



Completion Report

Project Number: 28395
Loan Number: 1529-KGZ
October 2008

Kyrgyz Republic: Rural Financial Institutions Project

CURRENCY EQUIVALENTS

Currency Unit – som

		At Appraisal	At Project Completion
		15 June 1997	31 Dec 2006
Som1.00	=	\$0.0575	\$0.0262
\$1.00	=	Som17.40	Som38.1

ABBREVIATIONS

ADB	–	Asian Development Bank
DITAC	–	Directorate of Investment and Technical Assistance Coordination
DGRV	–	Deutscher Genossenschafts-und Raiffeisenverband
FCSCU	–	Financial Company for the Support and Development of Credit Unions
GTZ	–	Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)
KAFC	–	Kyrgyz Agricultural Finance Company
NBKR	–	National Bank of the Kyrgyz Republic
PPTA	–	project preparatory technical assistance
SSC	–	Savings and Settlement Company
TA	–	technical assistance

NOTE

In this report, "\$" refers to US dollars.

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BASIC DATA

A. Loan Identification

1.	Country	Kyrgyz Republic
2.	Loan Number	1529-KGZ (SF)
3.	Project Title	Rural Financial Institutions
4.	Borrower	Kyrgyz Republic
5.	Executing Agency	National Bank of the Kyrgyz Republic
6.	Amount of Loan	SDR9,005,000 (original) SDR7,110,061 (revised-net)
7.	Project Completion Report Number	PCR:KGZ 1068

B. Loan Data

1.	Appraisal	
	– Date Started	24 February 1997
	– Date Completed	21 March 1997
2.	Loan Negotiations	
	– Date Started	8 July 1997
	– Date Completed	10 July 1997
3.	Date of Board Approval	21 August 1997
4.	Date of Loan Agreement	7 November 1997
5.	Date of Loan Effectiveness	
	– In Loan Agreement	7 February 1998
	– Actual	30 April 1998
	– Number of Extensions	1
6.	Closing Date	
	– In Loan Agreement	31 March 2005
	– Actual	27 March 2007
	– Number of Extensions	2
7.	Terms of Loan	
	– Interest Rate	1%
	– Maturity (number of years)	40
	– Grace Period (number of years)	10
8.	Terms of Relending (if any)	
	– Interest Rate	Interest payable shall not be less than the then current rate applicable to dollar loans from the Bank's OCR
	– Maturity (number of years)	20
	– Grace Period (number of years)	7
	– Second-Step Borrower	Financial Company for the Support and Development of Credit Unions (FCSCU)

9. Disbursements
a. Dates

Initial Disbursement	Final Disbursement	Time Interval
17 July 1998	27 March 2007	99 months
Effective Date	Original Closing Date	Time Interval
30 April 1998	31 March 2005	83 months

b. Amount (SDR)

Category or Subloan	Original Allocation	Last Revised Allocation	Amount Disbursed	Undisbursed Balance
1. Sub-project activities	6,051,500	6,016,500	6,016,592	-92.00
2. Consulting Services	1,701,500	108,953	60,026	48,927.00
3. Training	75,000	15,853	15,852	1
4. Equipment & Furniture	142,500	193,782	193,782	0
5. Service vehicle	36,000	35,789	35,789	0
6. Portion of recurrent costs	746,500	536,387	536,560	-173.00
7. Service charge	252,000	252,000	252,000	0
Total	9,005,000	7,159,264	7,110,601	48,663.00

10. Local Costs (Financed)

- Amount (\$)	1,057,686
- Percent of Local Costs	23.49
- Percent of Total Cost	11

C. Project Data

1. Project Cost (\$'000)

Cost	Appraisal Estimate	Actual
Foreign Exchange Cost	8.4	8.8
Local Currency Cost	13.7	10.7
Total	22.1	19.5

2. Financing Plan (\$'000)

Cost	Appraisal Estimate	Actual
Implementation Costs		
Borrower Financed	1.2	1.2
ADB Financed	12.5	9.9
Other External Financing	8.4	8.4
Total	22.1	19.5
IDC Costs		
Borrower Financed	0.0	0.0
ADB Financed	0.3	0.4
Other External Financing	0.0	0.0
Total	0.3	0.4

ADB = Asian Development Bank, IDC = interest during construction.

3. Cost Breakdown by Project Component (\$ '000)

Component	Appraisal Estimate	Actual
A. Establishment of CU System		
- Establishment of CUs/ Subloan activities	8.400	8.618
- Institutional Strengthening	3.120	0.157
Subtotal (A)	11.520	8.775
B. Project Management	0.630	0.743
Total Disbursement	12.150	9.518
Service Charge	0.350	0.356
Subtotal (B)	0.980	1.099
Total Cost	12.500	9.874

4. Project Schedule

Item	Actual
Date of Contract with Consultants	8 December 2006
Equipment and Supplies	
Dates	
First Procurement	16 June 1998
Last Procurement	28 February 2005
Completion of Equipment Installation	29 August 2005

5. Project Performance Report Ratings

Implementation Period	Ratings	
	Development Objectives	Implementation Progress
From 1 January 2006 to 31 December 2006	S	S
From 1 January 2005 to 31 December 2005	S	S
From 1 January 2004 to 31 December 2004	S	S
From 1 January 2003 to 31 December 2003	S	S
From 1 January 2002 to 31 December 2002	S	S
From 1 January 2001 to 31 December 2001	S	S
From 1 January 2000 to 31 December 2000	S	S
From 1 January 1999 to 31 December 1999	S	S
From 30 April 1998 to 31 December 1998	S	S

D. Data on Asian Development Bank Missions

Name of Mission	Date	No. of Persons	No. of Person-Days	Specialization of Members^a
Inception	22 November -8 December 1997	2	16	a, b
Review 1	8-19 June 1998	3	12	a, b, c
Special Loan Administration 1	20-25 July 1998	1	6	a
Special Loan Administration 2	7 September 1998	1	1	a
Loan Review 1	3-17 September 1999	2	15	a, d
Midterm Review	12 May-12 June 2000	4	32	a, b, d
Review Mission	14-19 March 2001	1	6	a
Loan Review 2	4-20 June 2001	4	17	a, b, d
Review 2	22-26 April 2002	1	5	e
Loan and TA Review 1	18-21 June 2002	1	4	a
Loan Review 3	2-10 October 2002	2	9	f
Loan Review 4	24-3 October 2003	2	9	f, g
Loan Review 5	24-29 November 2003	1	6	f
Loan and TA Review 2	8-12 December 2003	1	5	f
Loan and TA Review 3	15-16 March 2004	2	2	f, g
Project Steering Committee Meeting at Issyk-Kul	10-12 June 2004	2	3	f
Loan Reconnaissance and Review	3-13 November 2004	4	11	d, h, i, j,
Loan and TA Review 4	7-18 November 2005	3	21	b, d, g
Loan and TA Review 5	18-27 December 2006	3	10	b, d, g
Project Completion Review	17-5 October 2007	3	19	b, d, g

^a a – senior project economist, b – assistant project analyst, c – rural development specialist (finance), d – staff consultant (microfinance development specialist), e – principal project economist, f – rural financial market specialist, g – resident mission project implementation officer, h – economist, i - banking sector specialist, j – economic officer.

I. PROJECT DESCRIPTION

1. The Rural Financial Institutions Project was part of a broader effort to support the Kyrgyz Republic in the transition to a market economy.¹ After independence in 1991, the Government of the Kyrgyz Republic maintained its commitment to structural reform and macroeconomic stabilization despite deteriorating economic and social conditions. Rural areas were particularly hit hard by the challenges of land reform, liberalization of commodity prices, and the collapse of state-owned banks which had been the major providers of financial services. Despite a continuous decline in agricultural output from 1990 to 1995, the rural areas provided a livelihood (largely from agriculture and related enterprises) for more than 60% of the population, with the agricultural sector accounting for more than 40% of gross domestic product and 50% of export earnings.

2. Against this backdrop, there was a clear need for policy measures to address the dearth of financial services in rural areas. The collapse of Agroprombank, which previously provided more than 90% of credit to the agricultural sector, and other bank failures resulted in a decline in bank branches from 170 to 70, leaving 25 of 42 *raions* (districts) without banking services in 1996. In addition to requiring new institutions to deliver credit to rural areas, there was a pressing need to provide payments services and to mobilize savings, moving from the former system of centrally planned finance to one of market-based intermediation. To complement the ongoing reform of the banking system and the introduction of nongovernment organization-funded microfinance activities, the Government undertook three specific initiatives to address the dearth of credit and absence of savings mobilization in rural areas. It established (i) a state-owned financial institution to deliver savings and payments services, the Savings and Settlement Company (SSC); (ii) a new state-owned company to deliver agricultural credit, the Kyrgyz Agricultural Finance Company (KAFC); and (iii) a nationwide network of credit unions.

3. Credit unions—small, member-owned financial institutions—offered a means of bringing financial services to the vastly underserved rural areas, particularly smaller centers unlikely to attract commercial bank branches. The legal foundation for credit unions was introduced by presidential decree in November 1995, with the first three credit unions established as a pilot project assisted by the Asian Development Bank (ADB).² The project preparatory technical assistance (PPTA) and results of the three trial credit unions indicated that substantial savings amounts throughout the country were not deposited in banks, but with proper incentives these could enter the formal financial system. Mobilizing these savings could help to create self-sustaining institutions, thereby overcoming the ingrained reliance on centralized financing, a poor repayment culture, and a distrust of financial institutions. Building on successful completion of the pilot project, the Rural Financial Institutions Project was then developed to support the introduction of credit unions across the country.

4. The Project's long-term development goal was the establishment of a sustainable rural financial system, with an immediate objective of increasing the level and sources of savings mobilization and lending services in rural communities. The two components of the Project were the establishment of a credit union system, and project management. Establishing a sustainable credit union system included a first tier of individual credit unions, a second tier or apex institution to support credit union development, and an effective regime of regulation and supervision. Specific objectives were to (i) establish 280 credit unions across all regions,

¹ ADB. 1997. *Report and Recommendation of the President on a Proposed Loan to the Kyrgyz Republic for the Rural Financial Institutions Project*. Manila.

² ADB. 1996. *Agricultural Credit Pilot Project*. Manila.

supported by a credit line (to match member contributions) with the Financial Company for the Support and Development of Credit Unions (FCSCU) to train and develop credit union staff in management and operation of credit unions; (ii) support the further development of FCSCU to provide the services of an apex organization through technical assistance (TA) and financial support and promote regulation and supervision of credit unions; and (iii) train National Bank of the Kyrgyz Republic (NBKR) staff in regulation and supervision of the credit union system (footnote 1). Recognizing that building the capacity of FCSCU, NBKR, and individual credit unions to fulfill their respective roles was crucial to the success of a credit union system, the project included a significant TA component to provide management advice, training of trainers, development of an accounting system, product development, as well as systems and procedures for regulation and supervision. TA was also contemplated for NBKR in its role as Executing Agency in order to build capacity in project management, monitoring, and evaluation.

II. EVALUATION OF DESIGN AND IMPLEMENTATION

A. Relevance of Design and Formulation

5. Pursuant to the Government's Public Investment Program Review and Update for 1997–98,³ accepted at the Consultative Group meeting in October 1996, a clear policy was adopted to (i) avoid the proliferation of project-dependent credit schemes, and (ii) rely on the banks and other financial institutions for rural financial intermediation. ADB's country operational strategy emphasized support for the Government's reform activities.⁴ The Project was wholly consistent with supporting reform and meeting one of the Government's key policy objectives by establishing a new network of sustainable rural financial institutions. Credit unions were an entirely new concept in the country, and as a result the main consultation with the final beneficiaries—potential credit union members—took place in the context of the PPTA and, in particular, through the formation of three pilot credit unions. The project design was largely developed and implemented in a top-down manner through interaction with officials of the Government and NBKR.

