



Report and Recommendation of the President to the Board of Directors

Project Number: 42007-018
June 2016

Proposed Loan and Administration of Technical Assistance Grant Republic of Uzbekistan: Small Business Finance Project

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 June 2016)

Currency unit	–	sum (SUM)
SUM1.00	–	\$0.00034
\$1.00	–	SUM2,936.80

ABBREVIATIONS

ADB	–	Asian Development Bank
CAGR	–	compound annual growth rate
CAR	–	capital adequacy ratio
CBU	–	Central Bank of Uzbekistan
ESMS	–	environmental and social management system
GDP	–	gross domestic product
IFC	–	International Finance Corporation
IFRS	–	international financial reporting standards
IYB	–	Ipak Yuli Bank
LLR	–	loan loss reserve
NPL	–	nonperforming loan
PAM	–	project administration manual
PFI	–	participating financial institution
TA	–	technical assistance
ULC	–	UzbekLeasing International A.O.
US	–	United States

NOTES

- (i) The fiscal year (FY) of the Government of Uzbekistan, its agencies, and participating financial institutions ends on 31 December.
- (ii) In this report, “\$” refers to US dollars.

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PROJECT AT A GLANCE

1. Basic Data		Project Number: 42007-018	
Project Name	Small Business Finance Project	Department /Division	CWRD/CWPF
Country Borrower	Uzbekistan The Ministry of Finance of Uzbekistan	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		100.50
		Total	100.50
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG) Environmentally sustainable growth (ESG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive Environmental policy and legislation	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD) Knowledge solutions (KNS) Partnerships (PAR) Private sector development (PSD)	Institutional development Knowledge sharing activities Implementation Private Sector Promotion of private sector investment	Effective gender mainstreaming (EGM)	✓
5. Poverty Targeting		Location Impact	
Project directly targets poverty Geographic targeting (TI-G)	Yes Yes	Rural Urban	High Medium
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: FI Involuntary Resettlement: FI-C Indigenous Peoples: FI-C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		100.50	
Sovereign Project loan: Ordinary capital resources		100.00	
Sovereign Capacity development technical assistance: Financial Sector Development Partnership Special Fund		0.50	
Cofinancing		0.00	
None		0.00	
Counterpart		33.30	
Beneficiaries		33.30	
Total		133.80	
9. Effective Development Cooperation			
Use of country procurement systems		No	
Use of country public financial management systems		No	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Republic of Uzbekistan for the Small Business Finance Project. The report also describes the proposed administration of technical assistance (TA) to be provided by the Financial Sector Development Partnership Special Fund¹ for Strengthening Participating Financial Institutions, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.²

2. The proposed project will support participating financial institutions (PFIs) to provide loans to small businesses. The TA will help PFIs strengthen credit underwriting to improve rural outreach, and enhance financial literacy of their small business clients.³

II. THE PROJECT

A. Rationale

3. Favorable hydrocarbon revenues and substantial public investments supported a strong gross domestic product (GDP) growth at an annual average rate of 8% during 2000–2015. The GDP per capita increased from \$558 to \$2,036 and the poverty rate decreased from 27% to 14% during the same period. An industry-focused growth strategy resulted in an increase in the industry sector's share of GDP from 14% in 2000 to 24% in 2015, while the agriculture sector's share of GDP decreased from 30% to 17% during the same period. However, the strong GDP growth failed to effectively absorb the country's growing workforce. While the unemployment rate remained low at 5.2% in 2015, the number of Uzbek migrants doubled to 2 million during 2000–2015. The ongoing recession in the Russian Federation, which hosts over 90% of Uzbek migrant workers, has led to an increase of returning migrants, posing challenges to absorb them into the economy.⁴ Small businesses effectively generate employment and income, and are critical for Uzbekistan's inclusive growth.

4. Small businesses play an important role in the economy, contributing 57% to GDP and absorbing 80% of employment in 2015.⁵ In 2015, small businesses produced 98% of agricultural output, 87% of retail trade, 67% of construction, 51% of services, 39% of manufacturing, and 27% of exports.⁶ As of 2015, Uzbekistan had 225,998 active small and microenterprises and 227,646 individual entrepreneurs. About 80% of small businesses operated outside the capital. With 17.3% the rural poverty rate exceeds the urban poverty rate of 10.6% pointing to a significant income disparity between rural and urban Uzbekistan.

¹ Financing partner: the Government of Luxembourg.

² The design and monitoring framework is in Appendix 1.

³ The Asian Development Bank (ADB) provided project preparatory TA for preparing the Small Business Finance Project (TA 8986-UZB).

⁴ In 2014 and 2015, 330,000 migrant workers returned to Uzbekistan. ADB. 2016. *Asian Development Outlook 2016: Asia's Potential Growth*. Manila.

