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Prepared by

Development Alternatives, Inc.

Asian Development Bank

Study on Rural Credit and Savings in Kazakstan

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Part I: Rural Finance

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Currency Equivalents
(As of January 1997)

Currency Unit	-	Kazakstan Tenge (T)
Tenge 1.00	-	$0.01424
USD 1.00	-	70.2

Abbreviations and Special Terms

ADB	-	Asian Development Bank
ADMARK	-	government agricultural input and marketing monopoly in Malawi
ACLC	-	Asian Cross-Roads Loan Company
AGRO	-	Kazakstani farmers association
ALM	-	Asset-Liability Management
APB	-	Kazagroprom Bank
ASF	-	Agricultural Support Fund
BIMAS	-	former farm fertilizer credit program in Indonesia
Blue Book	-	ASF Manual of Procedures for Disbursements
BRI	-	Bank Rakyat Indonesia
CA	-	Chart of Accounts
CAAEF	-	Central Asian-American Enterprise Fund
CAMEL	-	Capital Adequacy, Asset Quality, Management/Administration, Earnings and Liquidity
CUs	-	Credit Unions
EBRD	-	European Bank for Reconstruction and Development
FDIC	-	Federal Deposit Insurance Corporation
GDP	-	Gross domestic product
GOK	-	Government of Kazakstan
ha	-	hectare
IMF	-	International Monetary Fund
ISP	-	International (Banking) Standards Program
LAW	-	Kazakstan Law on Banks and Banking Activity
MCI	-	Mercy Corps International
MFI's	-	Micro-finance Institutions
MOA	-	Ministry of Agriculture
MOF	-	Ministry of Finance
NBFI	-	Non-banking Financial Institution
NBRK	-	National Bank of Kazakstan
NGOs	-	non-governmental organizations
OECD	-	Organization for Economic Coordination and Development
Rayon	-	subdivision of an oblast
RB	-	Rehabilitation Bank
RK	-	Republic of Kazakstan

RLFs	-	Restricted Loan Funds
SLBs	-	Second Tier Banks
SME	-	Small/medium enterprises
t-bill	-	Ministry of Finance issued Treasury Bill
TA	-	technical assistance
TACIS	-	European Union Technical Assistance to CIS
UNDP	-	United Nations Development Program
USAID	-	United States Agency for International Development
US	-	United States of America
USD	-	United States Dollar
VOCA	-	Volunteers in Oversees Cooperative Assistance
WB	-	World Bank

Executive Summary

Slightly fewer than half of the Republic of Kazakstan's 17 million people live in rural areas. They reside in more than 8,000 village and settlements and are most densely concentrated in the southern and northern oblast (with 3-10.5 person/sq. km).

The Rural Sector

Since 1991 agricultural activity has declined by more than half. Yet the sector remains critical to the economy, generating about 14 percent of GDP in 1995. In 1995 the Ministry of Agriculture estimated that 80 percent of all farms were unprofitable, as were many non-farm rural enterprises. The terms of trade for the sector as a whole have deteriorated. Most farms, whether restructured or not, have seen a marked decline in their liquidity, value and profitability. Machinery has not been renewed, livestock have been disposed of or are in poor condition, and fixed assets have become dilapidated. Many farms are unable to maintain their current level of operations.

The majority of privatized farms that have not been restructured are unprofitable. Until farms become profitable their ability to obtain credit will remain severely constrained. Many large farms are encumbered by past due debts, too many employees and shareholders, social costs, inadequate machinery, lack of control over storage facilities, and restricted marketing outlets. In addition, many farmers find that the only way to finance their working capital is to contract their future crops by selling them before harvest. To date, few farms have managed to generate sufficient cash flow to finance their working capital, and most barter their rights to future produce to obtain inputs.

Problems affecting agriculture-lack of financing, lack of raw materials and inputs, lack of markets and the general decline in income and employment opportunities -- also affect rural non-farm enterprises. The very existence of rural communities is threatened unless the agricultural sector can be stabilized and nurtured to grow again. Resuscitating the rural economy is, therefore, a major issue for the government. Development of a thriving private, market-based agriculture is seen as the main element in rural revitalization and, indeed, as the starting point for broader economic recovery and human development.

The Banking Sector

The banking sector of Kazakstan has huge accumulated bad debts, leading to decapitalization and deterioration of the banks' capital and liquidity. The government's financial sector reform relieved banks of bad loans that were originally issued in response to instructions from various government authorities and which the banks were unable to workout because of the size of the debtors, the nature of the activities financed, and the social impact of foreclosure and liquidation of debtors' assets. A substantial portion of these loans has been transferred to special debt resolution entities.

Loan collection remains a key problem. This is due to unexpected distress of borrowers, but often also to willful default. In 1995 significant progress was made in improving property rights legislation. In 1996 attention shifted to making these rights enforceable through reporting and registration systems and judicial reform. However, several provisions of the draft law on bankruptcy are likely to jeopardize rights of secured creditors. The draft law curtails the rights of a secured creditor in a liquidation and fails to give them sufficient voice in voting procedures among creditors. Further, the draft law threatens the validity of sales of property seized from a corporation less than four months prior to bankruptcy.

Formal Rural Finance

Commercial banks. Formal rural financial services in Kazakstan are provided by Kazagroprom Bank, Narodny Bank, certain other and much smaller banks, several donor-funded activities and the Agricultural Support Fund. During the Study the Consultants visited the head offices of eight banks and 15 of their rural branches. All institutions exhibit the same basic weaknesses: lack of knowledge in financial and funds management, inability to assess the risks associated with project finance, lack of technical expertise in term lending, inexperience in portfolio management and inconsistent supervision and monitoring of portfolio. Sustainability of a financial institution relies on the ability to manage liquidity, interest rate risk and product pricing.

Transition from a command economy to a market-oriented one has hit rural communities hard, yet rural bank branches are reluctant to change. This is partly due to discomfort with the emerging private sector and to lack of loanable funds. Falling output, reduced banking services in general, the absence of financial intermediation in rural areas in particular, and the reduction of government subsidy have created a severe rural liquidity problem, reinforcing the dependence of the rural population on government supplied goods, services, and inputs. With resource limitations, banks have little incentive or ability to expand their client base. The low volume, high risk and costly servicing of rural branches have led many banks to close branches. Banks still operating in rural areas have had to reduce their lending; many are simply processing money transfers.

When funds are available, they tend to go to established customers and better known enterprises. The Governor of each oblast plays an important role in the distribution of credit. Political connection to the Governor is important for any farm or business that wishes to do business outside of its respective oblast and to receive quasi-directed credits from government bodies such as the Agricultural Support Fund. Oblast administrations have reportedly used strong-arm tactics to force private banks to lend to unqualified borrowers.

Interest rates remain high in real terms as banks seek to rebuild capital and as funds are scarce. The impact of high real rates of interest on loans varies greatly across the farm sector. In general their impact is to discourage borrowing, which is consistent with the quest for stable monetary aggregates. Large farms are likely to suffer most because much of their operation is monetized and credit would normally be used to cover many of the costs of getting from harvest to harvest. Small farms are likely to want to borrow proportionately less because their overheads are lower and because family labor does not have to be paid monthly. As a generalization, the purposes for

which a small farmer would want to borrow, as for seeds, fertilizer and some fuel would tend to represent a smaller proportion of the value of the crop than for the same crop grown on a large farm.

