

# PROSPECTS OF MICROFINANCE DEVELOPMENT IN UZBEKISTAN: ISSUES AND SOLUTIONS

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## ABSTRACT

Rendering the microfinance services (in the form of microcredits, microloans, microleasing and others) to the poor households, micro- and small businesses is still an important tool to reduce poverty as well as create more income generation and employment opportunities in countries with the developing and/or transition economies as Uzbekistan. Due to efforts of the Uzbek Government and international donors for the last 15 years, the microfinance sector could become a separate financial segment and address above-mentioned needs in progressive manner. On the other hand, the sector has relatively small share in the composition of financial mediation and its further development requires also consideration of such socio-economic and administrative factors as urbanization process along with uneven development of microfinance sector, acceleration of workforce growth due to increasing youth, the need for government's transition away from costly poverty control methods, etc. Based on the sector development analysis by concurrent reviewing of these factors the paper reveals the lack of diversified sources of resources for microfinance institutions (MFIs), stiffness of regulatory framework, the need for improving the sector infrastructure in terms of covering credit risks, building up sector's capacity in covering operational risks. Beside quantitative indicators for prospective development of the sector the paper also discusses qualitative areas to be stressed on to fill the identified gaps.

## JEL CLASSIFICATION & KEYWORDS

■ G21 ■ I32 ■ I38 ■ Q14 ■ R51 ■ Microfinance ■ Development Analysis ■ Urbanization Process

## INTRODUCTION

Microfinance, which emerged as a mass movement for making loans to the poor households, has grown up strongly in the last 20 years. Currently microfinance is a universally recognized supplier of a wide range of financial services to the millions of people in the developing world. The Monterrey Consensus, adopted in 2002, underscores the key role of microfinance and micro-credits for the micro-businesses as well as small and medium businesses to enhance socioeconomic impact of the financial sector. According to UN estimates, about 10,000 MFOs are operating worldwide and further financial development, which remedies shortcomings of the credit market, allows the poorest people to receive loans and invest in human development, consequently expanding their economic opportunities (UN Secretary General, 2010)<sup>1</sup>.

Development of microfinance in Uzbekistan started with the actions of the government of Uzbekistan to facilitate development of small businesses and private entrepreneurs. These efforts were accompanied with support for the poor in the framework of microfinance programs supported by international donors through NGOs: United Nations

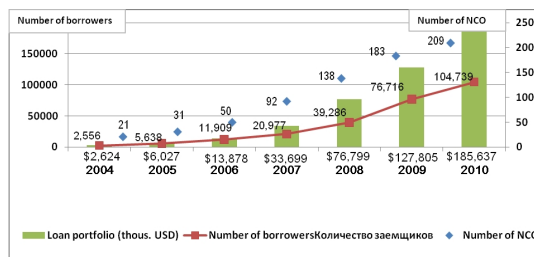
<sup>1</sup> For example, according to the several researches using Gini coefficient of the countries (Levine and Demiguc-Kunt, 2007) financial development resulted in that growth of income for 20% of the poorest people is more than other groups and more than increases caused by only the economic growth. To be more specifically, approximately 40% of the result is consequence of the decrease in the income inequality and the rest 60% is impact of financial development on the economic growth.

Development Programme (UNDP) initiated two pilot micro-crediting projects in Kashkadarya oblast and Karakalpakstan in 1998. Implementation of pilot projects laid the conceptual framework for development of microfinance sector in Uzbekistan by adoption of the Resolution 309 on Microfinance Development in Uzbekistan of the Cabinet of Ministers of Uzbekistan in August 2002. The Law on Credit Unions was adopted in the same year, whereas the Law on Microcredit Organizations and the Law on Microfinance were passed in autumn 2006. The sector started developing systemically after adoption of Microfinance Development Programme in Uzbekistan up to 2010. The goal of the Programme was implementation of actions to expand the coverage of broad population groups with microfinance services through economic and organizational incentives for growth and sustainable operation of the network of non-banking lending organizations in all regions of the country. By 2010 main projected indicators of the Programme were achieved. The Microfinance market became a separate segment of financial mediation with its own infrastructure, developed network of institutions, professional associations, regulatory framework, and most important, the sustainable client base.

