



**ENHANCEMENT OF LIVING STANDARDS
IN KARAKALPAKSTAN AND NAMANGAN REGION**

INITIATIVES ON MICROFINANCING



These projects
are funded by the European Union



These projects
are implemented by UNDP

Financed by the European Union (EU) and implemented by the United Nations Development Programme (UNDP), the projects Enhancement of Living Standards (ELS) in Karakalpakstan and Namangan offer concrete opportunities to local communities to play an active part in their own development and improve their lives.

This brochure provides an overview of the microfinance sector in Karakalpakstan and Namangan region and its role in improving people's living standards and supporting regional development.

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BENCHMARKING REVIEW OF MICROFINANCE IN KARAKALPAKSTAN AND NAMANGAN REGION

BACKGROUND

The Republic of Karakalpakstan is a sovereign state within the Republic of Uzbekistan. Its territory is 166,600 sq. km (37% of the total area of Uzbekistan) and its population is 1.6 million (approximately 5.6% of the total population), however, gross domestic product (GDP) is only 2.4% of the total GDP of Uzbekistan. The North of Karakalpakstan is populated mainly by Karakalpaks, whilst Uzbeks are more widespread in the South.

Karakalpakstan is situated in one of the most ecologically vulnerable regions in the world. Due to both natural and man-made factors, Karakalpakstan faces immense environmental challenges, including: degradation of water resources and related salinization of water and arable lands; desertification; and loss of ecosystem services and increased vulnerability to natural and man-made disasters. Issues pertaining to water are the most complex and have a negative impact on environment and socio-economic development.

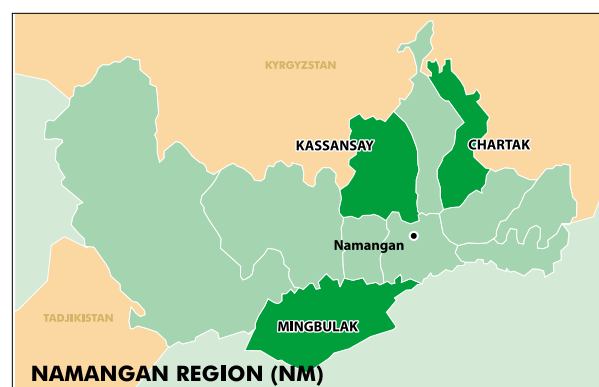
The impact of the Aral Sea disaster continues to be one of the major development challenges in Karakalpakstan, with environmental management and governance becoming key issues for the development of the region. In this regard, the government has recently prioritized agri-

cultural reform, in an effort to improve living standards and address existing environmental challenges, especially in rural areas.

There are serious health problems, including tuberculosis and cancerous illnesses; social problems; large-scale economic migration, both to urban areas and cross-border to neighbouring countries; and declining educational standards. For example, school attendance rates in the 8–14 age group show that Karakalpakstan has lower attendance rates for both boys and girls than Namangan region. The likelihood of being poor in Karakalpakstan is 32% greater than the national average, although not as high as in Namangan region, where this likelihood is 44% greater than the national average.

The region of Namangan is located in the East of the country, in the northern part of the Fergana Valley. Its territory is 7,420 sq. km with a population of approximately 383,000 people. Namangan city is the administrative centre, 432 km from Tashkent. There are 11 rural districts in the region.

According to the Living Standards Strategy of the Government of Uzbekistan, Namangan region ranks 9th out of 14 regions in terms of socio-economic development and has the highest percentage of unemployment in



Uzbekistan. Despite the existence of data and information recently collected and analyzed during the preparation of the Living Standards Strategy, the profile of poverty in Namangan and Karakalpakstan remains sketchy and under-researched.

In Namangan region, approximately 7.2% of the labour force is unemployed (compared to 6.6% in Karakalpakstan and 3.8% in Tashkent). Unemployment is 50% higher during the months of April, May and June, both in urban and rural areas, reflecting a high dependency of the regional economy on agriculture.

