membership rates (all at the lowest loan figures). These gaps do not account for other markets where per member loan figures are higher, and do not account for regions of the world that have limited retail banking loan markets (as is the case in Uzbekistan). The overall gap may be as high as $500 million when accounting for average membership figures and average loan sizes among the four continents where loan sizes are the smallest.

A summary of challenges includes:

General Policy and Macroeconomic Issues

- Deposit-to-GDP ratios are low, money circulating outside formal financial channels is high as a share of total broad money, and the general role of the informal economy is high despite GoU efforts to capture such transactions.

- Despite positive plans to increase public confidence in the banking system, GoU faces challenges on this front due to the legacy of the kartoteka system and continued tax evasion by the public.

- Subsidized loan programs and tax offsets on foregone interest income reflect a more interventionist and administered approach to banking that has failed to
provide sustainable lending to anything but a very small fraction of SMEs and households. While lending in these areas is increasing, as noted above, general loan levels remain low.

- There is no evidence that subsidized loan programs have been effective in targeting low-income households, and there is the possibility that, in some cases, subsidized loans are being allocated to those who need the loans less.

- Foregone market development resulting from low levels of lending at the household and SME sector and high levels of informal activity deprive GoU of a more expanded fiscal base.

Legal/Regulatory Issues

- Among the key impediments have been restrictions on MFOs’ ability to make loans in cash and to finance consumer goods.

- In general, MFOs in late 2006 were reluctant to proceed with their activities prior to finalizing the re-registration exercise.

- There is considerable uncertainty in the MFO market regarding re-registration prospects.

Donor/External Relations

- The establishment of Microcredit Bank and its subsidized loan policy in lieu of the proposed Microfinance Bank has sent a signal that GoU intends to pursue administered and subsidized loan programs instead of commercially viable approaches. On the other hand, GoU has indicated that such subsidized loan programs will not exist in perpetuity. Thus, there also appears to be a willingness on the part of GoU to consider other institutional mechanisms to provide loans to SMEs, particularly if focused on agriculture, manufacturing, and high value-added services to stimulate domestic production and job creation.

- The perception of GoU antagonism to NGOs may weaken prospects for needed donor support for the provision of technical assistance and capacity-building in the micro-credit field.

The Banking Sector

- While the GoU has stated the intention of reducing state involvement in the banking sector, the state banks still often appear to think in terms of social objectives rather than profitability. Comparative return on average equity figures reflect these differences.
The creation of the Microcredit Bank is helping to build infrastructure for micro-credit through the banking system. However, subsidized loan programs run through Microcredit Bank (or other banks) on a long-term basis may serve to distort the market for small business lending and micro-credit, mainly because of expectations raised by borrowers for 5 percent annualized interest rates on loans that are considerably below market rates and do not adequately compensate lenders for the costs of loan origination.

The deposit insurance program, in effect since 2002, has not succeeded in restoring depositor confidence in the banking system despite the lack of instability in Uzbekistan’s banks that has characterized other CIS (and other) systems in the last 15 years.

Restrictions on cash movements continue to limit the resources flowing through the banking system, ultimately reducing the pool of funds available for small business lending.

There is credit risk associated with some guarantors as well as borrowers.

Credit Unions and MFOs

Given the small-scale nature of non-bank credit organizations and their relative youth, there has been only very limited impact to date in Uzbekistan.

Credit unions and MFOs are very small, and this will remain a challenge to long-term viability for some time to come.

Credit unions have virtually no access to long-term funding to make loans exceeding one year.

MFOs are completely dependent on donors for operations and support.

The business climate for MFO clients reduces prospects for success and development.

As with the credit unions, MFOs do not have formal or systematic approaches to gathering market information apart from what is gathered from local contacts.

Links Between Banks and Non-bank Credit Organizations

There are few links between banks and non-banks, apart from the bank accounts opened up by credit unions and MFOs and utilization of banks for transfers.

The lack of linkage between banks and non-banks also means there is limited information sharing.
B. Recommendations

This Policy Note recommends consideration of the following as a basis for improving prospects for development of the microfinance market under stable yet competitive conditions. Many of the prescriptions for a robust micro-credit market are contingent on broader reforms in the banking sector. However, this Note focuses only on those areas that directly impact developments in the microfinance field. In many of these cases, the World Bank Group (WBG) could be in a position to help via technical assistance and, potentially, a lending operation. However, such developments would presuppose progress with reforms in the banking sector to ensure that WBG support in microfinance runs parallel to needed reforms in the broader financial sector. Priorities could be as follows:

Immediate Action

- CBU issues simple instructions for MFOs to be able to re-register and resume lending activities
- GoU coordinates with the currently unregistered Microfinance Association to develop a framework for a standards-based self-regulatory microfinance sector consistent with GoU’s larger objectives for poverty reduction and microfinance development

Short-term Actions in 2007

- Initiate discussions on development of a timetable for when subsidized loans for micro-enterprises through Microcredit Bank (or other institutions) will end to be replaced with a more targeted approach that focuses on credit enhancements for specific kinds of borrowers (e.g., means-tested)
- Approve license for Microfinance Bank once a formal application is submitted
- Initiate discussions on development of a timetable to phase out mandatory cash and non-cash transactions, and daily mandatory encashment services, with special emphasis on the latter
- Develop key micro-credit performance indicators at CBU for ongoing surveillance of financial soundness
- Re-draft parts of the recently adopted microfinance legislation to reduce the regulatory burden, and to structure the industry on a standards-based self-regulatory approach
- Develop an approach for one or more credit information bureaus to function in Uzbekistan, including pre-feasibility work to determine where such assistance might accelerate progress with existing initiatives
- CBU provides guidance for banks and other lenders to structure credit scoring systems, adapt banks’ MIS accordingly, and incorporate aggregated data into regular monthly or quarterly reports on credit quality
- Develop framework for partnership of the GoU with the Microfinance Association that is modeled on the approach taken to date with the Association of Credit Unions, and based on a consultative process
• Develop structure and business plan for a financing facility and design a pilot phase

Medium-term Actions Through 2010

• Develop standards for participation of banks in any subsidized loan schemes, focused primarily on market-based practices with subsidies serving as targeted enhancements as needed for borrowers
• Build up monitoring capacity of microfinance banks and other institutions, and promote foreign investment in new or existing banks
• Develop strategies that promote deposit mobilization and “voluntary dematerialization” of transactions, such as incentives through the banking system via debit and credit cards tied to various savings and loan products
• Develop data base at CBU on individual banks, credit unions and MFOs to monitor developments in the microfinance field and detect potential risks to the financial system, with results and data presented on the CBU web site
• Review microfinance standards and progress based on the self-regulatory model, and make any changes needed to encourage microfinance in a manner consistent with all legal, regulatory and tax requirements
• Work with UBA, CBU and other GoU entities (e.g., tax authorities, utilities companies) to consolidate credit performance for bank and trade credit, and begin comparable work with the Association of Credit Unions and Microfinance Association
• Refine credit scoring measures and strengthen linkage of banks’ and credit unions’ microfinance data to CBU financial stability assessments and stress testing
• Ongoing coordination of the GoU and Microfinance Association to (1) ensure compliance with regulatory standards, (2) compile useful industry information, (3) serve as a clearinghouse for commentary on the existing legal and regulatory framework, and (4) provide training and technical assistance to MFOs
• Provide funding to participating banks, credit unions and MFOs that meet eligibility criteria of the financing facility for microfinance, and begin to design asset securitization packages and ratings criteria

Long-term Actions for Impact Beyond 2010

• Gradual down-scaling of subsidy schemes focused on micro-enterprises, households and individuals as credit market access increases and market rates come down as a result of competition
• Continued monitoring of performance of microfinance institutions, and adjustments to policy if market share, revenue growth and profitability, product/service development and innovation, pricing patterns, etc. show major gaps or deficiencies relative to other markets
• Ensure dematerialization (non-cash) policies for transactions are consistent with incentives needed to maintain public confidence in the financial system
• Refine CBU indicators regarding consumer lending and impact on current account, and more generally risks to economic and financial stability
• Ensure policies, standards and practices for microfinance are consistent with objectives regarding aggregate amounts of micro-credit in the economy, poverty reduction, and other measures by which to gauge progress
• Bring credit information system(s) together from various segments to which all lenders can have access
• Expand credit scoring models to help develop asset securitization market by incorporating standards and performance measures as a basis for rating and pricing such packages in the secondary market
• Transform MFOs into licensed intermediaries able to mobilize deposits and provide fundamental savings products
• Achieve self-sustainability and growth of the microfinance financing facility based on commercial terms and secondary market investment
I. Background

A. Overview

The Government of Uzbekistan has requested the World Bank to provide observations and recommendations for development of the microfinance market in Uzbekistan. This includes credit unions and microfinance organizations (MFOs), and touches on “consumer lending” or small loans originated by commercial banks. For purposes of this Policy Note, the discussion focuses on issues pertaining to the non-bank institutions active in microfinance, as well as those that relate to the banks’ existing efforts in this segment of the market.

There is no particular focus on other groups, such as micro-leasing, micro-savings, micro-insurance, or agricultural credit cooperatives that are often included in separate categories, because they either are not active in Uzbekistan or data are not available for them. Current legislation envisions some of these activities unfolding, namely micro-leasing and micro-insurance. However, as of late 2006/early 2007, these were not included as part of the assessment.

B. Macroeconomic and Structural Issues Related to Microfinance

This Policy Note on Microfinance does not address larger issues regarding the macro-economy or banking sector, as this discussion falls outside the scope of understanding between the Government of Uzbekistan (henceforth GoU) and the Bank. At the same time, there are references to some of the key macro and structural issues that impact developments in microfinance, namely inflation and interest rates at the macro level, and the incentive framework for banks and non-banks specific to microfinance. In particular, high levels of government intervention in the banking system and deficiencies in the general business environment are part of a larger set of policies over the years that have constrained broad-based economic and income growth. The main issues on this front relate to differing notions of inflation rates as reported by the GoU on the one hand, and the IMF on the other.\(^1\) According to GoU (State Statistics Committee), the CPI inflation rate for 2005 was 6.4 percent (7.8 percent at year end), as opposed to the IMF’s reported figure of 21.0 percent.\(^2\) Estimated figures for 2006 showed official year-end CPI at 7.0 percent, but the IMF’s alternative CPI figure at 15.2 percent.\(^3\) The difference in these figures has a clear impact on notions of real effective interest rates, degrees of subsidization regarding below-market interest rate pricing policies on loan and deposit products by banks, and the differentiation of pricing practices between banks and non-banks. In very basic terms, should IMF estimates of current inflation rates be accurate, CBU refinancing rates are negative in real terms, and commercial banks’ subsidized loans are deeply negative in real terms. The table below highlights some of the key macroeconomic information without going into elaborate detail.

\(^1\) See “Selected Issues”, IMF, May 2, 2005.
\(^3\) See “Article IV Consultation”, IMF, January 2007.
### Table 1: General Macroeconomic Indicators (2000-06)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (billions $)</td>
<td>$9,662</td>
<td>$9,610</td>
<td>$9,700</td>
<td>$10,116</td>
<td>$11,941</td>
<td>$13,582</td>
<td>$16,044</td>
</tr>
<tr>
<td>GDP Per Capita</td>
<td>$366</td>
<td>$306</td>
<td>$330</td>
<td>$396</td>
<td>$462</td>
<td>$519</td>
<td>$606</td>
</tr>
<tr>
<td>Avg. CPI-State</td>
<td>24.9%</td>
<td>27.4%</td>
<td>27.6%</td>
<td>10.3%</td>
<td>1.6%</td>
<td>6.4%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Statistics Committee</td>
<td>24.9%</td>
<td>27.4%</td>
<td>27.6%</td>
<td>10.3%</td>
<td>1.6%</td>
<td>6.4%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Avg. CPI-IMF</td>
<td>49.2%</td>
<td>47.5%</td>
<td>44.3%</td>
<td>14.8%</td>
<td>8.8%</td>
<td>21.0%</td>
<td>19.3%</td>
</tr>
<tr>
<td>Year-end CPI-IMF</td>
<td>46.2%</td>
<td>58.1%</td>
<td>24.4%</td>
<td>7.7%</td>
<td>15.5%</td>
<td>18.8%</td>
<td>15.2%</td>
</tr>
<tr>
<td>Refinancing Rate of CBU</td>
<td>32.3%</td>
<td>26.8%</td>
<td>34.5%</td>
<td>27.1%</td>
<td>18.8%</td>
<td>16.0%</td>
<td>14.0%</td>
</tr>
</tbody>
</table>

**Notes:** Average CPI figures for 2006 were as of September; 2006 data are estimates apart from the CBU refinancing rate.

**Sources:** State Statistics Committee, IMF, World Bank, EBRD (for GDP in 2000-01) and GDP per capita (2000-03)

As for the role of the banking sector, its penetration ratio (assets-to-GDP) is moderately low by global standards, although higher than the poorest performers in the CIS region. For instance, loan-to-GDP and asset-to-GDP data for Uzbekistan are higher than found in Armenia, Azerbaijan, Georgia, Kyrgyz Republic and, in all likelihood, Tajikistan and Turkmenistan. On the other hand, the data largely reflect the influence of GoU, which still guarantees the majority of banking system loans which are largely run through the three major state-owned banks. As an example, subtracting GoU-guaranteed loans from 2006 totals would reduce the loan-to-GDP figure to 10.0 percent, as opposed to the gross loan-to-GDP figure of 20.9 percent when including GoU-guaranteed loans. As such, the mid-level performance ratios of Uzbekistan when compared with CIS peers are distorted due to the role of GoU in the banking system. While efforts are under way to reduce this over time, the fact remains that past policies have focused on economic policy and planning set by the government, and this has reduced the incentive for banks to pursue consumer lending, retail banking, and other activities focused on smaller enterprises and households. Such underdevelopment of this segment of the market has contributed to slower growth at the base due to less access to credit and other financial services.

**Total assets of the banks were $5.8 billion at December 31, 2006,** of which **57 percent were for credit.** Approximately 52 percent of these loans were state-guaranteed as of September 30, 2006, although this share has been decreasing steadily since 2002 when the share was 78 percent. Nonetheless, the continued high level of government-guaranteed loans indicates the state banks in many ways continue to act as on-lending institutions to finance government initiatives. Netting these out of the aggregate bank credit portfolio, non-guaranteed credit approximated $1.58 billion at year end 2006. Of this, the banks made a roughly estimated $171 million in small loans for individuals and households that might be classified as “micro-loans”. These loans are anecdotally under

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4 The asset figure shows a low level of penetration relative to GDP by global standards, at about 37 percent. This places Uzbekistan higher than the Caucasus states and most of the Central Asian banking systems, but lower than Kazakhstan, Moldova, Ukraine, Russian Federation and Belarus among the CIS.

5 The 52.2 percent government-guaranteed loan figure from September 30, 2006 is applied to year end 2006 aggregate loan data.
$10,000, although some are higher than the current legislation in Uzbekistan that defines micro-credits approximating $7,593. Generally, banks’ loans are well above the $1,275 global benchmark for SME loans exceeding 2.5 times per capita Gross National Income, although this is also the case globally for banks active in the micro-credit field (see Annex 1). Some of this lending has been derived from donor funding, such as the EBRD-Japanese Government credit program implemented via four licensed banks. However, the banks are also using their “own funds” for loans to finance purchases of cars, household appliances and other consumer items. Smaller private banks tend to lend to this segment more than the larger state banks, although Microcredit Bank may have the largest share and large banks like NBU have shown impressive growth in 2006 in adding new clients at the retail level.

**Banks’ total deposits at March 31, 2006 were $1.4 billion, or only 29 percent of total liabilities and equity of the banking system and a low 8.9 percent of projected 2006 GDP.** The latter reflects a low level of intermediation, indicative of a low level of public confidence in the banking system. As for deposits, data on individual or micro-enterprise accounts are not widely available. However, registered enterprises all have bank accounts, and individuals in urban areas likewise tend to have bank accounts. The GoU has introduced a deposit insurance system to provide protection for depositors’ accounts. GoU has also expressed the intention of introducing measures that would ultimately increase the use of the formal financial system in market transactions. This would include reducing the tax collection functions of the banks, facilitating access to cash transactions, and easing cash and foreign exchange surrender requirements. It is uncertain whether these measures will boost the deposit base of the banking system. However, even reaching a 15 percent deposit-to-GDP ratio by 2007 would nearly double deposits, from the current $1.4 billion to more than $2.7-billion equivalent.

**Banking sector data point to declining levels of intermediation relative to GDP, declining savings mobilization and declining capital.** Recent financial soundness indicators (September 2006) reflect adequate regulatory capital and fairly strong liquidity ratios. Non-performing loans have continued to decline since 2004, reflecting improvement in asset quality. However, earnings measures remain very low and inconsistent with the needs of commercially viable banks over sustained periods under market conditions. Poor earnings may reflect high cost structures involving personnel and other expenses (despite recent improvements in 2006). These indicators broadly show that the banks in Uzbekistan are less efficient than found in market-based systems, and that the gradual reduction of government guarantees will require banks to become far more adept at developing new products and managing new risks. The following table shows banking system data for 2000-06.