6. Financial sector reform was strongly supported by development partners, with ADB playing a particularly important role with respect to the rural financial system. The policy dialogue strongly influenced the Government decision to move away from a traditional reliance on delivery of credit through supply-led state-owned institutions towards self-sustaining institutions, similar to the three trial credit unions established as part of the PPTA. ADB successfully engaged the authorities in discussion of a number of issues central to the successful development of credit unions. One problem, however, was that credit unions were allowed to onlend ADB loan proceeds to their members before a legal and regulatory framework was established to adequately serve the purpose of savings mobilization and lending services. Another significant issue was the lack of full agreement on the issue of deposit-taking. NBKR was particularly concerned that individuals might lose their savings in poorly managed credit unions, bearing in mind the experience with the collapse of banks, and agreed only that deposits could be introduced in future for mature credit unions.⁵ While the caution was understandable, it meant that from the outset credit unions focused solely on lending rather than savings.

³ Kyrgyz Republic. 1996. *Public Investment Program Review and Update for 1997–1998*. Bishkek

⁴ ADB. 1996. *Country Operational Strategy Study: Kyrgyz Republic*. Manila.

⁵ NBKR. Letter to ADB dated 20 August 2001.

ADB. Aide Memoire of the Rural Financial Institutions Project (Loan 1529-KGZ) Review Mission, Bishkek., October 2002.

7. Two elements of the original project design warrant further attention: (i) the decision to establish FCSCU as a wholly-owned subsidiary of the central bank; and (ii) the expectation of rapid privatization of FCSCU through sale to credit unions. While establishing an entity with a development mandate as a subsidiary of a central bank was consistent with prevailing ADB views at the time of design,⁶ concerns with the potential conflicts between safety and soundness and promoting rapid growth of financial intermediaries have since become more prevalent. The need for NBKR to focus exclusively on its mandate to maintain stability and soundness as established in the Law on the National Bank led to the divestiture of SSC from NBKR to the Ministry of Finance in 2003, which also eliminated the potential conflict between NBKR's role as owner and its role as the supervisor of SSC under the banking law. No such change in ownership of FCSCU was contemplated, probably because the original project design envisaged divestiture of FCSCU to credit unions in year 3.

8. The anticipated divestiture of FCSCU to credit unions was central to meeting the objectives of establishing a second tier or apex organization controlled by credit unions. The project design contemplated that each credit union would invest 5% of its capital in shares of FCSCU. However, from the outset it was recognized that this might not be achievable as the Borrower and ADB agreed that other specialized financial institutions might be allowed to acquire shares in FCSCU (footnote 1). This aspect of the Project proved to be the most challenging, and later the condition on transferring the majority ownership of FCSCU to the credit unions was eliminated. Extensions beyond the originally planned 7-year span were agreed upon to provide additional time to deal with the FCSCU divestiture, which remained outstanding when the project completion review mission was fielded.

B. Project Outputs

9. Establishing a credit union system was the main component of the Project. The most successful aspect has been the introduction of credit unions in all regions of the country. The figure of 304 credit unions with almost 28,000 members at the end of 2004 exceeded the original target of 280 credit unions, and matches the original objective of 28,000 members, with these numbers having varied slightly through extensions to the actual project completion date of the end of 2006 (Table 1). Delving below the headline results, however, reveals that the project results differed significantly from the original design, leaving open the question of how many credit unions are truly sustainable.

⁶ See, for example, ADB, 2000, *The Role of Central Banks in Microfinance in Asia and the Pacific*, which endorses a promotional role for NBKR, notwithstanding the acknowledged primacy of price and financial stability as NBKR's objectives.

Table 1. Success Indicators for the Rural Financial Institutions Project

Item	Projected 2004 (original project completion)	Actual 2004	2006 (actual completion)	December 2007
Number of credit unions	280	304	305	272
Total credit union members	28,000	27,707	28,865	28,576
Shares and institutional capital (\$ million)	11	5.0	8.1	5.1
Credit union loans to members (\$ million)	19	10.6	17.7	21.6
FCSCU loans to credit unions (\$ million)	8.75	5.0	8.3	10.1
Net worth/total average assets (%)	67	42.3	50.2	42.7
Performing loans/total loans (%)	90	97.5	96.9	97.2
Net income/total average assets (%)	3.8	14.7	1.4	7.7

FCSCU = Financial Company for the Support and Development of Credit Unions

Note: End-2004 exchange rate \$1 = Som41.6, end-2006 exchange rate \$1 = Som38.1.

Source: Asian Development Bank. 1997. *Report and Recommendation of the President on a Proposed Loan to the Kyrgyz Republic for the Rural Financial Institutions Project*. Manila. 2004 and 2006 actual are taken from the Government of the Kyrgyz Republic project completion report.

10. The project design anticipated that, by the end of the Project, FCSCU loans would finance about 46% of credit unions' loan portfolios, with the balance funded through member deposits, shares, and retained earnings (institutional capital). The end-2004 and end-2006 results for FCSCU funding were broadly consistent with this objective, however the composition of credit unions' other funding sources was not as originally expected. Credit unions have mobilized a negligible volume of deposits, and thus are dependent on shares, retained earnings, and other external borrowings; wholesale finance provided by lenders other than FCSCU accounted for almost 11% of credit unions' external borrowing at the end of 2006.

11. The Project did not meet the objectives of mobilizing savings and providing basic financial services in addition to credit in rural areas. The six credit unions licensed to date to accept deposits are all among the largest credit unions, but thus far have mobilized deposits equivalent to less than 1% of credit union assets. Some credit union leaders attribute the small number of applications for deposit licenses to the prudential requirements of NBKR, which they view as overly strict.

12. At the request of the Government, the consulting services portion of the loan was cancelled in favor of grant-financed TA provided by the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) through Deutscher Genossenschafts-und Raiffeisenverband (DGRV). While understandable from a fiscal perspective, the decision weakened the link between the originally planned consulting services and delivery of the onlending program.

13. Through the life of the Project and continuing to the time the completion review mission was fielded, FCSCU has existed primarily to administer the onlending of the ADB credit line. The original Project design envisioned two other important functions for FCSCU—provision of apex services, and the supervisory function played by system-controlled audit companies or stabilization funds in some countries. Training and development activities were implemented through GTZ and DGRV, with FCSCU developing only limited capacity to offer ongoing training and consulting support to credit unions. FCSCU does not offer any products to credit unions beyond lending and leasing.

14. An effective supervisory oversight regime for credit unions was only implemented in the last year of the Project, rather than in the first year as originally intended. NBKR introduced

regular off-site reporting and analysis, on-site examinations, and, where required, enforcement action including license revocation and liquidation.⁷ The current regime varies from the original project design in that NBKR directly supervises credit unions rather than delegating this responsibility to FCSCU. This change was agreed in 2004 in conjunction with an FCSCU turnaround plan developed to meet concerns over financial performance and ineffective supervision, with NBKR assuming responsibility for supervision from July 2005 onwards.⁸ By the end of 2005 NBKR had commenced a formal series of on-site examinations which marked the beginning of effective credit union oversight.⁹

15. The project management component also suffered from the cancellation of the TA portion of the loan, which, among other things, had been intended to provide consulting services to build capacity within NBKR. The absence of project management support was cited by the June 2000 midterm review mission as the reason for the lack of reporting on benefits, monitoring, and evaluation, notwithstanding agreements reached by the 1998 and 1999 review missions on a timetable for delivery. While a regime of quarterly statistical reporting was subsequently implemented, timeliness remained an ongoing issue (reports for the third and fourth quarters of 2006 were not available when the project completion review mission was fielded in September 2007).

C. Project Costs

16. The total project cost was estimated at \$22.1 million, with the ADB loan of \$12.5 million comprising 56%, a Government contribution of \$1.2 million equivalent, and credit union contribution of \$8.4 million, matching the \$8.4 million onlending component. Subsequently there were two partial cancellations, the first of \$2.2 million representing the substitution of GTZ grant-financed TA for the originally planned TA, and the second of \$210,261 representing a portion of the originally budgeted \$1.04 million payments to FCSCU to offset recurrent costs during its start-up phase. Total disbursement at project completion was \$9.87 million, 99% of the reduced loan amount of \$9.95 million. The Government fully met its contribution obligation.¹⁰

D. Disbursements

17. Actual disbursements differed significantly from the original design. As noted in para.15, the TA component intended to be disbursed in the first 3 years of the program was cancelled. Although the GTZ grant-financed TA began to be fielded in 1999, there was no TA provided in 1998, when disbursements for the onlending line were almost three times greater than the originally planned \$218,000 (disbursements are shown Appendix 2). Onlending disbursements ran ahead of the original plan during the first 2 years of the Project, and subsequently were well below plan, reflecting a slowdown in FCSCU lending as efforts were made to deal with the problems that emerged in credit unions and weaknesses in FCSCU processes and systems, including the discovery of fraud in some credit unions (later confirmed to number 21) in 2002.

18. The loan agreement required the Borrower to open an imprest account to receive the loan proceeds from ADB. This arrangement for disbursement of loan proceeds was appropriate

⁷ Since 1997, 173 credit union licenses have been revoked for violating relevant laws and regulations.

⁸ ADB, Government of the Kyrgyz Republic. Memorandum of Understanding of the Rural Financial Institutions Project (Loan 1529-KGZ) Review Mission, November 2004.

⁹ By the end of 2007, NBKR's Non-Banking Supervision Department—with its licensing, off-site, and on-site units—was fully staffed and operational.

¹⁰ Including the paid institutional capital of FCSCU, reserves, and detained earnings not used by NBKR.

and disbursement of loan proceeds was completed in accordance with ADB's disbursement procedures.

E. Project Schedule

19. The sequencing of activities contemplated in the project implementation schedule (footnote 1) was not realized, which had adverse consequences that were noted at the time of the first review mission in 1998 and continued in evidence for the life of the Project. Finalization of the credit union legislation, prudential norms, and regulations was to have preceded the establishment of credit unions. In fact, the credit union system operated under interim legal arrangements until the enactment of legislation during the second year of the program (1999). The interim regulations did not permit mobilization of deposits, which meant that 165 credit unions established during the first 2 years of the program—far more than the 100 projected in the project design—were established largely because of the availability of ADB funding rather than with the intention of mobilizing local savings.

20. FCSCU's reporting system and procedures for surveillance were to have been introduced concurrently with the beginning of credit union formation (at the end of the first quarter of year 1). Fully fledged supervision was to have been in place by the middle of year 1. Effective surveillance was ultimately not implemented until after responsibility had been transferred to NBKR in year 8 of what had originally been designed as a 7-year project.

21. Consulting services were originally scheduled to be provided from the outset of the Project and be completed by the middle of year 3. After the decision to substitute the TA with the GTZ TA, delivery began in year 2 and continued until May 2007. Since TA was not delivered intensively at the outset as originally envisaged, much of the TA work was more difficult as it involved catching up with more than 100 credit unions already established and attempting to modify and correct systems within FCSCU, rather than training and putting systems in place prior to undertaking major operations.

22. The original objective was to transfer ownership of FCSCU to credit unions by the end of year 3, but no specifics were provided in the original program design as to how this would be achieved beyond the presumption that credit unions would devote 5% of their capital to purchase of FCSCU shares. The need for a detailed plan for ownership transfer of FCSCU was flagged in the first review mission in June 1998, although the authorities took the view that it was too early to address the specifics. The issue of FCSCU divestiture proved intractable, despite project extensions for the specific purpose of addressing the future of FCSCU and additional TA interventions. FCSCU remained wholly owned by NBKR as the project completion review mission was fielded.

F. Implementation Arrangements

23. NBKR was the Executing Agency, with FCSCU responsible under a subblending agreement for administration of the onlending component. Lack of progress by FCSCU towards most of its objectives was noted in successive review missions and the minutes to Consultative Committee meetings. In part this was due to the lack of consulting assistance to FCSCU for the development of a strategic plan and implementation of internal systems and controls. However, more precise and detailed projections for FCSCU could usefully have been incorporated into the original project design.

24. Assessing the financial performance of FCSCU as a development financing institution is challenging on several counts. First, the financial projections in the original program design forecast did not take into account the loan proceeds to be disbursed as a grant to FCSCU to offset operating losses in years 1–3. Second, it became clear in 2001 that the financial results reported by FCSCU in earlier years were questionable due to understatement of loan loss provisions and the corresponding overstatement of earnings and equity. Sharp increases in loan loss provisions in 2001 and 2002 partly reflected more realistic assessment of loans that had been extended to credit unions in earlier years. Part of the increased loan loss expense arose from the discovery in 2002 that a number of credit unions (later confirmed to be 21) misrepresented information and falsified documents to obtain FCSCU loans which were used to improperly benefit members and to invest in high-risk activities unreported to FCSCU.¹¹ While it is to the credit of FCSCU and NBKR that the incidents of fraud were detected and addressed, they served to demonstrate weaknesses in FCSCU's internal processes and the absence of supervisory oversight at that time.