Conditions facing the mainly rural population of Namangan region and Karakalpakstan are difficult and the two regions have low levels of living standards, compared to other regions of Uzbekistan (e.g. Tashkent and Syrdarya). Within Karakalpakstan and Namangan region, there is a widening gap between urban and rural areas in terms of the availability of work places and access to education, healthcare and other social services. It is important to develop strategies that meet the needs of the regions and local communities based on reliable data and poverty mapping techniques. The limited confidence of local communities in their own capacities to influence their own development is an issue that deserves atten-

tion. Limited employment opportunities and income-generating possibilities, due to limited access to finance impinge on the lives of both rural and urban population and require the attention of policy makers and donors.

EU/UNDP PROJECTS ENHANCEMENT OF LIVING STANDARDS IN KARAKALPAKSTAN AND NAMANGAN REGION

In order to meet these challenges, the EU and the UNDP have joined hands with the Government of Uzbekistan and initiated the ELS projects in Karakalpakstan and Namangan region. These two projects are funded by the EU and implemented by the UNDP in Uzbekistan. They support and encourage 100 local communities in six districts of Karakalpakstan and Namangan region to play an active part in their own development. The duration of the projects is two years (2005–2006). The ELS projects in Karakalpakstan and Namangan region work together with communities and local authorities on the preparation of a regional development strategy and the rehabilitation of social infrastructures. They also facilitate access by poor and small farmers to microfinance.







MICROFINANCING IN UZBEKISTAN

Microfinancing activities began in 1997, when the Business Women Association (BWA) – Karakalpakstan branch launched their Small and Medium Enterprise Development and Microfinance projects in the region, with UNDP financial and technical support.

The typical Microfinance Organization (MFO) in Karakalpakstan and Namangan region has five years of operational experience, which is less than the six years average in Eastern Europe (EE) and Central Asia (CA) and than that of its global peers. Within the last three years, between 2003 and 2005, the sector evolved rapidly with the financial and technical support of UNDP, Asian Development Bank (ADB) and Central Asia Microfinance Alliance (CAMFA–USAID).

WHAT IS THE PURPOSE OF BENCHMARKING MICROFINANCE IN KARAKALPAKSTAN AND NAMANGAN REGION?

During June–September 2005, the ELS projects in Karakalpakstan and Namangan region conducted an assessment to test the possibility of local MFOs in respect to their:

- Technical assistance and training needs
- Suitability as partners in managing lines of credit
- Attractiveness as candidates for equity investment.

The exercise is the first benchmarking effort for the Karakalpakstan and Namangan region microfinance industry and one which fills an important, but still largely unexplored niche. It aims to:

- Determine the stage of evolution of MFOs and compare it with EE and CA European Microfinance Industries (MFI)
- Build the capacity of MFO professionals in calculating and interpreting relevant performance indicators for their microfinance institution
- Promote the achievements of the Uzbek MFI in the context of the International Year of Microcredit 2005 and related initiatives
- Support lobbying efforts among bankers, investors in the sector and policy makers for continued support of the Uzbek microfinance institutions.

METHODOLOGY OF BENCHMARKING AND ASSESSMENT

The starting point of the assessment is the “CAMELS” assessment framework developed by U.S. bank regulatory agencies. This framework provides for a comprehensive review of the six critical elements of performance and determinants of safety and soundness: capital, assets, management, earnings, liquidity and sensitivity, with two additional elements: risk management capabilities and social and environmental impact.

The MFOs included in the assessment were: the BWA, the NGO Parwaz and the NGO Davlet from Karakalpakstan and FV-Mard institution from Namangan region. The organizations were grouped into peer groups by size and type, allowing for comparisons among similar institutions in the eastern European and Central Asian Region (ECA).

