



CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

STRATEGIC FRAMEWORK

for a Microfinance Model

May 2025

Executive summary

The 'Strategic framework for a microfinance model' has been developed to implement the measures related to access to finance outlined in the Socio-Economic Development Strategy of the Republic of Azerbaijan for 2022–2026, approved by Presidential Decree No. 3378 dated 22 July 2022.

The microfinance model aims to enhance the role of the microfinance sector in financing of self-employed individuals and MSMEs, deepening financial inclusion and supporting overall economic growth. In this regard, the model is designed to unlock the sector's potential by facilitating access to finance for self-employed individuals and MSMEs on favorable conditions. Additionally, the microfinance model aims to improve the provision of financial services across the country, particularly in regions and rural areas, and to support regional economic development and employment by offering comprehensive and high-quality financial services to customers.

The model outlines five strategic priorities to drive the development of the microfinance sector. Overall, it aims to improve the well-being of the population, strengthen the ecosystem supporting sectoral growth, and enhance both the capacity of market participants and the quality and diversity of financial services available.

Section 1. Introduction

1.1 Strategic view

MSMEs form the foundation of a resilient national economy and serve as a key driving force in the economy by stimulating domestic demand through characteristics such as mass job creation, ensuring competition, and promoting innovation. In this context, the development of the MSME segment is one of the main factors contributing to inclusive economic growth.

In general, one of the decisive factors for the growth and development of MSMEs is access to sustainable external financing. According to the World Bank¹, limited access to external finance is considered the biggest obstacle to the development of MSMEs in emerging economies.

The microfinance sector holds significant potential to ensure access to financial services for self-employed individuals and MSMEs in Azerbaijan. To unlock this potential, the CBA has made the development of the microfinance sector one of its strategic priorities.

The CBA's strategic goal is to establish a flexible, efficient, and inclusive microfinance sector by 2030.

The strategic view aims to:

- ensure access to diverse, efficient, and inclusive microfinance services for self-employed individuals, micro and small businesses, and consumers.
- establish a regulatory framework that promotes the sustainable development of the sector and fosters innovation.
- position microfinance as a distinct sub-segment within the financial sector, strengthening its role in the broader financial system.

1.2 Strategic priorities

The CBA has identified five priorities to achieve its strategic objectives:

- (1) strengthen the legal and regulatory framework for microfinance
- (2) diversify financing sources of NBCIs
- (3) enhance risk allocation mechanisms
- (4) support institutional development of NBCIs
- (5) improve the system for identifying the self-employed population and Family Farming Enterprises.

Each of these priorities is supported by strategic initiatives and measures aimed at establishing and developing a modern, inclusive, and diversified microfinance sector that

¹ The World Bank Enterprise Surveys

serves self-employed individuals and MSMEs. The priorities are interrelated. Strengthening the legal and regulatory framework will help define operational boundaries of the microfinance sector, contribute to the expansion of its activities, and safeguard financial stability. The diverse needs of self-employed individuals and MSMEs can only be effectively addressed through a broad and inclusive microfinance sector offering a wide range of financial products and services. The sector's effectiveness relies on its ability to respond to emerging challenges and opportunities, as well as its capacity to evolve in line with customer needs and market trends. Achieving the goals set for the improvement of the microfinance sector requires close cooperation between various public institutions and market participants in implementing this model.

Section 2. Microfinance: Status and Development Constraints

2.1 Sector status

The current legislative framework does not define the concept of a microfinance institution. In general, banks, NBCIs, credit unions, and other financial institutions provide microfinance services. Their microfinance activities – defined here as business loans up to AZN 25,000 – are summarized below.

Banks. The Azerbaijani financial system is primarily bank centric. Bank financing remains the dominant funding source for MSMEs and is considered the main channel for accessing external finance. As of end-2024, the outstanding amount of active microcredits issued by banks to legal entities and private entrepreneurs amounted to AZN 1.5B. Microcredits issued by banks accounted for 9.9% of the total business loan portfolio. In total, banks issued 280,221 microcredits, 96% going to private entrepreneurs. Around 84% of the total outstanding microcredit portfolio is concentrated in five banks.

NBCIs. NBCIs are the primary source of financing for micro-entrepreneurs (by number of customers served). A review of current lending practices shows that while banks mostly serve medium and large enterprises, NBCIs play a leading role in financing micro and small businesses, including self-employed individuals.