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7 Customer deposits approximated 42.7 percent of non-interbank loans at year-end 2005, estimated to approximate about $600 million.
Table 2: Banking System Data for 2000-06

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Loans</td>
<td>$2,850</td>
<td>$2,731</td>
<td>$2,724</td>
<td>$2,844</td>
<td>$3,040</td>
<td>$3,210</td>
<td>$3,307</td>
</tr>
<tr>
<td>Bank Assets</td>
<td>$4,649</td>
<td>$4,190</td>
<td>$3,869</td>
<td>$4,048</td>
<td>$4,355</td>
<td>$4,953</td>
<td>$5,807</td>
</tr>
<tr>
<td>Bank Deposits</td>
<td>$894</td>
<td>$675</td>
<td>$616</td>
<td>$811</td>
<td>$1,176</td>
<td>$1,304</td>
<td>$1,424</td>
</tr>
<tr>
<td>Bank Capital</td>
<td>$854</td>
<td>$729</td>
<td>$739</td>
<td>$793</td>
<td>$764</td>
<td>$789</td>
<td>$862</td>
</tr>
<tr>
<td>Bank Loans/GDP</td>
<td>29.5%</td>
<td>28.4%</td>
<td>28.1%</td>
<td>28.2%</td>
<td>25.3%</td>
<td>23.4%</td>
<td>20.9%</td>
</tr>
<tr>
<td>Bank Assets/GDP</td>
<td>48.1%</td>
<td>43.6%</td>
<td>39.9%</td>
<td>40.1%</td>
<td>36.3%</td>
<td>36.2%</td>
<td>36.7%</td>
</tr>
<tr>
<td>Bank Deposits /GDP</td>
<td>9.3%</td>
<td>7.0%</td>
<td>6.3%</td>
<td>8.0%</td>
<td>9.8%</td>
<td>9.5%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Bank Capital/GDP</td>
<td>8.8%</td>
<td>7.6%</td>
<td>7.6%</td>
<td>7.9%</td>
<td>6.4%</td>
<td>5.8%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Capital Adequacy</td>
<td>50.5%</td>
<td>44.1%</td>
<td>41.9%</td>
<td>39.9%</td>
<td>28.0%</td>
<td>25.0%</td>
<td>21.5%</td>
</tr>
<tr>
<td>GoU-guaranteed Loans/Total</td>
<td>82.9%</td>
<td>82.4%</td>
<td>78.2%</td>
<td>75.5%</td>
<td>69.5%</td>
<td>59.8%</td>
<td>52.2%</td>
</tr>
<tr>
<td>Non-performing Loans/Total</td>
<td>3.0%</td>
<td>5.1%</td>
<td>8.5%</td>
<td>10.9%</td>
<td>9.3%</td>
<td>8.9%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Return on Average Assets</td>
<td>2.7%</td>
<td>2.0%</td>
<td>1.5%</td>
<td>1.5%</td>
<td>1.5%</td>
<td>0.9%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Return on Average Equity</td>
<td>12.5%</td>
<td>9.4%</td>
<td>7.0%</td>
<td>7.3%</td>
<td>8.2%</td>
<td>5.2%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Expenses/Revenues</td>
<td>81.7%</td>
<td>85.7%</td>
<td>87.6%</td>
<td>87.8%</td>
<td>87.3%</td>
<td>90.7%</td>
<td>78.8%</td>
</tr>
<tr>
<td>Liquid Assets/Total Assets</td>
<td>11.8%</td>
<td>9.2%</td>
<td>17.8%</td>
<td>21.3%</td>
<td>22.2%</td>
<td>19.7%</td>
<td>25.5%</td>
</tr>
<tr>
<td>Liquid Assets/Short-term Liab.'s</td>
<td>35.5%</td>
<td>28.4%</td>
<td>48.4%</td>
<td>59.4%</td>
<td>66.5%</td>
<td>51.8%</td>
<td>64.4%</td>
</tr>
<tr>
<td>Demand Deposits/Total Liabilities</td>
<td>12.8%</td>
<td>10.8%</td>
<td>11.6%</td>
<td>12.3%</td>
<td>11.0%</td>
<td>18.4%</td>
<td>15.4%</td>
</tr>
</tbody>
</table>

Notes: Year-end soum figures divided by year-end US$ exchange rates except deposits in 2006, which are from Q1; Capital adequacy, Non-performing Loans/Total, RoAA, RoAE, Expenses/Revenues, Liquid Assets/Total Assets, Liquid Assets/Short-term Liabilities, and Demand Deposits/Total Liabilities all from September 2006.

Sources: IMF (Article IV, January 2007); IMF based on CBU data and Fund staff estimates (2000-06); State Statistics Committee for 2005 and Q1 2006.

There are now 35 licensed credit unions with more than 50,000 members, showing a high level of growth from 2004 when there were only about 14,000 members. Credit union assets were $12 million as of October 31, 2006, up from $3.1 million at December 31, 2004. Most (86 percent) credit union assets are loans, reflecting a high level of earning assets committed to members. Credit union loans approximated 6 percent of the banks’ estimated loans to individuals and small businesses, and 5.6 percent of total micro-credit in the system. Credit union deposits totaled $9.2 million as of October 31, 2006, representing 6,274 deposit accounts. Thus, the deposit base is still small (less than 1 percent of total system deposits), as is the average deposit account ($1,464).

Micro-credit as delivered by micro-finance organizations in Uzbekistan is relatively small as a share of overall credit to small businesses and households. As of July 2006, total cumulative loan disbursements were $35.6 million, and the number of beneficiaries was 62,888. The active portfolio as of July 2006 was under $5 million, and average loans approximated $145 (among 33,844 active clients). There are 14 MFOs, although five
account for most of the limited activity. More positively, May 2005 loan figures were $3.7 million spread across 24,586 active clients, which shows growth in the portfolio and client base. There are several micro-credit programs that have been funded by donors and NGOs as well as from GoU budgetary or extra-budgetary resources. These include programs to support farmers displaced by reform of the state farm system, the State Fund for Employment support to encourage job creation, and the EBRD-Government of Japan credit line for micro-enterprises. (These are briefly discussed below in “Products and Services”, and presented in Annex 2.)

The following table provides a snapshot of balance sheet measures of the three segments of the financial market active in micro-credit.

Table 3: Snapshot of Various Micro-Credit Segments in 2006

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Micro-Credit</strong></td>
<td>$186,716,065</td>
<td>100.0%</td>
</tr>
<tr>
<td>Banks</td>
<td>$171,425,234</td>
<td>91.8%</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>$10,386,197</td>
<td>5.6%</td>
</tr>
<tr>
<td>Microfinance Orgs.</td>
<td>$4,904,634</td>
<td>2.6%</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td>$4,868,589,892</td>
<td>100.0%</td>
</tr>
<tr>
<td>Banks</td>
<td>$4,850,330,579</td>
<td>99.6%</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>$12,128,521</td>
<td>0.2%</td>
</tr>
<tr>
<td>Microfinance Orgs.</td>
<td>$6,130,793</td>
<td>0.1%</td>
</tr>
<tr>
<td><strong>Deposits</strong></td>
<td>$1,432,738,166</td>
<td>100.0%</td>
</tr>
<tr>
<td>Banks</td>
<td>$1,423,553,719</td>
<td>99.4%</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>$9,184,447</td>
<td>0.6%</td>
</tr>
<tr>
<td>Microfinance Orgs.</td>
<td>$0</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Capital</strong></td>
<td>$802,707,578</td>
<td>100.0%</td>
</tr>
<tr>
<td>Banks</td>
<td>$800,247,934</td>
<td>99.7%</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>$2,459,644</td>
<td>0.3%</td>
</tr>
<tr>
<td>Microfinance Orgs.</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Notes: Bank micro-credit estimates are based on percentage of loans to households and individual entrepreneurs from 2004 and applied to 2006 data; credit union figures are for October 31, 2006; MFO figures are for July 2006; MFO assets assumed to be 1.25 times gross loans; exchange of UZS to US$ = 1210 at March 31, 2006 and 1237 at October 31, 2006

Sources: State Statistics Committee, IMF, Association of Credit Unions, Microfinance Association, authors’ calculations

There are also important issues of relevance concerning household incomes, the business and tax environment, remittance flows, labor markets, unemployment and underemployment, and the provision of municipal services. These matters have a direct impact on microfinance, particularly concerning the creditworthiness and asset base of borrowers as well as their capacity to save (if credit union members). Likewise, such issues relate to micro-enterprises as they affect enterprise costs (e.g., labor) and productivity (e.g., provision of services to home-based enterprises). Restrictions on the use of cash (discussed more fully below in the Note) have likewise had a major impact on
the informal sector, estimated to be a major (e.g., 50 percent) share of the economy, as well as on the activities of bank and non-bank financial institutions. This has reportedly served as a catalyst for corruption and illicit payments, as well as circumvented growth of the formal fiscal base. While the Note addresses these matters, this is mainly in reference to causes and consequences of developments in the microfinance market.

The microfinance market is deeply under-served through licensed or registered institutions, which adds to the cycle of informality in financial transactions despite government efforts to capture this market. Given that Uzbekistan had only about $15 million in outstanding loans from credit unions and microfinance organizations in late 2006, equivalent to less than $1 per capita, this suggests that the potential market is deeply under-served. With an estimated $171 million in bank loans to households and small enterprises, the gross loan figure averages of $7 per capita, or 1.2 percent of GDP. This represents a very low figure relative to the needs of small enterprises and households in the economy.

Based strictly on credit union membership data from other regions of the world and the lowest per member loan figures, Uzbekistan has a micro-credit gap of more than $40 million when compared to the least served markets, nearly $60 million when compared with very low penetration levels, and nearly $250 million when compared with average membership rates at the lowest average size of loan (see Scenarios 1-3 in the table below). These gaps do not account for other markets where per member loan figures are higher, and do not account for regions of the world that have limited retail banking loan markets (as is the case in Uzbekistan).

In fact, applying average membership rates of nearly 8 percent and average loan size from the four continents with the smallest loans (averaging $645), and accounting for the approximately $171 million in bank lending to the consumer sector, the estimated deficit is nearly $500 million (see Scenario 5 in table below). This approximates one third of the broad money currently circulating outside the banking system. This suggests that confidence-building measures initiated to attract deposits into the banks would likely be able to provide them with the funding needed to close this deficit. Conversely, as long as disincentives are in place for small businesses and households to place their funds with the banks, meeting the financing needs of households and SMEs through formally licensed channels will remain a serious challenge.

Credit unions and microfinance organizations alone will not be able to meet the vast needs of the household and SME sector. Rather, their capacity to operate in various market segments is important as a basis for creating market linkages throughout the system to allow very small borrowers to eventually graduate and migrate upward through the value chain. The following table presents data from credit unions that could be utilized to show how achievement of modest targets could close some of the financing gap for households and small enterprises. Scenarios 1-3 in the table show the enormous gaps when excluding the banks.
Table 4: Possible Scenarios for Uzbekistan to Narrow Financing Gaps

<table>
<thead>
<tr>
<th>Global Data for Comparison with Uzbekistan</th>
<th>Members/Economically Active Population (Penetration Ratio)</th>
<th>Size of Per Member Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>2.56%</td>
<td>$250</td>
</tr>
<tr>
<td>Asia</td>
<td>1.71%</td>
<td>$1,411</td>
</tr>
<tr>
<td>Caribbean</td>
<td>32.81%</td>
<td>$855</td>
</tr>
<tr>
<td>Europe</td>
<td>2.42%</td>
<td>$987</td>
</tr>
<tr>
<td>Latin America</td>
<td>2.05%</td>
<td>$488</td>
</tr>
<tr>
<td>North America</td>
<td>42.23%</td>
<td>$4,403</td>
</tr>
<tr>
<td>South Pacific</td>
<td>23.11%</td>
<td>$3,218</td>
</tr>
<tr>
<td>Avg.</td>
<td>7.93%</td>
<td>$3,593</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>UZBEKISTAN</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario (1)</td>
<td>Lowest Scenario 226,575 Loans 2006 75,643,750 Gap 15,200,000 -41,443,750</td>
<td></td>
</tr>
<tr>
<td>Scenario (2)</td>
<td>Low Scenario 289,513 Loans 2006 72,378,125 Gap 15,200,000 -57,178,125</td>
<td></td>
</tr>
<tr>
<td>Scenario (3)</td>
<td>Average Non-Bank Scenario 1,050,725 Loans 2006 262,681,250 Gap 15,200,000 -247,481,250</td>
<td></td>
</tr>
<tr>
<td>Scenario (4)</td>
<td>Average Scenario including Banks 1,050,725 Loans 2006 262,681,250 Gap 186,716,065 -75,965, 185</td>
<td></td>
</tr>
<tr>
<td>Scenario (5)</td>
<td>Average Scenario with Banks at Higher Loans 1,050,725 Loans 2006 677,717,625 Gap 186,716,065 -491,001,450</td>
<td></td>
</tr>
</tbody>
</table>

Notes: Economically active population assumed to = 50% of total population; Scenario (1) = Lowest Penetration Ratio (Asia) and Lowest Per Member Loan (Africa); Scenario (2) = Average Penetration Ratio of Africa, Asia, Europe and Latin America; Scenario and Lowest Per Member Loan (Africa); (3) = Average Penetration Ratio for all regions and Lowest Per Member Loan (Africa); (4) = Average Penetration Ratio for all regions and Lowest Per Member Loan (Africa) but including bank loans as part of the 2006 figure; (5) = Average Penetration Ratio for all regions and average loan from Africa, Asia, Europe and Latin America, and including bank loans in 2006 figure.

Sources: Data from WOCCU (2002 statistics); authors’ calculations.

Building on the same data and including existing estimates of banking exposures to the consumer loan market, there are still significant gaps in the system of anywhere from about $75 million to $500 million, depending on assumptions. Starting with Scenario 3 in Table 4 that assumes average access rates of nearly 8 percent in the micro-credit field but the smallest average loan of $250, when including bank loans to the consumer and micro-credit market, the gap is about $75 million. However, when accounting for the average size of loan in the four continents where loans are still smallest on average (albeit larger than in Africa where the average loan is smaller than other regions), the financing deficit is nearly $500 million.

While there is no optimal configuration or scale of microfinance, or for that matter any other kind of finance, general intermediation levels are low in Uzbekistan. With documented evidence that the increased provision of private credit on commercial grounds reduces poverty over sustained periods of time, Uzbekistan’s inability to increase the role of microfinance works against this trend. With loans from credit...
unions and microfinance groups accounting for little more than 0.1 percent of GDP, Uzbekistan shows very little penetration in these market segments. As noted above, confidence-building measures to encourage increased deposit mobilization through the banking system would ultimately provide the resource cover for banks to close the financing gaps while also helping to bring down market rates.

C. Specific Considerations Related to Microfinance for the Policy Note

Microfinance encompasses a myriad of activities, primarily focused on very small-scale lending, but also in areas related to savings, insurance, leasing, and even housing. As noted earlier, this Note focuses strictly on the micro-credit side of microfinance, as the other activities have not yet commenced, or are not sufficiently documented to be of material importance. In addition, the Note looks at the smallest loans made by the banking sector.

In general, there is little transparency in the banking system, and only fragmented information for MFOs. As such, it is not easy to obtain standard income statement and balance sheet data with explanatory notes and elucidation of the role of tax exemptions. Likewise, information on MFOs is fairly fragmented. One survey of four Uzbek MFOs (as part of a larger global survey) indicated that data quality was fairly limited. A separate regional (EECA) survey that included six Uzbek MFOs showed moderate levels of information disclosure, with one MFO appearing to be above average. (See Annex 1.) The credit unions are considered to be transparent in their reporting practices.

A rough estimate of “microfinance” lending in Uzbekistan approximates $187 million in late 2006. This is primarily based on the 5.1 percent of total banks’ loans that are provided to individuals/households, along with all available data on credit from the credit unions and microfinance organizations. These estimates may not be entirely accurate as (1) some credit unions do not yet report their data to the Association of Credit Unions, although they are required to submit reports to the Central Bank, (2) a handful of microfinance organizations do not share data with the (unregistered) Microfinance Association, and (3) the 5.1 percent figure applied to banks’ 2006 loans could not be fully validated as falling into the microfinance or micro-credit category. Nonetheless, the estimates are sufficient to profile the microfinance sector in Uzbekistan, as it is exceedingly small at about 1.2 percent of estimate 2006 GDP.

With micro-loans estimated to be about $187 million in late 2006, this represents an average of about $7 per person in Uzbekistan. Of this share, banks are estimated to account for about 92 percent of micro-lending. Thus, micro-lending is a relatively small share (about 5 percent) of total bank lending in a banking system that is fairly limited in

8 See www.mixmarket.org. The four MFOs were Barakot, Daulet, FINCA and the Karakalpak Department of Business Womens’ Association.
9 The six MFOs were Barakot, Daulet, FINCA, the Karakalpak Department of Business Womens’ Association, Business Womens’ Association of Kashkadarya, and FVRM. Of these, Daulet had the highest rating (four diamonds), while the others had three diamonds on a scale of five.
10 Data are generally assembled from July 2006 microfinance organizations’ data and October 31, 2006 credit unions’ data, along with estimates of SME and household loans by banks for 2006.
terms of its penetration of the economy. That the non-banks play a far smaller role reflects the low level of development of the microfinance market in spite of per capita GNI being among the lowest in the world. More positively, there are indications that GoU is interested in fostering development of this sector, although there is continued uncertainty in the microfinance community about prospects for the future (discussed below).

A common definition of micro-loans is a standard of 250 percent of GNI,\(^\text{11}\) which would approximate loans of $1,275 in Uzbekistan in 2006, while GoU programs and legislation can put the figures up to $10,000 or $7,593. The common figure at 2.5 times GNI is more in line with averages for the credit unions in Uzbekistan, whose average loans approximate $1,213 in value. By contrast, microfinance organizations in Uzbekistan make very small loans averaging $145, although some of the organizations are permitted to make loans that approximate the 250 percent of GNI norm. More recent legislation drafted in Uzbekistan for the microfinance sector defines a micro-loan for individuals as not exceeding one hundred times the amount of the minimum wage, which would approximate $759 as of late 2006. This represents a sizeable range for microfinance organizations should they want to increase their average loan size. For registered entities, micro-credit is permitted up to 1,000 times the minimum wage ($7,593 in late 2006), and micro-leasing is permitted up to 2,000 times the minimum wage ($15,187). (Whether such definitions require legislation is discussed in the Policy Note.) Likewise, GoU programs to assist very small businesses and individual farmers have provided loans up to $10,000-equivalent, which can also be used as a kind of benchmark for “micro-credit” in Uzbekistan. Thus, there are differing definitions of what constitutes a micro-loan or micro-credit. The Policy Note makes an effort to describe some of the smallest loans being made by banks in the consumer sector, reportedly up to about $10,000, while also profiling the credit unions and microfinance organizations that account for almost all of the traditionally defined micro-credits (up to about $1,275).

D. Balance of the Policy Note

For purposes of the Policy Note, differing definitions are considered relatively unimportant as the total amount of micro-lending is very small. Instead, the Policy Note works with the data made available and seeks to make relevant comparisons with other data when possible. In this regard, Annex 1 presents trends from Eastern Europe and Central Asia for a number of countries and institutions, including banks active in the micro-lending market, credit unions, microfinance organizations and others. Some of the performance measures are used in the Policy Note, although Uzbekistan generally has very little information on microfinance organizations due to difficulties the proposed Microfinance Association has faced getting registered for operations. There is also fairly limited information on the banking system. By contrast, and possibly serving as a model for other financial sub-sectors, the Association of Credit Unions provides reasonable information profiling the activities of the credit unions. In general, there is less focus in the Policy Note on definitions and more on issues that relate to development of the microfinance sector.

\(^{11}\) See [www.mixmarket.org](http://www.mixmarket.org).
The balance of the Policy Note consists of the following:

- **Section II: Status of Microfinance in Uzbekistan**, which profiles microfinance as of late 2006.

- **Section III: Key Issues for Market Development**, which provides observations on what is currently working and what are favorable trends, as well as areas of weakness that constrain microfinance development in Uzbekistan.

- **Section IV: Recommendations**, which essentially provide a road map for microfinance development based on short-, medium-, and long-term priorities.

- **Section V: Next Steps and Areas of Further Research**, which maps out some of the areas needed for further development to make recommendations more valid.

- **Annex 1: Microfinance in Uzbekistan Compared with Indicators from Eastern Europe and Central Asia**, which provides some useful information on microfinance trends in the transition countries of Eastern Europe and Central Asia and how Uzbekistan currently compares. Some of these data are incorporated into the main text of the Note. They can also be used to set certain targets or benchmarks for future microfinance performance in Uzbekistan.

- **Annex 2: Profile of Subsidized Loan Programs in Uzbekistan**, which presents a table of loan programs currently operating at subsidized interest rates with the intention of providing affordable credit to small-scale and disadvantaged borrowers.

- **Annex 3: Return on Average Equity and Asset Figures for Banks in Uzbekistan**, which presents some comparison of return ratios across different classes of banks in Uzbekistan.
II. Status of Microfinance in Uzbekistan

A. Market Structure

1. Overview

The microfinance market is small and underdeveloped in Uzbekistan, yet showing signs of growth in the banking system (both micro-loans via donor programs and growth in consumer loans) and credit unions. Demand is high, the number of clients is increasing, there is a good track record established on loan performance, and banks are beginning to show increased interest in this market. However, the microfinance organizations (MFOs) largely supported by non-governmental organizations (NGOs) are currently in a state of limbo as they await instructions on how to proceed with re-registration. This segment of the market is not showing growth, and by most measures is either stagnant or shrinking.