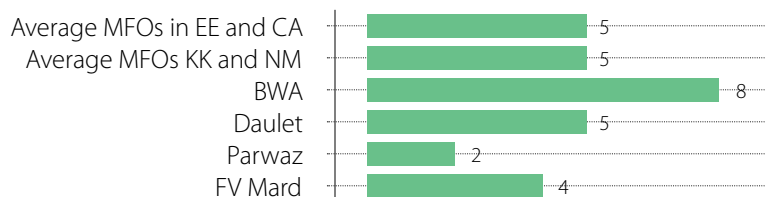
As Table 1 demonstrates, the industry consists primarily of small-sized organizations with a trend towards continued growth.

Table 1. Comparative characteristics of MFOs assessed by ELS

Peer group	Characteristics	Peer group member MFOs
All KK's MFOs		BWA, Parwaz, Davlet
Size Small MFO	Loan Portfolio < USD 2,000,000 Target: underserved low income population (active poor)	BWA, Parwaz, Davlet
Character	Non Governmental Organizations Business Association	Parwaz, Davlet. FV-Mard BWA

OUTREACH AND SCALE INDICATORS— INSTITUTIONAL CHARACTERISTICS

Graph 1. Age of MFIs, in Years



Graph 2. Total Average MFIs Assets, in USD



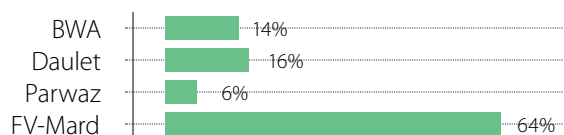
The difference in the average total assets administered by Karakalpakstan MFOs (USD 257,896) compared with those of the ECA average (USD 722,360), makes it important to focus on fund-raising. In addition to grants available from international donor organizations, market based funding is an option to be explored in the near future.

Table 2. Outreach Indicators of MFOs

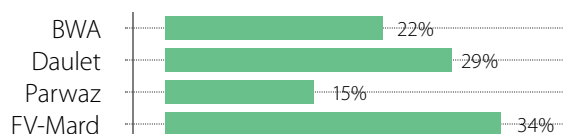
Name	Average MFOs in					
	EE&CA	KK&NM	BWA	Daulet	Parwaz	FV Mard
Women Loan Clients, in percent	76	81.5	97	100	73	56
Average Loan Balance, USD/UZS	167,176,700	106,112,000	85,205	74,377	50,244	240,000
GDP, UZS		142,000	150,600	150,600	150,600	150,600
Average Loan Balance as % of GDP	26	46	57	49	33	162
Maximum First Loan as % of GDP		96	27	38	40	280
Number of Active Borrowers	3,358	2,821	2,507	3,239	1,673	3,866
Total Loan Portfolio, USD	475,890	360,362	201,900	227,700	79,450	932,400

Scale and outreach indicators show that Karakalpakstan and Namangan region MFOs provided fewer loans than the average MFI in ECA, but served a larger portion of income clients (more than two times) than in ECA. FV-Mard, an ACIDI/VOCA funded USAID project has a loan portfolio twice that of the average MFI from the ECA region and finances larger scale investments in farming and small industry.

Graph 3. MFOs Total Loan Portfolio Distribution, in Percent



Graph 4. Active Clients of MFOs, in Percent



HASANUSAY TEKMEU
«WOOLSTREET»

KOSONSOY





FINANCIAL STRUCTURE — SOURCES OF FUNDS

MFOs finance their activities from a variety of funding sources. In the initial stage of their evolution, Karakalpakstan MFOs, like their peers from the ECA, heavily relied on donations and grants in order to finance growth.

None of the MFOs in Karakalpakstan received commercial funds. Karakalpakstan MFOs are registered as NGOs, a fact that often dissuades investors (banks and investment funds). FV-Mard, initially funded by USAID and implemented by ACDI/VOCA, is now registering as a local entity looking for alternative sources of funds.