The NBCI sector has experienced notable revitalization in recent years. Over the past three years, the total value of loans issued by NBCIs has more than doubled over the past three years to AZN808M. However, business loans account for only 31% of the lending portfolio. This imbalance suggests a misalignment with the core principles of microfinance and underscores the need to strengthen the regulatory framework for the development of business oriented NBCIs.

However, as of end-2024, 97% of NBCIs' business loans were under AZN25,000 (inclusive), indicating strong potential of NBCIs in the field of microfinance. NBCIs also currently hold a leading position in terms of regional branch network coverage. NBCIs operate 238 branches in the regions (78%), compared to 282 branches (58%) operated by banks. This highlights the significant role of NBCIs in financing MSMEs operating in the regions.

Despite this, NBCIs finance only about 2% of active taxpayer business entities, signaling that the sector remains underutilized and has room to expand its potential.

Another category of NBCIs engaged in microcredit services is credit unions. However, their activities are more limited compared to other credit institutions. As of now, there are 36 credit unions operating in the country, with a total loan portfolio amounting to AZN12M. Due to limited funding sources, both the number of credit unions and the scale of their operations have been declining in recent years.

2.2 Sector development constraints

The development of the microfinance sector is hindered by several key constraints. These include the lack of formal recognition of microfinance as a distinct sub-sector within the

financial system; the limited resource base and product diversity of core microfinance institutions; underdeveloped risk allocation mechanisms; and insufficient alignment with the specific characteristics of the microfinance sector; as well as weaknesses in the system for identifying self-employed individuals and Family Farming Enterprises — one of the main client groups of microfinance.

2.2.1 Legal and regulatory basis of microfinance:

- The legislation does not specify the definition of ‘microcredit’

The absence of a clearly defined microfinance segment in the legislation also limits the ability to implement supportive prudential and public policy measures. This regulatory gap hinders the development of specialized microfinance institutions focused on small business lending, restricting the effective implementation of government policies that support self-employment and micro-entrepreneurship.

The fact that most NBCI portfolios - despite of being considered as the main microfinance institutions - are concentrated in consumer lending highlights the need to formally incorporate the concept of ‘microcredit’ into the legal framework and introduce targeted policy incentives that promote business-oriented lending.

2.2.2 Financing sources:

NBCIs are financed and operated solely by their founders and private creditors, without reliance on population-based or public funding. Due to high sensitivity of financial stability to external factors in recent years, NBCIs’ access to foreign funding has narrowed. In some cases, taking into account currency risks, NBCIs are reluctant to attract such funds. As a result, the limited availability of long-term financing remains one of the key constraints of the development of NBCIs.

- Current structure of financing sources

Bank financing. As of end-2024, AZN155M worth of liabilities of NBCIs were financed through bank loans (48% of total liabilities). The volume of bank loans increased by 13% (AZN18.4M) year-over-year. All bank loans were sourced from resident banks. Of this amount, AZN8.1M was denominated in foreign currency.

Financing through issuance of securities. Another notable source of financing for the microfinance sector is the capital market. As of end-2024, the total volume of outstanding bond financing stood at AZN 61.2 million, accounting for 19% of total NBCI liabilities (Table 1). However, the cost of financing through bonds is higher: the average weighted interest rate in national currency is around 15% (Table 1). The high financing costs for NBCIs through bond issuance primarily stem from their risk profile.

Financing from foreign sources. Access to foreign financing remains limited. As of end-2024, funds from non-residents accounted for 27.5% of NBCIs’ total liabilities, with 42.2% of these funds denominated in foreign currency (Table 1).

High cost of financing

The average weighted interest rate on national currency denominated bank loans stood at 11.5%, the similar indicator on securities for residents and non-residents stood at 15% and 13% respectively, higher than the cost of financing by banks².