Savings mobilization. There is reported to be substantial savings throughout the country that are not deposited in banks due to distrust, low rates of return and reluctance to be subjected to scrutiny by the tax authorities. These savings are held in non-monetary assets. Lack of public trust in banks is by the far the greatest constraint to mobilizing savings and affects the whole banking sector. Citizens will deposit.their savings only when they have trust in the banking system, a particular banking institution and in the broader political and economic system. Public wariness is not unwarranted, as several recent bank failures testify. The development of savings mobilization by non-banks is prohibited by law. As a result, the opportunity for financial intermediation across whole communities is not realized. If non-banks such as non-governmental organizations (NGOs) could mobilize savings and if credit access were tied to a savings requirement, savings could be mobilized but there would be an obligation to guarantee full and immediate access to those savings by the depositors, except where the savings were pledged against a loan.

Institutional alternatives. Banks can provide a limited range of financial services in rural areas by expanding their branch networks and by using mobile banking units. The outreach and sustainability of there efforts are constrained by the high costs of staffing, and by the necessary use of procedures consistent with the bank's systems of operations. In addition, the volume of business in many rural areas is often insufficient to cover the overhead costs of banks operating in these communities.

Development is accelerated when financial services cover a broad spectrum of sizes of financial transactions, a whole range of sector activities and across the entire population from sparsely populated to densely populated rural areas. These services need to encompass enterprises as well as households. It is not advisable to provide such a broad range of services through a single type of financial institutions. It is better to have an overlapping of services among institutions to encourage, through competition, more efficiency in the provision of services. Alternative financing mechanisms would free-up working capital for purchase of inputs and fixed assets, would limit reliance on banks for financing, and would provide opportunities for establishment of farm support services critical for a properly functioning agricultural sector.

Informal finance provides small-scale rural financial services but tends to be limited to small, short-term loans. The roles and usefulness of both informal and formal suppliers of financial services are increasingly recognized. There needs to be a process by which alternative suppliers, such as credit unions (CUs) and NGOs, are given the opportunities and incentives to organize groups and associations. These organizations have a cost structure different from banks that allow them to be competitive in rural communities. They are able to provide effective and wide reaching rural financial services through operating and financial links with urban financial institutions.

Credit unions may succeed if they are established as a result of the efforts of the community in which they are located. They will fail if imposed on a community or established to meet target

or project objectives as means of channeling targeted credit to end-users. Properly established and supervised, CUs are an efficient way of providing a broad range of smaller-scale saving and lending services to small groups. They also provide healthy competition for banks, resulting in generally better financial services for rural communities. Formation of a CU system should be a long term goal in the rural financial policy of the NBRK. The Consultants' Project Proposal lists specific stages of implementation that will enable CUs to have a lasting effect on rural financial intermediation.

Small and Microenterprise

Informal estimates suggest that private sector output accounts for 20 percent of Kazakstan's GDP. Statistics on the small and medium enterprise sector are scanty, not entirely reliable and refer only to formal firms. The importance of small and microenterprise is not well recognized. While the viability of larger enterprises is in some doubt as a result of the loss of markets arising from the dissolution of the Soviet Union, demand for many items continues, although on a lesser scale. Small and microenterprise may profit from the opportunity presented by the lower volume of production. Where quality is less of a concern than availability, consumer tolerance of lower standards facilitates small enterprise. The sector's biggest contribution lies in perishable farm produce, market trading and small convenience stores and kiosks for everyday items, services by plumbers, electricians, carpenters, and minor repair services for shoes, watches, electrical appliances, and for vehicle repair and maintenance.

Considerable funds have been provided by international and bilateral organizations for advice on policy and legal issues related to small and medium enterprise development and for training, business advice and consulting services. Much of this effort is concentrated in major cities. Microenterprise, especially rural microenterprise, does not attract much attention.

The market in which small and microenterprises work is a pocket market close to the producer/trader base and suited to the volume of product offered. Small and micro-entrepreneurs are not restrained by lack of initiative but by the low incremental benefits of moving farther afield. Their costs in cash and time must be rewarded by a higher price in the distant market. Entrepreneurs with products that warrant the additional cost will travel beyond the immediate market.

Credit reaching the lower end of the small business sector is delivered by domestic NGOs in association with international NGOs which provide funds and act as catalysts for the development of the borrower constituencies. Each international NGO follows a similar pattern although there are variations in duration and supplementary training and orientation programs that reflect the special interests of the donor-humanitarian outreach, rehabilitation of the disabled, or environmental concerns, for example.

Commercial bank enthusiasm for micro credit is thin, even more so for disadvantaged groups. However, most NGOs were created specifically with the disadvantaged in mind and with specific objectives related to their betterment. Banks are unlikely to show much enthusiasm until it is demonstrated that the disadvantaged have skills, initiative and discipline. There is little to be gained from obliging unwilling and unconvinced institutions to lend where their intuition tells

them not to, since an unwilling participant lacks the dedication needed for success. In the initial phases of any program that includes credit for the disadvantaged it would be preferable to enlist the assistance of NGOs since they are committed.

NGOs active in credit in Kazakstan make a special effort to attend to the disadvantaged and to do so in a manner that ensures participation without alienating the remainder of the community. UNDP supports programs for women but Mercy Corps and VOCA would describe their approach as responding to needs without highlighting any group as being in greater need. Both actively encourage women and the very poor to participate. HIVOS does not discriminate by sex, although it offers single mothers and very poor women specialized assistance. HIVOS seeks to give their clients self-respect, self-reliance and a standing in the community based upon recognition of an ability rather than a disability.

Supporters of assistance to small and microenterprises would elicit a more favorable reaction from the unconvinced if they were able to demonstrate more specifically the areas in which such enterprises can contribute significantly. Concrete evidence of opportunity, benefit and sustainability is lacking.

Recommendations for a Proposed Project

The Project Proposal developed by the Consultants aims to help build an environment favorable to private enterprise in rural areas, to return insolvent farms to viable operations supported by sustainable credit delivery systems that reach into small communities, to foster the growth of small and microenterprises and to offer the disadvantaged an equitable opportunity to prosper.

The objectives of the Project are:

- to assist privatization in selected rural areas through a range of policy measures, market development initiatives and credit operations;
- to improve the effectiveness of the farm restructuring program and reduce the level of subsidy to the agricultural sector;
- to stimulate rural private enterprise in general and growth in small and micro-enterprise in particular, for income generation and employment creation; and
- to develop experience, policy and practices that can serve as a basis for the design and implementation of others.

The targeted beneficiaries include:

- privatized farms,
- private agribusiness,
- small and micro rural enterprises in all sectors, and
- the unemployed and other disadvantaged groups.