25. A further challenge to evaluating the performance of FCSCU is that, prior to 2004, it was not subject to specific operational performance targets. As part of the response to continuing concerns about FCSCU lending standards and financial performance, a number of financial targets were jointly developed and approved by NBKR, FCSCU, and ADB in December 2003 for implementation in 2004. Imprecise target definition resulted in divergent views between FCSCU management and ADB over whether the targets were met.¹² In response to continuing concerns, FCSCU with ADB TA developed a turnaround plan in October 2004, which included a wider range of performance targets.¹³ Many of the performance indicators were vague and difficult to measure (e.g., increasing professional skills of employees and healthy staff moral) and in some cases inconsistent with stated objectives (e.g., a 10% increase in personnel expenses in 2005 notwithstanding ongoing concerns about staffing levels and the planned transfer of supervision to NBKR with a resulting reduction in staff numbers).

26. Reported loan quality overall has been superior to that originally projected, illustrated by the generally lower loan loss expenses than expected (Appendix 3). Despite better asset quality and lower provisions (aside from 2002 as noted above), and reaching profitability faster than originally anticipated, FCSCU's net income since 2002 has trended below projections. This is because the benefits of lower than anticipated loan losses have been more than offset by lower interest margins and higher operating costs. FCSCU staff levels grew more rapidly than expected, and, although reduced somewhat from the peak of more than 60 to 53 at the end of 2007, have been maintained well above the originally projected total complement of 22.

G. Conditions and Covenants

27. Covenants and conditions were generally complied with throughout the Project, although, particularly with respect to supervision of credit unions and adherence to prudential norms, compliance has not been continuous (Appendix 4). A number of key changes to conditions and covenants were first officially requested by the authorities in April 2001.¹⁴ Given ongoing

¹¹ ADB. 2003. *Joint Attack on Fraud*.

Available: <http://www.adb.org/Integrity/fraud.asp>

¹² ADB, Government of the Kyrgyz Republic. Memorandum of Understanding of the Rural Financial Institutions Project (Loan 1529-KGZ) Review Mission, November 2004.

¹³ ADB. 2002. *Technical Assistance to the Kyrgyz Republic for Capacity Building in Savings and Credit Unions and Microfinancial Systems*, Manila.

¹⁴ Letter from NBKR dated 19 April 2001.

concerns about the condition of FCSCU, ADB staff was supportive of the request to defer privatization but was opposed to other requested changes. These would have expanded the Project to include Bishkek city, and increased the amount of credit that FCSCU could provide to individual institutions. The basis for opposing these elements of the request was that including Bishkek would fundamentally change the originally intended rural focus of the Project, and that increasing the amounts FCSCU could lend to individual credit unions would further undermine the already precarious project emphasis on savings mobilization.¹⁵

28. The requested changes and the ADB response appear to indicate that by 2001 there were divergent views of the future of the Project. Credit union leaders represented on the Consultative Committee¹⁶ and GTZ TA providers focused increasingly on the availability of external finance as the binding constraint on credit union development; ADB staff were focusing on the importance of savings mobilization. An exchange of proposals and counterproposals continued through 2003, with both credit union leaders and GTZ TA providers expressing frustration at the perceived intractability of both NBKR, which had some prudential reservations about increasing credit union external borrowing, and ADB, which was viewed as insufficiently flexible in its response to efforts to develop the credit union system through greater access to external finance.

29. Ultimately, in December 2003, agreement was reached on a package of minor loan amendments which went some way to meeting the expressed desire to increase external funding for credit unions while effectively introducing prudential limits on credit unions by adding definitions of total assets, institutional capital, share capital, and the capital adequacy ratio to the loan covenants. In addition, the number of members a credit union required before borrowing from FCSCU was increased from 10 to 50, a requirement for credit unions to be in operation for 3 months prior to borrowing was added, and the paid-in capital requirement was increased to address concerns that credit unions were being created solely to access the FCSCU credit line. Further, the requirement of the Loan Agreement that “the Borrower shall ensure that the majority ownership of FCSCU shall have been transferred from NBKR to the credit unions by no later than the end of the third year of project implementation” was amended to allow privatization by the end of 2005, with two further extensions to the end of 2006 and the end of 2007 subsequently agreed upon between the Government and ADB. The amended section of the Loan Agreement does not require the transfer of the ownership of FCSCU to credit unions.

H. Related Technical Assistance

30. The cancellation of the TA portion of the loan program and its replacement by a TA project grant-financed by GTZ and delivered by DGRV affected the Project in several ways. First, while selection of consultants under the original program plan had proceeded to the short-listing stage by June 1998, shortly after activation of the loan there was some loss of momentum as GTZ began a TA needs assessment in mid-1998, with actual TA delivery commencing in February 1999. The July 2001 review mission noted also that coordination with GTZ and DGRV was not as close as would be desirable, citing the unanticipated support by DGRV for formation of regional credit union associations and the planned formation of a national credit union association. The structure promoted by DGRV, including regional associations, a national association, and a credit union-owned audit company, was not

¹⁵ ADB. Aide Memoire of the Rural Financial Institutions Project (Loan 1529-KGZ) Review Mission, June 2001..

¹⁶ The project provided for ongoing stakeholder consultation through the constitution of a consultative committee. This was established in year 1 with 22 members, including one from FCSCU.

surprisingly very similar to the Raiffeisen model found in Germany and Austria. This structure, however, differed from the program design as it had been expected that FCSCU would be divested to credit unions by the third year, fulfilling apex functions including that of a credit union association, and that FCSCU would also supervise credit unions.

31. A grant TA project (footnote 16) was approved by ADB in December 2002 in response to the Government's request to strengthen the capacity of NBKR and FCSCU. While the TA was highly valued by the Government, overall it was rated "partly successful."¹⁷ While transfer of responsibility for supervision to NBKR was a good response to the continuing failure to implement effective oversight, one unintended consequence was that the value of TA provided to train inspectors in FCSCU was largely lost. FCSCU retained the bulk of its former examination staff in new roles, with only one of 10 inspectors hired by NBKR. While the presumption underlying the transfer of supervision from FCSCU to NBKR may have been that staff would be transferred en bloc, this was never specified, and perhaps was unrealistic from the outset as it involved individuals who would have to elect to leave one employer and join another, and, more importantly, the new employer deeming them suitable.

32. Further TA, particularly to address outstanding issues related to regulation and supervision and the divestiture of FCSCU, was provided at the request of the authorities in 2005.¹⁸ The recommended timeline for divestiture of FCSCU was very tight at the time of the November 2005 final report under the TA.¹⁹ The timeline proved unrealistic as: (i) consultants to undertake the valuation of FCSCU could not be fielded until the end of 2006, with the final valuation report delivered more than 1 year later than envisaged; (ii) divergent views persisted among credit unions regarding possible interest in investing in FCSCU ownership, with multiple national associations representing various portions of the credit union system having different visions of its future structure; and (iii) NBKR, Ministry of Finance, State Property Fund, and the Office of the Prime Minister did not reach agreement on a mechanism for divestiture of FCSCU. An external valuation of FCSCU, financed from loan proceeds, was completed in March 2007 for FCSCU's financial position as of the end of 2006. However, since the valuation of FCSCU might fluctuate sharply depending on developments with the quality of its loan portfolio, the inability to proceed with divestment of FCSCU shortly after receipt of the final valuation report limits the usefulness of the valuation.

I. Consultant Recruitment and Procurement

33. The Project had provisions for a total of 55 person-months of international and 15 person-months of national consulting services. However, since the TA component of the Project was cancelled, the consulting support to build project management capability was not delivered as planned. At a later stage of project implementation, the Government used loan proceeds to recruit an international firm to conduct an independent valuation of FCSCU. Selection and engagement of the international firm were carried out according to ADB's *Guidelines on the Use of Consultants* (2007, as amended from time to time). Despite some initial delay in short-listing of consulting firms due to unavailability of the potential bidders, NBKR and the Government were able to recruit and mobilize the international firm within the project implementation period. For all goods, works, and services contracts funded from loan proceeds, procurement was

¹⁷ More detail is available in the TA project completion report.

¹⁸ ADB. *Technical Assistance Consultant's Report on Credit Unions and Sustainable Rural Finance: Recommendations for Supervision and Development*. Manila

¹⁹ Fielding of the regional TA consultant was delayed from July until September due to United Nations field security warnings in advance of the July 2005 presidential elections.

undertaken in accordance with ADB's *Procurement Guidelines* (2007, as amended from time to time) following shopping procedures. Generally, no significant problems were encountered in procuring the services of the international firm, packaging contracts, preparing bidding documents, tendering, evaluating bids, and awarding contracts.

J. Performance of Consultants, Contractors, and Suppliers

34. An international firm, recruited for FCSCU evaluation, completed the assignment as scheduled, with its performance assessed as satisfactory. The performance of the suppliers of goods and works was satisfactory.

K. Performance of the Borrower and the Executing Agency

35. One of the challenges throughout the Project was the separation of sector policy responsibility, which rests with the Government, from the ownership of FCSCU, which lies with NBKR. NBKR may not have exercised the stewardship expected of the owner of a specialized financial institution, viewing itself as the owner in form only, since FCSCU in substance exists as an instrument of Government policy to deliver rural credit. Selection of NBKR as the Executing Agency and shareholder of FCSCU is understandable in the context of prevailing conditions at appraisal (NBKR already had in place a department to coordinate TA) and thus must have seemed a logical choice, even if the role of developing credit unions was not consistent with its core functions. The Government had looked to NBKR to provide direction to FCSCU, notwithstanding that support for the development of credit unions lies outside the core functions of the central bank, which are pursuit of price stability and maintaining the soundness of the financial system. NBKR oversight of FCSCU intensified after the midterm project review. However, problems surrounding strategic decisions on the divestiture of FCSCU have proved intractable.

36. NBKR as the Executing Agency suffered from the cancellation of the TA component of the Project as the anticipated consulting support to build project management capability was not delivered. Nevertheless, after difficulties in the early years of the Project (no reports had been provided by the time of the second review mission in June 1999), NBKR later came to deliver adequate quarterly reports, although timeliness was periodically an issue. NBKR prepared the required project completion report on a timely basis, and its capacity in carrying out procurement process, consultant selections, and contract administrations was generally adequate.

37. Overall, the performance of both the Executing Agency and Borrower is assessed "partly satisfactory." Notwithstanding the identified problems with the original design, including the lack of specificity on the plans and mechanism for divestiture of FCSCU, the inability of the Borrower and the Executing Agency to jointly agree on and implement a strategy to resolve the impasse over FCSCU after two 1-year extensions and additional TA is a continuing concern.

L. Performance of the Asian Development Bank

38. ADB staff flagged key concerns with the Project in the first review mission: (i) the pace of expansion was too rapid; (ii) there was an urgent need for continued and more substantial training for both FCSCU and credit unions, especially in light of weak internal controls and inadequate loan loss provisioning; (iii) there was an unconfirmed mechanism for transfer of FCSCU ownership to credit unions; (iv) the necessity of achieving sustainability by mobilizing

savings, which was not permitted by the interim regulations; and (v) the credit union law was not yet enacted, although it had been submitted to Parliament in 1997. Subsequent missions in 1999–2000 raised additional concerns on (i) project management by NBKR being adversely affected by the cancellation of the TA component, (ii) the appearance that many credit unions had been formed only to attract onlending funds, (iii) inadequate supervision by FCSCU, and (iv) noncompliance with agreed actions to address previously identified concerns.