## Current situation in the national microfinance sector

The Uzbekistan microfinance market is the smallest in the Central Asia in terms of both absolute numbers and penetration rate. As of 01.01.2011, 209 operating non-banking credit organizations (NBCOs) were registered at Central Bank of Uzbekistan, the market regulator: 116 credit unions (CUs), 25 microcredit organizations (MCOs) and 58 pawn shops. The capital of NBCOs totaled 98 billion soums (USD 59.7 million), assets – 350.6 billion soums (USD 213.8 million), (of which loans – 304.6 billion soums (USD 185.7 million), household deposits (at CUs) – 229.1 billion soums (USD 139.7 million), respectively.

Figure 1. Dynamics of loan portfolio against the numbers of borrowers and non-banking credit organizations



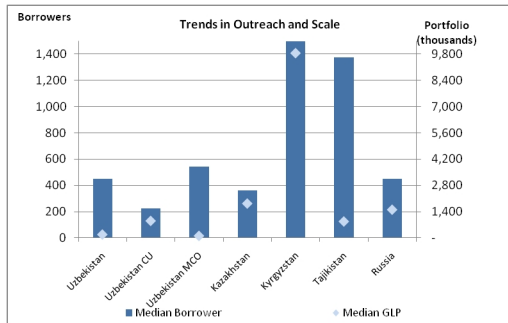
Source: Central Bank of Uzbekistan (2011)

Although Uzbekistan is characterized by proliferation of small institutions in the market as other countries of Central Asia the Uzbek MFIs represent the smallest institutions in the Central Asian region with median GLP (gross loan portfolio).(Figure 2)

On other hand, in terms median number of borrowers Uzbek MFIs represented on MIX are most similar to Kazakh and Russian MFIs (MIX, 2011). Mikrokreditbank, which offers microfinance services to the small businesses and private entrepreneurs, has a substantial market share. The bank offers subsidized microloans at 6 % annual percentage rate

(APR), offers microleasing services (5% APR), issues microloans to generate start-up capital of businesses (3% APR). As of 01.01.2011, the assets and loan portfolio of Mikrocreditbank totaled 419 billion soums (USD 255.5 million) and 320.7 billion soums (USD 195.5 million), respectively (of which microcredit portfolio – 160 billion soums) (USD 97.6 million), which is comparable to analogous indicators of all NBCOs. This enables to consider Mikrocreditbank as the main center of microfinance services for small businesses and private entrepreneurship.

Figure 2: Number of Borrowers and Gross Loan Portfolio for a median MFI in Central Asia and Russia



Source: MIX Market, 2009.

Demand for microfinance services is generated by a number of factors, which explain its growing significance in addressing vital socioeconomic development issues.

1. Microfinance is an *effective mechanism for small business development*, which is a main factor of economic growth. The small businesses accounted for 52.5% of GDP, and 74.3 percent of employment by the end of 2010. Small businesses generated 65% of all new jobs created in 2010. Microfinance has a special role in agriculture, where small businesses and private entrepreneurs produce 97.9% of all output.
2. Microfinance enables to *enhance living standards by increasing access to the borrowing opportunities*. Based on the World Bank data the percentage of poor households remains quite high (19.5% in 2009) despite substantial progress in this area (31.5% in 2000-2001). Access of poor households and micro-businesses to loans from traditional financial institutions – commercial banks is limited due to three reasons:
  - *Collateral requirements*. Average size of a bank loan amounted to 4.8 million soums in 2009 (circa USD 3300), although the household assets are quite substantial (circa USD 17,000). Average annual exchange rate in 2009 – USD 1 - 1454.5 soums, based on the data of Central Bank of the Republic of Uzbekistan. This enables to state that *high potential of collateral* for widescale lending operations of commercial banks is under-utilized. Based on findings of the Family Assets Mobilization Survey, disregarding the amount of savings, cost of household appliances and underestimated value of land plots, household assets (real estate, vehicle, equipment, cattle) totaled USD 17,000 per household (CER, 2009).
  - *Small (3.7%) share of microcredits in generating start-up capital* in the composition of commercial bank loans, although this credit line is essential to support civil entrepreneurial initiatives.
  - *Non-cash form of credit transactions*, which limit the access of broad groups of private entrepreneurs and households to bank microfinance. As opposed to them, NCOs offer microloans in cash, which *meets the*

*needs of private entrepreneurs and people with low incomes to the maximum extent.*