Total micro-credit is estimated to be $187 million, or about 1.2 percent of estimated 2006 GDP. This approximates 3.8 percent of combined assets for banks, credit unions and MFOs in 2006. The low percentage indicates that microfinance remains small as a share of formal financial sector activity. Given low overall levels of penetration and intermediation relative to GDP, and in light of Uzbekistan’s considerable economic resource base and potential, there is significant room for expansion in this segment of the market.

The banks account for most micro-credit, although exact figures from the banks are not available. Data from 2004 show the banks’ loan portfolio distribution included about $160 million to households and individual entrepreneurs.\(^{12}\) Utilizing the same percentage distribution of micro-loans and applying this to March 31, 2006 loan data results in an estimate of $171 million in micro-credit from the banks. The figure differs little when applied to estimated loans for year end 2006.\(^{13}\) One study estimated that banks accounted for more than 80 percent of total micro-credit as of 2004.\(^{14}\) More recent estimates approximate 91 percent, largely due to the capacity of banks to make larger micro-loans than non-bank lenders. The comparative of growth of banks in this market also reflects the stagnation of MFOs and the relatively small size (despite growth) of credit unions.

Banks’ micro-credit generally does not exceed $10,000, in local or foreign currency. There are several programs linked to state programs and guidelines (e.g., for farmers, for job creation).\(^{15}\) These are profiled in Annex 2 and include:

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\(^{12}\) This is equivalent to 5.1 percent of total loans (which were 3.216 billion soums, or about $3.04 billion).

\(^{13}\) Applying 5.1 percent to total loans equivalent to $3.307 billion = $169 million. Thus, earlier estimates based on April 1, 2006 data are left unchanged in the document.

\(^{14}\) See “Microfinance development in Uzbekistan”, CER, UNDP and Agfund, 2005.

\(^{15}\) The EBRD-Government of Japan micro-loan program has only involved four partner banks. Thus, most banks do not participate in this program, and subsequent disbursements envision only the use of one private bank for the near term.
The Fund for Preferential Crediting permits loans up to five years with principal up to $5,000 for individuals and $10,000 for legal entities. Interest rates are subsidized (not higher than the current CBU refinancing rate), while banks are permitted to apply tax deductions on pre-tax profits resulting from the foregone interest income resulting from subsidized rates. (Interest rates on loans are reported to often be about half the CBU refinancing rate.) Banks provide prepayment options without penalties, partly due to the scarce availability of long-term funds.

The Employment Promotion Fund permits loans up to three years with principal up to 150 times monthly minimum wages (about $1,139-equivalent) for individuals and 300 times monthly minimum wages (about $2,278-equivalent) for legal entities. Interest rates are heavily subsidized (generally 40-45 percent of the CBU refinancing rate). In the case of legal entities, a minimum of five jobs need to be created, while quotas are assigned to differing individuals’ activities and half of loans can be distributed in cash. Banks are permitted to apply tax deductions on pre-tax profits resulting from the foregone interest income resulting from subsidized rates.

The Fund for Support of Dekhkan and Farmers permits loans up to 10 years for legal entities and three years for others (e.g., farms, individuals) with principal up to $1,000 for private farms and legal entities, $5,000 for dekhkan (smaller owner-operated) farms lacking legal entity status, $5,000 for individuals, and up to 150 times monthly minimum wages (about $1,139-equivalent) for start-up capital. Interest rates are heavily subsidized (generally one-third to 40-45 percent of the CBU refinancing rate, and as low as one-sixth the refinancing rate for start-up capital). These loans have grace periods of at least two years, and in many cases half of loans can be distributed in cash. Banks are permitted to apply tax deductions on pre-tax profits resulting from the foregone interest income resulting from subsidized rates.

Even though banks are estimated to account for more than 90 percent of microcredit, they have been reported in many cases to not be interested in the smaller part of this market unless GoU-directed because of the high transactions costs associated with these loans, and the inability to make a minimum threshold of profits on these loans due to their size. This relates to the banks’ higher operating cost structures when compared with smaller non-bank lenders. In this regard, it will be revealing to see how the recently established Microcredit Bank performs, as it will have a vast network of branches throughout the economy and high costs relative to credit unions and MFOs. Considering that its loan rates charged are 5 percent annually, this will put further pressure on its earnings, although it will also clearly rely on tax benefits to offset some of these costs. More positively, banks in general are expressing interest in this market in different ways, with lending for auto purchases and leases accounting for about 80 percent of banks’ consumer loans. It remains to be seen how much banks will lend for

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16 These include validating collateral values, insurance costs, notary charges, and 20 percent VAT, plus time required to present requested tax exemptions to account for foregone interest income.
what GoU considers to be “productive” purposes. Microcredit Bank reported growth in lending activities as of early 2007, and it is responsible for lending to such enterprises. However, it is unclear the extent to which other banks are lending to agro-processors, light manufacturers and others engaged in “productive” activities.

The market is segmented, as banks generally make larger loans above the $5,000 threshold (and usually larger, except when linked to a donor-funded micro-credit program), while credit unions’ loans average $1,213. Below these two segments are the microfinance organizations, whose average loan size was $145 as of mid-2006. Thus, characterizing “micro-loans” requires that the sources be unbundled, as the characteristics and size of the loans are different. For instance, a $10,000 loan by a bank would be equivalent to 70 times the average credit from a microfinance organization, and more than eight times the average loan from credit unions.

Banks handle most deposit mobilization, although a significant amount of cash resources flows through the informal economy. Credit unions have increased their role in this regard, although their mobilized deposits remain small at about $9.2 million, which is less than 1 percent of deposits mobilized by the banks. Moreover, credit union deposits are generally placed in the credit unions’ local bank accounts. Microfinance organizations are prohibited from taking deposits and thus show no deposits on their balance sheets.

Other microfinance services are fairly limited. The legal framework for leasing has improved in recent years, and there is some leasing activity in Uzbekistan. This market is expected to grow, and new legislation applying to microfinance organizations envisions them playing a role in this market along with credit unions, banks and specialized leasing companies. However, the market is currently small, with average lease contracts of $2,000-$3,000 per contract, mainly for food processing equipment and office equipment and computers. Contracts tend to be for up to three years, helping to mitigate some of the term financing difficulties facing micro-enterprises. There is no known micro-insurance activity, and the prohibition against deposit mobilization that applies to microfinance groups has prevented development of micro-savings activities and products.

Loan processing is not a problem for borrowers at credit unions and MFOs. Procedures are simple, straightforward, and quick at these institutions. They may be more complicated at the banks, and this may serve as a deterrent to some to request loans from banks. However, overall, this is not considered a major constraint to credit access. Rather, other issues related to the reporting of income and assets and concerns about non-cash transactional requirements serve as greater obstacles to credit for most households and small businesses.

Banks and credit unions rely on collateral for loans. Banks routinely use the plant or equipment being financed as a source of collateral and are able to repossess when necessary, apart from primary residences in the small housing market. Banks and credit unions generally seek gold, vehicles and other forms of liquid collateral for consumer
loans and micro-credit. MFOs sometimes seek liquid assets as collateral as well, although many of their loans are unsecured or backed by group guarantees.

**Disclosure at the micro-credit and consumer loan level is not always complete, although this actually can provide some underlying comfort to lenders.** As there is a tendency to not fully report income and assets, lenders assume that the financial information reported is partial. As such, when they run income tests (e.g., relative to total household debt, relative to loan principal and interest payments), they believe that borrowers often have other sources of income or assets that can be sold in the event of a build-up of arrears.

**B. Legal and Regulatory Framework**

The legal and regulatory framework for banking gets mixed reviews, particularly as implementation in the banking sector has involved high levels of state ownership and intervention, excessive administrative controls, quasi-fiscal (tax administration) functions, and directed lending that has distorted market practices and competition. As all of this has been made possible within the existing legal framework for banking, such practices have been negative for sector development and go a long way in explaining why intermediation levels are low in Uzbekistan.\(^{17}\) Larger issues surrounding the investment climate may also contribute to why most major banks have not invested in Uzbekistan.\(^{18}\) Moreover, as noted, banking penetration ratios are particularly low when removing government-guaranteed loans (and related liabilities) from balance sheet measures and then comparing with GDP. On the other hand, GoU has signaled its interest in reducing State involvement in the banks, including easing up on the administrative controls that have undermined public confidence (keeping deposit levels low) and constrained formal market development. There are signs this is beginning to happen. Private banks are starting to capture more of the market, and the share of state banks in loans, assets, deposits and capital is shrinking. Thus, the legal framework is sufficient to allow growing levels of competition, although this is also subject to continued GoU support and initiative in moving forward with a market-based system. As of late 2006, Uzbekistan still lags most CIS and transition countries in this regard.

**From a legal and regulatory standpoint, there are no major impediments for banks to provide micro-credit or related services, although GoU involvement may distort the incentive framework.** The Law on the Central Bank (1995, and amended in 2000) and Law on Banks and Banking (1996) provide the basis for a two-tier banking system in which the Central Bank is responsible for supervision. The Law on Banks includes fundamentals such as minimum regulatory (risk-weighted) capital requirements, reporting requirements, provisioning guidelines for non-performing loans, audit requirements, accounting standards, etc. There have been no recognized legal or

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\(^{17}\) See “Selected Issues”, IMF, May 2, 2005.

\(^{18}\) ABN-Amro is the only major international bank in Uzbekistan. Other banks (e.g., Société Générale, Chase Morgan, Commerzbank, Dresdner) had a presence in Uzbekistan in earlier years, but have since departed. Net of ABN-Amro, other foreign banks that have recently operated in Uzbekistan are UzDaewoo Bank, UT Bank, Uzprivat Bank, and Bank Soderat. (There were four foreign banks as of March 31, 2006.)
regulatory impediments to banks entering the micro-credit market, although competition may be distorted by the subsidized pricing policies implemented by Microcredit Bank with GoU support.

At the regulatory and supervisory level, CBU advised the team that off-site and on-site supervision are in line with Basel requirements (and generally confirmed by auditors), with regular reporting and annual on-site inspections. While there are questions about the role of government-guaranteed loans and banks’ provisioning practices, CBU has stated that they have taken measures to rectify some of these potential shortcomings to better measure risks and challenges to solvency in the banking system.\(^{19}\) Specific soundness measures that are monitored include large exposures, connected lending, directed lending, and foreign exchange exposures. The extension of micro-loans/credit (irrespective of any measure used) by the banks is so small as to be non-material in terms of soundness concerns.\(^{20}\)

Moving ahead, CBU also mentioned that they expect some measures to be taken to encourage a more open and competitive environment. Some of the restrictions (e.g., banks’ access to correspondent accounts at CBU, depositors’ access to cash accounts) have already eased, although the latter is still considered problematic according to anecdotal reports. Some of the quasi-fiscal tasks (e.g., tax collection) may also diminish or be modified. Banks are likely to find greater opportunities to expand consumer lending and micro-credit if and as the system becomes less administered and controlled.

The Law on Credit Unions (2002) provides the framework for credit unions to operate in Uzbekistan under licensed and regulated conditions. The legislation addresses minimum capital requirements, governance and management requirements, permissible activities, reporting requirements to CBU, compliance requirements, etc. GoU recently amended the Law on Credit Unions (2002) to make the environment more conducive to growth, reportedly accepting all recommendations submitted by the Association of Credit Unions in what has been described as a cooperative and consultative process.\(^{21}\) Specifically, these proposals from the Association included the right to (1) establish branches, (2) engage in leasing, (3) make consumer loans in cash as well as dematerialized (non-cash) form, and (4) use third party guarantees for borrowers. These were previously restricted in the original legislation. These reforms should make it

\(^{19}\) CBU reportedly risk-weights some government-guaranteed loans at 20 percent according to existing regulations, as opposed to the common zero percent. This is to counter the lack of provisioning by banks as a result of government guarantees. However, when there is a clear government guarantee, as in the case with most NBU loans, government-guaranteed loans carry a zero risk weight.

\(^{20}\) The four banks participating in the EBRD-Japan Government micro-credit program may classify these loans as “directed”, yet they are so small as to not be of relevance for soundness purposes. Considering that directed loans were only 2.7 percent of total loans as of year end 2005, this issue has diminished as a major concern, as compared with the 12.0 percent of total loans they represented in 2000. That the micro-credit portion of these loans is nearly 100 percent performing, small scale by nature, diversified, and spread across banks indicates that there is no real risk posed by such loans to the banking system.

\(^{21}\) The credit union movement has received technical assistance from the World Organization of Cooperative Credit Unions (WOCCU). According to the Association, this has facilitated the reform process.
easier for credit unions to find opportunities to expand its loans and range of services to member clients.

Uzbekistan has had an active micro-credit market for years, dating back to the 1990s when several non-governmental organizations (NGOs) entered the market. Following legal and regulatory acts in the banking system, the main legislation in recent years applying to MFOs has been Resolution 309 of the Cabinet of Ministers (2002). This provided a fundamental framework for the registration and operation of MFOs in the provision of micro-credit. However, a series of restrictions on MFO activities has stunted development of the market. Among the key impediments have been restrictions on MFOs’ ability to make loans in cash and to finance consumer goods.

More recently, the Council of Ministers issued a Resolution “On Approval of the Regulation on the Procedure for Licensing Activities of Micro-credit Entities”, although MFOs are still awaiting specific instructions from the Central Bank related to re-registration. A series of other laws “On Microfinancing”, “On Microcredit Organizations”, and amendments to the Law “On the Central Bank of the Republic of Uzbekistan” have been adopted by the legislative chamber. However, the absence of specific instructions combined with areas of perceived or potential regulatory interference of specific MFOs has left the industry as a whole in a state of stagnation.

The previously unregulated operations of MFOs are now being reversed, suggesting that the CBU (and GoU) is less comfortable with their operations. New laws and regulations may reduce CBU concerns, although the very specificity of items of irrelevance (e.g., defining financial thresholds for micro-loans, micro-credits, micro-lease contracts) in the new legislation also raises questions about the degree of regulation to be imposed on MFOs. In the absence of deposit mobilization, there are reasonable questions about whether MFOs should be regulated in a manner similar to credit unions, or whether they should simply be permitted to operate on a self-regulatory basis in compliance with very basic legislation.

In contrast to the credit unions and, to some degree, the banks, the MFOs have faced a difficult legal environment in recent months that has slowed operations and created uncertainty for lenders and borrowers. In addition to the normal restrictions on their activities, such as limitations on the right to make cash loans (which causes delays for borrowers), they now have an uncertain legal status triggered by re-registration requirements. This is resulting in a slowdown in micro-credit from MFOs, subjecting them to the risk of lost clients and foregone income. On the other hand, initial legislation has been drafted, and it appears that much of this will seek to replicate the framework that exists for credit unions, albeit customized at the micro-credit level.

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23 MFO indicators show increases from August 2004-April 2005 in cumulative loan disbursements, cumulative clients, outstanding loans and active clients. However, conditions began to decline or stagnate around April-May 2005, and MFOs are now awaiting clarification of re-registration requirements and other conditions for sustained operations.
C. Institutional Support and Risk Management Capacity

Institutional and related issues of capacity and support run parallel to the incentives in the environment for the various financial institutions. In this regard, the banks and credit unions have associations that represent their interests to government. Some of the banks have received technical assistance and training from donors, including in the field of microfinance. Likewise, the credit union movement has been supported by donors and the World Organization of Cooperative Credit Unions (WOCCU), providing them with assistance in governance, operations and systems. MFOs have likewise received support from donors, largely through the Central Asian Microfinance Association (CAMFA). However, the local association has failed to obtain permission to register twice, reflecting an unfavorable environment for comparable support to be coordinated.

The banks have an association that provides a range of services, some of which may be useful building blocks in the future for increased credit for small and medium-sized businesses and at the micro-level. These include (1) formal training and certification, (2) credit performance information (member credit information bureau), (3) ratings of securities (for the small capital markets), and (4) other support services for their members. Likewise, the Association has close contacts with GoU authorities, and communicates the interests of the banking community when issues are considered by the government concerning banking sector matters.

The Association of Credit Unions appears to have served the credit union movement well since its inception. The Association was established in 2005, and has been effective partly because of support from WOCCU. The Association has developed capacity to represent the interests of the industry to GoU, as recently exhibited with amendments to the original legislation that were proposed by the Association on behalf of its members. Membership is voluntary, and currently includes 25 of the 35 licensed credit unions. Some of the non-members are relatively new and are expected to join the Association in 2007.

All the major MFOs are linked to NGOs with donor support. However, GoU is reported to suspect several of the NGOs of being a potential source of political instability. GoU has twice rejected the Microfinance Association in its application to be licensed and registered in Uzbekistan. As such, the kind of institutional support enjoyed by the credit unions has not been replicated in the MFO market, at least recently.

There is an emerging pattern of governance, management, regulatory reporting and compliance procedures that indicates coordination between lenders and CBU. Banks have been prompted to develop such capacity on an ongoing basis by CBU as part of the effort to identify problem banks. There is a lighter regime in place for regulatory oversight of the credit unions combined with capacity building support from WOCCU. The more commercial MFOs have reasonable capacity in these areas relative to their scale of lending activities, which are very small-scale, although they have not reported to CBU or any other regulator in the past.

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24 Fees for membership are 50,000 soums per month, or about $40 per month.
There are ongoing questions about credit and market risk management capacity at the banks. Banks still rely on collateral as a primary source of repayment in the event of arrears. The limited credit risk management capacity and systems of the banks are both the result of and due to (1) the prevalence of government-guaranteed lending, although this is declining, (2) problems (in some cases) of borrower information disclosure, (3) absence of detailed databases, (4) shortage of relevant market information, and (5) nascent stages of credit scoring systems. As the banking system has traditionally been heavily administered and controlled, banks have not had to develop the kinds of tools and techniques needed to manage risks found in more open banking markets. Likewise, because of tight controls on cash and foreign exchange, the market for treasury and hedging products has been slow to develop. Bankers do report utilizing variable rate loans to contain interest rate risk. However, cheap government and state enterprise deposits in large state banks has reduced their need to develop more competitive pricing strategies for deposits, which would imply the need for greater interest rate risk management capacity in the determination of pricing and products. Thus, in general, it appears that credit and market risk management capacity has been stifled, although this information is based on discussions rather than subject to a serious test.

At the credit unions, credit risk is managed by knowledge of the customer and is reinforced by liquid forms of collateral. Credit unions in Uzbekistan typically take collateral (e.g., gold, cars) and guarantees and use moral suasion to ensure high rates of timely repayment. This is also to avoid having to go to court, where litigation can take considerable time. In most cases, loans made by credit unions are relatively small, including as a share of capital. Thus, periodic incidence of arrears is costly for the credit unions, but their familiarity with their members allows for a fairly flexible approach to dealing with what are considered problem loans for regulatory reporting purposes. Amortization schedules tend to be equally spread across the term of the loan, with some grace periods for loans that are more than six months. In this regard, at least one credit union has stopped making loans with balloon payment structures (i.e., total principal paid at the end of the loan) after earlier incurring losses on this kind of loan, to mitigate the risk of default on total principal. Market risk issues at credit unions are addressed by working with clients to make adjustments to interest rates on deposits and loans (with their consent) to maintain agreed net spreads.