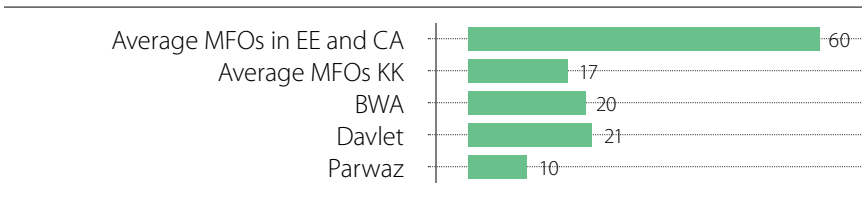
REVENUES

The ELS assessment did not consider MFOs’ earnings from sources other than their credit activities. However, Karakalpakstan and Namangan MFOs’ earning revenues are primarily from their loan portfolio, with one exception, the BWA in Karakalpakstan, which provides training and consultancy services to associated members.

EXPENSES

MFOs activities are generating a variety of expenses, from funding of their asset base, to operations of general expenses and provisions for potential losses from default. Expense indicators measure the importance of different expense categories and determine their impact on the profitability and sustainability of each activity. When making comparisons with the average MFOs in the ECA region, it should be borne in mind that for Karakalpakstan and Namangan MFOs, there is no cost of capital (interest expense) as all the initial funds of the industry were granted by donors without financial interest costs.

Graph 5. Cost per Borrower, in USD

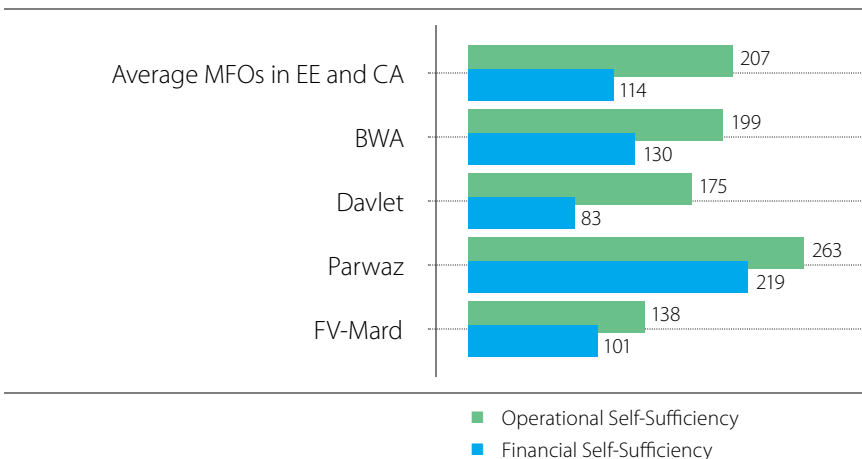


It can be concluded that Karakalpakstan and Namangan MFOs tend to perform better than their ECA peers when it comes to expense ratios. This is mainly due to the lending methodology as group lending lowers the credit risk. As a consequence, the provision for losses and write-offs is lower. Also, the absence of the cost of funds makes possible savings in the interest charges.

PROFITABILITY AND SUSTAINABILITY

All four MFOs reviewed are operationally self-sustainable. For MFO Parwaz in particular, to achieve the present level of self-sustainability during the first year of operation is a notable achievement. Parwaz’s performance and the overall performance of Karakalpakstan MFOs compare favorably to the ECA average, in terms of operational and financial self-sufficiency (See Graph 6 below). The indicators for Karakalpakstan MFOs show that in comparison to their ECA peers, Davlet and Parwaz should improve performance in order to achieve greater efficiency and productivity.