⁵ Effective 1 July 2014, the government groups small businesses in the following categories: (i) microenterprises, (ii) small enterprises, and (iii) individual entrepreneurs. A microenterprise is defined as not employing more than 20 staff in industry, 10 in services, and 5 in trade and catering. A small enterprise is defined as not employing more than 100 employees in the light industry, food, and construction sectors; 100 in industry; 50 in agribusiness; and 25 in services, retail trade, and catering. Individual entrepreneurs are defined as persons engaged in business activities. Government of Uzbekistan. 2014. *Presidential Decree No. 4609: About additional measures for further enhancement of the investment climate and the business environment in the Republic of Uzbekistan*. Tashkent.

⁶ Government of Uzbekistan, State Committee of the Republic of Uzbekistan on Statistics. 2016. *Statistical Review of the Republic of Uzbekistan*. Tashkent.

5. The financial system is dominated by banks, which control 94% of finance sector assets. Eight state-owned banks control 75% of banking assets and provide the bulk of credit to state-owned entities. During 2011–2015, bank credit to small businesses substantially increased from 4.5% to 7.1% of GDP, reflecting a compound annual growth rate (CAGR) of 34.1%. However, lending to small businesses still represents less than one-third of overall bank credit, which is insufficient given their economic significance. Eighty percent of small businesses are still being funded by family and friends and informal resources. Access to finance remains a key constraint for private business growth.

6. Significant cost of funding, perceived risks, and administrative costs associated with lending require banks to charge interest rates that range from 11%-25% for local currency and 6%-15% for foreign currency loans. Especially individuals and small businesses borrow at higher rates. Bank's focus on traditional collateral based rather than cash flow-based lending processes undermine the ability of small businesses to borrow from banks.

7. Although bank credit outside the capital represents about 65% of total credit, universal access to finance for private individuals and small businesses in rural areas is heavily constrained by weak rural branch networks and limited mobile banking services. Also, most bank loan products carry a tenor of up to 1 year, irrespective of farm cash flows generated by the multiyear agricultural product cycles. Small businesses have limited business sophistication and skills, which impede their growth, with surveys indicating that they lack access to information on market opportunities, suppliers, competitors, technology, and banking products.⁷ Low financial literacy of small businesses and low-income households, many of which are led by women, limit their access to financial services and their ability to invest and grow.

8. Compared with transition economies in Eastern Europe, the South Caucasus and Central Asia, Uzbekistan's depth and efficiency of financial intermediation is low, as evidenced by the low private credit-to-GDP ratio of 24.9% in 2015 and high lending–deposit rate spreads, which range from 12% to 15%. The loan-to-deposit ratio surged from 89% in 2012 to 120% in 2015, reflecting limited availability of deposits. While deposits represented the bulk of bank funding in 2015, banks obtained 87% of deposits from state-owned enterprises and private corporations, and only 13% from retail customers in 2015, indicating a volatile deposit base.⁸ A 2014 survey showed that 40% of the adult population had savings accounts, but only 2% had saved with financial institutions.⁹ Deposit mobilization is undermined by public mistrust in banks, which is compounded by administrative hurdles in withdrawing cash from bank accounts.¹⁰

9. In 2012–2015, banks' Basel I capital adequacy ratios (CARs) averaged 24%.¹¹ However, the introduction of Basel III capital adequacy, and mandatory full compliance with it by 2019, will require banks to meet additional prudential measures, including a liquidity coverage ratio and capital charges for operational and market risk, which will likely require additional capital.

⁷ Center for Economic Research. 2014. *Entrepreneurs of Uzbekistan as a basis for formation of the middle class*. Tashkent.

⁸ Central Bank of Uzbekistan. 2016. *Banking Sector Performance*. Tashkent. Unpublished.

⁹ World Bank. Business Environment and Enterprise Performance Survey. <http://data.worldbank.org/data-catalog/BEEPS> (accessed 1 June 2016).

¹⁰ Businesses are obliged to deposit daily local currency cash reserves above established limits. Depositors face difficulties in withdrawing cash; cash withdrawals are subject to fees of up to 20%.

¹¹ Basel I only measures credit risk.

10. The Central Bank of Uzbekistan (CBU) reported an average nonperforming loan (NPL) ratio of less than 1% in 2015.¹² However, Moody's Investors Service estimated a more realistic NPL ratio of 7% for banks for 2015.¹³ The expected decline in economic growth is likely to adversely affect borrowers' debt service capacity and banks' asset quality during 2016. Banks reported solid profitability and the return on average assets averaged 2.2% in 2015. The slowdown in remittances and economic growth may adversely affect profitability in 2016.