3. Microfinance *helps in the resolution of youth employment issues*. Based on State Statistics Committee of Uzbekistan as of 01.01.2010, children under 14 accounted for 30%, and persons under 19 – 41.4%. Individuals under 19 account for 41.4% in the demographic composition of population. Annually 600,000 people or 5.2% of workforce enter the labor market, aggravating the employment stress. Based on Information analytical review “Uzbekistan Economy”, 600,000 individuals graduated from vocational colleges, academic lyceums, and universities in the 1st half of 2010 (CER, 2010). Persons aged 18-30 make up 54.3% of all unemployed. The youth need small (accessible) loans, which would enable to start independent entrepreneurial work, home-based work, thereby, reducing the growth of youth unemployment. According to findings of the study Mobilization of Household Assets average size of a loan of NBCO was 0.867 million soums (USD 600) (CER, 2009).
4. *Microfinance may meet the demand for loans, which will grow in the cities because of stronger urbanization*. In recent years strengthening of urbanization processes are observed in Uzbekistan following the concurrent impact of two factors: rapid economic growth rates and completion of agricultural reforms. Ultimately, the urban population overtook the rural population for the first time in 2009, totaling 14.25 million (51.7% of total population)<sup>2</sup>. Reflection of fast-improving welfare, growing middle-class, and young urban population will be the rapid growth of *consumer lending*. This will increase demand for microcredit services: it is less costly to provide financial services to the people, when they live in densely population urban areas.
5. *Microfinance can become an effective tool for transition away from costly methods of poverty control*. High level of government financing for the social sector is a typical feature of development model of Uzbekistan. The spending for the programs focused on free access to the basic educational and health services as well as public welfare account for 60% in the composition of the state budget or 21-22% of GDP (considering the Pension Fund). In the long-run it will be harder for the government to support such a high level of financing for social sector. The need to search for other financial opportunities to improve public welfare will strengthen. Microfinance is an instrument, which facilitates transition from costly method of poverty control (benefits, subsidies) to the income-generation and access to financing programs *to promote self-employment and improve financial status of vulnerable groups of households*.
6. *Microfinance sector is more resilient to the implications of domestic and external macroeconomic shocks* due to the higher mobility of microfinance organizations compared to other financial institutions. Microfinance has won the fame of a countercyclical sector after the crises of the 1990s and the last global financial crisis of 2008-2010.

Summing up the outcomes of sector's development up to 2011, following conclusions may be made:

1. Microfinance sector has relatively small share in the composition of financial intermediation, but there is a

<sup>2</sup> According to the Resolution #68 on Additional Measures for Improvement of Administrative and Territorial System of Populated Areas of the Cabinet of Ministers issued on March 13, 2009, stock-taking was conducted at rural settlements with more than 2,000 residents and appropriate infrastructure. As a result, 965 villages with total of 4,434,300 residents obtained township status.

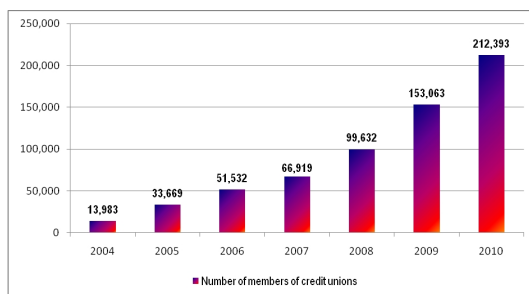
- stable trend of its increasing role, which indicates substantial potential for its further development.
2. A number of factors of country's socioeconomic development will generate high demand for microfinance services in the long-run.
  3. Microfinance institutions are more resilient to the negative implications of macroeconomic shocks. These very institutions become most on-demand in the rapidly growing economies with young population such as Uzbekistan.

However, on international level of financial sector development may be characterized or assessed with accessibility of the bank and microfinance services and according to the international methodology there are barriers, categorized into the physical access, affordability and eligibility barriers to deposit, loan, and payment services (Beck, T., Demirguc-Kunt, A. Martinez Peria, M., 2006).