The principal components are:

- establishment of a rural development trust for donor funds supporting rural enterprise and provision of technical services;
- support for the ongoing farm insolvency and debt restructuring program through debt work-out plans for individual farms;
- commercial credit delivered through participating banks, NGOs and traders, allied to savings mobilization and introduction of new security instruments directed at breaking the overdue receivables circle and releasing assets that could serve as loan security;
- formulation of policy and support for development of wholesale marketing, a marketing information system and revitalizing the inputs supply chain;
- fostering initiatives in agricultural extension, veterinary services, farm machinery hire and business advice and training for the private sector; and
- formulation of enabling legislation and the subsequent development of credit unions to build upon the foundation of existing groups and associations as a means of ensuring resource mobilization in support of local enterprise.

I. Introduction

1. Rural finance in Kazakstan is faced with severe constraints and multifaceted challenges. Since 1993, Kazakstan has been experiencing significant contraction in rural finance, a contraction which can be directly tied to the poor performance of the agriculture sector. A closer look at the negative growth performance of Kazakstan's agriculture sector shows that the decline can be attributed to a number of factors. A central factor is the macroeconomic restructuring which has changed pricing patterns in agriculture. As a result of macro policies designed to liberalize the economy of Kazakstan, marginal land has been eased out of production and agricultural yields have often declined. This fundamental shift in farm economics has caused the debt-capacity of agriculture to shrink; while input prices have risen and income levels, in real or inflation-adjusted terms, have declined.

2. Moreover, agricultural risk in Kazakstan-a key determinant of rural finance-has also been very high, as reflected in the large variations in the country's annual production volume. To date, two "bad years' have been experienced out of every five years. A very poor harvest in 1995 further contributed to agriculture's decline and collapse. Similarly, hyperinflation which was felt up till 1995, had an adverse impact on agriculture, which has relatively long production cycles in contrast to other economic activities such as trading, for example. At the same time, the reorganization of agricultural marketing and distribution channels resulted in temporary breakdowns and adjustments. With the consequent decline in agriculture income levels and in the economy in general, accompanied by rising food prices, consumption spending has declined, but to levels that fortunately remain generally adequate from the nutritional point of view. Agriculture finance has declined greatly because of reductions in the capacity to service debt, as the cost of supplies of seasonal inputs and spare parts have risen. Capital investment in agriculture has likewise dropped dramatically. Moreover, livestock herd sizes have been reduced as farmers liquidated their existing stock because of their inability to feed them or the need to trade them for other goods and services.

3. Against this background, the rural finance challenge in Kazakstan today has to deal with identifying the parameters and scope for generating "good agricultural loans," which can be defined as agricultural credits that can be repaid as promised. The "demand" for agricultural credit in Kazakstan obviously consists only of those loan applications that will ultimately produce good loans for the banks, that is, loans that can be repaid at no loss to the lenders. However, currently, the risks associated with rural lending are very high because of the uncertainties attached to profitability, yields and the weak legal basis for enforcement of credit contracts and perfection of collateral instruments. Banks face liquidity, capital and operating problems and are generally prone to concentrate on sectors and transactions that they view as more dependable and profitable than agriculture. In addition, regulations and controls in Kazakstan hinder the development of new, local financial intermediaries which might be better placed to handle the risks associated with agricultural lending.

4. Because of these factors, credit currently plays an extremely small role in rural production. While the government's financial sector reform program has been supported by the International Monetary Fund (IMF), the World Bank (WB) and United States Agency for International Development (USAID), the rural financial sector is just now beginning to receive donors' attention. With restructuring of Kazagroprom Bank (APB) progressing more slowly than anticipated and the

commercial banks unwilling to finance agriculture, the rural sector is suffering from lack of financing. Financial intermediation has also been limited because regulations have not been developed to encourage the establishment of small, rural financial institutions and non-banking financial institutions. Thus, the sector is still in the early stages of transition and faces serious resource, policy and capacity constraints. Furthermore, neither the growth objectives of the government nor socioeconomic concerns such as rural employment generation, regional inequalities, and gender disparities with income in the rural sector, can be fully addressed without a strong rural financial sector.

5. In response to the need to address the constraints to rural finance and a request from the Government of Kazakstan, the Asian Development Bank (ADB) approved the provision of Technical Assistance (TA-2449-KAZ), *Study on Rural Credit and Savings*. The objective of the study, as being carried out by Development Alternatives, Inc., is to provide a comprehensive review of important policy issues related to rural credit and savings services, and to formulate policy recommendations to assist the Government of Kazakstan in the reform of the rural credit and savings sector. The TA will deliver three main outputs, as follows:

- Presentation of briefing papers and seminars on key policy issues;
- Formulation of a set of policy recommendations for the formation and operating stability of micro-finance institutions (MFI's); and
- Design of a time bound action plan for the market-based reform of rural credit and savings services, involving financial institutions and other commercial institutions that will engage in efficient credit delivery and savings utilization services to the rural sector.

6. This report constitutes the Final Report due 22 November 1996 and presents the findings of the study and outlines the recommendations and plans of action the Consultants are proposing.

II. The Rural Sector

A. Basic Parameters

7. In 1994, the population of the Republic of Kazakstan was estimated at 16,679,000; 56 percent of which is urban and 44 percent rural. The rural population lives in over 8,000 villages and settlements throughout the country, most densely concentrated in the southern and northern oblasts (with 3-10.5 person/sq. km.) and least concentrated in the central and western oblasts (with fewer than 3 persons/sq. km). The southern oblasts of Jambyl, South Kazakstan, Almaty and northern oblasts of Akmola, Kostenia, Kokshetau and North Kazakstan are the predominant agricultural producing oblasts.

8. Despite the decline in agricultural activity over the past five years, the sector remains critical to the economy. As a result of the decline in output to less than half former levels, the contribution of the agriculture sector to the total economy has fallen from an average of 25 percent of GDP during 1986 -1990 to an estimated 14 percent in 1995. Government statistics from January

through April 1996, confirm that 1.03 million people were employed in the agricultural sector. This represents a 13.5 percent decline from the same period in 1994.

9. In 1995 the Ministry of Labor defined the cost of a minimal market basket for the low-income population, whose declared income per capita averaged 640 Tenge, by determining actual consumption of goods. The ratio of expenditures for food to other goods was 70 percent to 30 percent. On 31 December 1995, the cost of the minimal basket was 2,000 Tenge; on 30 November 1995 its value was 2,338 Tenge; and on 1 February 1996 the price had risen to 2,700 Tenge.

10. The State Statistical Committee also defined 33 basic food products for a minimal market basket. In August 1995 the average market basket cost by regions was 1,614 Tenge; by December 1995 the price of the market basket had risen to 2,036 Tenge. Based on an evaluation of 6,000 households, which was conducted by the State Statistical Committee in 1995, a large portion of the rural population live below the subsistence level of 1,614 Tenge.

11. The general economic decline has influenced the expansion of poverty in different regions to different degrees. Analysis shows that industrial regions have lesser proportions of their populations living under the subsistence line. The chart below shows the percentage of the population with a declared per capita income of less than 1,240 Tenge per month by oblast.

Oblast	Percentage
Akmola	12.2
Aktubinsk	15.3
Almaty	46.1
Atyrau	31.5
City of Almaty	0.8
Eastern Kazakstan	11.9
Jambyl	31.4
Jezkazgan	17.1
Karaganda	5.6
Kokshetau	3.0
Kostanai	14.0
Kzyl-Orda	29.3
Mangystau	3.3
Northern Kazakstan	15.5
Pavlodar	17.7
Semipalatinsk	14.1
Southern Kazakstan	49.8
Taldykorgan	35.0
Torgai	47.8
Western Kazakstan	27.7

* Based on the results of a selective evaluation of 6,000 families carried out by the State Statistical Committee in August 1995.