39. While some other issues would arise later, ADB staff had identified early on all of the major problems that would affect the Project over its life. Part of the problem was that the Project had developed a momentum of its own—credit unions were formed in advance of other key project activities, creating pressure for disbursement despite the delays in building capacity in NBKR, FCSCU, and credit unions themselves. Restricting credit union formation until the supporting infrastructure could catch up was an unattractive option for the Borrower given the burgeoning popularity of credit union formation as a way of accessing finance. However, in retrospect it appears that this was probably the only action that would have suitably energized the needed remedial actions and provided the breathing space for the actions to take effect. As had been the case during loan negotiations, when the decision was taken to proceed despite not having reached full agreement over the issue of deposit-taking or having developed a detailed mechanism for FCSCU divestiture, the staff view that these issues could be resolved as the Project was implemented proved overly optimistic.

40. Overall the performance of ADB was rated "partly satisfactory." While issues and concerns were identified on a timely basis throughout the life of the Project, earlier and more decisive action, including suspending disbursements until the fundamental concerns about the capacity of FCSCU, NBKR, and credit unions had been addressed, may have improved the outcomes and efficiency of the Project. Continued disbursements in the absence of well-developed governance, systems, and controls in the subborrower increased the project risks, some of which were realized with the subsequent discovery of fraud in some credit unions and the poor financial performance of FCSCU.

III. EVALUATION OF PERFORMANCE

A. Relevance

41. The Project overall is assessed "relevant." At the outset it was highly relevant as it was designed to introduce sustainable rural financial institutions to fill the gap created by the collapse of state-owned banks. It further intended to provide credit on market terms and conditions to the population, as well as introduce savings and other basic financial services into rural areas. The Project was highly relevant to the ADB country strategy at the time—that of supporting Government reform efforts (paras. 5–6). As the Project developed with a greater emphasis on refinance rather than mobilizing savings for self-sufficiency, and the Government's other initiatives—first establishing and then reforming the SSC, the successful launch and later preparation for privatization of the Ayil Bank (formerly KAFC), and the emergence of more than 100 microfinance organizations within a supportive policy environment—began to bear fruit, the rural finance project declined somewhat in relevance. While credit unions retained an important place in the Government's 2006 microfinance strategy, it is difficult to distinguish credit unions from other microfinance organizations as they have yet to move towards financial self-sufficiency, and there is now a wide range of financial services providers operating in rural areas (Appendix 5).

B. Effectiveness in Achieving Outcome

42. The Project was rated "less effective" in achieving the expected outcomes as only one key objective—effective supervision of credit unions—was fully met, albeit with delays and in a manner differing from the original project design (para. 12). The numerical objective of 280 credit unions serving all regions was met, but as noted there are questions about the sustainability of many of these institutions (paras. 9–10), and also questions about how many are actually credit unions. The widely accepted World Council of Credit Unions model stresses the development of savings as the foundation of a credit union, rather than beginning with lending. This is important, because the project objective of mobilizing savings in rural areas has not been met—only six credit unions raise deposits and even these are largely dependent on external funding for sustainability. While the Project has had a significant impact on provision of credit, it has had virtually no impact in terms of bringing other basic financial services to rural areas. An apex institution has not yet emerged, and FCSCU remains an NBKR subsidiary (paras. 8 and 13).

C. Efficiency in Achieving Outcome and Outputs

43. The Project was rated "less efficient" in achieving the expected outcome and outputs. As noted, the originally expected outcomes were only partially achieved. While the target number of credit unions was exceeded, gross formation had been much higher, with over 200 credit unions having subsequently closed—this “boom and bust” cycle consumed supervisory and TA resources that would have been better utilized if the formation of credit unions had been more tightly controlled through a sound licensing process from the outset.²⁰ Effective supervision was finally achieved, but only at the end of the Project rather than in the initial year as planned, and only after additional TA resources were committed. The credit union legislation was not enacted until 1999, even though originally submitted to Parliament in 1997. When enacted, the legislation did not expressly provide for deposit-taking or an apex institution.

D. Preliminary Assessment of Sustainability

44. The sustainability of the Project is assessed “less likely” based on the following points. Since the end of 2006 the number of credit unions has declined by 8%, and consolidation continues as credit unions are voluntarily wound-up or have their licenses revoked by NBKR. Frontiers, a commercial investor in microfinance organizations, included 12 credit unions in its portfolio at the end of August 2007 and estimates a further 10 credit unions could easily meet its lending criteria if they were prepared to pay Frontiers’ interest rates, which are higher than those charged by FCSCU. Another provider of wholesale funds, Credit Union Stabilization Fund, has extended loans to 20 credit unions, and estimates approximately 50 more might meet its lending criteria. SSC currently has wholesale loans to two credit unions, and anticipates expanding its portfolio, although a significant number of credit unions have not proceeded with applications after learning through initial discussions of the terms and conditions of SSC credit. There is some overlap in the estimates of viable credit union borrowers by the various lenders, but even assuming that each lender has identified credit unions not viewed by others as viable, it appears

²⁰ Total TA expenditure equated to about \$0.22 for every \$1 of credit union loans to members outstanding at the end of 2006, or about \$0.43 for every \$1 not financed by FCSCU under the ADB project. The ADB grant-financed TA, provided pursuant to the Government’s request in addition to the GTZ grant-financed TA of \$3.5 million in place of the cancelled \$2.36 million TA, totaled more than \$4 million—about 70% more TA funding than had originally been planned.

that only one-third of the 305 remaining at the end of the Project are sustainable using the microfinance model.

45. Credit unions with good prospects for continued success in their lending activities operate more as microfinance institutions, and even the six credit unions with deposit-taking licenses continue to be dependent upon external finance, and in at least some cases are devoting more effort to attracting additional external finance than to mobilizing savings for self-sufficiency. Few credit unions can be identified as being truly cooperative, as in many cases there appears to have been little understanding on the part of members of the concept of a cooperative financial institution, with the requirement of members to purchase shares frequently viewed as a fee paid to obtain a loan.

46. Rather than having been divested to credit unions as an apex institution as was originally designed, FCSCU remains an NBKR subsidiary with an uncertain future. As it begins to make repayments under the subloan agreement, its capacity to continue to provide finance to credit unions and to operate profitably will decrease unless it is able to attract new funding sources and improve its operating efficiency.

E. Impact

47. The Project did catalyze provision of rural finance, although not in the manner originally intended. The \$8.3 million onlending portfolio of FCSCU supported total credit union loans of \$17.7 million at the end of 2006. In effect, credit unions are operating as microlending companies, dependent on wholesale funding and retained earnings rather than mobilizing savings to fund their activities. The fact that investors such as Frontiers are prepared to lend to credit unions on commercial terms provides a market indication that some credit unions have achieved sustainability using a microfinance model, and will continue to be a source of credit in rural areas.

48. Credit unions and FCSCU directly employ about 1,500 people, the majority of whom are women.²¹ Women also comprise 57% of credit union borrowers, accounting for 49% of the total value of loans outstanding at the end of 2006.²² These data suggest that women borrow to establish or expand somewhat smaller-scale enterprises than men, indicating that credit unions are playing an important role in empowering women in poorer households. This marks significantly increased participation by women over that observed in the 1997 pilot credit unions, where 77% of members were men (Appendix 6). While most credit union borrowers are not themselves among the very poor, use of loan proceeds to expand businesses, buy additional livestock, or cultivate additional land increased the demand for labor and thus provided job opportunities for the very poor.²³ Credit union borrowers surveyed indicate that each loan for agricultural or business purposes created three jobs. A leading microfinance organization, Bai Tushum, estimates from its borrower data that each \$250 advanced sustains or creates one job;²⁴ extrapolating this figure to credit union members, whom Bai Tushum views as being quite similar to its clients, suggests that the financing provided by credit unions supports over 70,000

²¹ ADB. 2007. *Special Evaluation Study on Effectiveness of Participatory Approaches in Rural Development Projects*. Manila. The Study estimates 1200 to 1500 jobs. The GTZ and GTRV completion report estimates 1500 jobs, the majority held by women.

²² NBKR. 2006. *Rural Financial Institutions Project 2006 Fourth Quarter Report*. Bishkek

²³ ADB. 2007. *Special Evaluation Study on Effectiveness of Participatory Approaches in Rural Development Projects*. Manila.

²⁴ Bai Tushum. 2007. Bai Tushum Profile. Available: <http://www.baitushum.kg>

jobs. With almost 22,000 active borrowers at the end of 2006, this equates to just over three jobs per loan, which is quite consistent with the agricultural (59%) and small-scale trade and service (31%) sectors supported by the vast majority of credit union loans, and the credit union member survey response.

49. Credit unions have improved the outreach of the formal financial sector, with over three-quarters of credit union members surveyed not having an account with any other institution—19% have an account with SSC, and 5.6% deal with a bank. With the average Kyrgyz household consisting of five people, about 110,000 people were directly benefiting at the end of 2006 from credit union loans extended to almost 22,000 active borrowers.

IV. OVERALL ASSESSMENT AND RECOMMENDATIONS

A. Overall Assessment

50. The Project has been successful in terms of the formation of credit unions and attraction of members, albeit largely as borrowers rather than a balanced mix of net borrowers and net savers, but has not created the supporting infrastructure for sustainability—an apex institution—and only about one-third of individual credit unions appear sustainable. Effective supervisory oversight is now in place, however it may be burdensome for credit unions that do not take deposits. Credit unions without deposit licenses may seek to re-register as microfinance organizations, which for most would better align their legal status and regulatory regime with their business model—a wholesale-funded microlending company rather than a member-funded and controlled credit union.

51. Overall, the Project is rated “partly successful.” The original project design and schedule were broadly appropriate. However, serious weaknesses existed, including (i) the lack of an adequate legal and regulatory framework and the absence of initial provision for deposit-taking by credit unions, (ii) having no degree of resource mobilization from members of credit unions that would raise their interest in good governance and performance, and (iii) the lack of a detailed plan to transform FCSCU into an apex organization and divest it within 3 years. Since credit unions at the outset were not mobilizing savings other than member shares, it is hardly surprising that those that have become sustainable have done so using a microfinance model based on external funding rather than relying on the savings mobilization that was central to the original project design. The future of FCSCU remains unresolved, and credit unions still lack an apex organization.

B. Lessons

52. There are several lessons to be drawn from the project experience. First, savings mobilization is a crucial feature of credit unions. The decision to proceed with the Project despite the initial lack of legal provision and NBKR’s lack of enthusiasm for credit unions to take deposits undermined the cooperative foundation at the outset. The potential conflict between the role of NBKR as owner of FCSCU and its function as the supervisor of the credit union system added to it. The course of the Project has demonstrated the difficulty in building a credit union system while beginning with lending without a proper foundation.

53. The process by which FCSCU would become owned by credit unions was not detailed at the time of loan negotiations, and, despite being raised at the first review mission, was never resolved. The lesson from this experience is that, if such a state-owned financial institution is

established, there needed to be clear agreement at the outset on a mechanism for divestiture. Had the process been explored in detail, it may have led to adoption of a different ownership structure from the outset, perhaps dividing between two entities the responsibilities for administering the onlending program and the development of apex functions, which were combined in FCSCU under the Project.

54. Although the Project contemplated provision of TA concurrently with the implementation of onlending, better sequencing would have seen the provision of extensive assistance to support credit union formation and the establishment of an apex organization. Provision of matching funds to credit unions should have been considered only after they were well established on the basis of mobilizing their own resources, including deposit-taking from members to ensure a mix of both net borrowers and net savers. Net savers are important in the governance of credit unions, as those with funds invested take a keen interest in management.

55. Given the crucial importance of TA to the success of the onlending program and project management, decoupling the provision of TA from the rest of the Project introduced a serious weakness. The need for intensive TA when creating credit unions and their supporting infrastructure cannot be overemphasized. The program's initial design front-loaded the provision of TA, but actual delivery was delayed, in part due to the loss of momentum after the cancellation of the ADB-financed TA component while preparations were made to field the GTZ-grant financed TA. In addition to the delay, decoupling the TA from the loan served to introduce some divergence in the vision of the credit union system held by the TA providers, credit union leaders receiving TA, and the original program design, which was never wholly resolved.