Risk management systems at MFOs are fairly rudimentary, which is to be expected when average loans approximate $145 and are rarely higher than $500. Micro-credits are generally unsecured, and often times lent to risky entrepreneurs in agriculture and livestock farming and other activities sensitive to price fluctuations. In these cases, performance has been reported to have less impact than in other high-turnover businesses such as commercial trade, catering, and small-scale food processing. MFOs do not carry out systemic risk assessments. However, they tend to focus on high-turnover businesses and/or light manufacturing (e.g., food processing) where there is clear evidence of local demand.
The larger and more commercial MFOs have experience in other markets and have been operating for years. As such, they utilize systems that are based on their experience in other markets, and which have largely been synthesized into “best practice” based on years of experience. Much of this information is widely available on various industry websites. In addition, there has been a reasonable amount of training of loan officers and others in managing fundamental credit risk. However, some of the MFOs appear to lack some of the needed financial performance monitoring and evaluation systems for better results, partly because their work is focused on originating a large number of small loans that is time-consuming and labor-intensive.

In the case of problem loans, MFOs have used the traditional array of techniques from moral suasion to execution of collateral. While it is costly and time-consuming to go through formal court channels to resolve disputes, there are a few reports of collection efforts reaching this point. However, on the whole, MFOs report high levels of timely repayment, largely because borrowers want to establish a track record to position themselves for subsequent loans.

D. Tax and Other Business Environment Considerations Affecting Competition and Growth

Tax exemptions have been widely used by GoU for banks to compensate for foregone revenues when interest rates on loans are subsidized, while credit unions and MFOs have benefited from other forms of subsidization. Tax exemptions for banks are currently in effect with many of the subsidized loan programs presented in Annex 2. These include exemptions from income tax, assets tax, customs charges and some value-added taxes (e.g., in foreclosures). In some cases (e.g., turnkey construction projects), accrued interest is not included in the taxable base of income. However, in other cases such as farmer support programs, banks can only charge 50 percent of the preferential rate while banks have to pay for undisbursed portions of available funds at the official refinancing rate. Thus, it is unclear the degree to which tax offsets have compensated banks for foregone earnings, or whether subsidized rates for targeted beneficiaries have generated losses for banks. By contrast, credit unions and MFOs have charged commercial rates on loans, and have not dealt with the issue of subsidized loan rates. However, they have benefited from subsidies in the form of technical assistance.

Other business environment considerations include difficulties faced by MFOs that cater to commercial traders. This group has reportedly been subject to a series of obstacles that have made it difficult for them to operate. This includes sudden closure of markets and relocation to other areas considered less suitable for trade, and confiscation.

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25 As examples, see [www.cgap.org](http://www.cgap.org) and [www.mixmarket.org](http://www.mixmarket.org).

26 For instance, WOCCU has provided computers, technical assistance and software packages to individual credit unions, and even premises for the Association to provide the foundation for credit union development. Had these commodities and assistance been provided at cost, there is very little chance the credit union movement would have progressed to the point where it has. Likewise, commercial MFOs are considered profitable on an after-tax basis and able to recover their operating costs. However, it is uncertain if these groups would have been able to reach this point without support from parent NGOs and donors in getting started and establishing operations.
of goods by customs officials. This adds significant credit risk to the portfolios of MFOs dealing in trade, which are viewed negatively by GoU as exporting capital and undermining the position of domestic producers. (General weaknesses in the business environment include dealing with licenses, registering property, accessing credit, paying taxes, and trading across borders.\(^{27}\))

**By contrast, impediments to credit union development have largely been removed with recent amendments to the Law on Credit Unions.** Likewise, bankers generally believe that there is enough of a market under conditions of high real GDP growth\(^{28}\) for private banks and others to capture markets and build their businesses. While the state banks continue to dominate, their share of assets, credit and deposits have all shrunk in recent years, suggesting that concentration is diminishing and competition is increasing.\(^{29}\)

As for the banks, the state banks have benefited from cheap deposits placed by state enterprises and GoU, which have provided them with low-cost funding sources. Along with tax exemptions, these have been used to finance state enterprises and other initiatives at subsidized rates. By contrast, credit unions have paid market rates for deposits to attract funds.

**E. Products and Services**

**There is limited market information available for product and service development.** While some public information exists and is available, the market in Uzbekistan shows far less available information and disclosure for market competition and development purposes than is found in most markets. As such, detailed information on households and businesses that could be utilized for product and service development is not always available to the banks or other lenders. Likewise, the larger challenge of the informal sector and reluctance of people to disclose accurate information about income and assets weakens the environment for banks in developing new products and services. On the positive side, banks are reported to be increasing their share of lending for real estate development, SMEs and consumer loans. As this market becomes more developed and competitive, this will serve as a source of demand for more and better information to assist with product/service development, targeting and distribution.

The micro-credit market is segmented, with banks at the higher end, the credit unions in the middle, and MFOs at the small end of the market. This reflects a rational distribution of micro-credit, given the costlier operations of banks than credit unions, the relatively small scale of credit unions as opposed to banks, and the very small

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\(^{28}\) Uzbekistan has enjoyed higher than 7 percent real GDP growth rates since 2004, and these rates are expected to be sustained at least through 2006-07. See “Regional Economic Outlook: Middle East and Central Asia”, IMF, September 2006.

\(^{29}\) As of year end 2004, the three largest state banks accounted for 73 percent of loans, 67 percent of assets, and 44 percent of deposits. It is unknown what their shares would be netting out government-guaranteed loans and soft deposits placed by state enterprises and GoU, although it is likely their shares of aggregate banking system balance sheets would be much smaller.
Net of loans and deposits, there are few other products or services offered. The leasing market has increased activity in the last few years, and this is providing small and medium-sized enterprises (SMEs) with access to finance. On average, lease contracts tend to be for less than $5,000 over three-year periods, helping to finance small-scale machinery and equipment (e.g., food processing, computers, office equipment, some construction implements). Recent amendments to credit union legislation will permit credit unions to engage in leasing as well, which may increase the range of product and service offerings to SMEs and micro-enterprises. Likewise, there are provisions in recently adopted microfinance legislation for micro-leasing to be offered as well. However, in general, there is little offered to households and individuals apart from loans and deposits from the three major classes of credit intermediaries.

Box 1: Profile of Products Offered by Credit Unions and MFOs

<table>
<thead>
<tr>
<th>Credit Unions</th>
<th>Microfinance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan Products</strong></td>
<td>MFO and NGO loans generally do not exceed $500-equivalent, and the average is $145. There are small maximum values (up to 600,000 soums, or less than $500), and limits are particularly small for those participating in the first 1.5 years (where limits tend to be up to 100,000 soums, or up to about $80). Loans are generally for up to three months, and market rates are charged. These tend to be 5 percent monthly. MFOs report high repayment rates of 96 percent. As with the other lenders, there are no prepayment penalties. Loans are generally in non-cash form (with the MFO making direct payment to vendors), except where there is participation in GoU loan programs that permit at least of portion of disbursed loans to be in cash form.</td>
</tr>
<tr>
<td><strong>Deposit Products</strong></td>
<td>MFOs are not permitted to mobilize deposits in Uzbekistan.</td>
</tr>
</tbody>
</table>

Credit unions generally cater to those who can save, not low income groups. Deposit products tend to receive market rates, with interest paid on deposits approximating 24-36 percent annualized on a non-cash basis, and 36-60 percent annualized on cash deposits. Interest is generally paid monthly, although this is subject to agreement. Payment methods are both in cash and via bank transfer.

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30 The Association of Credit Unions summarized the maturities of credit union loan products ranging from 38-day minimums for commercial credit to 360 days for all categories of loans.
31 The Association of Credit Unions summarized the range of annualized interest rates being as low as 47.6 percent on consumer and commercial credit, and reaching as high as 81.6 percent for industrial credit.
32 The Association of Credit Unions summarized the range of deposit interest rates being as low as 12 percent on demand deposits and 15 percent on 30-day deposits, and reaching as high as 48 percent for deposit instruments from 270-360 days.
F. Financial Performance

The banking system shows relatively low returns offset by relative stability. Returns are particularly low at the larger state banks, while higher at the small banks. However, because the small banks are small, aggregate after-tax profits are not large. Banks are beginning to show increased risk-taking in their loan portfolios, albeit with most loans still government-guaranteed, which reflects the continued albeit declining dominance of the three largest state banks. However, this ratio is declining, and recent reports indicate banks are lending more to households and SMEs on an unguaranteed (by the State) basis.

Data from September 2006 indicate that banks’ profitability was relatively low when measured by return on average assets (1.6 percent RoAA) and return on average equity (8.3 percent RoAE), although these were both improvements over 2005 and more in line with performance in 2004. While 2006 reflected improvements in Uzbekistan, they are still relatively poor by comparison with CIS markets. These measures were 1.3-3.2 percent for RoAA and 6.8-24.2 percent for RoAE in CIS markets in 2005. Thus, Uzbekistan under-performs most reporting CIS banking systems in terms of profitability. Likewise, interest margins are low and have declined in recent years, including in 2006, and non-interest and other operating expenses generally increased through 2005 and then leveled off with a very slight decline in 2006. These all put pressure on earnings and weaken overall profitability of the banking system.

More positively, the low returns are mainly due to the performance of the three large state banks. Other banks show better ratios (see Annex 3), and banks are generally beginning to assume more risk as the share of government-guaranteed loans continues to decline. On the condition that these loans are properly managed and priced, this will help the banks generate higher earnings than they have in the past. Some of the increase in operating costs also relates to systems, training and personnel development in preparation for what GoU has stated will be a more competitive banking system with declining involvement of GoU in the coming years. However, risks remain in the system. There is still a high level of lending to manufacturers (51 percent in 2006, although this declined from 60 percent of total loans in 2005). Many manufacturers are reported to benefit from protection, continue to have difficulties servicing and repaying loans, and may not be competitive should the market open up. Meanwhile, non-performing loans have declined to 7.3 percent of gross loans, which represents a favorable trend. However, there are still questions about how accurate loan classification is, and whether NPLs are under-estimated.

In 2005, the 8.9 percent NPL figure was lower than expected. This is due to several factors: improved systems and training, better classification and capitalization of non-performing loans, and increased competition in the market. However, there are still concerns about the accuracy of loan classification and the potential for future problems. The government has taken steps to address these issues by implementing new regulations and increasing oversight of the banking sector. Overall, the banking system has shown improvement in recent years, but there is still room for further development and reform.
equivalent to about 37 percent of capital,\textsuperscript{36} which needs to be continuously monitored as risk-taking increases and capital adequacy declines. However, if the 2006 figures are accurate, this would bring the NPL share of capital down to 28 percent. With 21.5 percent capital adequacy ratios as of September 2006, there is little concern about major bank failures or systemic risk. However, should there be concentration of bad loans subject to less vigorous loan classification standards, it could lead to greater contingent monetary and/or fiscal costs in the event that recapitalization is required.

Liquidity measures continue to be reasonably strong at the banks, with declining loan-to-deposit ratios, rising coverage of liquid-to-total assets, and good coverage of liquid assets to short-term liabilities. However, anecdotally, some report that this partly relates to low levels of lending and investment, high levels of risk aversion, and an example of how the banking system is not responding to the investment needs of the economy. State Statistics Committee data for March 31, 2006 show that commercial banks only accounted for 2.9 percent of total capital investment, with most (51 percent) investment financing derived from enterprises’ funds, followed by extra-budgetary funds (11.7 percent) and savings (11.2 percent). With GoU moving away from guaranteed loans to/through the banks, banks’ strong liquidity measures at least partly reflect continued risk aversion.

Some of the expected growth in banks’ risk-taking is expected to be in the area of consumer lending. This has already begun to some degree with loans for vehicles, appliances and other kinds of household items. As banks increase their retail networks and plastic card clients, more consumer lending can be expected from the banks. However, it is unknown how much of this will be for consumer goods purchases (often imported) as opposed to lending to job-creating activities with higher multiplier effects in the domestic economy.

Financial performance for the credit unions is largely reviewed within the context of the PEARLS system.\textsuperscript{37} While credit unions had early problems with loan performance, these have largely been brought under control, with non-performing loans routinely at 5 percent or less, and generally constituting loans in arrears rather than unrecoverable assets. As for physical deposit safety, credit unions have vaults for temporary safekeeping of cash and collateral with alarm systems linked to local police stations. Credit unions also have bank accounts where assets are regularly deposited.

Credit unions are showing profitability and capacity to pay out dividends. Aggregate earnings are still relatively limited due to the small size of the credit unions. As of tightened up in recent years, and that this may be one of the reasons why banks are being more selective in their decision-making (resulting in greater risk aversion).

\textsuperscript{36} The figure may actually be higher as the calculation is based strictly on gross loans, and not off-balance sheet items of the banks. Given that the 8.9 percent figure for 2005 and 7.3 percent figure for September 2006 should be applied to exposures, this would include off-balance sheet items (e.g., guarantees) if the data were available.

\textsuperscript{37} This is WOCCU’s credit union equivalent to CAMELS in the banking sector, and is based on quantitative and qualitative measures focused on Protection, Effective financial structure, Asset quality, Rates of return and costs, Liquidity, and Signs of growth.
November 1, 2006, after-tax earnings for 23 reporting credit unions\textsuperscript{38} were about $0.6 million, or $30,451 per credit union annualized. However, when measured against average equity, profitability measures are strong at 33.8 percent.

**Credit unions generally report good performance by most members, while having to apply friendly pressure for those whose loans fall into arrears.** On the one hand, most arrears are considered to result from unanticipated circumstances or delays in payments from members’ clients. On the other hand, credit unions typically will extend the payment period as needed to accommodate these delays, much as banks will apply waivers to loan covenants when delays or violations are considered reasonable, non-material, correctible, or not the fault of the borrower.

**MFO performance is variable, with some indicating they are profitable on an after-tax basis.** However, systematic data for all 14 MFOs are not available. Therefore, it cannot be determined how many are profitable on an after-tax basis, and the degree to which these profit figures are dependent on subsidies/grants from outside sources to be operationally self-sustaining. Anecdotally, loan quality is strong, with 96 percent repayment. While a 4 percent loss ratio would be high for well managed banks, MFOs charge higher interest rates partly to cover for loss loans. Systematic information on earnings is not available, but anecdotal reports with MFOs indicate they are profitable at this level of asset quality. The 4 percent loss ratio is little different from the credit unions that also show profitability at what are generally reported to be 5 percent loss ratios. Liquidity issues for MFOs are really cash management issues, and these essentially relate to funding from donors (for start-up and initial loan capital), recoveries from loans made plus profits on such loans.

\textsuperscript{38} The Association has 25 members. Figures are for 23 reporting members. An additional 10 credit unions have recently been established in Uzbekistan, but do not report to the Association as they are not members. However, their share of earnings is small or even non-existent on an aggregate basis.
### Box 2: Profile of Financial Indicators for Banks, Credit Unions and MFOs: 2005-06

| Banks | • Total capital: $800 million, or $28.6 million on average (as opposed to a minimum $5 million requirement).  
• Capital adequacy: 21.5 percent regulatory capital to risk-weighted assets, and 14.1 percent of total assets.  
• Non-performing loans: 7.3 percent of gross exposures (loans and commitments).  
• After-tax earnings: $40.5 million (estimated for 2005\(^{39}\)), or about $1.45 million per bank (for 2005). (Earnings increased in 2006.)  
• RoAA: 1.6 percent.  
• RoAE: 8.3 percent.  
• Liquid Assets to Short-term Liabilities: 64.4 percent.  
• Liquid Assets to Total Assets: 25.5 percent. |
|---|---|
| Credit Unions | • Total capital: $2.5 million, or about $107,000 on average (as opposed to a minimum $10,000-$20,000 requirement).  
• Capital to assets: 20.3 percent.  
• After-tax earnings: $684,533 annualized, or about $30,000 per credit union.  
• RoAA: 7.4 percent.  
• RoAE: 33.8 percent.  
• Loans-to-Deposits: 113.1 percent. |
| MFOs | • Cumulative loan disbursements: $35.6 million.  
• Cumulative number of clients: 62,888.  
• Outstanding loans: $4.9 million.  
• Active clients: 33,844.  
• Average loan size: $145. |

**Notes:** Data sets vary by segment and are not necessarily comparable; specific data on banks’ consumer lending not available for more direct comparison with credit unions and MFOs

**Sources:** IMF, State Statistics Committee, Association of Credit Unions, Microfinance Association, authors’ calculations

### G. Prospects for Self-Sufficiency

**GoU’s approach to financial sector issues has long been driven by concerns about stability.** More recently, it has stated its intention to gradually reduce state involvement in the banking system, effectively requiring that banks become self-sustaining under competitive conditions. However, what is lacking is a specified timetable for reforms to achieve this. (As noted at the beginning, this is outside the scope of this Policy Note.)

**One of the key elements missing in the financial sector is credit infrastructure to facilitate and accelerate loan processing and risk evaluation.** As one example, banks and other lenders do not have access to comprehensive information on past credit performance. The Uzbekistan Bankers’ Association has a credit information system for its members that sheds light on negative performance. The four banks participating in the EBRD-Government of Japan micro-credit program also set up their own informal system, although this has since been discontinued. Movement to develop a comprehensive system involving bank and trade credit, and disclosing positive and negative performance

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\(^{39}\) This estimate is based on 5.2 percent RoAE applied to average capital figures for the banks between 2004 and 2005, and then adjusted for the average exchange rate. Earnings increased in 2006.
information would serve as a useful tool to increase access for borrowers on the one hand, and for banks to determine loan features and price risk on the other. In this regard, coordination through the three associations along with other sources for trade credit would be a way to build the data base and maintain guidelines for participation.

There is little question about long-term prospects for self-sufficiency of the banks. GoU’s approach to financial sector issues has long been driven by concerns about stability. Notwithstanding policies that have stifled reform and innovation when compared with many other banking systems, Uzbekistan has benefited from underlying stability that has provided some protection against the volatility experienced in most other CIS markets. GoU has stated its intention to gradually reduce state involvement in the banking system. Continued year-to-year reductions in the share of government-guaranteed loans are an indication that there is some movement in this direction. Over time, it is expected that the banks will operate commercially and be responsible for their own capacity to compete in the market.

Banks have access to deposits as well as borrowings. Prospects for self-sufficiency will be bolstered by increased confidence of households, as reflected in a willingness to place more deposit funds with the banks. Likewise, while there is a legacy of coordination with donors, the most sustainable way for commercial banks to access non-deposit funding is to demonstrate sound systems of management and strong returns, and to obtain international credit ratings to be able to access the syndicated loan market, bond market and other sources of debt and equity in the global capital markets. As banks proceed with these reforms, they will eventually be able to strengthen the sustainability of their funding sources. Likewise, reforms should lead to progress in both areas, with rising deposits reducing banks’ borrowing needs and providing them with a comparatively low-cost source of funds.