** Data received from Republican Center for Public Opinion Research.

12. Most rural incomes are a combination of cash and in-kind payments, with the latter becoming increasingly more important in the last two years. Typically, in-kind payments originate as produce, such as grain or inputs. Based on government statistics, the total income in 1995 for a typical rural household in the Almaty Oblast was 33,877 Tenge. Of this amount, 50.3 percent comes from wages, 10.6 percent from social benefits, 26.5 percent from sales of goods, produce and livestock and 12.7 percent from other sources. In the poorest oblasts, wages and social benefits represented a significant portion of the household income. Delays in receiving wages increase the possibility that these households will sustain severe hardships. As of March 1996, 33.7 billion Tenge were owed in wages, or 2.7 times the country's entire yearly payroll fund.

13. Economic crisis in the rural communities has led to an increase in the number of unemployed people. The official number of registered unemployed from January to August 1996 was 255,800 people. This was an increase of 122,000 people over the same period in 1995. *The UNDP Kazakstan Human Development Report 1996* states that in December 1995, over 183,000 people were on forced leave from their jobs and the hidden unemployment rate had increased to 10.2 percent, as compared to 7.9 percent in 1994. The economically inactive portion of the population remains very high. In 1993, 18.3 percent of the labor resources were classified as engaged in work at home, compared to 9.1 percent in 1991.

14. In the last two years, the social and economic situation in Kazakstan's rural sector has caused a net increase in the migration of workers to Russia, Ukraine and other CIS countries. It is expected that during the next two to three years, migration of the rural population to the cities will increase, especially among the young people. Also, hidden unemployment will become open unemployment and thus, will be more apparent. While government reforms at the macroeconomic level, as well as structural and institutional changes have largely been successful, reforms at the micro and regional level are progressing slowly. This slower pace of policy, structural, and institutional changes at the micro and regional levels has had a negative effect on the rural population.

15. One of the most difficult issues concerning the rural communities is the problem of company towns. There are fifty-seven of these small and medium sized cities in Kazakstan that are dependent upon large industrial complexes for employment, housing and social facilities. As a result of macroeconomic restructuring, dissolution of former distribution channels, inflation and falling demand for their products, some of these companies have closed or have been forced into downsizing and complete liquidation as a result of their financial condition. Thus, unemployment has reached extremely high levels in these cities and the former employed have no choice but to migrate to larger cities to seek employment.

16. The decline in agriculture has been reflected in other areas of the rural sector. Many of the problems affecting agriculture, lack of financing, lack of raw materials and inputs, lack of markets and the general decline in income as well as employment opportunities, equally affect rural non-farm enterprises. The very existence of rural communities is threatened unless the agricultural sector can first be stabilized and then nurtured to grow again. Resuscitating the rural economy is, therefore, a major issue for the government. The development of a thriving private sector-led and

market-based agriculture is seen as the main element in rural revitalization and, indeed, as the starting point for broader economic recovery.

B. Agriculture

17. The agricultural sector is a critical and significant part of the Republic of Kazakstan (RK) economy. As a result of the decline in output to less than half of the former levels, the agricultural sector has seen its contribution to the total economy fall from an average of 25 percent of GDP during 1986-1990 to an estimated 14 percent in 1995. Some Government officials predict the 1996 contribution to be less than 12 percent. Gross agricultural production in 1994 prices was down by 23 percent, as compared with the previous year's level of production. GDP was estimated at USD $950 per capita in 1995, following five consecutive years of declining outputs. The agricultural sector performed relatively well until the last two years when significant output reductions were experienced. In 1995, the situation was exacerbated by the drought which affected most of the country. Overall, agricultural outputs, by 1995, had declined by as much as 40 percent since 1990. The sharp reduction in agricultural production can be attributed mainly to the drop in productivity and the fall in the proportion of land utilized for agriculture. The sector contributed on average throughout 1996, 23 percent of the total national employment. This figure is probably understated as many farm workers are not counted because of their migrant status.

18. Agricultural land accounts for over 75 percent of the land area in the RK. In 1995, over 160 million hectares (ha) of agricultural land were steppe or semi-arid pasture and meadow lands or fallow. This leaves about 31 million ha of cultivable area. The grain producing area is in the north, with pockets of dairy farming close to large cities. The south and east landscape is more varied with a difference in altitude, allowing a wider range of crops to be grown. The central region is the only area suitable for supporting extensive livestock farming.

19. The livestock subsector has shown significant decreases in the number of animals and overall productivity levels. Government data confirmed that the number of heads had decreased 66 percent from a level of 60 million heads in 1991 to 20 million in 1995. The number of sheep and goats was reduced by 25 percent since the middle of 1995 and the total number of cattle by 14 percent. In addition, total output decreased by 55 percent during the same time period. This decrease is partly due to reduced demand as a result of overall decline in the population's real income, increased cost of maintaining herds and decrease in farmers' income.

20. The total area planted with crops has fallen by 20 percent since 1990; while the area planted with grains, by 18 percent. It seems probable that these areas will decline again in 1996 due to farming systems adjustments and growing areas of marginal crops. The unavailability of or lack of access to inputs suppliers, have had a dramatic effect on productivity levels. Because of the significant fall in productivity levels individual household plots and gardens have substituted for the large farms as the main provider of staple crops such as fruits, vegetables, potatoes and limited livestock.

21. Historically, Kazakstan had been a major world producer of cereals with average annual output of 24.5 million tons from 1981 to 1990. Since 1991 annual production has been erratic

with a declining trend to about 16 million tons per year. This trend has been partly due to a 20 percent reduction in the area sown, but it is also due to declining productivity. The past three harvests have all been associated with an average yield of less than 1 ton per hectare. As a result of the 1995 drought, average yields dropped to 0.5 tons per hectare for an all time low of 10 million tons. MOA had predicted that the 1996 harvest would yield between 15-16 million tons. Many government officials have stated that this number could be misleading because of the current trend of farmers to understate yields deliberately and give false figures because of fears that the grain could be confiscated by the government. The government tried to reassure farmers that only 1.1 million tons of grain was needed for state needs and this grain was purchased in the spring of 1996 with USD $165 million.

22. The decrease in farm productivity is a contributing factor to the decline in output for the agri-processing sector in Kazakstan. All of the principal industries; grain processing, fruit and vegetable production, sugar production, vegetable oil, dairy production and vegetable production, have experienced significant output reductions and plant closures. Competition from imported products has driven buyers away from low quality, locally produced products. Thus, there is a need for the sector to adjust to the changing patterns of consumer demand which involve adoption of new technologies and identification of new marketing opportunities.