11. **Government efforts and development coordination.** The Government of Uzbekistan has implemented programs to support small business and banking sector growth.¹⁴ To improve the banks' ability to assess borrower creditworthiness, the Law on Credit Information, which was promulgated in 2011, provided for the establishment of a public credit bureau, which covered 19.4% of adults in 2015, compared to the 37.4% average of its Eastern European and Central Asian peers.¹⁵ It provides limited information from banks; exposures to other creditors such as nonbanks and information from mobile phone and utility providers are not covered. Assisted by the International Finance Corporation (IFC), the government is expanding the coverage and improving the quality of the credit bureau. To facilitate registration of movable assets as loan collateral, the Law on Collateral Registry, which was promulgated in 2013, supported the establishment of an electronic secured transactions registry, which commenced operations in 2014. Laws enacted in the late 1990s need to be improved to facilitate the use of movable property as collateral. Assisted by IFC, the government has prepared draft legal amendments for enactment in 2017.

12. The following multilateral and bilateral development partners support small business development: (i) the World Bank provides credit lines to farmers and small agricultural enterprises; (ii) IFC supports the private sector through advisory services and investments; (iii) the United Nations Development Programme has helped improve business registration; and (iv) the United States Agency for International Development and the European Union have promoted horticulture and women-owned businesses¹⁶ in agriculture.

13. **The Asian Development Bank's value addition and lessons.** The project will support financial inclusion, especially outside the capital, by providing loans to small businesses for working capital and fixed asset investments. The project will improve financial inclusion for women-owned businesses through (i) agreed business lending targets and appropriate gender policies with the PFIs, and (ii) dedicated TA to foster financial literacy of women entrepreneurs. The attached TA will strengthen the PFIs' lending processes and product offerings, including mobile banking service outreach and financial literacy training to small business clients.¹⁷ In addition, PFIs' environmental and social management systems (ESMSs) will be strengthened to satisfy the Asian Development Bank (ADB) Safeguard Policy Statement (2009).

14. Since 1996, ADB has provided five loans and five related capacity building TA projects to PFIs in Uzbekistan. In 2013, ADB made an equity investment in Ipak Yuli Bank (IYB). The

¹² The NPL ratio is very low compared to Uzbekistan's regional peers. As the CBU criteria for asset classification are not disclosed, the NPL ratio should be treated with caution.

¹³ Moody's Investors Service. 2015. *Banking System Outlook: Uzbekistan*. London.

¹⁴ Government of Uzbekistan. 2010. *Presidential Decree No. 1438: On priority areas for further reforms and sustainability improvement of country's finance and banking system in 2011–2015 and achieving high international ratings*. Tashkent; Government of Uzbekistan. 2011. *Presidential Decree No. 1474: On further strengthening micro, small, and medium-sized enterprise development*. Tashkent.

¹⁵ World Bank. 2016. *Doing Business*. Washington, DC. <http://www.doingbusiness.org/data/exploretopics/getting-credit>.

¹⁶ Women-owned businesses are defined as businesses with more than 50% female ownership.

¹⁷ Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

first two loans funded 59 subloans averaging \$1.5 million to medium-sized enterprises during 1996–2002,¹⁸ whereas the remaining three loans, which focused on micro and small enterprises and individuals, funded 29,340 subloans averaging \$10,000 during 2002–2014.¹⁹ ADB's experience in these loans shows that privately owned PFIs display better asset quality and sustainability compared to public sector banks and credit unions. The PFIs selected for this project are majority privately owned banks and one leasing finance company with 49% private ownership. To enable PFIs to service a larger range of job-creating small enterprises, the maximum subloan size limit is set at \$300,000 under the proposed project, up from \$100,000 under the previous loan (Loan 3043), which is still moderate compared to small business loan sizes issued by banks in the region.²⁰ The leasing company will finance sound small businesses that do not meet documentation required by lenders. ADB's due diligence also identified the need to upgrade PFI skills to match international financial reporting standards (IFRS) and avoid conflicts of interest arising from the use of external auditors for advising PFIs in preparing financial statements. Under the proposed project, the PFIs will hire accounting staff familiar with IFRS prior to loan disbursement.

15. The project is aligned with ADB's Midterm Review of Strategy 2020 by supporting the development of financial institutions and financial services.²¹ The PFIs' emphasis on small businesses in underserved areas with significant income and employment opportunities will promote inclusive growth. The project supports the government's development strategy for 2016–2020, which aims to accelerate economic growth, promote the private sector, improve access to finance, and address regional disparity.²² The government's development strategy is consistent with ADB's country partnership strategy, 2012–2016 for Uzbekistan and is included in ADB's country operations business plan, 2016–2018 for Uzbekistan.²³

B. Impact and Outcome

16. The impact will be an improved contribution of small businesses to inclusive economic growth and employment. The outcome will be increased sustainable provision of PFIs' financing to small businesses. The PFIs are expected to set examples for other financial institutions on how to deepen their outreach while retaining good asset quality and funding private enterprise activities that generate jobs.