Cost of funds has not been a problem for the state banks, as they have received low-cost or no-cost deposits from state enterprises and GoU. CBU refinancing rates have also declined over the years, from 34.5 percent in 2002 to 14.0 percent in 2006. However, private banks and others have reportedly bid up the price of deposits to obtain additional funding, particularly when long-term borrowings are limited or non-existent. This has also been partly reinforced by GoU, as tax offsets have been provided to banks to compensate for the higher interest rates paid on deposits.

New sources of income will be important for banks to achieve self-sufficiency, as will more efficient operations. Additional income sources will bolster retained earnings, reducing the need for borrowings or other liabilities. This will also strengthen return measures, making it more feasible to borrow in the capital markets. However, the

40 Deposits were only 29.4 percent of total liabilities and equity for the banks at March 31, 2006. As some of this is from the enterprise sector and GoU, the figures indicate that household deposits are a small share of bank funding. Demand deposits were only 15.4 percent of total liabilities in September 2006, a decline from 2005 ratios of 18.4 percent.

41 Bank balance sheets at March 31, 2006 showed 54 percent of liabilities and equity (on-balance sheet funding) to be from non-deposit liabilities, a relatively high figure for CIS. These are frequently sourced directly or indirectly from donors or extra-budgetary funds.
achievement of higher return measures will require greater efficiency from operations, which currently show high costs relative to revenue generation. The link to efficiency has to do with increased and more diversified earnings resulting from a broader array of products and services, ultimately generating higher revenues relative to costs.

**Prospects for self-sufficiency are more challenging at the non-bank level.** Credit unions will need time to grow, although the current climate is favorable for them to do so. It remains to be seen if the credit unions will achieve sustainability and financial self-sufficiency after 2010 when tax exemptions may no longer be in effect. Likewise, WOCCU support has provided a subsidy to the movement that will not last forever. However, as the number of members increases and member incomes rise, there are reasonable prospects that credit unions will be able to achieve a level of self-sufficiency that will permit them to play a niche role in household and small business financing. This will primarily depend on their ability to mobilize deposits, and eventually access term funding to permit longer-term loans.

**Credit unions currently are focused on particular regions or local groups, and there is still very little geographic distribution of their loan portfolios.** Such geographic concentration could pose a risk, although credit unions are now permitted to open up branches and expand their operations around the country. This offers greater potential for credit unions to diversify the geographic focus of their loan portfolios, which in the long run should improve prospects for long-term self-sufficiency on the condition that these new risks are properly managed.

**Credit unions are paying market rates for deposits. Thus, the cost of funds will continue to be a challenge.** Fortunately, CBU refinancing rates have come down, lowering the overall interest rate reference point. However, this has more to do with the banks in terms of financing costs, not the credit unions. In general, credit unions will need to ensure they have adequate net interest margins to cover operating expenses and generate sound returns. This will position the credit unions as well-managed community-based enterprises that are worthy of membership, thereby helping to expand the base of clients.

**New sources of income will also be important over time for credit unions to supplement fundamental net interest earnings from loans.** Excess reliance on one source of income raises risks of long-term sustainability. Thus, credit unions will eventually need to think about new product and service delivery that involve commissions and other sources of earnings. This will be needed to help reduce per unit costs of loan origination which are likely to be moderately high since they are small and there are not too many outstanding loans at any one time.42

**The long-term prospects for MFOs are far less clear.** This has much to do with the legal and business environment, underpinned by GoU suspicions of NGOs and how this may affect political and social stability in the future. Moreover, even in a more favorable

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42 The number of outstanding loans approximated 372 per credit union as of October 31, 2006. Average loan size was $1,213.
environment, there are simple business reasons to question prospects for some of the
MFOs, particularly those that are non-commercial in their orientation. Likewise, as the
credit union movement expands and provides other services (e.g., deposit-taking) that
MFOs do not offer, there is a simple competitive threat to MFOs as a result of potential
credit union expansion. Likewise, should the Microcredit Bank (and any other
comparable institution) pursue this market segment, this would intensify the competitive
challenge faced by MFOs. There is already evidence that this is under way as Microcredit
Bank has shown strong growth in its first year of operations. However, the other
argument is that the micro-credit market is vastly under-served and largely suppressed as
a result of the numerous restrictions imposed on the micro-credit groups. Thus, creation
of a more conducive environment for MFOs to provide greater credit products would
help to determine whether sustainability and self-sufficiency are feasible objectives.
Evidence from other markets shows that there are good prospects for MFOs in markets
like Uzbekistan when the legal, regulatory and institutional framework is favorable, and
when MFOs exhibit sound management, good governance, and accountability. However,
in Uzbekistan, MFOs face an unfavorable environment that undermines prospects for
additional funding. Under such circumstances, prospects for self-sufficiency are fairly
weak.

Like credit unions, MFOs tend to be focused on particular regions or local groups,
raising the risk of geographic concentration. However, on a positive note, recently
adopted legislation provides a basis for MFOs to be able to expand their operations and
diversify their geographic focus once they are re-registered, subject to certain conditions
(e.g., acceptable management, adequate financial resources). This should help MFOs
reduce the risk of geographic concentration, which will improve prospects for long-term
self-sufficiency.

Cost of funds for MFOs is generally free or deeply subsidized relative to market
rates as they have been supported by donors. Because of restrictions on mobilizing
deposits, MFOs have had no alternative as a basis for building up capital (loan funds,
etc.) from earnings derived from the seed capital provided by their donor sponsors.
Commercial MFOs charge high monthly interest rates on their loans to cover their
operating costs. High repayment rates suggest that borrowers are willing to pay such rates
because they have generally not been able to access formal finance from other sources.

New sources of income are unlikely for MFOs apart from micro-leasing or possibly
micro-insurance. Micro-leasing does exist on a limited basis and is a definite possibility
for MFOs. Recently adopted legislation makes this possible after re-registration, much as
this is now allowed for the credit unions. There has been no reported movement in the
direction of micro-insurance to date.
III. Key Issues for Market Development

A. Existing Foundations for Market Development

As noted above, there have been numerous positive developments in the microfinance sphere. These constitute important building blocks that will help with efforts to reduce poverty, finance small business, increase jobs and incomes, and generally support evolution to a competitive, market-based financial system in due time. Some of the more important considerations are described below. These are broken out by policy and macro-framework issues, legal and regulatory issues, donor/external relations, banking sector developments, credit unions and MFOs, and links between banks and non-bank credit organizations active in micro-credit.

Macro-Framework and Government Policy Issues

Policy objectives as described by GoU are broadly supportive of financial sector deepening, particularly with regard to banks and credit unions. It is expected that banks will increase branch networks partly to expand consumer banking and retail operations, including small loans and other products/services that will help SMEs with their financing needs. Likewise, credit unions have been granted permission to expand their networks, which will likewise help small businesses and some micro-enterprises with their financing needs. Increasing access of banks to CBU correspondent accounts and increasing access of retailers to their cash resources will facilitate intermediation.

There is clear recognition by banks and GoU of excessive dependence on the State budget. This has undermined efficiency and competitiveness, and drawn down needed reserves from time to time, while also requiring policies of import substitution and protection that undermine full development of Uzbekistan’s substantial competitive potential and advantages. GoU also recognizes that if it is serious about joining the WTO, it will have to revise some of its traditional approaches to economic management. These and other factors should contribute to more liberalized financial markets over time, which will improve prospects for credit unions and MFOs as well as improve prospects for more effective poverty reduction, and increased job creation and household incomes.

While the interest rate market is distorted in the banking sector due to the presence of subsidized loan programs (and corresponding tax offsets), the market is commercially based in the credit union and microfinance segments. This will help credit unions and MFOs to generate the earnings needed for more competitive operations, larger pools of loan funds, and increased entry that will eventually have the benefit of bringing down interest rates for borrowers and introducing a broader range of offered products/services. Moreover, CBU refinancing rates have been coming down in recent years, and as of late 2006 (14 percent) were close to the mid-point of the range of 2006 inflation rates reported in September by the GoU (8.3 percent) on the one hand and estimated by the IMF (19.3 percent) on the other.

Legal/Regulatory Issues
The legal, regulatory and supervisory regime is reported by CBU to be adequate for the banks and credit unions. Concerning banks, efforts have been made in recent years to establish adequate reporting systems that help to monitor the loan portfolio for risks. Meanwhile, credit unions have noted that regulatory reporting is reasonable in terms of required information. While annual inspections occur without warning, serving as a burden when CBU is present (as credit unions are not fully prepared at the time and have to retrieve documents, etc.), there was broad recognition that monthly reports are not overly burdensome. Moreover, the Association of Credit Unions was praiseworthy of the consultative process with GoU regarding legal reforms, including the role played by CBU.

New guidelines for MFOs may prove to be beneficial to prospects for long-term sustainability. While there are many arguments against regulation (as opposed to self-regulation), minimum capital, restrictions on lending, etc., the current Resolution approved by the Council of Ministers and put into effect November 10, 2006 along with associated legislation provides a basic framework for micro-credit. While the legislation may include some conditions that are excessively rules-based for MFOs, there is also an argument that capital requirements and associated licensing requirements serve as a catalyst for linkage to professionally managed, commercially-oriented MFOs that, in the end, have a greater chance of achieving self-sufficiency. There is no uniform view on this issue. Nonetheless, should GoU replicate the pattern of legislation and practices regarding credit unions, the legal and regulatory framework may in the end turn out to be conducive for MFOs to operate commercially and to expand. The Resolution and new laws on microfinancing and MFOs hint at movement in this direction, as they permit MFOs to engage in factoring, leasing and other credit-related activities as well as to open up branches. In fact, the new legislation presents few limitations on MFO financing activities, provides the basis for expanding the branch network of MFOs, and supports efforts to increase skills and training. As such, these can be interpreted favorably on the condition that subsequent instructions for re-registration and actual implementation are supportive and promotional, as they have been in the credit union sector.

**Donor/External Relations**

There is a long tradition of banks and GoU working with donors in administering lines of credit according to agreed terms, as well as making payments in a timely manner. This offers the potential prospect of providing term funding for micro-credit which would clearly assist banks, credit unions and MFOs in providing loans beyond one year for small-scale and micro-enterprises. There has already been one reasonably successful project involving the Japanese Government, EBRD and LFS, a Berlin-based consulting group working with four commercial banks. In this regard, the positive environment for leasing has partly addressed this need. The long-standing precedent of

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43 The banks are Hamkorbank, Ipoteka, Pakhta, and Ipak Yuli. Hamkorbank was particularly cited as being a strong institution in terms of utilization of funds. More broadly, LFS believes that all four banks displayed decent skills in developing credit risk management policies, procedures and controls that will serve them well in the micro-credit and small business financing market as it evolves.
GoU coordination with donors offers the possibility of future lines of credit that may help to play a role in increasing funds made available for micro-credit purposes. Likewise, the strong repayment record of the GoU on these lines underscores a positive reputation with regard to creditworthiness.

**There has been substantial technical assistance provided to credit unions and MFOs.** The credit union experience has been particularly positive, with high praise communicated by credit union managers, donors and GoU on the performance of WOCCU. This is a clear precedent for moving to standards-setting self-regulatory organizations in the microfinance field, accompanied by more formal and regulatory-friendly structures as are in force with the credit unions. The commercial MFOs have benefited from direct assistance from their parent/partner NGOs, as well as from UNDP in helping with implementation of CGAP standards. This has been beneficial in promoting sustainable practices that could potentially have a favorable effect on the delivery of micro-credit to low-income segments of the population.

**GoU has had good experience with some of the NGOs that have demonstrated capacity and ability to transfer skills via technical assistance programs.** These programs have been part of larger support programs in which commodities (e.g., computers, software) have also been supplied. The WOCCU model is a precedent for future development. Likewise, the larger MFOs benefit from comparable support from their partner NGOs. Continued support for the commercial MFOs would very likely contribute to meeting some of the financing gaps unlikely to be taken up by banks or credit unions.

**The Banking Sector**

**While intermediation, penetration and return measures of the banks are weak, other measures of financial soundness are reasonable or improving.** If CBU data from September 2006 are accurate, regulatory capital is adequate relative to risk, asset quality is improving, concentration is diminishing, exposures are diversifying across sectors, and liquidity is strong relative to short-term requirements. Thus, a reasonably sound environment will position the banks to expand their presence in the consumer lending market.

The banking system is experiencing a decline in concentration as the 25 banks that are not wholly owned by the state gradually increase market share. This will encourage competition over time, with benefits throughout the economy. Such competitive pressures will encourage many banks to increase their focus on consumer lending, thereby contributing to efforts to close the gap in the micro-credit market between existing levels of exposure and estimated unmet demand.

As part of the gradual move to a more competitive market, banks are being encouraged to diversify their product range. While there may be some specialization linked to legacy patterns in the Uzbek commercial banking market, most banks appear to be moving away from earlier specializations linked to particular sectors of the economy.
Ironically, one exception may be the formation of the Microcredit Bank. On the other hand, such specialization is not tied to any particular sector, and instead reflects a more formalized effort by GoU to link licensed banks with the micro-credit market.

**As part of the diversification effort, banks are expected to increase their presence in consumer lending.** Commercial banks are increasing their branch networks, with much of the expansion driven by plans to increase consumer lending for cars, appliances, furniture, and other consumer items as well as to expand plastic card networks. Recent trends also indicate banks are lending more for real estate (housing and construction) development as well as to SMEs for a range of activities.

**Credit Unions and MFOs**

**There are low rates of default in the credit union and MFO markets.** In general, credit unions and MFOs report 95-96 percent performance, and “non-performing” loans tend to be slight arrears (equivalent to “sub-standard” bank loan classifications up to 30 days) that are usually corrected fairly quickly. Likewise, GoU has a track record of prompt repayment. Thus, it appears that there is a “credit culture” that appreciates the importance of creditworthiness, depending on the specific incentives in place. Even banks show manageable levels of non-performing loans, with many of the non-performing loans (based on official statistics) resulting from government guarantees, a loss of discipline, or off-balance sheet methods of compensating for foregone interest and principal payments. In general, there appears to be a serious streak of creditworthiness built into the cultural fabric of Uzbekistan that is positive for financial sector development prospects.

**In addition to high repayment rates, credit unions and MFOs provide additional benefits to their clients that cannot be found in the banking system.** These include ease of processing for clients that might not be able to access funds from banks, and faster turn-around time on loan applications.

**Based on technical assistance received, the Association of Credit Unions has developed capacity to evaluate member (and other) credit unions according to PEARLS standards.** Based on PEARLS, the Association has set up a five-point rating system (similar to CAMELS44) by which credit unions are judged to be suitable for membership in the upcoming Stabilization Fund. This Fund will help to protect member deposits based on observance of sound practices as elaborated in the PEARLS methodology. It is also useful as a vehicle for maintaining sound standards for stable development without having to involve more expensive audits from external auditors.

**Links Between Banks and Non-Bank Credit Organizations**

Safekeeping is not an issue in Uzbekistan, as banks and credit unions have strong facilities to ensure the physical safety of funds. Credit unions have vaults for temporary

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44 CAMELS = capital (adequacy), asset quality, management, earnings, liquidity, and sensitivity to market risk.
placements of deposits and collateral, and bank facilities for longer-term storage. Likewise, credit union facilities visited had direct links to local police stations in the event that vaults were penetrated. All of this, along with the strong role of CBU in banking system matters, conveys a sense of security.

Credit unions and MFOs have bank accounts, largely deposits representing their funding sources. This presents an opportunity for banks to develop “wholesale” products (e.g., funding facilities, liquidity facilities) for non-bank credit organizations that could alleviate some of the term or pricing pressure on these groups. For instance, if banks are able to borrow at CBU refinancing rates, this offers enormous opportunity to on-lend to credit unions and MFOs given the gap in interest rates charged on loans by these smaller financial institutions.

At the moment, liquidity management and market risk management are not major issues for non-banks (or, for that matter, banks in the case of liquidity management). There is no real foreign exchange rate risk for non-banks since deposits (mobilized by credit unions) are generally in local currency, although not exclusively. Interest rate risk at credit unions is managed by coordinating rates (and maturities) on deposits and loans, and working directly with members to discuss the consequences of decisions when changes are proposed, and holding spreads at roughly comparable levels. While credit union practices in this regard are slightly different from banks (that claim to have variable rate interest linked to the refinancing rate, at least in the case of private banks), there appears to be a basic approach to holding net interest margins relatively stable. As such, in some cases, borrowers at credit unions will forego lower interest rates on loans to avoid reduced interest income paid on deposits. This may be a function of loans being very short-term, while deposits (even if current accounts) are viewed as being long-term even if they can be withdrawn on short notice or within a very short period (one to three months).

While credit risk management is not well developed in Uzbekistan, all the financial institutions apply practical income tests on loans extended to individuals, households and small businesses. Most of these tests relate to documented income, capacity to handle total monthly debt, and the all-inclusive costs of enforcing collateral contracts when necessary. In the case of the banks, there are reports that reliance on collateral values is even easier now that property markets (for land and premises) are developing. On the other hand, credit unions take relatively liquid forms of collateral (e.g., gold, cars) that are easy to enforce, and MFOs rely on pledges and guarantees that rely more on honor and reputation than assets. In the end, credit unions and MFOs have higher reported levels of repayment. Banks also tend to take collateral that they can enforce (e.g., gold, cars, properties that do not present eviction challenges).

B. Challenges to Market Development

While there are numerous aspects to the environment that are positive for microfinance development, there are also challenges. In some cases, these simply involve some fine-tuning of existing approaches and practices. In other cases, this has to
do with impediments that constrain capacity, opportunities and delivery of micro-credit, and may serve to keep micro-credit limited in impact as a tool of poverty reduction and economic growth. These are broken out by the same categories as in the section above.

**Macro-Framework and Government Policy Issues**

**Deposit-to-GDP ratios are low, money circulating outside formal financial channels is about half of broad money (which is high), and the general role of the informal economy is high despite GoU efforts to capture such transactions.** These characteristics reflect a significant degree of disenfranchisement of households from the formal financial system. Even with growth in the credit union movement and expansion of the branch networks and retail operations of the banks, a significant percentage of the population’s financial business is conducted outside licensed channels. In support of efforts to mobilize household and enterprise deposits through licensed financial institutions, GoU has recently begun to ease the conditions under which lenders can make loans on a cash basis. However, continued mandatory encashment services imposed on retailers and small businesses, and a general desire to hide assets and income from tax authorities continues to hinder broader development of the formal financial system. This will take time to remedy, and until then, will reduce the pool of funds available to micro-enterprises through formal channels. As such, individuals and micro-enterprises are likely to continue relying on private savings for business activities. Yet such characteristics likewise constrain investment to avoid visible asset growth and detectable income streams.

**Despite positive plans to increase public confidence in the banking system, GoU faces challenges on this front due to the legacy of the kartoteka system and continued tax evasion by the public.** This will remain a challenge for banks in particular in mobilizing household deposits, and to a lesser extent for the credit unions. This has the consequence of constraining the supply of formally available resources, and driving up the effective costs of funding (on a commercial basis) that also impose significant challenges to borrowers’ capacity to service and repay loans. High interest rates also limit the aggregate size of loans and shorten maturities, further weakening prospects for capital investment in job-creating industries and services where needed.