C. Recommendations

1. Project Related

56. The completion of the Project has left outstanding questions about the future of the credit union system in the Kyrgyz Republic. Some portion of the system appears sustainable under a microfinance model. Given that development to date has been spurred by external finance, it is not clear whether there is any near-term prospect for development of a credit union system founded on the mobilization of member savings. Targeted TA for credit unions seeking to expand into deposit-taking, and training focusing on developing the democratic processes of credit unions and their association, may yet be helpful in developing a true credit union model. However, any large-scale interventions should be considered only on the basis of supporting microfinance development, taking into account the fact that the supply of microcredit is quite significant as compared to overall bank lending (Appendix 5). This could encompass credit unions, which in the Kyrgyz Republic are generally indistinguishable from microfinance organizations in their funding and operations, notwithstanding the fact that credit unions at least nominally are cooperatively owned.

57. The divestiture of FCSCU remains unresolved. Any action requires consensus among NBKR and various parts of Government. Two options are under discussion: (i) NBKR, using the authority of the Law on the National Bank to own and dispose of property, will proceed to sell its 100% ownership in FCSCU; and (ii) in accordance with the generally applicable provisions for privatization of state property, NBKR will transfer its ownership share in FCSCU to the State Property Fund.

58. Under either option, the objective should be a prompt sale by tender of FCSCU to eliminate the uncertainty over its future and before its value deteriorates as lending curtails. Solicitation of bids provides a market test to substantiate the value of FCSCU. While the original design had been to divest FCSCU to credit unions, this was premised on the assumption that FCSCU would develop into an apex organization. As FCSCU exists primarily to provide wholesale finance, and credit unions themselves have developed the Credit Union and Cooperatives Association of Kyrgyzstan which could be the basis for an apex organization, the original premise no longer holds. Under either option, credit unions have the capacity to be among the bidders for FCSCU, but there is some question whether credit unions would want to purchase FCSCU as they would have to curtail their lending to finance such an acquisition. An alternative scenario would be that credit unions propose purchasing only a portion of FCSCU—this would then require divestiture of the balance to a strategic investor or to another state-owned entity. Under this option (discussed in para. 60), the Government would have to pay NBKR for the shares in FCSCU that were transferred to the State Property Fund, which would proceed with privatization using the same process applicable to other financial institutions such as KAFC.

59. An important consideration for Government is whether repayment of outstanding loans by credit unions, and hence FCSCU's ability to repay the Government, is influenced by the ownership of FCSCU. In theory, credit unions should make the same effort to honor debts regardless of the ownership of the creditor. However, some stakeholders have suggested that credit unions service their loans from FCSCU only to maintain the opportunity to obtain future loans. As FCSCU makes repayments under the subloan agreement, the volume of new loans will decrease unless FCSCU is able to either earn sufficient profits to both make repayments and maintain lending levels, or obtain additional funding sources. Whether owned by credit unions or someone else, repayment prospects for the FCSCU portfolio will be enhanced if FCSCU continues in the business of providing wholesale financing to credit unions with the effective internal management applied.

60. Valuation of FCSCU is central to either option—how can NBKR determine whether a prospective offer by credit unions is adequate, or how much the Government should pay NBKR to transfer ownership to the State Property Fund? The valuation completed in March 2007 provides some guidance, but is becoming dated. Divestiture at a price equal to the end-2007 audited book value would be a defensible option. Should the option of sale by tender be exercised, the tender would provide a market test of the value of FCSCU.

2. General

61. While the project design was broadly appropriate, the lessons from the experience with implementation suggest several recommendations for improvements in future projects. First, any privatization of a state-owned entity presents complex issues of legal and political process, whether the entity is owned directly by government or, in this case, by an independent government agency (NBKR). At the stage of project design and loan negotiations, a workable model needs to be agreed for the anticipated divestiture, together with a sufficiently detailed plan to avoid later misunderstandings or disputes.

62. Second, establishing the legal framework and building supervision capacity should precede large-scale credit union formation. Funding for onlending programs should not proceed if the anticipated legal and supervisory foundation for the ultimate borrowers has not been put in place.

63. Third, TA central to achieving a program's objectives should not be decoupled from the other components. Should TA provided by another source be a closely integrated part of an ADB program, a formal agreement should provide for close coordination, including, if necessary, provisions for delayed disbursement if there are delays in provision of the TA.

64. Fourth, mobilizing savings is the foundation for credit union development and is crucial if cooperatively owned financial institutions are to achieve self-sufficiency. External finance, especially in the early stages of credit union development, can undermine the concept of cooperative ownership. Development assistance provided to credit unions should initially focus on training and education, particularly on enhancing the capacity of directors and members to understand and oversee the activities of the credit union.

PROJECT FRAMEWORK

Design Summary	Project Targets and Measurable Indicators	Project Achievements	Monitoring Mechanisms	Risks and Assumptions
<p>Goal To rebuild a sustainable rural financial system</p>	<p>More than 90% of established credit unions maintain operations and remain viable beyond the end of the project</p> <p>Credit unions become major financial intermediaries in rural areas</p>	<p>297 credit unions operating at end-April 2007, 3% decline from end-project date (end-2006, extended from originally planned end-2004). About 500 credit unions were founded, far exceeding the original plan, but approximately 200 credit unions have been wound-up voluntarily or at the instigation of NBKR</p> <p>Although credit unions have become a major source of credit, savings mobilization has been almost exclusively limited to member shares and reinvested earnings, as only six credit unions take deposits</p>	<p>Project completion report</p> <p>NBKR's reports on the financial sector</p>	
<p>Objective/Purpose To increase the level and sources of savings mobilization and lending services in the rural community</p>	<p>Som190 million (\$11 million) of members contributions mobilized</p> <p>Som330 million (\$19 million) loans outstanding to members by credit unions</p>	<p>Member shares Som174 million (\$4.4 million) at end-2006, negligible deposits</p> <p>Som707 million (\$17.7) million credit union loan portfolio</p>	<p>Monthly, quarterly, and annual reports to FCSCU and NBKR</p> <p>Project management reports</p>	<p>Assumptions</p> <ul style="list-style-type: none"> • Macroeconomic situation remains conducive to the development of financial institutions • Competing financial institutions charge market rates of interest • Bankruptcy and Pledge laws are implemented effectively • NBKR requirements are complied with

Design Summary	Project Targets and Measurable Indicators	Project Achievements	Monitoring Mechanisms	Risks and Assumptions
<p>Components/ Outputs</p> <p>1. Established and self-sustaining national network of credit unions</p> <p>1.1 Accredited and operational individual credit unions</p> <p>1.2 Sustainable FCSCU</p> <p>1.3 Legal and regulatory framework operational</p> <p>1.4 Trained staff in credit union supervision</p>	<p>280 credit unions operational by year 7</p> <p>28,000 members of credit unions by year 7</p> <p>Full cost recovery by the end of the project</p> <p>Functioning systems, procedures, and controls to international accounting standards</p> <p>Credit union decree/law in operation</p> <p>NBKR regulatory requirements for credit unions enforced</p> <p>Eight FCSCU and two NBKR staff trained in supervision and</p>	<p>304 credit unions at end of year 7, 305 at project completion (extended to end-2006)</p> <p>27,107 members at end of year 7, 28,865 at project completion (extended to end-2006). Six credit unions licensed to take deposits</p> <p>FCSCU reporting profitability without grant funding. Lower credit union success rate offset by higher gross formation of credit unions. FCSCU's only business is lending to credit unions—has not developed other apex functions for credit unions. FCSCU has unqualified audit opinion under IFRS from Jacobs Audit</p> <p>Law enacted October 1999 (over 150 credit unions were already in operation); law required an additional license and compliance with bank legislation to take deposits</p> <p>FCSCU began on-site inspections in 2004 (year 7) responsibility transferred to NBKR in 2005, which conducted on-site examinations in 2005 and 2006</p> <p>TA subsequently cancelled in favor of grant-financed TA provided by GTZ. Value of supervisory training lost as</p>	<p>Project management reports</p> <p>Monthly, quarterly, and annual reports to FCSCU and NBKR</p> <p>Monthly, quarterly, and annual reports to FCSCU and NBKR</p> <p>Annual audit</p> <p>Decree/law approved</p> <p>Regulations issued</p> <p>Annual reports by FCSCU and NBKR</p> <p>Project management reports</p>	<p>Assumptions</p> <ul style="list-style-type: none"> • There are no significant tax disincentives to capital and savings mobilization • Mature credit unions permitted to provide savings deposits for members • Accredited credit unions have high (90%) success rate • Credit unions are willing to pay for services provided by FCSCU • Government agrees to allow FCSCU to use interest rate spread on borrowed funds to finance costs • FCSCU effectively supervises credit unions under guidance of NBKR • Training is effective

Design Summary	Project Targets and Measurable Indicators	Project Achievements	Monitoring Mechanisms	Risks and Assumptions
1.5 Trained credit union staff	<p>regulation of credit unions</p> <p>Four staff completed study tour</p> <p>Members of board of directors, supervisory committee, and credit committee are trained in management and financial administrative operations for credit unions</p>	<p>FCSCU staff were retained in other roles when responsibility transferred to NBKR. Additional TA subsequently provided by ADB, but turnover has been a continuing problem for NBKR.</p> <p>September 1999 project review mission found the level of training needed at the commencement of the project was underestimated—3.5 days per credit union clearly inadequate. GTZ TA program from February 1999 to May 2005 included training and training-of-trainers components—assessed as successful by GTZ.</p>	<p>Annual reports by FCSCU and NBKR</p> <p>Project management reports</p>	
<p>2. Project management</p> <p>2.1 Effective project management system</p>	<p>Monitoring and evaluation system is used effectively</p>	<p>June 2000 Mid-Program Review mission found the absences of consulting services had adversely affected project management, resulting in no reports on benefits, monitoring, and evaluation being provided by the Development and International Technical Assistance unit of NBKR. Project management component of loan not implemented</p>	<p>Project management reports</p> <p>Project missions</p>	<ul style="list-style-type: none"> • Management system is appropriate to situation

ADB = Asian Development Bank, FCSCU = Financial Company for the Support and Development of Credit Unions, GTZ = Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation), IFRS = International Financial Reporting Standards, NBKR = National Bank of the Kyrgyz Republic, TA = technical assistance.

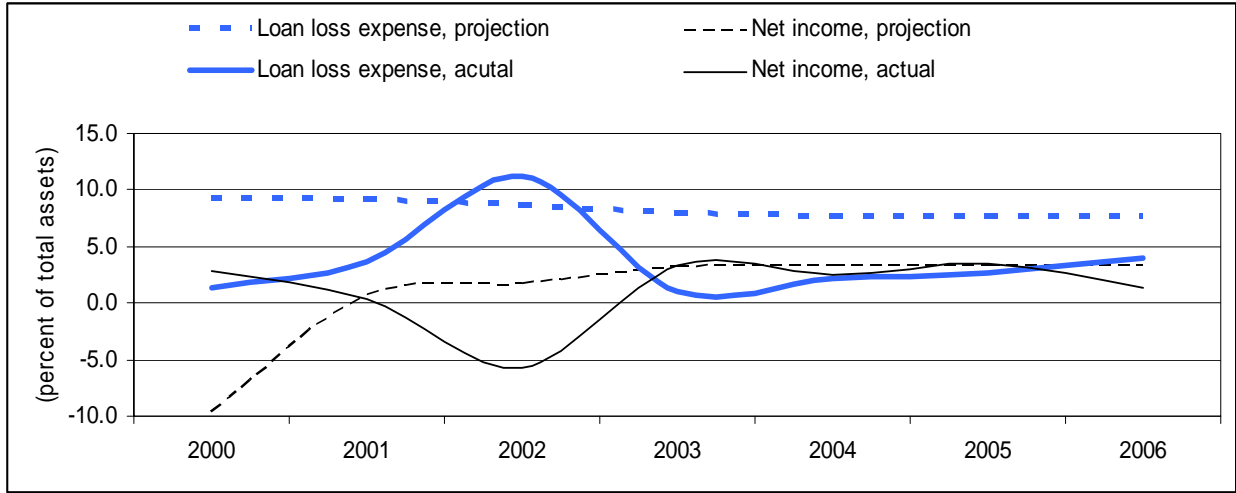
ANNUAL DISBURSEMENTS
(\$'000s)

Item	1998	1999	2000	2001	2002	2003	2004	2005	2006
Onlending	622	980	1,572	3,176	3,729	4,512	6,126	8,107	8,346
Consulting	0	0	0	0	0	0	0	0	86
Training	2	7	12	17	20	20	20	21	21
Equipment and Furniture	25	44	63	70	87	195	196	272	271
Service Vehicle	50	50	50	50	50	50	50	50	50
Subsidy to FCSCU	67	197	328	428	467	490	622	708	742
Service Charge	2	11	29	53	93	147	217	301	357
Total	768	1,289	2,054	3,794	4,446	5,414	7,231	9,459	9,874

FCSCU = Financial Company for the Support and Development of Credit Unions.