Table 1: Volume and cost of financing of NBCIs, Q4 2024

	Outstanding amount (thousand AZN)	out of which in foreign currency	Average weighted interest rate NC	Average weighted interest rate, FC
Bank loans	154,902	8,135		
Residents	154,902	8,135	11.5%	6.7%
Securities	61,207	11,254		
Residents	43,414	10,166	15.1%	9.2%
Non-residents	17,793	1,088	13.2%	9.0%
Loans from other financial institutions (excluding banks)	106,180	36,262		
Residents	35,494 ³	-	1.5%	-
Non-residents	70,687	36,262	13.1%	7.0%

2.2.3 Range of services of NBCIs:

According to the *Law of the Republic of Azerbaijan on Non-bank Credit Institutions*, NBCIs are permitted to issue loans, as well as open and manage payment accounts for this purpose and issue credit cards. Additionally, NBCIs may trade debt liabilities (factoring, forfeiting), engage in leasing, accounting of promissory notes, issuing guarantees, and provide insurance and/or payment agent services.

However, it is considered necessary to revise and expand the range of financial services provided to self-employed individuals and MSMEs, while ensuring that financial stability is not compromised. In this regard, the possibility of expanding the range of services will be explored, including the execution of money transfers without opening an account, conducting currency exchange operations, processing payment transactions for utility

² Cost of financing of banks for the relevant period was as follows:

1. Interest expenses on deposits of individuals – in national currency 5.7%, in foreign currency – 1.79%
2. Interest expenses on deposits of legal entities – in national currency 1.53%, in foreign currency – 1.13%
3. On interbank loans – in national currency 10.25%, in foreign currency – 7.2%

³ AZN7.5M of this amount are funds of the Entrepreneurship Development Fund (AZN4.7M) and the Agrarian Credit and Development Fund (AZN2.8M), remaining funds are loans taken from NBCIs.

payments, transportation of cash and other valuables, and the storage of valuables in safes.

2.2.4 Risk allocation mechanisms:

NBCIs actively lend to the agricultural sector, the riskiest sector of the real economy, particularly to FFEs (farmers), self-employed individuals without collateral. A significant share of NBCIs' lending portfolio is concentrated in the regions.

The state support funds' guarantee and subsidy mechanisms may act as one of the key mechanisms for reducing risks in micro and small businesses. Portfolio guarantees are particularly important in the microfinance context. However, these mechanisms are not fully tailored to the specific characteristics of NBCIs and microlending.

Credit guarantee mechanism. There is potential for further improvement of the guaranteed parameters for microloans in the guarantee mechanism of state support funds. Areas for improvement may include covering NBCI customers with the credit guarantee mechanism and aligning the parameters of portfolio guarantee mechanisms (e.g., the minimum credit limit covered by portfolio guarantees, the ratio of the guarantee amount to outstanding principal, etc.) to the characteristics of the microfinance segment.

Hedging of foreign currency risks. The underdevelopment of the domestic derivatives market limits the hedging opportunities for funds raised in foreign currency, which in turn prevents the attraction of additional resources from foreign sources, hinders the development of the sector and undermines the sector's resilience to macroeconomic shocks. The inability to hedge foreign currency liabilities also negatively impacts the sector's long-term sustainability. In international practice, in such cases, central banks create hedging mechanisms.

2.2.5 Institutional development of NBCIs:

The institutional development of NBCIs remains limited. Key weaknesses stem from deficiencies in internal control mechanisms—such as risk management, compliance, internal control, and internal audit—as well as the limited involvement of Supervisory Board and Audit Committee members in organizational oversight

Recently, significant steps have been taken to strengthen the regulatory framework for NBCIs. The Management Board of the CBA by its decision dated 15.11.2024 approved the *Regulation on prudent management of non-bank credit institutions* and the *Regulation on credit risk management in non-bank credit institutions* both effective from 24.11.2024. However, such efforts need to be continued.

2.2.6 Identification of self-employed population and FFEs:

- Identification of self-employed individuals

According to the requirements of the existing regulatory framework, the provision of consumer loans requires the submission of information on formal income, while the issuance of business loans requires customers to have current accounts opened as taxpayers. In this regard, self-employed individuals without formal income or a current account opened as a taxpayer face limited access to credit.