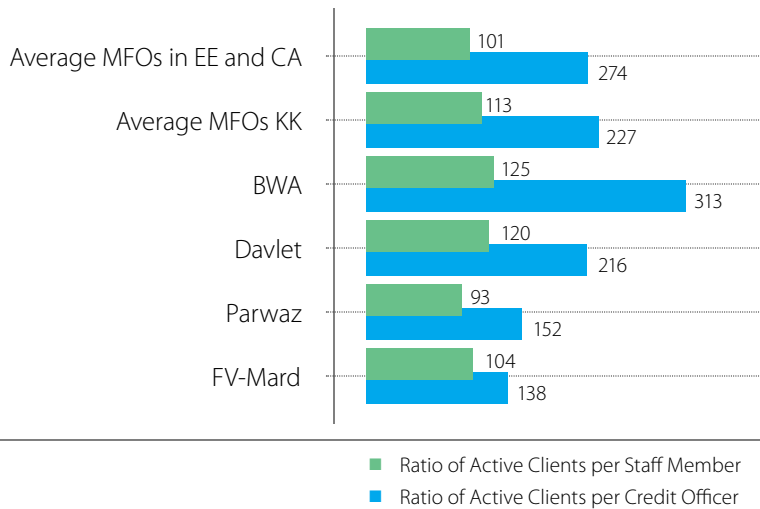
Graph 6. Self-Sufficiency Indicators of MFOs, in Percent





EFFICIENCY AND PRODUCTIVITY

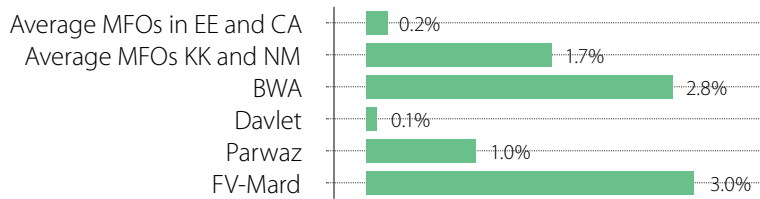
Graph 7. Efficiency and Productivity of MFOs



PORTFOLIO QUALITY

Portfolio quality indicators help to determine the MFOs future revenue as well as the institutions’ ability to increase their outreach and continue serving existing clients. In Karakalpakstan, at the time of the ELS benchmarking, the MFOs, with the exception of Davlet, did not have a proper management information system to record delinquency (when a loan is due, but not paid). The information systems were purchased with the support of the ELS projects in late 2005.

Graph 8. Loan Loss Ratio, in USD



The microfinance sector in Uzbekistan is currently focusing on improving portfolio quality and improving the retention rate of their clients in microfinance schemes. Increased competition on the market, the need to increase the portfolio and access to funds are becoming issues of concern which deserve increased consideration by MFOs and donors. Questionnaires to assess the reasons for leaving peer groups are presently used to develop measures for service improvement.

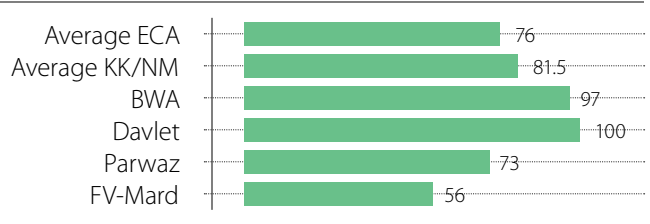




TARGET CLIENTS

The ELS component on income generation seeks to reach 100 communities located in six districts, three in Karakalpakstan and three in Namangan region. In addition to the current loans offered by the selected MFOs, the ELS project intends to launch new financial products that are secured with group guarantee to assist farmers and small entrepreneurs in animal husbandry and poultry and issue them with individually based loans.

Graph 9. Percent of Women Clients of MFOs



It is estimated that the ELS projects will reach approximately 4300 clients in Karakalpakstan and 1500 in Namangan region. Microfinance clients in Karakalpakstan are mainly women engaged in small trade activities, production, animal husbandry and services. The average percentage of women clients of MFOs in Karakalpakstan and Namangan region is 5.5% higher than in the ECA. Participation of women in economic activities financed through microfinance offers women-entrepreneurs a possibility to improve their socioeconomic status.





CONSTRAINTS AND OPPORTUNITIES IN IMPLEMENTING THE ELS INCOME GENERATION COMPONENT

CONSTRAINTS

As experienced by the ELS projects, banks do not make any difference between microcredits and grant funds. Thus microcredit funds are subjected to the provisions contained in the Government Decree № 56, which regulates the use of grant funds. According to the decree there are two banks designated to serve grant funds with a special commission composed by representatives of various ministries to ensure coordination, avoid duplication and prevent money laundering. Approval to use funds for microcredits has been taking longer than planned.