23. Over the past five years, the purchase and use of input supplies by farms have fallen dramatically as a result of their lack of liquidity and fundamental unprofitability. In addition, input supply channels for feed and farm inputs have been severely disrupted by sector restructuring. Prior to the initiation of privatization, a limited number of state agencies was responsible for ensuring the provision of these items as a part of the command system. In early 1995, the government agencies responsible for the distribution of fertilizers, chemicals and agricultural machinery were reorganized as joint stock companies in preparation for the sale of their shares. Privatization broke these companies up into small regional operations with little hope that they could remain in their former business. Some of these companies have diversified into distributing non-agricultural goods, while a few continue to operate under difficult financial conditions resulting from the lack of farm liquidity to purchase inputs.

24. Closely associated with the decline in output is the loss of real income for farms and farmers, in both absolute and relative terms. As of September 1996, the average agricultural wage was 50 percent less then the national average.

25. Appendix 1 lists the donor programs working to resolve key constraints to the growth of the rural sector, both agricultural and non-agricultural.

26. This section only provides a brief synopsis of the sector and for a better understanding of the problems associated with the agricultural sector, please refer to the final report for ADB Technical Assistance Project TA-2356-KAZ, *Strengthening the Implementation of Agricultural Sector Reforms.*

III. The Financial Sector

A. Background

27. Before 1988 the Soviet Union had a one-tiered banking system comprised of the State Bank of the USSR (Gosbank) and three specialized banks that were a part of the Gosbank structure. With perestroika in 1988, a two-tier banking system was established to allow private and state-owned banks to operate. However, it was not until late 1991 that the first private bank was established in Kazakstan. In 1991, Gosbank was dissolved and the State National Bank was made responsible for the supervision of the five specialized state-owned banks. These specialized state-owned banks included the former branches of the All-Union specialized banks; the Savings Bank (Sber Bank), the Agricultural Bank (Kazagroprom), the Industrial Bank (Turan Bank), the Foreign Trade Bank (Kazvnesheconom Bank), and the Construction Bank (Kredsots Bank). In early 1991, these banks became joint-stock banks and their mandated specialization was abolished.

28. By the first quarter of 1992, the banking sector had grown to 115 banks. These banks had been established by state-owned enterprises and by private enterprises primarily to obtain refinance credit from NBRK and to pool their owners' resources for lending to owner-clients. By the first quarter of 1993 the number of banks had risen to over 200. Since then, the banking sector has gone through a retrenchment, as a result of stringent bank supervision by NBRK and the powers vested in it under the Kazakstan Law on Banks and Banking Activity (LAW). Over one hundred banking licenses have since been withdrawn, leaving a current total of 102 banks. Table 1 in Appendix 2 provides information on the number of banks and branches by oblast as of November 1996.

29. In October 1996, there was a further reduction in the number of banking institutions when the NBRK took action against two of the top ten banks in the country. Turan Bank was placed under NBRK conservatorship for a period of six months to stabilize liquidity and prevent further deposit runoff and Kramds Bank was subject to liquidation proceedings due to the bank not meeting capital adequacy requirements set out by NBRK regulations.

30. The five former specialized banks, together, account for 40 percent of banking assets and almost 90 percent of all branches and outlets. As of August 1996, three former specialized banks had been fully privatized, Turan, Kredsots and Kazagroprom. In 1994-1995, the government created five new specialized state banks: the Housing Construction Bank, Rehabilitation Bank, Budget Bank, Exim Bank and the Central Asian Bank for Reconstruction and Development.

31. Since 1994, the World Bank has conducted diagnostic studies on the following banking institutions: Alem Bank, Narodny Bank, Kazagroprom, Turan, Kredsots Bank, Igilik Bank, Kramds Bank, Kazdor Bank, Center Credit Bank. The purpose of the studies was to determine the financial condition of the banks, review operating procedures and recommend institutional changes that would enable the banks to meet international standards. As a follow up to the diagnostic studies, the WB established a twinning program that will identify western banks to help foster the institutional development of Kazakstani banks. The WB and NBRK have identified five local banks to participate in the program, but to date, no local banks have been invited to take part in the program because of their continued financial difficulties. Table 2 in Appendix 2 shows the capital composition of all second tier banks (SLBs).

32. The total assets held by the commercial banking sector, before significant loan loss provisioning, were recorded at 253 billion Tenge at the end of 1995. This amount was equivalent to USD $4 billion, or 21 percent of GDP.

33. Deposit mobilization by banks has been extremely low because of a transition problem. Prior to 1994, inflation was by some estimates over 3,000 percent. Inflation declined sharply from an annual rate of 1,160 percent in 1994 to 61 percent in 1995 in response to the macroeconomic policies implemented after April 1994. As a result of the high inflation rates, negative rates were offered on deposit instruments, causing a liquidity problem for the commercial banks. Customers were often not able to withdraw their funds from the banks. In addition, a scandal concerning a local investment company and a number of recent bank closures caused a great deal of concern over the safety of banks. Most importantly, tax authorities are given access to bank records. The 1995 tax code allowed the tax inspector to seize bank deposits, for arrears on monthly tax payments as well as the penalties associated with those arrears. Thus, small businesses are reluctant to deposit funds in excess of the absolute minimum amount required to operate their demand accounts.

34. As of June 1996, the Kazakstan Tax Authorities and NBRK required tax registration numbers on all banking transaction documents. Banks are subjected to a penalty of 5 percent of the amount of the transaction if they fail to comply with this requirement. While this regulation supports the collection of state tax revenues, it affects the way people view their financial institutions. Lack of trust in banks and the aversion to inform tax authorities in a direct or indirect way on how they acquired their money are cited as two main reasons why people do not place deposits in licensed financial institutions.

35. As the WB report on the latest *Financial Sector Adjustment Loan* suggested, the deposit base of the banking sector has expanded in real terms over the past year. Part of this expansion stemmed from foreign currency deposits that now comprise 40 percent of total deposits. Total deposits held by the commercial banking sector as of the end of 1995 was 65 billion Tenge or the equivalent to USD $1 billion . Tenge deposits amounted to only 3 percent of GDP at the end of 1995. These developments indicated that, while the use of the Tenge as a means of exchange has improved, public confidence in Tenge deposits as a store of value remained limited.

36. In addition to financial institutions, the formal financial sector includes 169 private investment funds, 120 insurance companies, a stock exchange, state social fund, 12 small, private pension funds and 2,446 foreign exchange bureaus that are licensed by the NBRK.

B. Role of the National Bank of Kazakstan

37. In 1995 the Government defined the role and powers of the National Bank of the Republic of Kazakstan by adopting in March "The Law on the NBRK" and in August, "The Law on Banks and Banking Activity". The NBRK is the leading financial institution of the country and is responsible for all functions related to central banking operations.

1. Banking Supervision and Regulations

38. Within the last two years, the NBRK has made sufficient strides in the formation and implementation of new policies and procedures for effective bank supervision regulation. These prudential norms are being enforced by the 1995 Presidential decree, "Law On Banks and Banking Activity". Presently, there are two donor technical assistance programs which are providing hands-on technical assistance and training to the Banking Supervision Department of the NBRK. The USAID Off-Site Supervision Group is in the remaining months of an eighteen-month technical assistance program that has developed regulations to support the Law on Banking, developed a training and procedure manual for bank examinations, and provided training to NBRK bank examiners. The off-site examiners are responsible for monitoring monthly call reports and evaluating financial, operational, and compliance data that are submitted to the NBRK on a monthly basis. Simultaneously, the World Bank On-Site Examination Team is training 40 NBRK bank examiners over the next 12 months, in providing on-site evaluation involving 25 banks. The examiners will be reviewing the operations and financial results of the banks, based on International Banking Standards and the CAMEL bank Rating System.