- **Identification of FFEs:**

Although the activities of FFEs producing goods within a certain annual turnover threshold under the existing legislation are not considered entrepreneurial activity, agricultural loans may be classified as business loans under certain conditions in line with the *Regulation on creation of specific provisions for asset classification and loan loss provisioning*. Note that, according to the *Law on Family Farm Enterprises*, municipalities maintaining records of FFEs should issue a certificate confirming their status, employment activity, and work experience. Accordingly, the *Regulation on creation of specific provisions for asset classification and loan loss provisioning* requires FFE borrowers to possess this municipal certificate for a loan to be classified as an agricultural loan. In practice, the limited issuance of such certificates by municipalities restricts family farms from benefiting from the concessions applied to agricultural loans as defined by the CBA's regulations.

Section 3. Transforming the Sector: Core Challenges and Opportunities

Several key challenges have been identified that may hinder the realization of the strategic vision and objectives outlined in the *Strategic Framework for a Microfinance Model*. These include:

- *Resilience* – The difficulties caused by price volatility in the global energy market during 2015–2016 revealed multiple vulnerabilities and weaknesses of microfinance institutions, particularly their limited access to funding and low resilience to macroeconomic shocks.
- *Competitiveness* – NBCIs operate at a limited scale within the financial system. Due to narrow operational scope and relatively high operating costs, their ability to offer a wide range of financial products and services remains constrained.
- *Inclusion* – Gaps persist in the ecosystem responsible for delivering financial services to vulnerable segments, including self-employed individuals, FFEs, and micro and small businesses.
- *Integration* – The integration of the microfinance sector to the financial system remains weak. Only a limited number of microfinance institutions can attract funding from domestic banks.
- *Governance* – The corporate governance structures of microfinance institutions are underdeveloped.

Analyses suggest that the microfinance sector, including NBCIs, is currently operating below its potential. The sector has significant room for growth in terms of market size and customer outreach; there are also opportunities for deeper institutional development of microfinance institutions.

Section 4. Strategic framework for a microfinance model

Five strategic priorities have been defined to shape the microfinance model. These priorities aim to foster the development of a sustainable and inclusive non-bank financial system and contribute to the economic development of the country by increasing financial inclusion and transparency of micro financial institutions.

Priority 1. Enhance the legal and regulatory base of microfinancing

Although a basic legal and regulatory framework exists, there is a need to further revise and strengthen it to expand development opportunities for microfinance and other non-bank financial institutions, while reducing the legal and regulatory burden on market participants.

- *Incorporate the 'microcredit' concept in legislation*

In international practice, the definition 'microcredit' refers to national currency denominated loans to legal entities and individuals for income-generating activities, within a defined amount (e.g., AZN25,000) and maturity (e.g., up to 60 months). Incorporating this definition into the legal framework – aligned with international standards - would lay the foundation for formally recognizing institutions specializing in microfinance. In international practice, a microfinance institution is typically defined as an entity whose loan portfolio consists of at least 50% microcredits.

Formalizing this definition in law, would enable the implementation of targeted, incentive-based policies for both banks and NBCIs specializing in microfinance.

- *Identification of NBCIs specializing in microfinance and expansion of their operational scope*

Eligibility criteria for NBCIs specialized in microfinance (hereinafter – broad-scope NBCIs) are planned to be defined. These criteria are expected to include at a minimum:

- Minimum share of microcredits in the lending portfolio (e.g., at least 50%, as commonly accepted in international practice).
- to mitigate potential risks, additional capital requirements may be introduced for broad-scope NBCIs. Institutions intending to engage in currency exchange operations may also be subject to specific requirements regarding charter capital.
- strengthening the prudential reporting framework (for instance, in addition to quarterly prudential reports submitted to the CBA, broad-scope NBCIs may be required to submit monthly reports containing key data. Like banks, the provision of certain daily reports, the expansion of prudential reporting framework may also be considered to reflect the nature and scale of services provided).

The following additional service areas are under consideration for eligible NBCIs:

- execution of money transfers without opening an account

- currency exchange operations
- processing utility bill payments
- cash and valuables transportation
- storage of valuables in safe boxes.

Additionally, within the parameters to be defined, the potential for broad-scope NBCIs to facilitate the opening of current accounts for business clients in banks, as well as to provide services through POS terminals, will also be evaluated.

Priority 2. Diversification of financing sources of NBCIs

Strengthening financing through banks. To increase access of broad-scope NBCIs to institutional financial resources is the implementation of a lending mechanism by banks using the microcredit portfolio as collateral. Although there are no legal restrictions on the application of this mechanism, it is not actively used, and in some cases, banks require a disproportionately high amount of collateral from NBCIs relative to the loan amount as a condition for its implementation. To channel bank resources into the microfinance sector, a revision of the Risk-Weighted Asset (RWA) rates is planned with respect to NBCIs that meet the relevant criteria and banks specialized in microcredits.