¹⁸ ADB. 1996. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Uzbekistan for the Rural Enterprise Development Project*. Manila (Loan 1504-UZB); ADB. 2000. *Report and Recommendation of the President of to the Board of Directors: Proposed Loan to the Republic of Uzbekistan for the Small and Medium Enterprise Development Project*. Manila (Loan 1799-UZB).

¹⁹ ADB. 2002. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Republic of Uzbekistan for the Small and Microfinance Development Project*. Manila (Loan 1963-UZB); ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Republic of Uzbekistan for the Second Small and Microfinance Development Project*. Manila (Loan 2634-UZB); ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Republic of Uzbekistan for the Small Business and Entrepreneurship Development Project*. Manila (Loan 3043-UZB).

²⁰ The definition of small businesses in the European Union, which also applies to the Eastern Neighborhood region, includes enterprises with an annual business turnover of up to \$12 million and up to 50 staff. Loans up to \$1 million–\$3 million are considered as small business loans.

²¹ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

²² Government of Uzbekistan. Forthcoming. *Medium-term financial sector development strategy, 2016–2020*. Tashkent (under approval).

²³ ADB. 2012. *Country Partnership Strategy: Uzbekistan, 2012–2016*. Manila; ADB. 2015. *Country Operations Business Plan: Uzbekistan, 2016–2018*. Manila.

C. Output

17. The output will be expanded capacity of the PFIs for financing small businesses. The PFIs will expand lending to small businesses for investment and working capital purposes. At project completion, the PFIs are expected to have made at least 20% of eligible loans to women-owned small businesses, and at least 60% to small businesses outside the capital. The attached TA will support the PFIs in pursuing small business lending by introducing credit scoring and loan origination facilitated by mobile devices, such as tablet computers, and improve financial literacy of PFIs' small business clients (footnote 17).

D. Financing Plan

18. The government has requested a loan of \$100.0 million from ADB's ordinary capital resources to help finance the project. The loan will have a 15-year term, including a grace period of 5 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions as set forth in the draft loan and project agreements. The financing plan is in Table 1.²⁴

Table 1: Financing Plan

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Ordinary capital resources (loan)	100.0	75.0
Subborrowers (through equity contribution) ^a	33.3	25.0
Total	133.3	100.0

^a Subborrowers will contribute equity to the subprojects at a level consistent with market norms. Based on discussions with the participating financial institutions, the average contribution is estimated at 25%.
Source: Asian Development Bank.

19. The government will relend the proceeds of the loan in US dollars through subsidiary loan agreements to PFIs that satisfy ADB's eligibility criteria set out in the project administration manual (PAM) and the loan and project agreements.²⁵ The government is expected to relend the proceeds of the loan to the PFIs at the same tenor and grace period at which it received the funds from ADB. The government's relending rate will be the interest rate charged by ADB for the loan plus an appropriate margin to cover administrative and risk costs on the PFIs.²⁶

20. The PFIs will use the loan proceeds to finance subloans and leases to eligible small business subborrowers to support working capital and fixed asset investments. Subloans and leases may be issued in US dollars and sum, and priced by the PFIs at market rates that cover

²⁴ Every \$1.00 of ADB subloan is expected to mobilize an average of \$0.33 of small business investment on the assumption that PFIs will require eligible borrowers to provide, on average, 25% of a subproject's cost with equity. PFIs will determine the subborrower equity contributions based on the nature of the credit risk, which based on the credit policy of each PFI would range from 20% to 30% of the project cost. PFIs will contribute capital that they must hold against subloans. The PFIs' capital and loan loss reserves are the first defenses against subborrower defaults, and incentivize PFIs to lend to creditworthy clients.

²⁵ Based on each PFI absorptive capacity, subject to review and adjustments during project implementation, loan allocation is currently set as follows: Hamkorkbank (\$45 million), IYB (\$38 million), UzbekLeasing International A.O. (\$10 million), and Davr Bank (\$7 million).

²⁶ The government will charge ADB's funding cost plus 0.2% per annum to the PFIs. The PFIs' interest rates carry the cost for (i) loan origination, (ii) the provision of foreign exchange to service the ADB loan, (iii) the repricing risk arising from the mismatch of 6 months of repricing of ADB loans (as subloans may carry a fixed interest rate up to 5 years), and (iv) credit risk and related capital charges. Under the current foreign exchange regime, the cost of providing US dollars at payment dates is substantial, justifying the significant net interest margins.

foreign exchange, credit, maturity, and interest rate risks. Such subloans will have a tenor of up to 5 years. PFIs will determine the creditworthiness of subborrowers and assume full credit risk. The maximum subloan size is currently set at \$300,000.