**Subsidized loan programs and tax offsets on foregone interest income reflect a more interventionist and administered approach to banking that, to date, has failed to provide sustainable lending to anything but a very small fraction of SMEs and households.** While there is not sufficient information to determine the degree to which this approach may have distorted the market, subsidized lending programs continue to set interest rate benchmarks on loans that are below inflation rates, while also creating a non-level playing field as in the support provided to Microcredit Bank. Several banks are able to participate in GoU programs that offer interest rates on loans that are considerably lower than market rates. This puts non-recipients at a competitive disadvantage, while also creating room for kickbacks from prospective borrowers for them to be able to access these rationed loans. The presence of such programs also affects expectations on the part of the larger prospective borrowing community, putting pressure on financial
intermediaries to lower interest rates on loans without adjusting loan pricing for risks. Such formulas tend to discourage market-based competition which, in the long run, is what ultimately provides an adequate supply of credit to creditworthy borrowers at sustainable and affordable rates. Likewise, such competition is predicated on risk-adjusted pricing so that intermediaries are able to generate earnings and expand their lending in these areas.

There is no evidence that subsidized loan programs are effective in targeting low-income households. In many markets, including advanced markets, subsidies often benefit those who need them less. As such, the economic and social benefits are limited or even negative when accounting for the fiscal costs associated with the subsidies. Yet, their presence in Uzbekistan deprives non-participating banks, credit unions and MFOs of potential clients. There is no evidence to suggest that subsidized loan programs are being allocated to comparatively wealthy households or businesses. However, in many markets, subsidized loan programs have been costly fiscally, poorly targeted, and limited in impact. Further, as related above, they can affect expectations and distort the competitive market.

Constraints on market development resulting from subsidization and other distortions deprive GoU of an expanded fiscal base for the future. Establishing an environment in which competition is distorted constrains growth and development of the micro-credit market. This, in turn, reduces the number of tax-paying enterprises and individuals, their incomes, reported transactions, and tax payments made.

Legal/Regulatory Issues

Among the key impediments have been restrictions on MFOs’ ability to make loans in cash and to finance consumer goods. There are expectations that these constraints will be partly eased, although this was not certain as of late 2006. Above all, GoU appears to have a very negative view of MFOs due to their perceived predilection for making loans to commercial traders, rather than farmers, light manufacturers and other “productive” enterprises. Moreover, as many traders are dealing in imports, GoU perceives their activities to weaken domestic production and job creation.

In general, MFOs in late 2006 were reluctant to proceed with their activities prior to finalizing the re-registration exercise. The Government also closed down one of the smaller MFOs (Partners for Academic Development, or PAD) in 2006 following an audit by the Ministry of Justice and tax officials. Other MFOs are hesitant to carry on or expand their operations to avoid activities that might later be considered by the authorities to be out of compliance with laws and regulations. Likewise, the current impasse has resulted in an unwillingness of donors or other investors to commit additional funds to the MFOs, at least until the current phase of uncertainty is clarified.

There is considerable uncertainty in the MFO market regarding re-registration prospects. Some reports have indicated that MFOs will soon be able to borrow from external sources, and that new legislation may permit deposit-taking. On the other hand,
perceptions of GoU distrust towards the Association and the NGO community have slowed operations and created uncertainty. Likewise, the closure of PAD has introduced an element of perceived arbitrariness by the tax authorities that MFOs (and the NGOs to which they are linked) may be subject to close scrutiny and controls that will impede their capacity to operate.

**Donor/External Relations**

The establishment of Microcredit Bank in lieu of the proposed Microfinance Bank sends a signal that GoU intends to pursue administered and subsidized loan programs instead of commercially viable approaches. This raises the issue of whether donors should provide such capital and resources for a tested and successful concept utilized in numerous other markets. This also raises the risk that while GoU has expressed willingness to work together with the donor community (as it has in the past with a long track record of success), that it is also sponsoring a state-owned bank that will operate on preferential terms and consequentially weaken prospects for impact and effectiveness of donor funding.

The perception of GoU antagonism toward NGOs may weaken prospects for needed donor support for the provision of technical assistance and capacity-building in the micro-credit field. While not all MFOs are commercially run, the perception of suspicions about NGO agendas raises the risk that commercially-oriented MFOs will also show less interest in working in Uzbekistan. It is not at all clear if the credit union movement would be willing and able to step in and meet micro-credit needs handled by MFOs, as the credit unions tend to cater to less needy households with savings.

**The Banking Sector**

While the GoU has stated the intention of reducing state involvement in the banking sector, the state banks still appear to think in terms of social objectives more than profitability. This partly reflects the legacy of government guarantees and the belief that subsidization keeps loans affordable for needy borrowers. However, such approaches reduce prospects for capital formation and investment necessary to build competitive, efficient and market-responsive banks.

The creation of the Microcredit Bank may serve to distort the market for small business lending and micro-credit. By offering 5 percent annualized rates of interest (effectively negative in real terms), low interest income combined with tax offsets for Microcredit Bank will deprive other commercially functioning institutions (banks and non-banks) of prospective clients. In the end, this will serve as an impediment to sustainability for the other institutions, which in turn will weaken prospects for a larger micro-credit market characterized by strong and competitive institutions able to mobilize resources and make loans to this market segment on sustainable and profitable terms. Likewise, depriving market participants of these potential earnings will reduce incentives to make investments in hardware, software, personnel and systems that ultimately create innovative products, reduce per unit operating costs, and make such lending operations
both efficient and responsive to market needs. While this risk should not be over-emphasized, as the micro-credit market is segmented and Microcredit Bank is not planning to make very small loans of the sort made by MFOs and, in many cases, credit unions, the risk still exists that Microcredit Bank’s “soft” approach will distort the incentive system for other banks to capture the small business market on commercial terms. Against this concern is the limitation of resources available from the GoU that can be used for subsidized lending. As the micro-credit market is so under-served, there is a likelihood that banks and other lenders will continue to develop this market at commercial rates, even in the presence of subsidized loans from Microcredit Bank.

The deposit insurance program, in effect since 2002, has not succeeded in restoring depositor confidence in the banking system despite the lack of instability in Uzbekistan’s banks that has characterized other CIS (and other) systems in the last 15 years. While this scheme could play a role in contributing to household confidence in the banking system in the future, GoU and CBU will also need to monitor for potential moral hazard. Meanwhile, it has been evident for several years that the presence of a deposit insurance scheme, even if well designed, is not sufficient for the attraction of deposits if other obstacles remain. With still high levels of funds outside the banking system, tax and business environment challenges continue to undermine deposit mobilization.

Restrictions on cash movements continue to shrink the resources flowing through the banking system, ultimately reducing the pool of funds available for small business lending. Cash surrender requirements imposed on the banks have reportedly been officially abandoned, yet daily encashment services on retailers and small businesses restrict general business operations in the market. As a result, small businesses seek to bypass official collections placed in the banks by operating “off the books”. Systems of advanced budgets and non-cash transfers detailing salary payments, travel allowances, values of planned purchases and other requirements are cumbersome, rigid, and excessively control-oriented for a market economy. These systems also add cost to business processes and the operations of banks which already show very high operating costs and low return ratios. For small transactions, cash exchanges are preferable. Other restrictions or burdens, such as access to foreign exchange on a timely basis, serve as a further disincentive to place funds in the banks.

There is credit risk associated with some guarantors as well as borrowers. In some cases, banks (and other lenders) rely on guarantees from insurance companies as a source of collateral. However, once loans are made, mechanisms are not in place for banks to monitor whether borrowers have continued to make payments on insurance policies to keep the policy active and effective as a source of collateral. This is more an issue on

45 As currently designed, the Deposit Insurance Scheme protects depositors up to 100 times the minimum wage and up to 90 percent of 250 times the minimum wage in both local and foreign currency deposit accounts if a bank fails and the license is withdrawn. Payout is required to be within 2.5 months. Should accumulated resources of the Fund not be sufficient for payout, there is a provision that allows the Fund to borrow from the government.
larger credits, but may serve as a challenge for banks in the future as they expand their consumer lending operations.

The limited development or use of credit infrastructure undermines microfinance development in Uzbekistan. The incompleteness and limited dissemination of credit performance information is one obstacle to growth of a more dynamic system in which lenders obtain full information and compete on loan terms. The absence of developed credit scoring systems within banks is also a reflection of a system that has not catered to the vast potential market that exists.

Credit Unions and MFOs

Given the small-scale nature of non-bank credit organizations and their relative youth, there has been only very limited impact to date in Uzbekistan. Notwithstanding growth, the combined outstanding loans of credit unions and MFOs were only about $15 million as of late 2006, or about $3 per household.\(^{46}\)

Credit unions and MFOs are very small, and this will remain a challenge to long-term viability for some time to come. While credit unions and MFOs are now permitted to expand their networks, it will take time for them to reach the “critical mass” needed to play more than a peripheral role in financial intermediation (e.g., exceeding 5 percent of total loans among licensed financial institutions). The relatively small scale of credit union operations will likely mean relatively high per unit costs of operations, although these have been partly offset by WOCCU support during the early years of market development. MFOs likewise are very small, and even with a more favorable legal framework, this will remain the case until outside sources of funding can be increased to expand the overall loan pool for future retained earnings.

Credit unions have virtually no access to long-term funding to make loans exceeding one year. Most deposits tend to be for up to three months or less. As such, credit unions can only make short-term loans that are relatively small and focused on working capital or household consumption needs. For the moment, this may not be a negative, as the credit unions are still developing capacity in managing credit risk. However, in the long run, they will want to access term funds to be able to extend long-term loans.

Market information is generally not a problem for credit unions as they are very familiar with the economic status, financial condition, and reputation of their members. On the other hand, credit unions are focused on serving their members, and may not be as vigilant as they need to be in their loan origination standards. Thus, the challenge for credit unions is to achieve a balance between lending on a financially sound basis based on creditworthiness criteria, while remaining service-oriented towards members. In general, these decisions are based on local market information along with a reliance on member education to understand that sound credit quality is essential for future loans as well as for the overall sustainability of the credit union. To the extent that certain individuals turn out to be a detriment to the credit union

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\(^{46}\) This is based on a population of about 26.5 million and average household size of 5.1.
as a whole, this has consequences in the community concerning the individual’s reputation. Discussions with credit unions indicated that members were fully aware of these issues, and in some cases had even made major sacrifices to ensure that loan repayments were made on time.\textsuperscript{47} More sophisticated approaches to market information may be needed with time to assist credit unions with product development (loans and deposits), new services (e.g., leasing, factoring) and more efficient operations (as volume increases). However, these are next generation issues that credit unions typically address once they begin to show maturity and larger assets. For now, Uzbekistan’s credit unions are still in their early development phase, and are wisely focusing on the fundamentals for long-term growth.

**MFOs are completely dependent on donors for operations and support.** With restrictions in place on deposit mobilization, the only way they can make progress towards sustainable operations is with donor funding and the gradual build-up of retained earnings. While some claim to be profitable and self-sustaining, this is not a uniform position. Likewise, any material expansion of operations to cover the large number of potential borrowers whose financing needs are not met would require an increased presence of donor involvement.

**Unlike the banks and credit unions, MFOs have faced difficulties at numerous levels.** As an example, the Microfinance Association has twice been rejected in its application to be registered on behalf of its 11 members. With close links to the Central Asian Microfinance Association (CAMFA) and access to services provided by the Microfinance Information eXchange, the Consultative Group to Assist the Poorest and other institutions, the Association could be very helpful in working with the GoU to increase access to finance at the small (low-income) end of the market. This would be particularly helpful for home-based and other very small-scale entrepreneurs who tend to hire two to three family members in such activities as trade, foodstuffs and catering services, although research to date indicates that microfinance has had less impact in agricultural crops and services.\textsuperscript{48}

**The business climate for MFO clients reduces prospects for success and development.** Arbitrary tax inspections, closures of markets, relocation of traders to unfavorable locations, seizures of goods by customs officials, and other forms of harassment are considered to be in conflict with GoU objectives to expand the economy, reduce poverty and boost incomes. While it is not clear how pervasive such behavior is, the perception of abuse and arbitrariness constitutes a challenge for existing and future prospects of micro-credit and small business development in Uzbekistan. Other indicators related to licensing (permits), registering property, accessing credit, paying taxes, and

\textsuperscript{47} One story mentioned a member who ripped up wooden flooring panels from his primary residence for sale in the market to generate the cash needed to repay a loan on time. This action was because one or more of his customers were late with payments on which he depended to make repayment to the credit union. When these payments from his clients were not forthcoming, he effectively sold part of his house to be able to comply with loan repayment terms.

\textsuperscript{48} See “Microfinance development in Uzbekistan”, CER, UNDP and Agfund, 2005.
trading across borders all reflect a difficult business environment that can stifle investment and growth.

**As with the credit unions, MFOs do not have formal or systematic approaches to gathering market information apart from what is gathered from local contacts.** MFOs have generally concentrated on specific regions, as their programs have been small. Market information largely comes from local market conditions, the reputation of borrowers, and development of a track record over time. However, with high levels of performance reported, commercial MFOs have been able to manage this process without requiring more formal or systematic processes. In any event, reliable data and access to systematic information at household and micro-enterprise levels is scarce in Uzbekistan.

**Links Between Banks and Non-bank Credit Organizations**

There are few links between banks and non-banks, apart from the bank accounts opened up by credit unions and MFOs. While this partly reflects the scale of operations of the MFOs plus the relative youth of the credit unions, banks have not approached the non-banks as prospective borrowers. Given the gap between banks’ cost of funding and the rates charged on non-bank loans, there is considerable room for liquidity facilities to be originated by the banks. That this has not occurred reflects a lack of innovation and entrepreneurship in much of the banking community, as well as the legacy of being “corporate” in orientation rather than “retail” or focused on small businesses in the economy (apart from government-guaranteed loan programs).

The lack of linkage between banks and non-banks also means there is limited information sharing. The absence of a broader credit performance reporting system will keep credit unions and MFOs fragmented, although informal efforts to share names of non-performers (“black listings”) will still help among the banks, credit unions and MFOs even if the systems are not linked.
IV. Considerations for the Government of Uzbekistan

This Policy Note recommends consideration of the following as a basis for improving prospects for development of the microfinance market under stable yet competitive conditions. Many of the prescriptions for a robust micro-credit market are contingent on broader reforms in the banking sector. However, this Note focuses only on those areas that directly impact developments in the microfinance field. In many of these cases, the World Bank Group (WBG) could be in a position to help via technical assistance and, potentially, a lending operation. However, such developments would presuppose progress with reforms in the banking sector to ensure that WBG support in microfinance runs parallel to needed reforms in the broader financial sector. Priorities could be as follows:

**Immediate Action**

- CBU issues simple instructions for MFOs to be able to re-register and resume lending activities
- GoU coordinates with the currently unregistered Microfinance Association to develop a framework for a standards-based self-regulatory microfinance sector consistent with GoU’s larger objectives for poverty reduction and microfinance development

**Short-term Actions in 2007**

- Initiate discussions on development of a timetable for when subsidized loans for micro-enterprises through Microcredit Bank (or other institutions) will end to be replaced with a more targeted approach that focuses on credit enhancements for specific kinds of borrowers (e.g., means-tested)
- Approve license for Microfinance Bank once a formal application is submitted
- Initiate discussions on development of a timetable to phase out mandatory cash and non-cash transactions, and daily mandatory encashment services, with special emphasis on the latter
- Develop key micro-credit performance indicators at CBU for ongoing surveillance of financial soundness
- Re-draft parts of the recently adopted microfinance legislation to reduce the regulatory burden, and to structure the industry on a standards-based self-regulatory approach
- Develop an approach for one or more credit information bureaus to function in Uzbekistan, including pre-feasibility work to determine where such assistance might accelerate progress with existing initiatives
- CBU provides guidance for banks and other lenders to structure credit scoring systems, adapt banks’ MIS accordingly, and incorporate aggregated data into regular monthly or quarterly reports on credit quality
- Develop framework for partnership of the GoU with the Microfinance Association that is modeled on the approach taken to date with the Association of Credit Unions, and based on a consultative process
• Develop structure and business plan for a financing facility and design a pilot phase

Medium-term Actions Through 2010

• Develop standards for participation of banks in any subsidized loan schemes, focused primarily on market-based practices with subsidies serving as targeted enhancements as needed for borrowers
• Build up monitoring capacity of microfinance banks and other institutions, and promote foreign investment in new or existing banks
• Develop strategies that promote deposit mobilization and “voluntary dematerialization” of transactions, such as incentives through the banking system via debit and credit cards tied to various savings and loan products
• Develop data base at CBU on individual banks, credit unions and MFOs to monitor developments in the microfinance field and detect potential risks to the financial system, with results and data presented on the CBU web site
• Review microfinance standards and progress based on the self-regulatory model, and make any changes needed to encourage microfinance in a manner consistent with all legal, regulatory and tax requirements
• Work with UBA, CBU and other GoU entities (e.g., tax authorities, utilities companies) to consolidate credit performance for bank and trade credit, and begin comparable work with the Association of Credit Unions and Microfinance Association
• Refine credit scoring measures and strengthen linkage of banks’ and credit unions’ microfinance data to CBU financial stability assessments and stress testing
• Ongoing coordination of the GoU and Microfinance Association to (1) ensure compliance with regulatory standards, (2) compile useful industry information, (3) serve as a clearinghouse for commentary on the existing legal and regulatory framework, and (4) provide training and technical assistance to MFOs
• Provide funding to participating banks, credit unions and MFOs that meet eligibility criteria of the financing facility for microfinance, and begin to design asset securitization packages and ratings criteria

Long-term Actions for Impact Beyond 2010

• Gradual down-scaling of subsidy schemes focused on micro-enterprises, households and individuals as credit market access increases and market rates come down as a result of competition
• Continued monitoring of performance of microfinance institutions, and adjustments to policy if market share, revenue growth and profitability, product/service development and innovation, pricing patterns, etc. show major gaps or deficiencies relative to other markets
• Ensure dematerialization (non-cash) policies for transactions are consistent with incentives needed to maintain public confidence in the financial system
• Refine CBU indicators regarding consumer lending and impact on current account, and more generally risks to economic and financial stability
• Ensure policies, standards and practices for microfinance are consistent with objectives regarding aggregate amounts of micro-credit in the economy, poverty reduction, and other measures by which to gauge progress
• Bring credit information system(s) together from various segments to which all lenders can have access
• Expand credit scoring models to help develop asset securitization market by incorporating standards and performance measures as a basis for rating and pricing such packages in the secondary market
• Transform MFOs into licensed intermediaries able to mobilize deposits and provide fundamental savings products
• Achieve self-sustainability and growth of the microfinance financing facility based on commercial terms and secondary market investment

Key components are identified below:

**Government Policy**

As a matter of policy, it is recommended that the GoU reconsider its traditional approach to subsidized lending and tax offsets in the banking sector, including current support for the state-owned Microcredit Bank. Apart from very specific and targeted areas, these should be reduced and kept to a minimum. Above all with regard to microfinance and financial sector development, they should not be used to provide a competitive advantage to any particular bank, such as for Microcredit Bank or any other bank. More often than not, such approaches are likely to undermine development of financial markets rather than encourage them, as has been demonstrated by Uzbekistan’s low levels of financial intermediation. Rather, Microcredit Bank and others with demonstrated expertise in this segment of the market should be encouraged to compete base on their knowledge of local markets, product range, training, and related advantages. Eventual curtailment of such programs should be considered (including for Microcredit Bank), and more market-based pricing should be encouraged in the banking system as currently occurs among many private banks as well as with the credit unions and MFOs. To the extent that targeted subsidies are used, these should be as invisible from the lender side as possible, low-cost fiscally, and supportive of other measures that encourage prudent commercial lending practices in Uzbekistan. Targeted credit enhancements for low-income households or needy businesses to help get their enterprises off the ground might be a better way of accommodating this segment’s needs, possibly through interest supplements on payments owed or partial guarantees.