The Georgian experience. During the pandemic, the National Bank of Georgia implemented a two-component financing portfolio under the portfolio collateral system to promote the financing of MSMEs.

1. Banks obtained liquidity in the national currency by pledging SME loans as collateral with the National Bank
2. The regulatory authority encouraged the financing of microfinance organizations through banks. Microfinance organizations obtained financing by pledging SME loans, meeting parameters set by the regulator, as collateral with commercial banks.

Financing through the securities market (bond issuance). Another key source of financing for the microfinance sector is capital market-based funding. However, the cost of financing through bond issuance is high for NBCIs, primarily due to their risk profiles. Introduction of broad-scope NBCIs and the expansion of permitted activities, along with stricter regulatory and governance policies, will enhance the resilience of financial institutions, which will enhance NBCIs' credibility with investors and reduce financing costs. In parallel, it is planned to revise the regulations on bond issuance under the 'Regulation on Requirements for the Maximum limits on the Volume of an Issuer's Bond Issue' for broad-scope NBCIs and banks that meet relevant criteria regarding the size of their microcredit portfolios.

Priority 3. Enhancing risk allocation mechanisms

Improving guarantee mechanisms for microcredits. To ensure broader coverage of microcredits through credit guarantee mechanisms, it is proposed to review the existing guarantee mechanisms of state support funds in the following directions:

- Extend of existing mechanisms for individual and portfolio guarantees to NBCIs as well (currently applicable only to banks)
- Revise the minimum threshold for loans under portfolio guarantees
- Revise of the maximum ratio of the guarantee amount to the outstanding principal loan amount, as well as the duration of the guarantee.

It is also planned to explore the feasibility of using NBCI-issued bonds as guarantee-eligible instruments. If this initiative is implemented, it would be appropriate to adapt the bond guarantee mechanism to the characteristics of NBCIs (e.g., the minimum nominal value of bonds per guaranteed prospectus, circulation period, etc.) The creation of such a mechanism would serve to promote the financing of NBCIs through bonds and reduce costs associated with bond issuance.

Creation of a hedging mechanism for foreign currency risks of NBCIs by the CBA.

The CBA intends to develop hedging opportunities for broad-scope NBCIs to manage foreign currency risk through swaps or non-deliverable forward contracts. To increase external financing by reducing foreign currency denominated borrowing costs of broad-scope NBCIs, the CBA will assess providing hedging options for funds attracted from abroad within a specified period and limit.

In this regard, the CBA plans to introduce a legal and operational framework for hedging foreign currency-denominated funds attracted by NBCIs through swaps or non-deliverable forward contracts.

To prevent excessive foreign currency exposure, the CBA will consider restricting such hedging instruments to one-year maturities (with an option for extension), and will establish institution-specific ceilings (e.g., a limit for a broad-scope NBCI might be determined based on the size of its capital).

Following the establishment of the hedging framework, the CBA will explore the feasibility of establishing a fund for this purpose.

Note that, in 2020, due to the pandemic, the CBA and the banks operating in the country conducted non-deliverable forward contract operations with a duration of up to one year. The amount for each non-deliverable forward contract operation with a bank was determined based on the portion of the deposit in national currency that was converted to foreign currency.

Georgian experience. During the pandemic, the National Bank of Georgia provided liquidity support to banks and microfinance institutions by creating a swap opportunity totaling \$400M (\$200M for banks and \$200M for microfinance institutions), mainly through FX swaps and stand-by FX swaps. The operation involves the purchase of foreign currency at the spot price for one month and the sale of the same currency at the forward price. The calculation of the forward price for foreign currency is based on the 1-month TIBR1M for GEL and the 1-month LIBOR for the US dollar (LIBOR1M). The stand-by FX swap operation was created to provide additional liquidity in the market when needed, with a higher interest rate applied to ensure liquidity in the national currency. In the stand-by FX swap operation, a penalty interest rate is added, which is the difference between the overnight credit rate and the policy rate set by the National Bank of Georgia. The swap operation is executed for a one-month period and can be renewed each month. Furthermore, the total amount for the swap operation is distributed among the participants based on their market share, and to reduce concentration, each financial institution is assigned a limit of 25% of the total amount (\$200M).