21. **The Participating Financial Institutions.** The PFIs were selected among commercial banks and leasing companies that expressed interest to participate in the project and subsequent detailed due diligence. ADB selected four PFIs: Hamkorbank, IYB, Davr Bank, and UzbekLeasing International A.O. (ULC). All PFIs have business strategies reflecting a strong track record and a commitment to serving rural and women-owned small businesses. Hamkorbank is fully privately owned. It has a strong regional footprint, with 95% of its loans booked outside the capital, and it serves nearly 22,000 borrowers, including about 6,000 women, with an average loan size of \$12,900 and a maximum loan size of \$350,000 equivalent. IYB, in which ADB holds 13.4% of the share capital, has 75% private ownership. Relative to Hamkorbank, it caters to the upper small business client segment, with 62% of its loans booked in the regions outside the capital, an average loan size of \$54,100, and a maximum loan size of \$2 million equivalent. Davr Bank, a local private bank, has a growing small business focus. It provides loans at an average size of \$42,700 and a maximum loan size of \$2 million equivalent. ULC is 49% privately owned. It is a leasing company with 72% of its leases booked outside the capital with an average lease size of \$117,000 and a maximum lease size of \$2 million equivalent. These lenders, which use alternative strategies and distribution channels, will stimulate competition for the benefit of small business clients.

22. All PFIs meet ADB's eligibility requirements for financial intermediaries, including (i) financial soundness as evidenced by adequate capital, asset quality, liquidity, and profitability; (ii) adequate credit and risk management policies, operating systems, and procedures; (iii) acceptable corporate and financial governance and management practices, including transparent financial disclosure policies and procedures; (iv) sound business objectives and strategies; (v) adequate policies and procedures to assess and monitor social and environmental impacts of subprojects; (vi) autonomy in lending and pricing decisions; and (vii) financial covenants determined by ADB.²⁷ The three PFI banks meet prudential limits issued by the CBU.²⁸ Hamkorbank and IYB have adequate financial management systems in place. Davr Bank and ULC have committed to recruit qualified accounting staff familiar with IFRS. All PFIs have passed ADB's integrity and anti-money laundering due diligence. Ownership, business focus, and financial performance of the PFIs are summarized in paras. 23–26.

23. **Hamkorbank.** Founded in 1991, Hamkorbank has 30% foreign ownership (15% owned by IFC and 15% by FMO, the Netherlands Development Finance Company). Its small business loan book (\$284 million in 2015) is estimated to grow at a CAGR of 25% by 2021, compared with 35% during 2012–2015. Hamkorbank's CAR of 13.6% at the end of 2015 exceeded the CBU minimum of 10% in 2015. Hamkorbank lends to small business borrowers involved in industry (32.6%), trade (27.3%), services (8.3%), and agriculture (5%). Hamkorbank's asset quality is sound, with an NPL ratio of 0.2% in 2015. Loan loss reserve (LLR) coverage remained satisfactory, representing 107.7% of NPLs in 2015. Hamkorbank is profitable. Its net income increased by 55% to \$34 million in 2015 because of robust loan growth and a stable net interest margin of 7.4%, while its return on average assets improved to 3.8% in 2015 from 3.7% in 2014. In 2015, Hamkorbank sourced 70% of its funding through deposits and supplemented the remaining 30% through borrowings. In February 2016, the CBU suspended certain Hamkorbank foreign exchange operations for 6 months due to noncompliance with foreign exchange

²⁷ ADB. 2008. Financial Intermediation Loans. *Operations Manual*. OM D6/BP. Manila (para. 8).

²⁸ Leasing companies are not subject to CBU prudential requirements.

regulations of the CBU. The resumption of full foreign exchange operations will be a condition for disbursement of the loan to Hamkorbank.

24. **Ipak Yuli Bank.** This bank was incorporated in 1990. In April 2013, ADB became a shareholder of IYB, holding 13.4% of shares at the end of 2015. IYB's small business loan portfolio (\$271 million at the end of 2015) comprised 78% of the total loan portfolio and is targeted to grow at a CAGR of 20% by 2021. With 40% of small business loans issued outside the capital, IYB plans to increase its rural coverage through expansion of a regional branch network and e-banking. Its CAR was 12.6% at the end of 2015, down from 16.2% at the end of 2013. The decline in its CAR reflects the increase of 90% in risk-weighted assets on the back of a growing loan book compared with a 55% increase in total capital. Portfolio quality is satisfactory and has improved, with an NPL ratio of 2.1% of gross loans at the end of 2015 compared to 3.8% at the end of 2013. LLR coverage of NPLs comprised a very comfortable 190.0% in 2015 and 215.4% in 2014, up from 124.7% in 2013. IYB's profitability is strong, with a return on average assets ratio of 2.3% in 2015, supported by a solid net interest margin and fee-based earnings. Net income increased to \$13.1 million in 2015 from \$11.0 million in 2014. IYB had a stable funding profile in 2015, with customer deposits representing 80% of total funding and long-term debt from international financial institutions accounting for 17% of total funding.