• Short-term focus could be on initiating plans to determine when 5 percent loans offered by Microcredit Bank will no longer continue beyond a specified date, while identifying alternative targeted efforts that transfer preferential treatment away from selected banks and towards targeted borrowers.
Medium-term focus could be on ensuring that any targeted subsidy programs that are run through the banking system are available based on transparent eligibility criteria, including validated means-testing. This focus would include minimizing the fiscal cost of subsidies, and utilizing “enhancements” (e.g., covering loan processing fees, paying for credit information reports, offering partial guarantees on principal repayment up to stated limits) as a basis for increasing affordability and access for low-income creditworthy borrowers.

Long-term focus could be on down-scaling the use of any subsidies and tax offsets utilized for lending to micro-enterprises and small businesses as their access increases through competitive market development.

CBU should extend a license to Microfinance Bank in the interests of stimulating competition in the banking sector to support increased access to credit for individuals, households and small businesses, as well as to increase deposit mobilization. In other markets where such banks have operated, there have been favorable results in both deposit mobilization and loan activity in the microfinance sphere. GoU should eliminate preferences for Microcredit Bank that would interfere with prospects for a licensed Microfinance Bank as well as other banks (domestic, foreign or joint) that are interested in pursuing this market. Above all, GoU should consider establishing an environment in which the proposed Microfinance Bank would itself face significant competition, as its high levels of earnings in many other markets have largely resulted from an absence of meaningful competition.

Short-term focus could be on approving the application for a license in a timely manner, assuming all licensing conditions have been met.

Medium-term focus could be on monitoring developments in the banking sector, and sending signals to the international community that the microfinance market needs more competition (and, therefore, foreign entry) in the event that existing banks, credit unions and MFOs are unable to meet demand under sustainable, commercial terms.

Long-term focus could be on monitoring general levels of competitiveness in the financial system based on market share, revenue growth and profitability, product/service development and innovation, pricing patterns, etc. Should there be major gaps or deficiencies relative to other markets, policy adjustments could be made to encourage a more competitive market.

GoU should consider accelerating movement to reduce distinctions between cash and non-cash transactions, or perhaps announce a timetable for its approach. Access to cash balances has increased in recent months, signaling progress. Likewise,

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49 There are many examples in Central and South Europe and CIS markets, with these banks generally playing a positive role in mobilizing deposits from otherwise disenfranchised depositors, and subsequently increasing their loan exposures to micro-enterprises. The latter often are unable to obtain loans from conventional banks.
Dematerialized transactions will remain an important component of Uzbekistan’s economy for many reasons. However, the approach taken to date has dissuaded many small businesses and households from placing funds in the banks in the first place apart from mandatory daily cash deposit requirements. This has translated into low levels of confidence and deposits in the banking system, thereby reducing the funds available for microfinance lending. This has also reduced the base for credit performance information, one of the key infrastructure pieces for building a broad-based lending system (see below).

- Short-term focus could be on initiating efforts to determine a timetable to gradually phase out mandatory cash and non-cash transactions, and particularly daily mandatory encashment services.

- Medium-term focus could be on developing strategies that promote incentives for “voluntary dematerialization” via incentives through the banking system. This can include the issuance of debit and credit cards tied to various savings and loan products.

- Long-term focus could be on ensuring policies are consistent with incentives needed to maintain public confidence in the financial system.

Legal/Regulatory/Supervisory

As the consumer loan market develops, CBU will need to establish key indicators to track developments in this field. As consumer lending is new for banks, there are financial soundness issues that mainly focus on credit risk management that should be monitored within the banks and by CBU. Likewise, generating such information will also be helpful in determining trends, identifying gaps, and reviewing policies and regulations to see if more can be done to encourage sustainable and prudent levels of credit to this segment of the economy. Moreover, as this market evolves, it will be important for CBU, the banks and other lenders to be able to access such information for product and market development.

- Short-term focus could be developing the key performance indicators CBU needs to track as a matter of its ongoing surveillance of financial soundness. These could be built into the regular reporting requirements of the banks and other financial institutions supervised by CBU, and would require coordination with banks’ and other financial intermediaries’ management information systems for regular data collection, processing and reporting.

- Medium-term focus could be on developing the data base on individual banks, credit unions and MFOs to map out developments in the microfinance field, as well as any potential risks to the financial system. General results and data could also be presented on the CBU web site for market use.
• Long-term focus could be on refinement of indicators to be used as a tool for risk management by CBU. While this is not an issue during the nascent stages of market development, in many transition economies, consumer lending has spiked as markets have opened up and as incomes have risen, leading to major current account pressures. Thus, in the long run, CBU and others in GoU may need to refine the indicators to better measure risks to economic and financial stability.

GoU should accelerate efforts to create a conducive legal, regulatory, and tax framework for MFOs. This has been accomplished with the credit unions, which can serve as a bit of a precedent. However, as MFOs are not permitted to mobilize deposits, emphasis should be more on standards and self-regulation, rather than direct CBU regulation and supervision. Above all, simple and straightforward instructions for re-registration of MFOs should be presented to break the impasse faced by MFOs since mid-2005. Because of restrictions on MFO deposit mobilization, these organizations pose no threat to financial stability. Likewise, CBU supervisory resources should be allocated primarily to where the risks to stability are greatest, which will be in the banking system for some time to come. In contrast to the self-regulatory approach, a more restrictive and control-oriented regulatory regime carried out by CBU could constrain microfinance development while it also would tax scarce supervisory resources that are better allocated by focusing on banking system risks.

• Immediate focus could be issuing simple instructions for MFOs to be able to re-register and resume lending activities.

• Short-term focus could be on re-drafting or amending recently adopted legislation to reduce the regulatory burden, and to structure the industry on a standards-based self-regulatory approach. This would include simple guidelines for self-regulatory standards that can be modeled on best practice from other successful microfinance markets.

• Medium-term focus could be on reviewing standards and progress, and making any changes needed to encourage microfinance in a manner consistent with all legal, regulatory and tax requirements.

• Long-term focus could be on ensuring policies, standards and practices are consistent with objectives regarding aggregate amounts of micro-credit in the economy, poverty reduction, and other measures by which to gauge progress.

Financial Sector Infrastructure

GoU should encourage development of a more comprehensive and integrated credit information system. GoU may want to encourage building on the existing Uzbekistan Banking Association (UBA) and CBU systems to highlight negative as well as positive performance so that such information can be used to set loan amounts and maturities and to price on a risk-adjusted basis. In this regard, efforts could also be made with the Association of Credit Unions and a registered Association of MFOs to build such credit
performance information systems as well. Over time, these data could be used by lenders to offer better loan products for sound performers, helping to increase the allocation of credit resources to enterprises and households with demonstrated track records of creditworthiness. An alternative approach would be to encourage one or more private investors to enter the market and build such systems based on their expertise and experience from other markets.

- Short-term focus could be on developing an approach for one or more credit information bureaus to function in Uzbekistan. This could include a review of differing models and markets, determination of the appropriate approach, and movement in that direction. This would include the pre-feasibility work involving fee structures, necessary investment for establishment and ongoing maintenance, etc.

- Medium-term focus could be on working with UBA, CBU and other GoU entities (e.g., tax authorities, utilities companies) to begin consolidating credit performance for both bank and trade credit. Preliminary work could also begin with the Association of Credit Unions to develop an information bureau among its members. Should the GoU agree to register the Microfinance Association, this could be one of its key tasks.

- Long-term focus could be on bringing the system(s) together from various segments to which all lenders could have access and would utilize as a regular part of their credit marketing and credit risk evaluation process.

**Institutional Support and Risk Management Capacity**

**CBU should devise guidelines for banks and other lenders to develop internal credit scoring systems.** Banks are beginning to diversify their loan portfolios and move away from GoU guarantees on loans, triggering the need for new approaches to credit and market risk management. Credit scoring systems will need to be developed for both borrower and project/transaction risk based on a series of variables (e.g., macroeconomic, sectoral, financial, operational, managerial) and stratification models so that banks can determine (1) whether they want to extend the credit, (2) how to structure the credit, and (3) how to price the credit relative to risk. These will all be important building blocks for portfolio management models as well as for regulatory reporting requirements over time.

- Short-term focus could be on CBU consideration of guidance for banks and other lenders to structure credit scoring systems, adapt banks’ MIS accordingly, and incorporate aggregated data into regular monthly or quarterly reports on credit quality.

- Medium-term focus could be on refinement of such measures, as well as closer linkage of banks’ and other lenders’ data to CBU financial stability assessments and stress testing.
Long-term focus could be on the expansion of such models for use in development of an asset securitization market, namely the incorporation of standards and performance measures as a basis for rating and pricing such packages in the secondary market. This could build on the existing UBA rating system or be entirely new based on tested international models in the credit rating business applied to securities.

GoU should seek to work with the Microfinance Association to build a standards-based organization for a broadly self-regulatory microfinance market. Typically, associations can help to monitor compliance with professional and regulatory standards, compile useful industry information, serve as a clearinghouse for commentary on the existing legal and regulatory framework, and provide training and technical assistance to help MFOs with compliance requirements with the regulatory framework. These could be considered among the core functions of the Association in support of GoU efforts to increase access to finance as a part of the larger effort to reduce poverty. Moreover, as noted above, in the absence of the right to mobilize deposits, MFOs pose no risk to financial stability. CBU requirements for management should not be rules-based, particularly as MFOs are very small scale and can often be run on the basis of common sense cash management practices. Rather, the use of the Association to set standards and to monitor for implementation, as is currently done by the Association of Credit Unions, should be considered as a model to pursue at the micro-credit level. Likewise, the use of “approved” NGOs/MFOs with international experience and favorable reputations for performance can serve as a basis for personnel development and training, much as WOCCU has done for the credit unions. While MFOs will need to adapt to the evolving CBU framework for re-registered MFOs, CBU (and GoU) should consider adopting a framework that is more consistent with international standards and practice. These approaches tend to maintain a “light” approach to regulation, particularly when these entities pose no systemic threat to underlying financial stability. They also relieve the regulatory authority (i.e., CBU) of the burden of oversight and inspections that are more efficiently focused on institutions that pose the greatest potential risk to financial stability (e.g., banks).

Immediate focus could be on GoU coordination with the currently unregistered Microfinance Association to develop a framework based on best practice. The Association has access to regional (i.e., CAMFA) and international resources (e.g., CGAP) to present a framework to GoU consistent with GoU’s larger objectives for poverty reduction and microfinance development.

Short-term focus could be on development of the framework for partnership of the GoU with the Microfinance Association modeled on achievements to date by the Association of Credit Unions. This framework could be based on a consultative process similar to that adopted with the credit unions, working with the Microfinance Association to build consensus on a mutually acceptable framework. In this regard, GoU should agree to register the Association under conditions similarly applied to the Association of Credit Unions.
• Medium-term focus could be on ongoing development of a consultative process by which the Association works with GoU and CBU to (1) ensure compliance with basic regulatory standards (e.g., credit quality, consumer protection), (2) compile useful industry information, (3) serve as a clearinghouse for commentary on the existing legal and regulatory framework, and (4) provide training and technical assistance to help MFOs with compliance requirements with the regulatory framework. This can also involve regular monthly or quarterly reporting to provide updates on progress, as well as to identify needs.

• Long-term focus could be on gradual transformation of MFOs into licensed intermediaries able to mobilize deposits and provide fundamental savings products that may not be offered by banks or credit unions. In this regard, the efforts of the Microfinance Association would need to be regularly adjusted to reflect developments and needs in the microfinance industry and, more broadly, the financial sector.

**Funding**

Rather than direct ownership in and support for Microcredit Bank, GoU could consider establishing a refinancing facility under market conditions for microcredit. This could involve loans to participating banks that could then provide wholesale lending and liquidity facilities to approved MFOs. Likewise, based on credit scoring models and asset securitization rating systems (discussed above), participating banks could also serve as purchasers of MFO loan packages as a basis for offering ongoing funding in the micro-credit market. Over time, maturities could expand to help meet some of the financing needs of households and individuals that exceed one year. Likewise, such a facility would serve as a catalyst for systematic credit performance information, helping to build credit histories for individuals and micro-enterprises that can later be used for larger loan requests from banks and other lenders. The refinancing facility could be at market rates or CBU refinancing rates, which would still provide significant room for MFOs to lend at profitable rates. Over time as MFOs themselves develop creditworthiness ratings, banks can determine if lower rates are warranted relative to costs of processing and risks incurred. Irrespective of how the refinancing facility is structured or evolves, it should be market-based, commercially managed, and compliant with strict creditworthiness criteria to be sustainable. The objective would be to provide the banks, credit unions and other lenders (e.g., MFOs, leasing companies) with liquidity facilities and, eventually, term facilities in the absence of a transparent and liquid securities market.

• Short-term focus could be on development of a structure and business plan, as well as eligibility criteria for participation at the “wholesale” and “retail” levels. This could be tested via a pilot phase, from (1) disbursement of funding to at least two wholesalers to (2) disbursement to MFOs and other lenders to (3) the individual micro-credit loan origination, disbursement and collection process to (4) recycling of funds for continued lending, along with all associated reporting requirements.
• Medium-term focus could be on actual funding to other participating wholesale banks, as well as directly to credit unions and certain MFOs if they meet eligibility criteria. Initial design of asset securitization packages and ratings criteria could occur at this juncture.

• Long-term focus could be on complete self-sustainability and growth based on commercial terms, relying on the secondary market for investment and funding.
Annex 1. Microfinance in Uzbekistan Compared with Indicators from Eastern Europe and Central Asia

A. General Background

General indicators for microfinance institutions (MFIs) in Eastern Europe and Central Asia (EECA) show comparatively low coverage and savings mobilization, but comparatively large loans on average by global micro-credit standards. In Central Asia, the number of active borrowers in Central Asia is lower than EECA norms (coverage), savings data are scarce, and average loans are well below the average for the EECA region.

EECA MFOs are among the youngest in the world. On average, MFIs have existed for about six years, similar to the Middle East-North Africa region, but considerably less than MFIs in Africa, Asia and Latin America where some have been operating for more than three decades. Many are less than six years old, and the origins of the oldest MFOs in EECA date back to 1992, as opposed to the 1970s-1980s in other continents. In Central Asia, MFIs are only about 4.5 years old on average.

Competition and general financial deepening affect the performance of MFIs. Uzbekistan was cited as having the highest interest rates in the region, at about 80 percent in 2005. While these have come down in 2006, they remain among the highest in the region. Where financial systems show higher levels of penetration and intermediation, MFOs tend to have lower interest rates, lower profit margins, and higher delinquencies. This suggests that intensified competition represents a key challenge to MFOs, and that many of the “objectionable” aspects to their lending programs in nascent markets (e.g., high interest rates charged in markets where financial sector deepening is limited) are best overcome by open and competitive markets without discriminating against MFOs or imposing price controls.

By extension, because financial systems are generally weaker in Central Asia (apart from Kazakhstan) and the Caucasus, microfinance institutions are among the most profitable in the EECA region. Central Asian microfinance institutions (including banks, credit unions, MFOs and others) showed return measures against assets and equity that were higher than the EECA average. Likewise, Central Asian institutions showed slightly higher self-sufficiency measures than the norm for the region.

50 For source data, see www.mixmarket.org.
51 MFIs include banks, non-bank financial institutions, credit unions, and non-governmental organizations (NGOs) linked to microfinance organizations (MFOs).
52 Microfinance Organizations tend to be supported by Non-Governmental Organizations in supplying micro-credit. MFOs are a subset of MFIs.
53 Common indicators include assets-to-GDP or loans-to-GDP for penetration ratios, and broad money-to-GDP and the percentage of broad money in or outside the banking system as proxies for intermediation.
MFOs are increasingly moving to international standards of reporting and disclosure. This is partly driven by the requirements of those funding the MFOs or their NGO partners.

A large proportion of borrowers are women. This partly reflects difficulties women have had in accessing credit from banks and other financial institutions that are less focused on the micro-credit market.

About half of the banks involved in micro-credit have average loan balances below 250 percent of GNI per capita. This is observed as one of the quantitative thresholds between micro-credit and SME loans. This would be equivalent to $1,275 in Uzbekistan as of 2006, which was nearly nine times the average loan size of MFOs and slightly higher than the average loan size of the credit unions in mid- to late 2006. Uzbekistan’s Government micro-credit programs tend to use a multiple of the monthly minimum wage as a basis for classifying micro-credits. The smallest tends to be 150 times the minimum wage, which approximates $1,139 at mid-November 2006 exchange rates and varies slightly from the 250 percent of GNI measure more broadly utilized by MFOs.

B. Financial Profile

The microfinance market includes banks, non-bank financial institutions, MFOs/NGOs, and credit unions. Based on one sample of 108 microfinance institutions in EECA, gross loans were $2.8 billion at year-end 2005. The combined organizations had 1.26 million loans outstanding for an average outstanding loan of $2,237. These are broken out as follows:

- **Banks**: Twenty banks accounted for $2.2 million in gross loans for an average loan of $3,213. Thus, banks accounted for more than half of loans made, with their loans about 44 percent larger than the average.

- **Non-bank Financial Institutions (NBFIs)**: Forty-five NBFIs accounted for $0.424 million in gross loans for an average loan of $1,116. Thus, NBFIs accounted for about 30 percent of loans made, with their loans about half the average size.

- **MFOs (with NGO Links)**: Thirty-one MFOs accounted for $0.123 million in gross loans for an average loan of $759. Thus, MFOs accounted for about 13 percent of loans made, with their loans about one-third the average size.

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55 GNI per capita is reported to be $510. (See Doing Business 2007, World Bank.)
57 NBFIs = Non-Bank Financial Institutions that are separate from banks, credit unions and MFOs, but include institutions focused on micro-leasing, micro-savings and other specialized activities (often overlapping with micro-credit, such as group lending for farmers). However, because they do not currently play a material role in microfinance in Uzbekistan, this category is restricted to the regional and global data used in Annex 1 to help provide information for comparative purposes. There are no references to micro-NBFIs active in Uzbekistan in the main text of the Policy Note.
• **Credit Unions**: Twelve credit unions accounted for $0.043 million in gross loans for an average loan of $1,868. Thus, credit unions accounted for only 2 percent of loans made, but their loans were larger than the other non-bank groups at about 84 percent of the average.

By comparison with these figures, credit unions in Uzbekistan offer smaller loans to their members when compared with regional figures for credit unions. Data from October 31, 2006, show credit union loans in Uzbekistan averaged $1,213, about two-thirds the regional norm. However, this average is growing. At year-end 2004, the average loan made by credit unions was $1,092-equivalent.

MFOs make loans that are less than 20 percent of the average MFO loan in the region. Average loan size in mid-2006 approximated $145. Loans in 2006 have been slightly higher than $127 in third quarter 2004.