Priority 4. Institutional development of NBCIs

Strengthening corporate governance plays a significant role in enhancing the institutional potential of financial institutions, which, in turn, creates an enabling environment for microfinance specialized NBCIs to operate sustainably and develop successful strategies. In capacity building, it is essential to support initiatives that improve corporate governance and promote market behavior. In this regard, it is planned to make relevant amendments to the legislation, establish and implement requirements for corporate governance standards, prepare necessary guidelines, and conduct training sessions. Additionally, sector initiatives aimed at strengthening corporate governance and market behavior through codes of conduct and other similar measures will be supported.

Furthermore, it is planned to develop requirements for external audits in NBCIs and address any shortcomings in this area.

Additionally, strengthening the framework for public disclosure of information by NBCIs, and enhancing requirements for price transparency in microfinance and NBCIs to protect customer rights and ensure fair market competition, will also be implemented.

Priority 5. Improving identification of self-employed population and family farms

Relevant public institutions are planned to implement initiatives aimed at improving the identification system of the self-employed individuals to increase their access to finance. It is envisaged to revise the existing legal framework for the self-employed individuals and FFEs, clarify their legal status, and align them with various laws and regulations. Examples of related best practices are outlined below.

Egyptian experience. Given that most micro and small businesses with annual sales below 20 million Egyptian pounds (~420,000 USD) operate in the informal sector, they are allowed to be financed without requiring financial statements. However, banks should evaluate these types of business entities using alternative methods in accordance with the Central Bank's relevant regulations. Banks should use digital credit scoring models based on alternative data such as customer behavior, social information, financial, and non-financial transactions for risk analysis.

Russian experience. The scope of self-employment activities is defined by the Law on the Special tax regime for 'Professional income tax' approved in 2018. The law will remain in effect until 31 December 2028. According to the Law, both individuals and private entrepreneurs can qualify as the self-employed population. Individuals should pay a 4%, and private entrepreneurs a 6% tax. To qualify as self-employed under the Law, an individual should:

- be over 16 years old
- be a Russian citizen
- operate independently, without hiring employees
- earn less than 2.4 million roubles (~26,000USD) annual income.

Individual operating within the special tax regime can only engage in activities subject to professional income tax, without the need for registration as private entrepreneurs. However, certain activities under this law require registration as a private entrepreneur.

Uzbekistan experience. In 2020, the President of Uzbekistan issued a decree aimed at promoting entrepreneurship and stimulating formal employment by simplifying the state regulation of entrepreneurial activity and self-employment. According to the decree, individuals engaged in self-employment with an annual income of up to 100,000 soms (~8,000 USD) are exempt from income tax (income above this threshold is subject to personal income tax). These individuals are only required to make social payments for pension contributions. For families engaged in self-employment with at least three members, the tax rate is reduced by 50%. According to Uzbek law, a self-employed person cannot hire employees and cannot work for another employer. Furthermore, changes to the current legislation have expanded the scope of self-employment activities, and a total of 101 types of activities are now considered self-employment (e.g., tutoring, childcare, household appliance repair, etc.). In addition, the registration process for self-employed individuals has been simplified. Now, self-employed individuals can register through an online mobile application.

To strengthen the effectiveness of the registration mechanism for FFEs, relevant public authorities, and other sector representatives (the Azerbaijan Banks Association and the Azerbaijan Microfinance Association) will carry out joint activities. The first step here will involve conducting surveys to clarify the scope of the challenges and preparing and implementing a corresponding action plan. Note that, a survey has already been conducted among selected NBCIs and the main reason identified was the lack of awareness among the population (potential family farms). To increase awareness,

awareness-raising activities will be carried out in cooperation with the relevant institutions.

Abbreviations

CBA – Central Bank of the Republic of Azerbaijan

NBCI – Non-bank Credit Institutions

MSMEs – Micro, Small and Medium-sized Enterprises

SMEs – Small and Medium-sized Enterprises

GDP – Gross Domestic Product

FFE – Family Farming Enterprises

NC – National Currency

FC – Foreign Currency