39. Nine specific regulations have been developed by the Supervision Project since the Law on Banking was passed in 1995. New regulations concerning "Safety and Soundness for Banking Operations" and "Enforcement Procedures" are being developed by the banking supervision department and these should become enforceable in early 1997.

40. In May 1996, the NBRK took a further step to refine its prudential regulations and began a program of transition to international standards for SLBs. This program is expected to take three years to fully implement and is designed for those banks not currently meeting existing regulatory standards but which exhibit the potential to meet the standard within a designated time frame. Participation in the program is possible for those banks which submit plans for recapitalization and show overall improvement in their operations. Banks located in Almaty had until 1 July 1996 to submit a plan to the NBRK and banks located outside of the city had to submit their improvement plans by 1 October 1996. The NBRK reviewed each plan and then approved or rejected it. Banks that were in violation of laws and prudential regulations at the time this program was put in effect, and who did not get prior dispensation from the NBRK, were not eligible to participate in this program. To date only one bank has been accepted to the program. A copy of the International Standards Program (ISP) is attached to this report as Appendix 3.

2. Accounting

41. The accounting framework for the NBRK and commercial banks has gone through a substantial transformation within the past 18 months and has brought the current system up to conformity with International Accounting Standards. During 1995, technical assistance projects were responsible for the development of two separate chart of accounts; the Central Bank of France developed the NBRK chart of accounts and the USAID Accounting Reform Project developed the chart of accounts for commercial banks. In addition to the development of the chart of accounts, the USAID project is also responsible for the development of compliance

procedures for the chart of accounts, providing hands-on training to the NBRK Accounting Reform Team, and implementing the new chart of accounts in two pilot banks (Kazkommerts, Narodny Bank).

42. The NBRK has issued regulations which make the new chart of accounts, reporting formats and accounting standards mandatory for all commercial banks as their primary accounting system by January 1997. The process of producing subsidiary ledgers systems will enable vital decision-making information to flow directly to the chart of accounts. This will then enable the banks to produce the monthly call reports the banking supervision department has developed. The significance of this project can not be overemphasized since its successful implementation will overcome one of the most glaring weaknesses of the banking sector—lack of viable and complete information concerning a bank's financial condition.

3. Loan Documentation

43. The regulation on Maintaining Loan Documentation was passed in 1996 and it establishes requirements for banks on maintaining loan documentation, with the objective of ensuring uniform conditions for the inspection of bank activities by NBRK examiners. The list of required documents included in the regulation meets international standards and represents another step forward in the development of uniformity and transparency in the banking sector for credit granting guidelines. The procedures will not apply to loans made prior to the regulation's approval, except during instances when the loan is restructured or refinanced.

4. Loan Classification and Loan Loss Reserve

44. The regulation on Loan Classification was passed in December 1994 and has five specific loan grades: Standard, Substandard, Unsatisfactory, Doubtful, and Loss. In 1995, the regulation on Loan Loss Reserve was passed and required all SLBs to maintain reserves at a level that is adequate to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. In addition, the reserve should be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as letter of credits. Normally, financial institutions estimate the amount of expected reserve on the basis of historical examination of the losses from the bank's portfolio. But because Kazakstani banks do not have this historical data, they are now required to reserve in the following format; Standard loans require 1-3 percent; Substandard, 5-10 percent; Unsatisfactory, 20-25 percent; Doubtful, 50 percent and Loss, 100 percent. Determining whether to reserve 1 or 3 percent for a standard loan is a judgment decision made by the NBRK examiner and based on soundness in underwriting of the banks loan portfolio.

45. Each of the classifications is discussed below.

46. **Standard:** Loans classified as standard are not subject to criticism and these loans were made using sound underwriting standards and are well protected by the sound worth and paying capacity of the borrower. The loans are in accordance with the original terms and conditions and don't expose the bank to more than a normal degree of loss. In general, performing loans which

are fully secured as to principal and interest, by cash or cash-substitutes are classified as standard loans. These loans require loan loss reserve provisions in the amount of 1 to 3 percent.

47. **Non-Standard:** Loans included in this category do not expose the bank to a sufficient degree of risk to warrant adverse classification; however, they do posses credit deficiencies that require bank management's close attention. Failure to correct deficiencies could result in greater credit risk in the future. Ordinarily, such borderline credits have characteristics which corrective action by management would remedy. Often it is the bank's weak origination and/or servicing policies which constitute the cause for criticism. Such practices may include not obtaining complete financial information on the borrower, making loans that are not in full compliance with internal policies, inappropriate capitalization of interest, failure to properly evaluate collateral and/or failure to aggregate related borrowers in the analysis of the credits. These loans are less than 30 days in arrears and require loan loss reserve provisions of 5 to 10 percent.

48. **Substandard:** These loans were not underwritten with sound credit procedures and the debt repayment capacity of the borrower is in question. The primary source of repayment is insufficient to service the debt and the bank should begin to look for secondary sources of repayment. This includes the need for additional collateral, sale of fixed assets by the borrower or refinancing of the loan. These loans are past due by 30 days but less than 60 days and require loan loss reserve provisions in the amount of 20 to 25 percent.

49. **Doubtful:** These loans exhibit the same weaknesses inherent in substandard loans with the added characteristic of not having adequate security. These weaknesses make collection in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of a loss is high and the bank should begin to investigate legal action against the borrower to enforce collateral and guarantee agreements. Doubtful loans are more than 60 days past due but less than 90 days and are accorded a reserve provision of 50 percent of the total balance outstanding.

50. **Loss:** These are loans which are considered uncollectable and past due for more than 90 days. Banks should not retain these loans on their books while attempting recovery. Losses should be taken in the period in which they are realized and the time needed to realize collateral should not exceed one year from the date of legal action is initiated or guarantees should be honored within 60 days of being called. Loans classified as loss must be reserved 100 percent.

51. In reviewing the loan classification and reserve procedures for APB and other rural branches, the Consultants found that all of the banks were complying with the NBRK regulations but the banks had primarily based their classification decision on the amount of days past due and did not consider any other credit quality indicators such as cash flow, liquidity, payment performance, collateral coverage and other support indicators. Thus, there were discrepancies during examinations between the banks' classifications and examiners.

52. Un-funded reserves present a difficult problem for large and small banks. At this point, banks' earnings are insufficient to fund the un-funded portions and the possibility of recapitalization from private sources is limited. A NBRK policy concerning un-funded reserves should be developed that requires banks to schedule the funding of these amounts over a term

dependent on the amount need. Without proper management of this problem, banks' capital positions will continue to deteriorate.

53. In response to bank's reluctance to make loan loss provisions, tax legislation was amended to allow, before tax, specific provisions on all classified loans pre-dating 1995 in full, and up to 50 percent of the book value of all outstanding loans from 1995 or thereafter.

54. It is the Consultants' opinion that the loan classification and loan loss provision regulations meet international standards and the banks which the Consultants reviewed had implemented the regulations. The following recommendations apply to the enforcement of the regulations.