25. **Davr Bank.** Established in 2001, Davr Bank is a small private bank lending to small businesses (91% of total loan portfolio). It expects its small business loan book (\$43.5 million in 2015) to grow at a CAGR of 25% by 2021, compared with 58% during 2012–2015. Davr Bank targets to increase lending outside the capital by 25% each year from 2016 to 2021. It increased its lending to women entrepreneurs from \$0.5 million in 2012 to \$12.4 million in 2015, and it is projected to reach \$22.3 million by 2021. Davr Bank's CAR remained high at 21.8% in 2015, though it had declined from 22.0% in 2014. This reduction reflects only a 22% rise in total capital versus 71% in risk-weighted assets driven by the bank's strong loan growth. Davr Bank forecasts CAR at an average of 19.7% during 2016–2019 due to solid profitability and the issuance of new shares. Its asset quality is satisfactory, with an NPL ratio of 0.3% and LLR coverage at 110% of NPLs in 2015. Fueled by higher fee and commission income, Davr Bank's profitability was strong, with a return on assets of 6.6% by the end of 2015. Net income increased to \$4.7 million in 2015 from \$3.3 million in 2012. It sources its funding primarily through customer deposits, which made up 82.7% of total funding in 2015.

26. **UzbekLeasing International A.O.** Established in 1996, ULC is the third-largest lessor in the country. Its shareholders are the National Bank of Uzbekistan for Foreign Economic Activity (41.6%), Malayan Banking (19.7%), and Uzbek-Oman Investment Company (38.7%). About 90% of ULC's clients are small enterprises. It offers direct finance leases and sale and leaseback transactions. Manufacturing (44%), construction (21%), and services (15%) represent key sectors for ULC leasing products. About 10% of ULC clients are women's businesses. With 80% of leases provided outside Tashkent, ULC has a strong rural outreach. ULC's lease portfolio is projected to grow by a CAGR of 16% by 2021, increasing from \$34 million in 2015. ULC's CAR in 2015 was a robust 40.9%, allowing enough room for growth and to cushion against loan losses. In 2015, ULC raised capital through the issuance of new shares. Its asset quality is strong, with an NPL ratio of 0.1% and LLR coverage at 100% in 2015. ULC had return on assets of 10.3% and return-on-equity ratio of 27.7% in 2015 due to high net interest margin. Borrowings from its shareholders and international financial institutions constitute 75% of total funding.

E. Implementation Arrangements

27. The Ministry of Finance will be the executing agency. The PFIs will be the implementing agencies. Each PFI will establish a project implementation unit to administer the project. The PFIs will monitor and report on the use of loan proceeds and compliance with environmental and social safeguards requirements and agreed covenants. The implementation arrangements are detailed in the PAM and summarized in Table 2.²⁹

Table 2: Implementation Arrangements

Aspects	Arrangements
Implementation period	October 2016–December 2021
Estimated completion date	31 December 2021 (estimated completion date) 30 June 2022 (estimated loan closing date)
Management	
(i) Executing agency	Ministry of Finance
(ii) Implementing agencies	PFIs: Davr Bank, Hamkorbank, Ipak Yuli Bank, and UzbekLeasing International A.O.
(iii) Implementation units	Each PFI establishes a PIU
Disbursement	The loan proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and detailed arrangements agreed between the government and ADB.

ADB = Asian Development Bank, PFI = participating financial institution, PIU = project implementation unit.
Source: Asian Development Bank.

III. TECHNICAL ASSISTANCE

28. The proposed capacity building TA is an integral part of the project and will strengthen the PFIs' capabilities to lend to small businesses on a commercially sustainable basis (footnote 17). The TA will (i) strengthen PFIs' credit underwriting policies and procedures, (ii) develop a credit-scoring and loan-origination system facilitated by mobile devices for small business loans, (iii) improve rural outreach by establishing mobile loan processing, and (iv) strengthen PFIs' financial literacy programs for their small business clients.

29. The TA is estimated to cost \$650,000, of which \$500,000 will be financed on a grant basis by the Financial Sector Development Partnership Special Fund and administered by ADB. The PFIs will provide counterpart support of \$150,000 in the form of staff, logistical support, funding consultants, and necessary related investments. The Ministry of Finance will be the Executing Agency and the relevant PFIs will be the implementing agencies for the TA. Consultants for the TA will be recruited in accordance with ADB's Guidelines on the Use of Consultants (2013, as amended from time to time). Disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time). The TA will be implemented from the date of TA effectiveness until 31 December 2019.