Problems related with cash withdrawal are also not infrequent since banks set limits for withdrawal for each organization and MFOs require 100% cash portfolio in order to implement microfinance activities.

According to recent surveys conducted by the ELS projects, the ability of the MFOs to reach low income population in Karakalpakstan and Namangan is still low. This finding is consistent with the overall capacity of all MFIs in the country which amount to 9.2% of the actual demand. Also, the average credit amount required for establishing and expanding business in Karakalpakstan and Namangan region is often higher than the maximum amount that can be provided both by non-banking MFIs and banks according to the law.

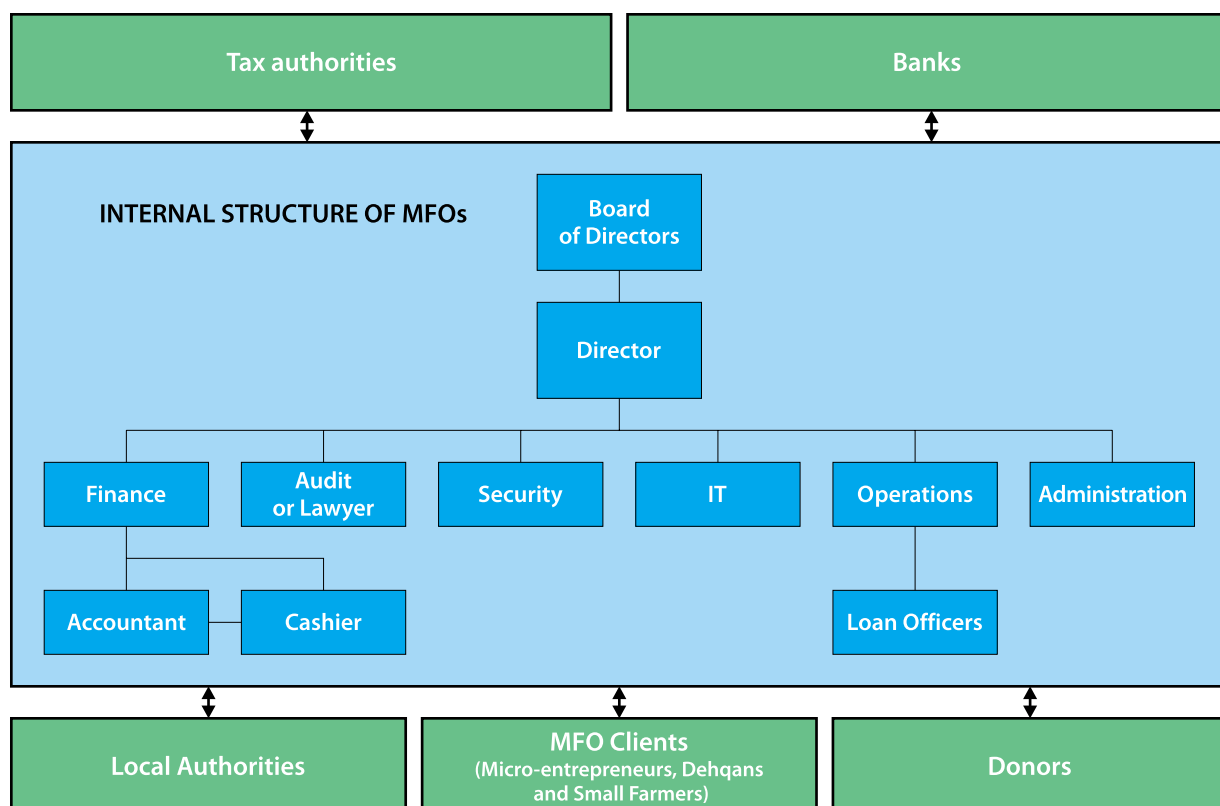
OPPORTUNITIES

Up to 2006, MFIs in Uzbekistan have enjoyed tax vacations as regulated by the Government Decree № 309.