As there are not adequate data on the banks for comparison (and no Uzbek banks were included in this regional sample), a comparison cannot be made between the micro-credit made by Uzbek banks and those of their peers in the region. However, the broad figures from the sample indicate that banks dominate micro-credit throughout the region, making larger loans and more of them than the various non-bank credit organizations. Estimates of banks’ micro-credits in Uzbekistan suggest they account for more than 90 percent of total micro-loans, and these are likely far larger on average than those originated by credit unions and MFOs.

In terms of cost structures, NGO-supported MFOs have the highest relative costs, while banks have the highest aggregate costs. In the case of the former, MFOs’ costs account for 23 percent of their total budgets, about half of this related to personnel costs. Banks had the lowest relative operating costs (9 percent of total assets). However, their costs per loan generally exceeded $1,000, which were higher than the other MFIs. Banks offset these costs by making larger loans, while personnel costs are high in Central Asia because of the premium paid for skilled personnel. (This may be a factor in the larger banking system as well, as Uzbekistan’s banking system shows comparatively high operating and personnel costs.)

Notwithstanding cost issues mentioned above, MFOs providing the smallest loans also reached more clients, of whom most tend to be lower income. Moreover, the higher productivity measures (e.g., clients per staff member) reflect capacity at these MFOs to reduce costs by using group lending strategies, a form of economies of scale for MFOs.

To the extent that MFOs are used to extending micro-credit in rural areas, there is likely to be a higher per unit cost structure. This is because rural residents are harder to reach than low income populations in urban areas. This is a relevant consideration for Uzbekistan, particularly in light of dislocation in rural areas resulting from the transformation of the state farm system. Other research has shown that micro-credit
organizations have been less effective in lending for primary production in the agricultural sector than they have been in lending for small-scale food processing and urban-based services (e.g., catering, trade). 58

C. Regional Data for EECA

The following table highlights norms in EECA and provides specific references to Central Asian figures and figures for Uzbekistan as available.

Table 5: Comparative Financial and Operational Indicators

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</tr>
<tr>
<td>GNI per capita</td>
<td>$1,304</td>
<td>$400</td>
<td>$510</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M3/GDP</td>
<td>28.5%</td>
<td>12.0%</td>
<td>16.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Borrowers per Staff Member</td>
<td>80</td>
<td>66</td>
<td>n/a</td>
<td>39</td>
<td>n/a</td>
</tr>
<tr>
<td>Loans per Staff Member</td>
<td>80</td>
<td>67</td>
<td>n/a</td>
<td>40</td>
<td>n/a</td>
</tr>
<tr>
<td>Borrowers per Loan Officer</td>
<td>157</td>
<td>168</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Loans per Loan Officer</td>
<td>165</td>
<td>169</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>FINANCIAL RATIOS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital/Asset Ratio</td>
<td>37.3%</td>
<td>46.7%</td>
<td>14.1%</td>
<td>20.3%</td>
<td>n/a</td>
</tr>
<tr>
<td>Debt/Equity Ratio</td>
<td>1.7</td>
<td>1.3</td>
<td>4.7</td>
<td>3.9</td>
<td>n/a</td>
</tr>
<tr>
<td>Gross Loans/Total Assets</td>
<td>82.6%</td>
<td>82.8%</td>
<td>69.8%</td>
<td>85.6%</td>
<td>n/a</td>
</tr>
<tr>
<td>Average Loan Size/Borrower</td>
<td>$1,141</td>
<td>$335</td>
<td>n/a</td>
<td>$1,231</td>
<td>$145</td>
</tr>
<tr>
<td>Average Loan/Borrower Income</td>
<td>73.1%</td>
<td>73.0%</td>
<td>n/a</td>
<td>237.8%</td>
<td>28.4%</td>
</tr>
<tr>
<td>Return on (average) Assets</td>
<td>1.4%</td>
<td>1.6%</td>
<td>1.6%</td>
<td>7.4%</td>
<td>n/a</td>
</tr>
<tr>
<td>Return on (average) Equity</td>
<td>5.1%</td>
<td>6.3%</td>
<td>8.3%</td>
<td>33.8%</td>
<td>n/a</td>
</tr>
<tr>
<td>Operational Self-Sufficiency</td>
<td>123.3%</td>
<td>135.9%</td>
<td>n/a</td>
<td>118.0%</td>
<td>n/a</td>
</tr>
<tr>
<td>Nominal Yield on Gross Portfolio</td>
<td>30.5%</td>
<td>45.3%</td>
<td>n/a</td>
<td>46.7%</td>
<td>n/a</td>
</tr>
<tr>
<td>Real Yield on Gross Portfolio (1)</td>
<td>23.2%</td>
<td>34.6%</td>
<td>n/a</td>
<td>37.9%</td>
<td>n/a</td>
</tr>
<tr>
<td>Real Yield on Gross Portfolio (2)</td>
<td>23.2%</td>
<td>34.6%</td>
<td>n/a</td>
<td>21.2%</td>
<td>n/a</td>
</tr>
<tr>
<td>Portfolio at Risk &gt; 30 Days</td>
<td>0.9%</td>
<td>0.7%</td>
<td>7.3%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Portfolio at Risk &gt; 90 Days</td>
<td>0.4%</td>
<td>0.3%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Non-earning Liquid Assets/Total Assets</td>
<td>5.0%</td>
<td>7.8%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Notes: Debt-Equity for Uzbek banks and credit unions is total liabilities to capital; Loan Size per Borrower is

58 See “Microfinance development in Uzbekistan”, CER, UNDP and Agfund, 2005.
slightly higher than average loan size as some borrowers have >1 loan; Average Loan/Borrower Income uses GNI per capita as the denominator; RoAA and RoAE figures annualized for 2006 for credit unions, September 2006 for banks

Sources: CBU data from IMF, Association of Credit Unions, Microfinance Association, State Statistics Committee data, www.mixmarket.org, authors’ calculations
## Annex 2. List of credits granted by banks at preferential rate of interest

<table>
<thead>
<tr>
<th>Designated purpose</th>
<th>Rate of interest</th>
<th>Loan amount</th>
<th>Term</th>
<th>Source of financial resources</th>
<th>Tax benefits provided to banks</th>
<th>Relevant statutory act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Microcredit lending: 1) Start-up capital for private entrepreneurs without forming a legal entity 2) Start-up capital for microfirms and dehkan farms (with the status of the legal entity) 3) Start-up capital for farming enterprises (with the status of the legal entity)</td>
<td>5% per annum</td>
<td>Up to 50 MMW</td>
<td>1.5 year</td>
<td>«Microcreditbank»</td>
<td>«Microcreditbank» is exempt from the following taxes till January 1, 2011: - income (profits) taxes; - assets tax; - customs payments (with the exception of customs clearance fees) for imported bank equipment and technologies; - value-added tax in case of foreclosure sale.</td>
<td>Decree of the President No UP-3750 «On establishment of the joint-stock commercial bank «Microcreditbank», of May 5, 2006</td>
</tr>
<tr>
<td></td>
<td>5% per annum</td>
<td>Up to 100 MMW</td>
<td>1.5 year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5% per annum</td>
<td>Up to 200 MMW</td>
<td>1.5 year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Micro-leasing</td>
<td>50% of the refinancing rate</td>
<td>Up to 2000 MMW</td>
<td>Up to 3 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expansion of activities and replenishment of working assets of small enterprises</td>
<td>No higher than the rate of refinancing</td>
<td>Up to 500 MMW</td>
<td>2 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Microcredit lending to low-income families for development of cattle-farming on personal subsidiary plots or dehkan farms (for individual persons with or without forming a legal entity).</td>
<td>2-5%</td>
<td>Up to $10000 US dollars</td>
<td>Up to 3 years</td>
<td>State Fund for promotion of employment under the Ministry of labour and social protection</td>
<td>-</td>
<td>Regulations on the procedure for granting preferential targeted microcredits by banks to personal subsidiary homesteads and dehkan farms with the object of cattle-farming development, out of the proceeds of the Fund for promotion of employment, of May 2, 2006, No 1567.</td>
</tr>
<tr>
<td>Long-term mortgage lending to individual borrowers, especially in small towns and rural areas</td>
<td>No higher than 5%</td>
<td>Up to 2500 - and 3000 –times over MMW и 75% of</td>
<td>No less than 15 years with a three</td>
<td>Fund for support to mortgage lending</td>
<td>Incomes of commercial banks from mortgage foreclosure sales and mortgage loans, are exempt</td>
<td>Resolution of the President, of 16.02.2005, No PP-10, and the Law</td>
</tr>
<tr>
<td>Organization, development and expansion of business activities, connected with output of products, including construction, technical re-equipment and renovation of production buildings, procurement of machinery, equipment, auxiliaries, implements, purchasing raw materials and supplies. Loans for: - replenishment of working assets, necessary for purchasing raw materials and supplies, semi-finished products and other production stock to small and medium enterprises; - replenishment of working assets for organization of agricultural production, given to farming enterprises, as well as dehkan farms with formation of legal entity; - Investment projects crediting for all small and medium enterprises, including farming enterprises and dehkan farms with formation of legal entity</td>
<td>50% of the refinancing rate</td>
<td>year grace period</td>
<td>Preferential crediting fund for manufacturing microfirms, small enterprises, dehkan farms and farming enterprises at commercial banks</td>
<td>Incomes of commercial banks transferred for increase of resources of the Preferential crediting fund, and received out of the proceeds of the Fund’s credit, are exempt from income (profits) tax for the period of 5 years.</td>
<td>Resolution of the Cabinet of Ministers of 19.05.2000 No 195 «On additional measures for stimulation of participation of commercial banks in the development of small business”. Regulations “On the procedure for credit lending by commercial banks to small and medium enterprises, dehkan farms and farming enterprises out of the proceeds of the special Fund for preferential credit lending”.</td>
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<td></td>
</tr>
<tr>
<td>Credit lending up to 50% of the production costs of agricultural enterprises, producing raw cotton and grain</td>
<td>3%</td>
<td>Amount of the loan is determined depending on the current purchasing prices</td>
<td>Financing of raw cotton production - 1.5 years Financing of grain</td>
<td>Settlement fund for payments for agricultural products, procured for state needs</td>
<td>none</td>
<td>Regulations on the procedure for crediting production costs of agricultural enterprises, producing raw cotton and grain, which are procured</td>
</tr>
<tr>
<td>Description</td>
<td>Credit lending for raw cotton production:</td>
<td>Credit lending for grain production:</td>
<td>Notes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------------------------------------------------------------</td>
<td>-------------------------------------------</td>
<td>-------------------------------------</td>
<td>----------------------------------------------------------------------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Formation of initial start-up capital</td>
<td>Up to January 1, at the rate of 5% of costs;</td>
<td>Up to January 1, at the rate of 20% of costs;</td>
<td>Up to 1 year.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Up to April 1, at the rate of 20% of costs;</td>
<td>Up to April 1, at the rate of 30% of costs;</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Up to July 1, at the rate of 35% of costs;</td>
<td>Up to June 1, at the rate of 50% of costs;</td>
<td></td>
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<td></td>
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</tr>
<tr>
<td></td>
<td>Up to September 1, at the rate of 50% of costs.</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Development and enlargement of dehkan farms and farming enterprises,</td>
<td>Up to 150 MMW</td>
<td>Up to 150 MMW</td>
<td>Up to 3 years.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>procurement of agricultural machinery, construction of farm buildings</td>
<td>Up to $10000 US dollars</td>
<td>Up to 3 years</td>
<td>Dehkan and farm enterprises support fund under the Association of dehkan and farm enterprises (extra</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>There are no specific tax privileges to banks for granting credits out of the proceeds of extra-budetary funds. The bank is only entitled to a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Regulations on the procedure for credit lending to individual entrepreneurs and small enterprises by commercial banks out of the proceeds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production and processing of raw stuff and materials, development of local industry</td>
<td>40% of the refinancing rate</td>
<td>budgetary fund</td>
<td>margin in the amount of 50% of preferential rate of interest. At the same time, the bank has to pay an interest in the amount of the rate of refinancing for the undisbursed part of the credit line. Interest on proceeds of the extra-budgetary fund is charged and paid by the bank regardless of the actual receipt of interest by the bank from borrowers.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Procurement of terminals for payments by plastic cards by organizations of retail trade and services.</td>
<td>50 % of the refinancing rate</td>
<td>In the amount of the terminal cost</td>
<td>Not available</td>
<td>Commercial banks</td>
<td>Banks and the Unified republican processing centre since January 1, 2005 are exempt from assets tax regarding automatic teller machines, data terminal equipment, connection and other equipment, as well as software, used for payments by plastic cards, for the period of 3 years; up to January 1 2007, they are exempt from customs payments (with the exception of customs clearance fees) for import of plastic cards, consumables, graphic and electronic</td>
<td>Resolution of the Cabinet of Ministers of 24.09.2004, № 445 &quot;On measures for further development of the system of settlements on the basis of plastic cards&quot;</td>
</tr>
<tr>
<td><strong>Leasing of modern agricultural machinery, manufactured by the enterprises of the holding company “Uzselkhozmash-holding) and supplied to machinery and truck fleets, shirkats and farms.</strong></td>
<td>50 % of the refinancing rate</td>
<td>500 000-130 000 000 soums.</td>
<td>From 2 to 7 years</td>
<td>Uzselkhozmasheleasing and the State Fund for promotion of equipment of rural areas with agricultural machinery</td>
<td>“Uzselkhozmasheleasing&quot; company is exempt from payment of state and local taxes, with the targeted allocation of the released funds for replenishment of sources of financing the supply of agricultural machinery to rural areas for the period of five years.</td>
<td>Resolution of the Cabinet of Ministers of 2.11.2000, № 424</td>
</tr>
<tr>
<td>---</td>
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<td>---</td>
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<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>Credit lending to firms of building contractors for “turnkey&quot; project construction</strong></td>
<td>2%</td>
<td>Up to 25% of the project cost, determined as a result of bidding</td>
<td>For the period of “turnkey” project construction + additional period of 1 month</td>
<td>Remaining part of budgetary funds from centralized sources within the limits of capital investment financing in accordance with the approved investment program</td>
<td>The amount of the accrued interest on the specified credits is not included into the taxable basis of a commercial bank at calculation of the income (profits) tax until the final payment is made by the building owner to the firm of building contractors</td>
<td>Regulations on the procedure for credit lending to firms of building contractors for “turnkey” project construction out of the proceeds of centralized sources of financing, of May 4, 2004, № 30, 253-B. 60, 6</td>
</tr>
</tbody>
</table>
Notes to the Table:

1. **Small business enterprises in the Republic of Uzbekistan**

Small business enterprises are as follows:
- individual entrepreneurs;
- microfirms with annual average number of workers, employed in manufacturing industries, - no more than 20 people, in service and other non-manufacturing industries - no more than 10 people, in wholesale and retail trade, and public catering - no more than 5 people;
- small enterprises with annual average number of workers, employed in the following industries:
  - light and food industries, metal working and instrument-making industry, woodworking, furniture making and building materials industry - no more than 100 people;
  - engineering industry, metal manufacture, fuel-energy and chemical industry, production and processing of agricultural products, construction and other industrial-manufacturing spheres - no more than 50 people;
  - science, applied science, transport, communication, services (except insurance companies), trade and public catering and other non-manufacturing industries - no more than 25 people.

2. **Dehkan (peasant) farm** - family small-scale farm, producing and selling agricultural products, based on personal labour of family members on a plot of land attached to a house, functioning both with and without forming legal entity.

3. **Credit lines of extra-budgetary funds** - resources allocated by extra-budgetary funds to a commercial bank for credit lending to small enterprises only for designated purposes, with reflecting these amounts in the bank statements of these banks.
### Annex 3. Ranking of Uzbek Banks on Profitability of Assets and Equity
(9-Month Results of 2006)

<table>
<thead>
<tr>
<th>Banks</th>
<th>ROA</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banks with Foreign Capital (total 5)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UzKDB Bank</td>
<td>4.1 percent</td>
<td>17.6 percent</td>
</tr>
<tr>
<td>UT-Bank</td>
<td>3.6 percent</td>
<td>17.6 percent</td>
</tr>
<tr>
<td><strong>On average</strong></td>
<td>≥ typical international rate</td>
<td>≥ typical international rate</td>
</tr>
<tr>
<td><strong>Private Banks (total 10)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Davr Bank</td>
<td>32.4 percent</td>
<td>64.8 percent</td>
</tr>
<tr>
<td>Samarkand Bank</td>
<td>19.5 percent</td>
<td>72.8 percent</td>
</tr>
<tr>
<td>Credit Standard</td>
<td>6.8 percent</td>
<td>46.7 percent</td>
</tr>
<tr>
<td>Alp Jamol Bank</td>
<td>4.3 percent</td>
<td>29.9 percent</td>
</tr>
<tr>
<td>Parvina Bank</td>
<td>2.9 percent</td>
<td>25.1 percent</td>
</tr>
<tr>
<td>Trust Bank</td>
<td>2.0 percent</td>
<td>23.0 percent</td>
</tr>
<tr>
<td><strong>On average</strong></td>
<td>≥ typical international rate</td>
<td>≥ typical international rate</td>
</tr>
<tr>
<td><strong>Joint Stock Banks (total 10)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hamkor Bank</td>
<td>7.8 percent</td>
<td>44.8 percent</td>
</tr>
<tr>
<td>Galla Bank</td>
<td>3.2 percent</td>
<td>14.7 percent</td>
</tr>
<tr>
<td>Aloka Bank</td>
<td>2.1 percent</td>
<td>12.8 percent</td>
</tr>
<tr>
<td>Ipak Yoli Bank</td>
<td>1.9 percent</td>
<td>22.3 percent</td>
</tr>
<tr>
<td>Uzpromstroybank</td>
<td>1.6 percent</td>
<td>19.6 percent</td>
</tr>
<tr>
<td>Pahta Bank</td>
<td>1.5 percent</td>
<td>24.5 percent</td>
</tr>
<tr>
<td>Turon Bank</td>
<td>1.4 percent</td>
<td>28.9 percent</td>
</tr>
<tr>
<td>Ipoteka Bank</td>
<td>1.2 percent</td>
<td>25.0 percent</td>
</tr>
<tr>
<td>Kapital Bank</td>
<td>2.1 percent</td>
<td>41.1 percent</td>
</tr>
<tr>
<td><strong>On average</strong></td>
<td>≤ typical international rate</td>
<td>≥ typical international rate</td>
</tr>
<tr>
<td><strong>Government Owned Banks (total 3)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Halk Bank</td>
<td>0.6 percent</td>
<td>7.0 percent</td>
</tr>
<tr>
<td>Asaka Bank</td>
<td>0.3 percent</td>
<td>1.5 percent</td>
</tr>
<tr>
<td>NBU</td>
<td>0.1 percent</td>
<td>0.7 percent</td>
</tr>
<tr>
<td><strong>On average</strong></td>
<td>≤ typical international rate</td>
<td>≤ typical international rate</td>
</tr>
</tbody>
</table>

**Source:** Banking Bulletin for 9 months of 2006, information of Avesta Group

**Note:** Yellow highlighted are the banks of which the indicator level is lower than that traditionally accepted in international practice (4 percent of ROA, 15 percent of ROE).