Source: Asian Development Bank.

FINANCIAL COMPANY FOR THE SUPPORT AND DEVELOPMENT OF CREDIT UNIONS FINANCIAL PERFORMANCE COMPARISON



Sources: Projections are taken from Asian Development Bank. 1997. *Report and Recommendation of the President on a Proposed Loan to the Kyrgyz Republic for the Rural Financial Institutions Project*. Manila. Actual data are from quarterly reports of the Financial Company for the Support and Development of Credit Unions.

LOAN CONDITIONS AND COVENANTS

Covenants	Implementation Status
Financial Covenants	
<p>1. The Borrower shall relend the loan proceeds to FCSCU in local currency for the matching loan funds (credit line of \$8.4 million) and other investment costs (\$352,000) at a variable interest rate for a period of 20 years including a grace period of 7 years. The relending rate will not be less than the interest rate applicable to the Bank's Ordinary Capital Resources loans. The Government will provide \$3.398 million equivalent of loan funds to FCSCU, as a grant, for a portion of the recurrent costs of FCSCU (\$1.036 million). LA, Article III, Section 3.01 (a).</p>	<p>Being complied with. At the request of the Government, ADB approved in 2005 changing the calculation of the interest rate on funds relents to FCSCU. Accordingly, instead of the interest rate applicable to pool-based single currency loans, currently at 6.14%, which FCSCU had applied, FCSCU will repay at floating LIBOR-based interest rate.</p>
<p>2. FCSCU shall be responsible for determining whether a credit union is eligible for participation in the Project on the basis of the criteria specified below [in (b)] and for monitoring performance of participating credit unions with respect to such criteria and the use of Project funds. LA, Schedule 5, para. 5 (a).</p>	<p>Partly complied with. The requirement was not met on a continuous basis:</p> <ul style="list-style-type: none"> • The June 2000 review mission noted that not all credit unions had complied with the minimum share capital requirement • Fraud was detected in 2001, with 21 credit unions having misrepresented information and falsified documents to obtain credit in contravention of the loan criteria • A July 2004 on-site examination of FCSCU by NBKR found long-standing non-compliance with the single borrower limit • Due to concerns over ineffective supervision by FCSCU, the supervision function was transferred to NBKR in July 2005, becoming fully effective at the end of 2005 and beginning of 2006
<p>3. A credit union shall be required to meet the following criteria in order to participate in the Project: (i) it shall have obtained a license from NBKR to operate as a credit union; (ii) it shall have a minimum paid in share capital of Som50,000; and (iii) it shall have established appropriate lending arrangements. LA, Schedule 5, para. 5 (b).</p>	<p>Complied with. Criteria for participation in the project were tightened in through minor loan amendments in 2002, with 2003 credit unions required to operate for 3 months prior to be allowing to participate in the project, as well as having at least 50 members and share capital of minimum Som100,000.</p>
<p>4. Once accredited for participation in the Project, a credit union shall receive an initial matching loan from FCSCU out of the Loan proceeds equivalent to its total paid-in share capital at the date of accreditation. Subsequent disbursements of matching loans shall be subject to such credit union's performing satisfactorily in accordance with the requirements set by NBKR. The amount of matching funds to credit unions shall be: (i) up to \$250 equivalent per member for credit unions with 50 members or less; and (ii) up to \$350 equivalent per member for credit unions with more than 50 members,</p>	<p>Complied with.</p>

until a maximum of \$35,000 equivalent per credit union is reached, at which time no further matching funds shall be provided under the Loan. LA, Schedule 5, para.5(c).	
5. The Borrower shall ensure that FCSCU onlends the portion of the proceeds of the Loan for Part A(i) of the Project to credit unions. The onlending rate shall be not less than the rate of inflation. Onlending shall have a maturity period of ten years, including a grace period of three years, provided, however, that FCSCU may accelerate the repayment of a loan disbursed to any credit union in the event such credit union violates the terms of its onlending agreement with FCSCU. LA, Schedule 5, para. 5 (d).	<p>Complied with. Although the 1999 review mission noted that rates charge by FCSCU were below the rate of inflation, this was addressed and compliance observed for the bulk of the project.</p>
6. Except as the Borrower and the Bank may otherwise agree, (i) allocation of the Loan proceeds among the eligible credit union s shall be made on a first-come-first-served basis; (ii) Subloans shall be provided for a variety of activities in rural areas; and (iii) the amount of each subloan shall not exceed three times the capital of the Subborrower in the credit union. LA, Schedule 5, para. 6 (e).	<p>Complied with. Formula (iii) has been replaced with individual loan limit of not more than 15% of total capital.</p>
7. Subloan Arrangements. The credit unions shall make subloans to Sub-borrowers at market rates to be determined by the credit committee of each credit union under the guidance of NBKR and FCSCU. LA, Schedule 5, para. 7 (a).	<p>Complied with.</p>
8. The credit union s shall lend to Subborrowers under the following conditions: (i) the terms and conditions for, and approval of, Subloans shall be determined by the credit committee of each credit union; (ii) the maximum Subloan size per Sub-borrower shall not exceed a loan/share capital ratio of 3:1 and shall not in any event exceed 15 percent of the total paid-in share capital of the credit union; and (iii) Subloans shall be extended against collateral, however, collateral requirements for Subloans less than Som7,000 shall be optional. LA, Schedule 5, para. 7 (b).	<p>Complied with. Minor loan amendments in 2003 increased to Som 20,000 the Som7,000 level above which collateral is required because of the cost and procedures for notarization, and the 3:1 ratio was been superseded by the percentage of institutional capital.</p>
9. Except for the applicable rules and regulations and the provisions of paragraph 6(e) of the Loan Agreement, there shall be no restrictions on the types of Subloan activities. LA, Schedule 5, para. 7 (c).	<p>Complied with.</p>
10. Review of Relending and Onlending Rates. The relending and onlending interest rates determined pursuant to Section 3.01 (a) (i) of the Loan Agreement and Schedule 5, paragraphs 6(d) and 7(a) above shall be reviewed every six months, or as needed, jointly by the Borrower, NBKR and the Bank. LA, Schedule 5, para. 8.	<p>Complied with. At the request of the Borrower, the ADB approved in 2005 changing the calculation of the interest rate on funds relent to FCSCU.</p>
11. Each credit union shall be required to comply with the prudential, reporting, and financial accounting requirements and other rules and regulations pertaining to the operations of credit unions specified by NBKR. These requirements shall include: (i) the classification of the loan assets on the basis of quality and making loan loss provisions on the basis of asset quality; (ii)	<p>Complied with. Compliance was not continuous, particularly in the early years of the program. It was not until end-2005 that effective supervision was put in place, providing comfort that credit unions were accurately reporting on their compliance with prudential norms.</p>

<p>maintenance of an adequate liquidity ratio; (iii) a capital adequacy ratio larger than for banks or a debt/equity ratio of 5:1; and (iv) a return on total assets of not less than 1 percent. The accounting requirements specified by NBKR shall be consistent with international standards for financial institutions. LA, Schedule 5, para. 9(b).</p>	
<p>Economic Covenants</p>	
<p>12. Each credit union shall be established in accordance with a charter, which has been approved by NBKR and is in a format acceptable to the Bank. Each credit union shall have a minimum of ten members and a paid-in capital of at least Som30,000 before being eligible to obtain a license from NBKR to operate as a credit union. The initial paid-in share capital of each member shall be not less than Som1,000 and the maximum paid-in share capital of any member shall not exceed 10 percent of the total paid in capital of the credit union. Each member of a credit union shall have one vote irrespective of the percentage of such member's share in the credit union's paid in capital. LA, Schedule 5, para. 4.</p>	<p>Complied with. Minor loan amendments in 2003 increased to 50 the minimum number of members required to qualify a credit union for participation in the program.</p>
<p>13. Project Benefit Monitoring and Evaluation (PBME) shall be carried out by the Directorate of Investment and Technical Assistance Coordination (DITAC) in accordance with arrangements acceptable to the Bank. DITAC shall submit to the Bank a brief BME report on Project benefits at the end of each year of Project implementation. LA, Schedule 5, para. 10.</p>	<p>Partially Complied With. Quarterly reports have not always been timely—the end-2006 report was not available when the project completion mission review was fielded in September 2007.</p>
<p>14. Ownership of FCSCU Except as the Bank may otherwise agree, the Borrower shall ensure that the majority ownership of FCSCU shall have been transferred from NBKR to the credit unions by no later than the end of the third year of Project implementation. LA, Schedule 5, para. 12.</p>	<p>Complied with. Minor loan amendment allowed for privatization by 31 December 2005. Two further one year extensions of the deadline for divestiture were provided. However, divestiture still not complete when the project completion review mission was fielded in September 2007.</p>
<p>Other Covenants</p>	
<p>15. Established, Staffed, and Operating Project Management Unit/Project Implementation Unit The Borrower shall establish by the end of the first year of Project implementation, or as soon as a minimum of ten (10) credit unions have been established, whichever shall first occur, a Consultative Committee which shall comprise seven to ten members, all elected by the credit unions from among themselves. These elected members shall then elect a chairperson. The Consultative Committee shall: (i) represent the interests of the credit unions; (ii) serve as a consultative body to the FCSCU Management on all policy matters concerning the credit unions; and (iii) provide operational feedback on the development of the credit</p>	<p>Complied with. Credit union representatives elected a Consultative Committee on 27 February 1998 comprising 22 members, including a representative from FCSCU, although the Committee did not have the anticipated close relationship with senior FCSCU management.</p>

<p>union network. The Consultative Committee shall terminate upon acquisition of majority ownership of FCSCU by the credit unions. LA, Schedule 5, para. 3.</p>	
<p>16. Fielding of Consultants</p>	<p>Not applicable. The provision of consulting services was replaced with TA grant-financed GTZ and delivered by DGRV, the national apex organization of the German cooperative sector.</p>
<p>17. Supervision NBKR shall maintain appropriate supervision of FCSCU and the individual credit unions, including carrying out regular reviews of their operations and taking necessary steps to ensure all financial requirements are met. However, NBKR shall delegate the direct supervision responsibility of the credit unions to FCSCU, while retaining the overall supervision responsibility. Loan Agreement, Schedule 5, para. 9(a). Refer to para. 30 of the main text of RRP.</p>	<p>Complied with The condition was not continuously met as effective supervision was not in place until end-2005, after the 2004 decision to transfer supervision from FCSCU to the NBKR.</p>
<p>18. The credit unions shall be required to report monthly to FCSCU, including financial statements, subloan classification, size and number, and size of member contributions. FCSCU staff shall regularly visit credit unions to advise on managerial, procedural and financial matters, with the frequency of visits declining as credit unions mature. LA, Schedule 5, para. 9 (c).</p>	<p>Partly complied with. There are some deficiencies in timeliness and accuracy of credit union reporting to FCSCU, but overall it has become sufficient for loan monitoring. FCSCU has developed only limited capacity to advise credit unions on managerial, procedural and financial matters.</p>
<p>19. NBKR, FCSCU, the Consultative Committee and the Bank shall jointly carry out a comprehensive review of the Project after 18 months from the beginning of the Project implementation, and a midterm review at the end of the third year of the Project implementation. These reviews shall, among others, assess the overall performance of the Project, including the progress in the development of credit union network and the relending and onlending terms and conditions, and the need for changes, if any, in the Project design. LA, Schedule 5, para. 11.</p>	<p>Complied with. First comprehensive review was conducted in May/June 2000. Mid-term review was completed in June 2001.</p>
<p>20. Legislative Matters (a) The Borrower shall prepare and present a draft Law on Credit Unions to Parliament for consideration before the end of the first year of Project implementation. L.A., Schedule 5, para. 13(a). (b)The draft Law on Credit Unions shall, among others, provide for: (i) mature credit unions being allowed to accept savings deposits from their members; (ii) credit unions being exempt from taxes as non-profit organizations; and (iii) a comprehensive framework for a credit union system, including an apex union. Loan Agreement, Schedule 5, para. 13(b).</p>	<p>Complied with. The Law on Credit Unions was approved by the Parliament in October 1999, at the end of the second year rather than in the first year of the program as originally planned. An amendment to the Tax Code for credit unions to be exempt of income tax was signed into power by President in June 2004. Complied with in paras (i) and (ii) Not complied with in para (iii) The current version of the law does not clearly describe the comprehensive framework for the credit union system, including an apex union. A Law on Central Credit Union has been discussed, but has been tabled. Special committee has been established comprising of credit unions and NBKR</p>

	<p>to develop amendments to the Law. NBKR began in 2003 to allow deposit taking by 10 pilot credit unions. The pilot phase ended in December 2004. No credit union has been licensed yet for deposit taking since none has met NBKR's licensing requirements.</p> <p>During 2006 NBKR conduct the work to change the Law "About credit unions" in cooperate with representatives of credit union's association. In particular, it's planed to change the frames conditions with respect of activity of apex institutions – Central Credit Union, Stabilization Fund and Deposit Insurance System for credit unions.</p>
21. Submission of consolidated quarterly reports by NBKR and FCSCU on the execution of the Project and the subloans. LA, Section 4.03(b) and PA Section 3.05)	Complied with.
22. Furnish to ADB, as soon as available, but in any event not later than six months after the end of each related fiscal year, certified copies of such audited accounts and financial statements and the report of the auditor relating thereto (including the auditors' opinion on the use of the Loan Proceeds and compliance with the covenants of the Loan Agreement.	Complied with.
23. Submission of Project Completion Report, LA, Section 4.03(c)	Complied with.