There are significant opportunities for the microfinance sector of Uzbekistan. For example, the portfolio balance amounts to more than USD 4,700,000.00. In only one month (December 2005), the portfolio balance has grown to more than USD 132,000, reaching 35,000 clients in all regions of Uzbekistan.

MFOS IN KARAKALPAKSTAN AND NAMANGAN REGION

The NGO BWA in Karakalpakstan started its microfinance operations with the assistance of UNDP in 1998 for a microcredit project in Karakalpakstan. The goal of KK BWA is to improve the social well-being of the poor population, attract the poor into entrepreneurial activities and provide access to microfinance. In December 2005 BWA signed a contract with UNDP to implement the ELS income-generation component and received its first tranche of funds amounting to USD 56,272. Within the framework of the ELS project, BWA will work in Kegeily and Karauzyak districts. Currently BWA provides only one type of loan with general characteristics. The current loan portfolio of KK BWA amounts to USD 303,462.



The NGO Parwaz started its microfinance operations in 2004 with the assistance of the ADB project "Innovative poverty reduction in Karakalpakstan". In December 2005 Parwaz signed a contract with the ELS project and received the first tranche of funds amounting to USD 42,503. Within the framework of the ELS project, Parwaz will work in Karauzyak district. Currently, Parwaz provides only one type of loan with general characteristics. Its current portfolio amounts to USD 128,567.

The NGO Davlet started its microfinance operations in 2001 with the assistance of UNDP Sustainable Income Generation Programme in Karakalpakstan. Within the framework of the ELS project, Davlet will work in Kegeily and Shumanay districts. Currently Davlet provides only one type of loan with general characteristics. Its current portfolio amounts to USD 381,353.

FV-MARD started its operations in Uzbekistan in March 2002. Currently, it has six branches, with its main branch in Andijan and sub-branches in Asaka, Shahrihan, Margilan, Kokand and Namangan city. The goal of FV-MARD is to provide socio-economic technical and financial assistance to over 15,000 individuals by improving their incomes and creating new jobs. In December 2005, within the framework of the ELS project, UNDP and ACDI/VOCA signed a Cooperation Agreement. The first tranche of funding, amounting USD 70,000, funds microfinance activities in Chartak and Mingbulak districts where FV-Mard has opened a sub-office. The Current Outstanding Loan Portfolio of FV-Mard is USD 1,107,386. The number of active clients is 4,369. The Portfolio at risk is 0.28%.

CONCLUSIONS

The microfinance sector in Karakalpakstan and Namangan region is entering a new stage of development. The legal, economic and financial landscape will continue to offer opportunities for MFOs individually and to the microcredit sector as a whole. The MFOs' development strategy in Karakalpakstan and Namangan region as supported by the ELS programme focuses on:

- Improvement of performance indicators, especially operational and financial sustainability, productivity and risk management;
- Increase of portfolio capital through:
 - a) lowered costs on portfolio yield and maintaining or lowering the interest to a level from 6% per month to around 4–5% per month
 - b) borrowing from investors or accessing grant funds, if available
- Improvement of the MFOs management information systems in order to properly manage the lending risk associated with increased geographical outreach, portfolio and diversification of financial products offered to clients.





The projects Enhancement of Living Standards in Karakalpakstan and in Namangan region are funded by the European Union and implemented by the United Nations Development Programme in Uzbekistan. They support and encourage 100 local communities in six districts of Karakalpakstan and Namangan region to play an active part in their own development. The duration of the projects is two years. The ELS in Karakalpakstan and in Namangan region projects work together with communities and local authorities on the preparation of a regional development strategy and the rehabilitation of social infrastructures. They also facilitate access by poor and small farmers to microfinance.