That's why, while identifying and addressing the issues for the sector development it is more appropriate to consider also these barriers, which can be measured by number of physical locations to submit a loan applications and their proportional distribution, the minimum balances required for deposits, consumer and SME loans and at the fees for these loans, number of documents and days for processing a loan application. Considering above-mentioned the most important issues to be addressed in the upcoming years include:

1. *Uneven development of microfinance sector.* Most microfinance institutions are located in Tashkent city and Tashkent oblast, which hinders the prospects of utilizing the sector as an effective tool to reduce poverty, which is primarily concentrated in the rural areas. As of January 1, 2011, the number of clients of NBCOs totaled 246,400 or 0.9% of total population. Most people, particularly in the rural and remote areas *still do not have access* to microfinance services. The coverage rate of most active NBCOs – credit unions vis-a-vis the employed population is growing but it is still low. As of the end of 2009, it totaled 1.5%, up from 0.3% in 2005.

Figure 3: Dynamics of growth of the membership base of credit unions



Source: Central Bank of Uzbekistan, 2011

2. *Lack of diversified sources of resources for NBCOs.* In Uzbekistan only credit unions are authorized to accept deposits. But this resource is quite volatile and costly amid quite high interest rates, which evolved in the country (30-38% APR). Yet an integrated mechanism of raising and distributing microfinance grants and loans has not been created, although it was envisaged in the Microfinance Development Programme for up to 2010 using the resources of Mikrokreditbank of Uzbekistan. Thus, the national microfinance sector is still relatively isolated from global microfinance markets, which results in limited funding, stunts growth and drives interest rates high.

3. *Stiffer regulatory requirements.* Current situation in the microfinance sector can be, on one hand, described as prone to excessive regulation, whereas, on the other hand, sector is underdeveloped and fragmented. Although the NBCOs are in the early stage of development, are very small and do not pose threat for stability of financial sector, they must comply with the licensing and capital requirements, while opening of a branch and expansion of the service network are equal to opening a new NBCO because of stiff regulatory requirements. The largest MCO in Uzbekistan has asset size of approximately USD 500,000 (equivalent). The assets of most MCOs range between \$50,000 and \$250,000. By all standards, they must be regarded as weak financial institutions operating as a small business in the "sidelines" of the banking sector. The percentage of loans issued by MCOs account for 3% of total loan portfolio of the sector and this is low by international standards: microfinance penetration rates are usually not high and range from 2.5% to 5% in the region.
4. *Building up sector's capacity.* Operations of NBCOs, similar to other financial organizations, because of direct work of the staff with financial flows, are more prone to operational risks compared to entities in other sectors of economy. Thus, human resource policies of NBCOs must be focused not only on human resources management but also improvement of organizational structure, standardization of working processes, implementation of internal control mechanisms, and clear delegation of authority and responsibilities.
5. *Financial infrastructure is underdeveloped.* Microfinance sector in Uzbekistan is currently beyond the sight of credit ratings, although a group of quite large and sustainable CUs and MCOs has already emerged in the market. Currently, the process of development of legislation on the exchange of credit information, credit bureaus and mortgage register, with technical assistance of IFC. Furthermore, NBCOs are not connected to the credit information exchange system to effectively manage specific risks related to the special features of most clients of NBCOs – households and small businesses. Beside difficulties with availability of the credit histories of borrowers, most of their assets such as movable property (equipment, vehicles, etc.) are not regarded as possible collateral, which sharply reduces the accessibility of financing.

NBCOs could not use the chance to tap into the resources of the Employment Promotion Fund of the Ministry of Labor and Public Welfare. Legislation does not limit NBCO's access to the extra-budgetary funds. But if they utilize the resources of these funds, they must offer micro-credits at the rate 16-45% at most. Whereas, current interest rates in the sector are much higher. *Dilemma of current development* has emerged: NBCOs cannot reduce interest rates down to the level, which would enable them to obtain access to the resources of these funds. On other hand, low interest rates will not suffice to cover operational costs.