FCSCU = Financial Company for the Support and Development of Credit Unions, LA = Loan Agreement, NBKR = National Bank of the Kyrgyz Republic.

FINANCIAL SECTOR OVERVIEW AND CREDIT UNION DEVELOPMENT

1. Rural and poor residents of the Kyrgyz Republic are served by a larger number and wider range of financial services providers—including credit unions, microfinance organizations, and commercial banks—than is observed elsewhere in Central Asia. Total microfinance credit extended in the Kyrgyz Republic is equivalent to about 42% of the conventional bank credit outstanding (Table A5.1), which in sharp contrast to the usual situation where microfinance amounts to only a small portion of formal credit in the economy. Just over 54% of credit extended by nonbank lenders is to the agricultural sector; more than 85% of nonbank credit is advanced outside the major urban center of Bishkek city.¹

Table A5.1: Formal Providers of Financial Services, end-2006.

Item	Credit Unions	Micro finance	KAFC (Aiyl Bank)	SSC	Banks ^a
Number	305	168	1	1	19
Service locations	320 ^b	200 ^c	54	109 ^d	152
Borrowers	21,929	81,800	45,100	0	-
Loans (som million)	707	2,055	2,069		11,299
Average loan size (som)	32,000	25,000	46,000		-
Average loan interest rate (%)	25.9	33.5	14.2		24.4 ^e
Deposits (som million)	0	0	0	705	14,271

^a Commercial banks excluding Aiyl Bank and Savings and Settlement Company.

^b Estimate: Most credit unions have only one location, but a few have multiple offices.

^c Estimate: Most microfinance organizations have only one location, although some the larger ones have multiple offices. The three large microcredit organizations (FINCA, Bai-Tushum, and Kompanion) account for about 65% of loan volume.

^d Includes 50 branches, 15 savings offices, and 44 field cash offices; excludes agency offices in 1,000 post offices, which account for about 3% of Savings and Settlement Company deposits.

^e Rate for loans in som. Average interest rate for foreign currency loans was 18.0%.

Sources: National Bank of the Kyrgyz Republic, Savings and Settlement Company.

2. The financial sector has developed significantly since the commencement of the Rural Financial Institutions Project.² While the commercial banking sector stabilized after the transition challenges in the 1990s, and has increased its total assets sixfold, nonbank growth has been more impressive. Almost 149,000 loans by credit unions, microfinance organizations, and the Aiyl Bank (formerly the Kyrgyz Agricultural Finance Corporation [KAFC]) were outstanding at the end of 2006. Considering that the average household is five people, the outstanding microfinance loans directly benefit about 745,000 people, approximately 15% of the total population. This is a dramatic change from the beginning of 1997 when there were three small pilot credit unions, KAFC was just commencing operations, and a handful of nongovernment organization-sponsored microfinance organizations were operating informally in the absence of a legal framework.

3. In the period from 1997 to 2003, KAFC and credit unions played the largest role in providing rural finance. KAFC quickly became the largest provider of credit in the country due to (i) its low rates facilitated by donor financing, (ii) its wide geographic outreach, and (iii) the fact that the banking system was still recovering from the challenges of transition and was only gradually expanding its loan portfolio. Credit unions quickly developed in all regions, largely because of the availability of Asian Development Bank (ADB) onlending through the Financial Company for the Support and Development of Credit Unions (FCSCU) (Table A5.2).

¹ NBKR. 2006. *Annual Report of the National Bank of the Kyrgyz Republic*. Bishkek.

² ADB. 1997. *Report and Recommendation of the President on a Proposed Loan to the Kyrgyz Republic for the Rural Financial Institutions Project*. Manila.

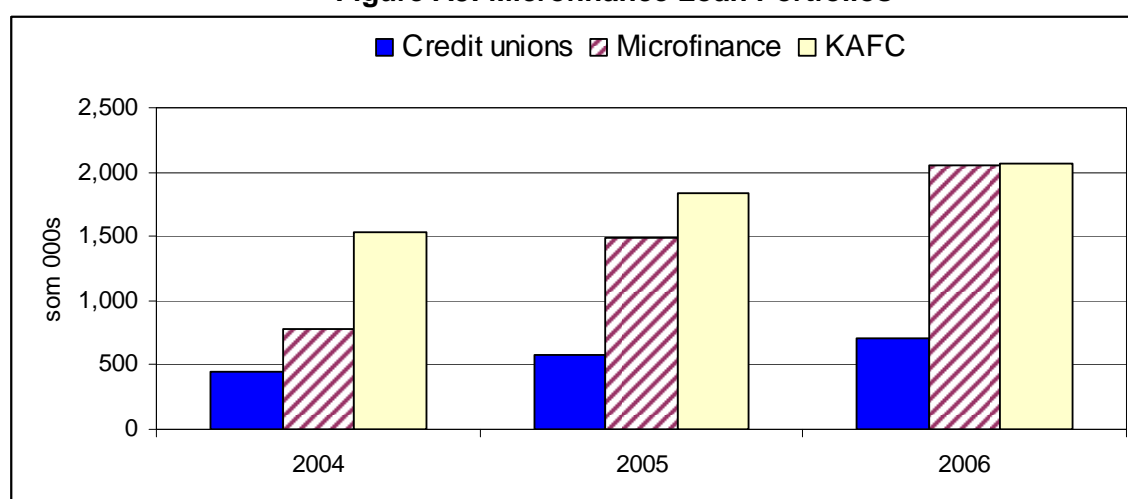
With the exception of a pilot project in 2004, the majority of credit unions have not mobilized deposits to support their operations, remaining almost exclusively dependent on external finance, almost 90% of this provided by FCSCU. Starting in 2006, some financially credible credit unions were allowed to take deposits, but the scope is still limited. The average credit union loan tended to be smaller than loans provided by KAFC, although this gap began to narrow after 2004, reflecting the fact that KAFC retained its microfinance focus while some more mature credit unions were able to increase their loan size. Credit unions were soon eclipsed by microfinance organizations in the number of clients served, and by the end of 2006 the loan portfolio of microfinance organizations had grown to match that of KAFC (Figure A5.1).

Table A5.2: Development of Credit Unions

Item	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Number	13	83	166	191	275	350	303	304	310	305	272
Members	308	2,849	7,350	11,085	21,080	18,953	22,678	27,107	27,813	28,865	28,576
Borrowers (som '000s)					16,196	13,365	17,631	19,597	22,042	21,929	20,670
Total assets		14,994	53,346	103,967	241,343	264,473	317,232	487,644	632,439	727,845	822,850
Loans	1,626	13,875	48,120	96,911	230,094	240,367	288,839	448,679	580,483	707,190	767,658
Deposits	--	--	--	--	--	--	17	2,554	544	--	5,568
External funding	275	4,903	19,583	35,087	87,863	90,152	116,787	209,089	300,038	339,068	392,701
Share capital	1,512	8,509	28,991	49,199	117,596	126,900	138,278	160,780	166,890	173,763	181,190
Institutional capital	--	--	--	1,154	6,494	13,035	26,260	43,948	88,794	133,812	170,086
Total capital	1,512	8,509	28,991	50,353	124,090	139,935	164,538	204,728	255,684	307,575	351,276

Sources: National Bank of the Kyrgyz Republic and Financial Company for the Support of Credit Unions.

Figure A3: Microfinance Loan Portfolios



KAFC = Kyrgyz Agricultural Finance Corporation.

Source: National Bank of the Kyrgyz Republic

4. Microfinance organizations began to grow very rapidly once a clear legal framework was established through the 2002 law On Micro-finance Organizations, and related regulations. Despite having average interest rates 7.5% higher than average credit union loan

rates and almost 20% higher than KAFC, the success of microfinance organizations indicates there is still significant unmet demand for credit. A further indicator of the unmet demand is the 75% increase in the number of pawnshops since 2002, which are concentrated in Bishkek city, despite the fact that they charge interest rates equivalent to 150% per annum (Table A5.3). This suggests ample scope to extend credit unions and microfinance into urban areas where it could further support the development of small traders.

Table A5.3: Number of Microlending Institutions

Item	2002	2003	2004	2005	2006
Microfinance	0	72	104	136	168
Credits unions	349	303	305	320	305
Pawnshops	85	108	116	140	148

Source: NBKR. 2006. *2006 Annual Report*. Bishkek

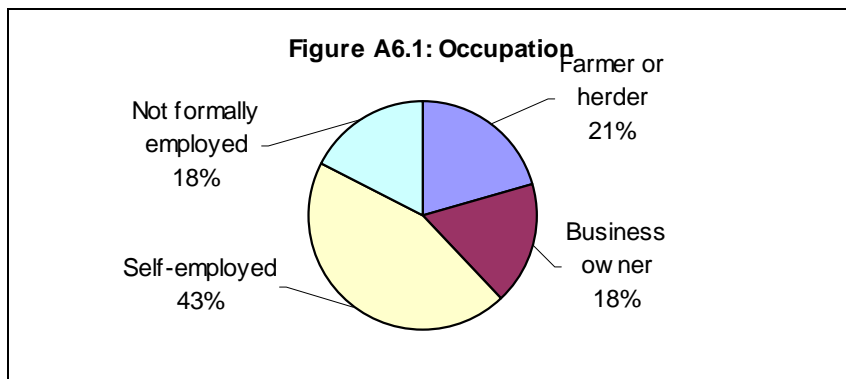
5. One continuing concern about the development of the financial sector, and in particular the nonbank institutions, is the reliance on external funding for sustainability. Total credit extended to financial institutions at the end of 2006 was about Som1.1 billion more than the total deposits mobilized by the entire financial system (Table A5.1), reflecting that credit unions, microfinance organizations, and KAFC are all dependent on donor or wholesale funds. This is not sustainable over the longer term, and additional domestic resource mobilization is required if the unmet demand for credit is to be addressed. Credit unions could play an important role. However, since they have developed to date with high dependence on external finance, it is not clear whether there is scope for emergence of a credit union system built on a foundation of mobilizing member savings.

CREDIT UNION IMPACT SURVEY

1. The Asian Development Bank (ADB) recruited Public Association Centre for Public Opinion Research EI-Pikir, a local nongovernment organization to conduct the credit union impact survey. EI-Pikir completed 126 structured interviews with current credit union members in December 2007 and January 2008 to gain insights into their relationship with the credit union and to determine how borrowing from the credit union has affected their economic and social condition. EI-Pikir selected one large credit union (more than 100 members) and one small credit union (less than 100 members) in each *oblast* (province)— Batken, Chuy-Bishkek, Jalaabat, Issyk-Kul, Naryn, Osh, and Talas— interviewing 12 members from the large credit unions, and 6 from the small credit unions. While a larger sample and random selection would have been preferable for statistical validity, the approach taken provides indicative results given the resources available for the survey.