55. Responsibilities of NBRK bank on-site and off-site supervision.

- consider all facts and circumstances that affect the repayment of the loan as of the evaluation date and not solely concentrate on the number of days the loan is past due;
- consider the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's credit grading system and loan review function;
- review an institution's loan review system, including credit grading by an examiner will usually include tests involving a sample of the bank's loans. If differences noted between the examiner credit grades and those of the bank's loan review system indicate problems with the loan review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of the credit grades to the loan portfolio and to its estimate of loan loss reserves;
- evaluate the loan loss reserve evaluation process that management has followed to arrive at an overall estimate of the reserve and the related assumptions made by management, in order to ensure that all significant factors that affect the collectibility of the portfolio have been appropriately considered;
- perform a quantitative analysis as a check of the reasonableness of the reserves. Ratio analysis can be helpful in identifying divergent trends in the relationship of the reserve to classified and nonclassified loans, to past due and nonaccrual loans, to total loans and binding commitments and to historic gross and net charge-offs;
- review the adequacy of the documentation that has been maintained by management to support the adequacy of the loan loss reserve.

56. In assessing the adequacy of loan loss reserves, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when a bank maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept

management's estimates in their assessment of the adequacy of the loan loss reserves when management has:

- maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner;
- analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and
- established an acceptable loan loss reserve evaluation process that meets the objective for an adequate loan loss reserve.

57. The Consultants recommend that an on-site review should take place on a quarterly basis, or more frequently as warranted, and off-site monitoring should be a function of monthly report analysis for the fifteen largest banks in Kazakstan. This will enable the NBRK to properly monitor the loan portfolio of these large banks.

58. Responsibilities of banks for maintaining adequate loan loss reserve.

- ensure that the institution has an effective loan review system and an effective credit grading system that identify, monitor, and address asset quality problems in an accurate and timely manner;
- ensure the prompt charge-off of loans and portions of loans, that available information confirms to be uncollectable;
- ensure that the institution's process for determining an adequate level for reserves is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses; and
- develop an effective loan review system that would work to ensure the accuracy of internal credit grading system and, thus, the quality of the information used to assess the adequacy of the loan provisions.

59. The complexity and scope of the bank's loan loss reserve evaluation process, loan review system and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities. It should provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

5. Capital Adequacy

60. The new capital adequacy regulation is designed to be consistent with international standards, namely the Basle agreement on risk based capital. Assets will be weighted by a risk factor that reflects the relative risk of the bank asset. The sum of these risk-weighted assets will then be compared to the volume of capital to arrive at a risk based capital ratio. The eligible capital will be according to a definition which identifies capital as Tier I, or Primary Capital, and Tier II, or Secondary Capital.

Tier I Capital includes:

- capital;
- surplus;
- reserves;
- unallocated profits for the prior years, less intangibles, losses;
- excess of current expenses over revenues; and
- unformed provisions (additional loan loss provisions required by NBRK).

Tier II Capital includes:

- current year profits;
- revaluation of fixed assets and securities;
- loan loss reserves resulting from the required provision for standard, non-standard and low quality credits that was required to be made by 1 January 1996, but not to exceed 1.25 percent of risk weighted assets; and
- subordinated debt of original maturity of not less than five years and not to exceed 50 percent of Tier I capital.

61. The new minimum capital ratios are 4 percent Tier I to total assets and 8 percent Tier I plus Tier II to risk weighted assets. Risk weights for various classes of assets follow the international standard.

C. Resolving Problem Loans

62. The present state of affairs in the banking sector of RK can best be characterized by huge amounts of accumulated bad debts in the SLBs—leading to the decapitalization and deterioration of the banks' capital and liquidity positions. According to NBRK figures, as of August 1996, total overdue financial obligations had accumulated to 399.20 billion Tenge. Of these total obligations, 7.76 billion were for short term loans, 64.80 million for long term loans, and 391.37 billion for inter-enterprise debt. With the introduction of loan loss classification and reserve requirements in 1995, banks are now obliged to build their loan loss provisions for these loans. However, NBRK and WB examiners have indicated that small and medium sized banks are still not adequately provisioning for loan losses and not classifying their loan portfolios to meet international standards.

63. The NBRK and the Government stepped in, to try to solve some of the debt problems by transferring a portion of the state loans to governmental units. Under a burden-sharing concept, the Government financial sector reform program relieved banks of bad loans that had been directed by various government authorities. Since 1995, the Government has transferred these loans that banks were unable to work out on their own because of the size of the debtors, nature, and social impact of the foreclosure to special debt resolution banks. By the end of first quarter 1996, a substantial portion of the loans had been transferred.

64. A large percentage of non-performing loans to around thirty of the country's largest insolvent net debtors were transferred to the Rehabilitation Bank (RB) which was created in

1995. In 1996, the Government transferred to the RB some of the largest insolvent debtors that were under management contracts, but still owed significant amounts of past due loans to the banks. The RB's debtors are some of the largest industries in Kazakstan, which dominate company towns, are far beyond the commuting distance from alternative employment and lack major alternative sources of revenue to operate social infrastructure. Because of these complex constraints, the RB has moved slowly in restructuring these entities through downsizing, social asset disposal and liquidation.

65. In December 1994, the Agricultural Support Fund (ASF) was established by Resolution 1447 of the Cabinet of Ministers, to provide direct Government support to the agricultural sector. A subsequent Cabinet Resolution in March 1995, provided for the transfer of debts from the Kazagroprom Bank (APB) to the ASF in the amount of 31 billion Tenge. The major share of this debt comes from agricultural enterprises that received directed credits from the Government—through APB prior to 1994. As of October 1996, the ASF has canceled twenty-one billion in Tenge of this debt with the remaining ten billion in principal to be repaid by the end of 1996. If five billion of the debt is paid by the end of the year, the ASF has said the remaining portion would be written off. To date, only twenty million in loan principal has been repaid.

66. Inability to assess and manage lending risks together with non-payment of previously made directed loans, have caused serious liquidity problems for the SLBs. After the transfer of the directed credits to the workout institutions, commercial banks still hold substantial amounts of non-performing loans of small and medium enterprises. Commercial banks have begun creating in-house workout departments that are responsible for debt restructuring, collateral foreclosure, forced debtor liquidation and negotiated partial forgiveness. But despite their efforts, banks are still hindered by the precarious financial situation of their borrowers and the weak framework for secured lending.

IV. Rural Finance

A. Supply of Rural Financial Services

67. Formal rural financial services in Kazakstan are provided by Kazagroprom Bank, Narodny Bank, certain other and much smaller banks, several donor-funded activities and the Agriculture Support Fund. Each of these is described in this section.

1. Kazagroprom Bank (APB)

68. Just as the economy of Kazakstan is in transition from a centrally planned to a market based economy, APB is an institution in transition. It is going through the painstaking process of changing from a government bank, which channeled credit to state-owned enterprises, to being a financially viable bank capable of responding to the credit and savings demand of people and private enterprises in the rural sector. APB has made significant progress in transformation within the last year, but additional operational and organizational changes need to be made.