IV. DUE DILIGENCE

A. Economic and Financial

30. The economic benefits of the project will be mainly derived from the increased productivity and profitability of small businesses. Direct economic benefits will flow from the contribution of small businesses to economic output and employment. The project will increase sustainable provision of bank loans to small businesses, with a special effort to reach those

²⁹ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

outside the capital and those majority owned by women. The project is expected to enhance the ability of the PFIs to deliver financial services to and improve financial literacy of small businesses.

B. Governance

31. ADB assessed the PFIs' financial management systems and classifies the overall pre-mitigation financial management risk as moderate. Identified issues include Davr Bank's limited number of appropriately qualified accounting staff (especially for IFRS), and Davr Bank's and ULC's lack of familiarity with ADB's disbursement and reporting procedures. An action plan to address the accounting issues is detailed in the PAM, and training of staff in ADB project administration requirements will be carried out by ADB within 6 months of the approval of the proposed project. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and PFIs. The specific policy requirements and supplementary measures are described in the PAM.

C. Poverty and Social

32. The project supports poverty reduction indirectly through its focus on improved access to finance by small businesses. Rural and women's small businesses are expected to benefit substantially and, as a result, boost their investments and help maintain and expand employment and provide stable incomes for themselves, their employees, and their suppliers. A gender assessment was carried out, which categorizes the project as effective gender mainstreaming. The project will enhance PFIs' gender policies and improve women's access to financial services, including credit. It will also improve their financial literacy.³⁰

D. Safeguards

33. The project is categorized as financial intermediation treated as C for involuntary resettlement and indigenous people safeguards, and as financial intermediation for environment. Subprojects (i) identified on the ADB Prohibited Investment Activities List provided in the Safeguard Policy Statement, (ii) classified as environment category A, and (iii) classified as category B that are in the ESMS exclusion list are not eligible for financing under the project. Eligible subprojects will comply with the national regulations. ADB carried out due diligence of the PFIs' ESMSs. All PFIs must have ESMSs in place that satisfy the Safeguard Policy Statement's requirements prior to the first disbursement of their respective loans. The TA will provide assistance in capacity strengthening and monitoring to help PFIs keep their ESMS operations in accordance with the Safeguard Policy Statement.³¹

E. Risks and Mitigating Measures

34. Major risks and mitigating measures are summarized in Table 3 and described in detail in the risk assessment and risk management plan.³² The integrated benefits and impacts are expected to outweigh the costs. The project pre-mitigating risk is medium.

³⁰ Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).

³¹ Financial Intermediary: Environmental and Social Management System Arrangement (accessible from the list of linked documents in Appendix 2).

³² Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

Table 3: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Moderated economic activity reduces small businesses' debt service capacity	PFI's carefully underwrite their lending to help their clients achieve adequate debt service capacity.
Depreciation of the sum against the United States dollar adversely affects PFI's credit risk profile and their clients' debt service capacity	PFI's have asset-liability management systems in place, and periodically conduct stress testing and adjust lending policies as necessary. PFI's lending policies take into account the impact of devaluation on their clients' cash flow and debt service capacity.
Increased risk provisions and anticipated challenges of banks related to adoption of Basel III's capital adequacy requirement may require additional capital to maintain compliance with prudential limits	Banking PFI's and the CBU will conduct stress testing and internal capital adequacy assessment programs. Banking PFI's will raise capital as required.
Credit risk incurred by PFI's	PFI's were selected based on their excellent past financial track record, including their prudent management of credit risk in lending to small and microenterprises. The TA will further assist PFI's in better credit risk management.
PFI's lack of (i) sufficient professionally qualified accounting staff, and (ii) experience in the application of IFRS	PFI's agreed with ADB to (i) recruit qualified accounting staff with IFRS knowledge, and (ii) conduct regular training.

ADB = Asian Development Bank, CBU = Central Bank of Uzbekistan, IFRS = international financial reporting standards, PFI = participating financial institution, TA = technical assistance.

Source: Asian Development Bank.

V. ASSURANCES AND CONDITIONS

35. The government has assured ADB that implementation of the project shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and loan documents.

36. The government has agreed with ADB on certain covenants for the project, which are set forth in the loan and project agreements. Conditions of loan effectiveness are that the government enters into a subsidiary loan agreement with each PFI, in form and substance satisfactory to ADB. Conditions for loan disbursement include: (i) with respect to each PFI, the establishment of an ESMS that responds to Safeguard Policy Statement requirements; (ii) with respect to Hamkorbank, the removal of all foreign exchange operation restrictions by the CBU; and (iii) with respect to Davr Bank and ULC, recruitment of qualified accounting staff with adequate knowledge of IFRS.

VI. RECOMMENDATION

37. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$100,000,000 to the Republic of Uzbekistan for the Small Business Finance Project, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and project agreements presented to the Board.