A. Members Surveyed

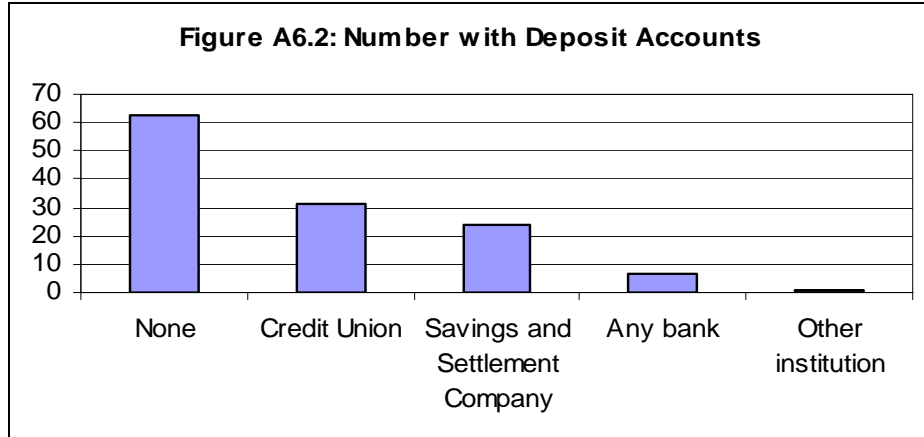
2. A total of 126 credit union members who had borrowed from the credit union within the last year were interviewed. Of these, 58% were female, indicating that the sample is broadly representative of credit union borrowers.¹ The average age of the members surveyed was 42 (median 40). The average household size of five persons is consistent with the national average for the Kyrgyz Republic. More than 80% of the borrowers were engaged in entrepreneurial activity (farmer or herder, business owner, or self-employed) with the balance indicating they were not formally employed (Figure A6.1). Respondents not formally employed are likely to be engaged in businesses without having been formally registered.



Source: EI-Pikir credit union impact survey.

3. Half of the survey respondents do not have a deposit account with any formal financial institution, indicating that credit unions have expanded financial services market rather than simply providing another option for those already accessing the formal market. When considered together with the finding that 21.4% of respondents joined the credit union to obtain a good return on their share investment, and that 1.6% joined because it was a safe place to deposit money, it appears that some credit unions are successfully attracting savers, although more than three-quarters of survey respondents joined their credit union to obtain a loan.

¹ NBKR. 2006. *Rural Financial Institutions Project 2006 Fourth Quarter Report*. Bishkek. Women comprise 57% of total credit union borrowers. .

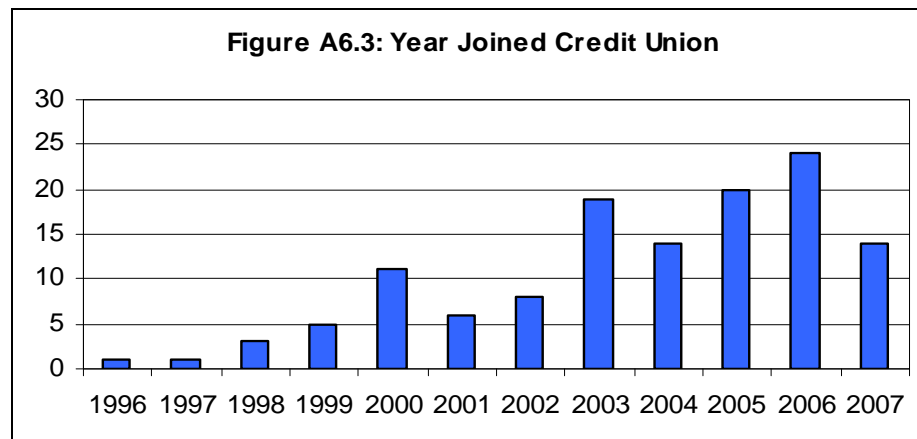


Source: El-Pikir credit union impact survey.

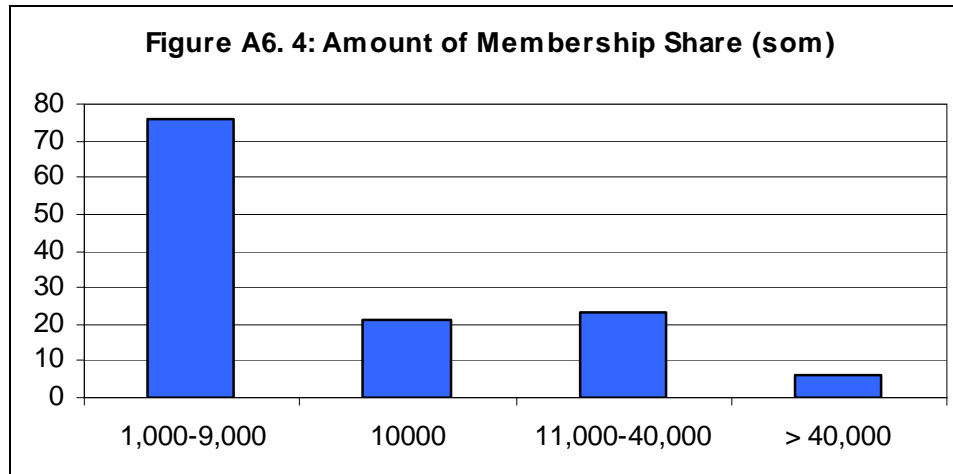
B. Membership and Borrowing

4. Members interviewed appear to take an active ownership role in the credit union, with 84% having attended the last annual general meeting of the credit union. The survey methodology probably resulted in an upward bias of this finding, as borrowers agreeing to be interviewed might be expected to be among the most active. All respondents had taken a loan within the last year. Repayment periods range from 3 months to 5 years, with three-quarters of the loans advanced for terms of 1 year or less. Interest rates range from 18% to 36% per annum, with an average rate of 26.9%.

5. About one-quarter of those surveyed had belonged to the credit union for 5 or more years (Figure A6.3), with the average membership share amounting to about Som11,000 (Figure A6.4). This average is inflated by a small number of very large share accounts, but even the median of Som6,700 (approximately \$175) indicates that credit unions are not directly serving the poorest of the poor. This conclusion is reinforced by the finding that over half of respondents would have waited to make the purchase or investment until they had saved the money if the credit union had not provided their most recent loan. These findings are encouraging with respect to the sustainability of credit unions, as active members with the financial capacity to repay are crucial to a successful cooperative enterprise.

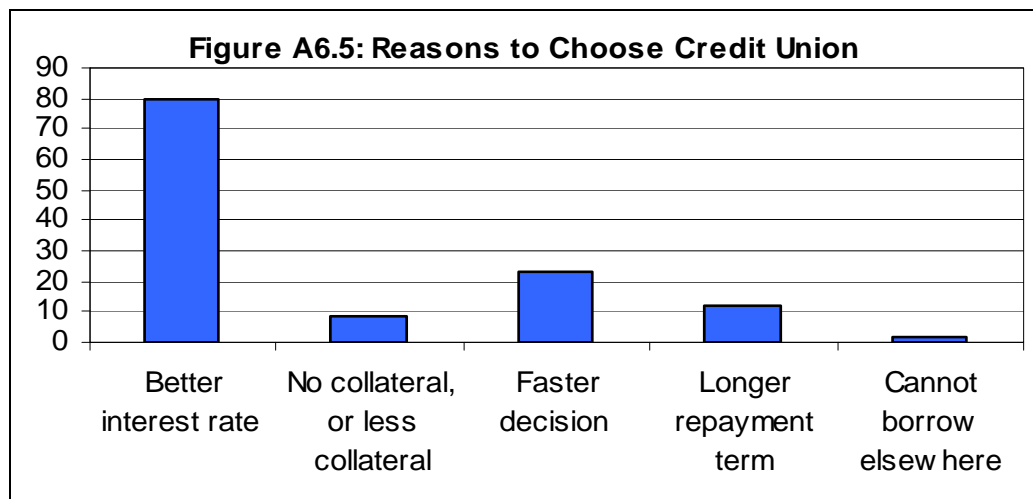


Source: El-Pikir credit union impact survey.



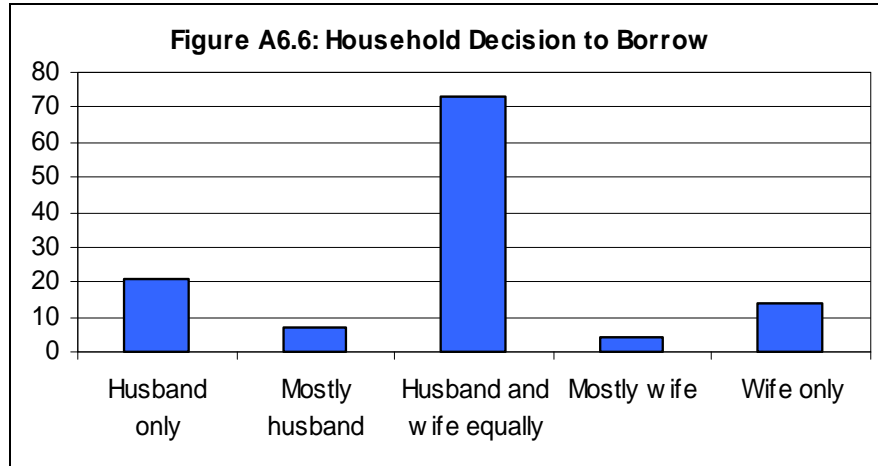
Source: El-Pikir credit union impact survey.

6. Survey respondents were overwhelmingly attracted to borrow from credit unions because of better interest rates or collateral requirements, or faster decision making (Figure A6.5). Less than 2% of respondents indicated that the credit union was the only source of credit available to them, reinforcing the impression that credit union members would be viewed as desirable clients by other lenders.

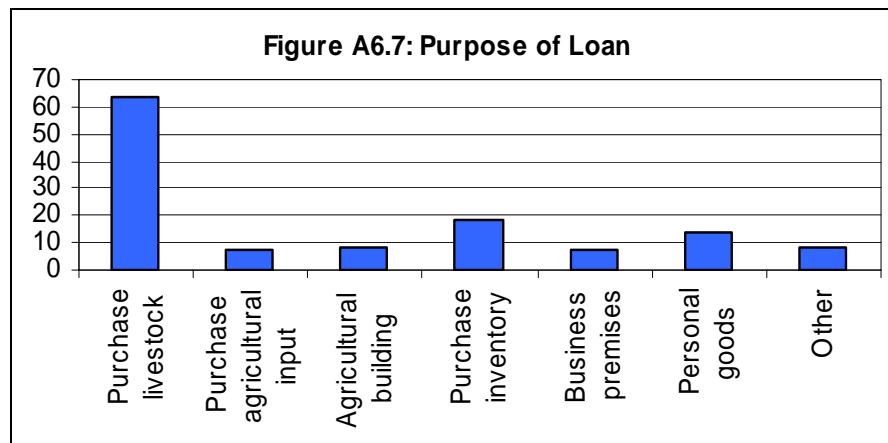


Source: El-Pikir credit union impact survey.

7. In the vast majority of responses, women play a significant role in the household decision to borrow (Figure A6.6). Financing business or agricultural activities, largely the purchase of livestock, is the dominant purpose for borrowing among survey respondents, with only about 15% borrowing for personal goods or other purposes (Figure A6.7). Respondents estimated on average that each loan for agricultural or business purposes generated three jobs. Thus, while credit unions themselves do not target the poorest of the poor, their lending does create employment for those less well-off than credit union members.



Source: El-Pikir credit union impact survey.



Source: El-Pikir credit union impact survey.

8. Extrapolating the figure of three jobs per loan to the total of 22,000 credit union loans outstanding at the end of 2006 suggests that credit union lending assisted in the creation of 66,000 jobs—a figure broadly consistent with the estimate of 70,000 jobs and three jobs per loan obtained by extrapolating individual loan data from Bai Tushum to the end-2006 credit union aggregate data.