**Conclusion: Further targeting for development**

Improved accessibility<sup>3</sup> of financial services, regardless of type of financial institutions, is the main objective for development of financial mediation in Uzbekistan in the long-run. This envisages development of the strategy of improved accessibility of the microfinance services, creation

<sup>3</sup> For example, the accessibility of financial services – territorial and technological accessibility of five basic financial services: loans, savings, remittances (money transfer), insurance, and leasing.

of a diversified model of retail financial market, which reflects diversity of institutions and technologies of financial services. In the medium-run (2012-2015), this requires integration of microfinance institutions, which implies the need for: (a) substantial increase in the scale and outreach of microfinance services; (b) significant expansion of coverage of the households (particularly poor households) by microfinance services. Inequality in accessing financial services increases social inequality and all related public, economic, and political risks. Main recommendations for development of microfinance sector to successfully counter growing challenges of instability in the global markets as well as greater significance of the sector in addressing social challenges within the country requires not only quantitative (increasing the capital of MFIs, amount of deposits being raised, increased amount of micro-credits being issued and network of MFIs) but also qualitative indicators of microfinance development. These qualitative areas can include:

1. Facilitating welfare-oriented development of the sector. NBCO in Uzbekistan primarily work with their clients on commercial basis, i.e. offer services at market rates. There is a number of MCOs focused on providing access for unbanked and under banked population. However their market share is too small. Measures on reforming of microfinance sector should be an integral part of the Welfare Improvement Strategy being developed with technical assistance from the Asian Development Bank. Moreover, there is a need to improve legislation in the aim of stimulating the development of microfinance and social promotion of socially-oriented MCOs
2. Improvement of interest rate policy. Interest rate policy of NBCOs has numerous times caused a number of questions related to access to microfinance services for broad population groups. Certainly, the price of microfinance services, as indicated by international experience, should not be limited to the formula "cheap loans for the poor", which ultimately, may cause degradation of microfinance, which has developed and expanded due its rate of return.
3. Interest rate policy improvement measures will provide sector transparency and encouraging competition. The amendments to the legislation on effective interest rate disclosure of all financial institutions are expected.
4. Encouraging competition .Reform efforts should also focus on encouraging competition in the financial sector, thereby lowering the cost of financial intermediation and providing better services. In terms of development and efficiency, competition leads to lower margins and lower costs for financial intermediation—lower cost of capital for borrowers and higher rates of return on investment for lenders, spurring growth. A fundamental means by which to expand access is to promote increased competition in providing the full range of financial services. Competition not only benefits users by reducing the cost of financial services, but drives providers to seek new products, clients, and geographic markets, resulting in expanded access. Competition also creates incentives for innovation in production and distribution of financial services, which helps to both expand access and reduce costs.
5. Client protection and development financial literacy program. There is a need to adopt State Programme on improving financial literacy of population. Main target audience of the State Programme can be children and youth. According to the European experi-

ence the most successful programmes on financial literacy were those based on secondary and higher education. "Financial driver license" programme in Austria is a good example of it. Vulnerable population and population with low income will be another target audience. NGOs or Consumers Rights Protection Associations could be involved in financial literacy programmes. As an example the experience of "Stay positive programme" in Netherland can be referred.

6. Technological innovations. Encouraging technological innovations (ATM, mobile banking, credit scoring, POS terminals etc) in the microfinance sector in Uzbekistan could help improve operational efficiencies and expand outreach to remote areas far more rapidly.

In order to address the aforementioned issues, the President issued the Resolution on Priorities of Further Reforms and Enhanced Sustainability of Financial and Banking System in 2011-2015 on November 26, 2010. The Resolution approved the Activities, which envisaged achievement of target indicators of market development. It includes:

1. Improved financial sustainability of NBCOs through increasing their total assets in 2011-2015 on average by 2.1 times.
2. Twofold increase of deposits at NBCOs in 2011-2015.
3. 2.8-fold increase of issuance of micro-loans by banks and provision of microfinance services by NBCOs in 2011-2015 and doubling the amount of deposits.
4. Increase in the number of NBCOs by 1.7 times.

It is expected that implementation of these measure will lead to several effective results for Uzbekistan economy:

- improving accessibility to micro financial services within regional distributions and different client groups;
- development of small business microfinancing technologies;
- improving savings among population, creating opportunities for savings and investments;
- improving wellbeing of vulnerable population;
- improving financial literacy of population.

The overall direction is right, but deeper institution-building, especially in the judicial area, is still needed and will take much more time to facilitate easy access to financial services. The speedy and adequate implementation of Resolution is essential to enhance access to microfinance services. Ensuring sustainability and maintaining the course of the reform program, and promoting competition will be essential to reap the benefits in the form of an efficient financial system capable of providing better financial products and services at low costs, catering to all types of clients. Ultimately, a more developed and well-functioning financial system will enhance economic growth and development in Uzbekistan.

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