Takehiko Nakao
President

9 June 2016

DESIGN AND MONITORING FRAMEWORK

Impact the Project Is Aligned with:			
Improved contribution of small businesses to inclusive economic growth and employment ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Increased sustainable provision of PFIs' financing to small businesses	By 2021 ^b <ol style="list-style-type: none"> a. PFIs' volume of small business loans and leases increased to SUM4,400 billion (2015 baseline: SUM1,770 billion), of which SUM1,730 billion are to small enterprises (2015 baseline: SUM730 billion); SUM1,640 billion are to micro enterprises (2015 baseline: SUM650 billion); and SUM1,030 billion to individual entrepreneurs (2015 baseline: SUM390 billion) b. PFIs' volume of small business loans and leases outside Tashkent increased to SUM2,600 billion (2015 baseline: SUM1,100 billion) c. PFIs' volume of loans and leases to women-owned businesses increased to SUM700 billion (2015 baseline: SUM310 billion)^c d. At least 60% of the numbers of subloans are received by small businesses located outside Tashkent (2015 baseline: 0%) e. At least 20% of the numbers of subloans are to women-owned businesses (2015 baseline: 0%) f. PFIs' net NPL ratios (loans overdue for more than 90 days) remain less than or equal to 5% of gross loans (2015 baseline: 1%^d) g. Participating banks' Basel III capital exceeds 14.5% of risk-weighted assets (2015 baseline: not applicable) 	a–g. PFIs' progress reports	Macro-economic and currency instability may constrain business development
Output 1. Expanded capacity of the PFIs for financing small businesses	By 2021 <ol style="list-style-type: none"> 1a. PFIs' small business borrowers reach 35,000 (2015 baseline: 28,261), of which 7,700 are small enterprises (2015 baseline: 6,158), 11,900 are microenterprises (2015 baseline: 9,662), and 15,400 are individual entrepreneurs (2015 baseline: 12,441) 1b. PFIs' small business borrowers 	1a–e. PFIs' progress reports	Insufficient demand for credit at market rates

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
	<p>outside Tashkent reach 27,000 (2015 baseline: 24,000)</p> <p>1c. PFIs' women-owned business borrowers reach 9,000 (2015 baseline: 7,500)</p> <p>1d. Selected PFIs have improved credit underwriting policies and systems in place (2015 baseline: not applicable)</p> <p>1e. At least 8,000 PFI borrowers trained on financial literacy, of which at least 50% are women (2015 baseline: 6,520)</p>		
Key Activities with Milestones			
<p>1. Expanded capacity of the participating financial institutions for financing small businesses</p> <p>1.1. ESMSs of PFIs are established to ADB's satisfaction before the first disbursement (October 2016)</p> <p>1.2. PFIs disburse loans to small businesses (Q4 2016–Q4 2021)</p> <p>1.3. PFIs adopt improved underwriting policies and procedures (December 2018)</p> <p>1.4. PFIs develop and adapt a gender policy and conduct a series of workshops for management and staff on gender issues (March 2018)</p> <p>1.5. PFIs conduct annual marketing customer satisfaction surveys to assess the quality of financial services and demand for services (Q1 2018)</p> <p>1.6. PFIs train customers on financial literacy (Q1 2017–Q4 2019)</p>			
Inputs			
<p>ADB: \$100 million (loan) (ordinary capital resources)</p> <p>Financial Sector Development Partnership Special Fund: \$500,000 (capacity development TA)</p>			
Assumptions for Partner Financing			
Not applicable			

ADB = Asian Development Bank, ESMS = environmental and social management system, NPL = nonperforming loan, PFI = participating financial institution, Q = quarter, TA = technical assistance.

^a Government of Uzbekistan. 2015. *Presidential Decree No. UP-4707: On the measures for structural reforms, modernization and diversification of production in 2015–2019*. Tashkent; Government of Uzbekistan. 2015. *Presidential Decree No. UP-4725: On the measures for ensuring reliable protection of private property, small business and private entrepreneurship and removal of barriers to their accelerated development*. Tashkent.

^b Individual PFI outcome and output performance targets are reflected in the project administration manual.

^c Women-owned businesses are defined as businesses with more than 50% female ownership.

^d Baseline data for NPLs according to official information from the Central Bank of Uzbekistan.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=42007-018-3>

1. Loan Agreement
2. Project Agreement
3. Sector Assessment (Summary): Finance
4. Project Administration Manual
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Attached Technical Assistance
8. Financial Analysis
9. Economic Analysis
10. Country Economic Indicators
11. Summary Poverty Reduction and Social Strategy
12. Gender Action Plan
13. Financial Intermediary: Environmental and Social Management System Arrangement
14. Risk Assessment and Risk Management Plan