69. Historically, APB has been the major supplier of formal credit to the agricultural sector for Kazakstan. Registered in 1991 as a joint stock commercial bank with over 7,000 individual shareholders, APB has close to 7,000 corporate shareholders who together account for 100 percent of total shares. Structurally, the bank is composed of 236 branches, is governed by a Supervisory Council, with daily operating decisions made by the Board of Directors. The Board of Directors is composed of upper management from the central office in Almaty. By the end of 1993, Agroprom had over USD $3 billion in assets of which 60 percent were problems loans resulting from directed credits to agro-industrial complexes and former state farms. In 1995, the Government established the Agricultural Support Fund and removed 11 billion Tenge of directed farm credits and 19 billion Tenge in accrued interest from the books of APB .

70. In addition to the 31 billion in Tenge loans that were transferred to the Agricultural Support Fund, the bank has been receiving agricultural support credits from the NBRK for the past two years. Table 3 summarizes these data on agricultural support from NBRK to APB.

Table 3

NBRK Agricultural Support Credits to APB
March 1995 to November 1996

Month	Credit Amount (million Tenge)	Weighted Average Interest Rate	Paid Back to NBRK	Balance Due
1995:				
March	372,000	134.8	372,000	0
April	198,000	105.5	198,000	0
May	100,000	86.0	100,00	0
November	8,880	50.0	8,880	0
December	39,590	58.6	39,590	0
Total	718,470	86.93	718,470	0
1996:				
April	411,000	46.00	0	411,000
June	21,000	46.00	0	21,000
July	300,000	32.00	366	299,634
Total	732,000	40.26	366	731,634

*NBRK Statistics from November 1996

71. The April 1996 agricultural support credit, shown above, was part of a 650 million Tenge credit auction held by the NBRK in support of spring planting. Five banks received funds from this auction. An auction was held in July for the fall harvest and APB received 300 million Tenge. This fall harvest loan is short term and due in December. Without NBRK and Government support for the agricultural sector, APB would have difficulty in providing financing to its clients.

72. In May 1996, a three-year agreement was signed between the NBRK and APB concerning the stabilization of APB activities. The agreement requires the bank to submit on a quarterly basis information on how they are complying with current NBRK prudential norms and requirements under LAW. If the bank fails to meet the new capital adequacy requirements, the NBRK is entitled to prohibit the bank from accepting deposits from all physical persons except family farmers. Additionally, if APB fails to implement actions for stabilization of its activities, NBRK is entitled to implement sanctions stipulated by LAW.

73. The NBRK on-site supervision team, under the guidance of the WB consultants, completed the audit of APB in April 1996. Format of the audits conforms in principle to international standards and the CAMEL rating system. All areas are examined in detail and narrative conclusions were developed, but at this point, no numeral rating is assigned to the institution. The Consultants examined the following areas and information was obtained from the NBRK audit report, NBRK 1995 year-end reports, internal bank documents and talks with APB and WB consultants.

74. After the submission of the Interim Report in August 1996, the NBRK requested changes to be made to the loan provisioning and capital adequacy tables based upon new financial data that APB had submitted to the NBRK in September 1996. The data has been confirmed by the NBRK and Consultants.

a. Deposit Mobilization

75. Deposit mobilization continues to be a problem for the bank. Total deposits decreased from 2.67 billion Tenge as of year end 1995 to the April 1996 level of 2.06 billion Tenge. The continued run-off of deposits since April has dropped the total deposits to a low of 2.01 billion Tenge as of 1 July 1996. The bank attributes this decline in deposits to the inability of clients to generate sufficient cash flow and the nation-wide delay in salary payments to the general population.

76. According to the "Primary Measures on Further Stabilization of Bank's Activity for 1996", APB recognized the importance of mobilizing deposits and developed a plan of action to address the current low rate of deposit mobilization. The bank intended to:

- attract funds of foreign banks, banks from other CIS countries, legal entities and individuals;
- develop new types of deposit instruments;
- improve the quality of services;
- advertise to attract deposits from agricultural and non-agricultural enterprises; and
- develop program for issuing long-term securities for investment in agricultural production and infrastructure.

This plan of action was developed by the central office of APB and every oblast branch was responsible for implementing the plan. Each of the bank's oblast branches are in charge of developing semi-annual projections for total deposits, based on economic conditions in their

oblasts. APB's "Resource Plan for Second Half of 1996" projects total deposits as of 31 December 1996 to be 2.28 billion Tenge, which is a 11 percent increase in deposits from July 1996. Flexibility in pricing appears to the Consultants to be essential for the realization of APB's plan.

77. In conversations with the Asset/Liability department, pricing of savings instruments was based on the current refinancing rate at the NBRK and rates from other banks. No concrete formula is used and latitude is given to the Oblast branches in determining their own rates based on market conditions. Table 4 shows data that was supplied by APB for savings instruments in Tenge and foreign currencies, corresponding balances, and average interest rates as of 1 July 1996. The relationships among rates for different maturities do not appear to be rational based on normal market conditions determining the time value of money.

78 The Consultants have determined that the decline in deposits at APB is attributed to three factors; continued popular perception of bank instability, deposit rates below second tier banks weighted average, and inability to attract new clients due to restrictions that were placed on it by NBRK. A more realistic and concrete plan for mobilization of domestic funds should be a key component of the bank's restructuring strategy.

Table 4

Balances and Rates of APB Savings Instruments

	Legal Entities				Individuals			
	Tenge (000)		Hard Currency		Tenge (000)		Hard Currency	
Deposit	**Amount**	**Rate**	**Amount**	**Rate**	**Amount**	**Rate**	**Amount**	**Rate**
< 1 month	145	34.5	0	0.0	103	0.0	0	0.0
1 month	2,110	34.0	0	0.0	0	0.0	0	0.0
1-3 months	177,556	38.6	57	25.6	68,694	47.6	4,723	11.5
3-6 months	97,941	29.7	939	20.0	27,237	43.1	2,012	17.8
6-9 months	28,645	45.7	0	0.0	7,288	48.1	0	0.0
1 year	74,945	23.7	1165	20.2	46,223	34.4	2,873	23.2
1-3 years	14,257	38.2	0	0.0	43,390	35.1	0	0.0
3-5 years	220	8.5	0	0.0	6,228	46.2	0	0.0
5-10 years	71	4.0	0	0.0	3,797	32.9	0	0.0
Over 10 years	35	2.0	0	0.0	233	4.9	0	0.0
Total Demand	37,100	20.2	0	0.0	164,670	16.3	68	2.7
Total Time	335,925	77.8	2161	19.6	203,193	41.0	9,608	16.3
Total Deposits *	373,025	72.1	2161	19.6	367,863	29.9	9,676	16.2

* does not include settlement accounts.

b. Capital Adequacy

79. Subsequent to the submission of the Interim Report, APB submitted new financial data as of August 1996. The NBRK and the Consultants have verified the new numbers. This new financial data has had a positive effect on the banks' capital position. Per NBRK capital adequacy norms, which require banks to maintain a minimum 4 percent ratio, adjusted tier one capital to total assets, APB has improved to 10.6 percent. The second capital requirement is the internationally approved Basle 8 percent capital ratio, adjusted tier one plus tier two to total risk weighted assets, which all banks must meet by 1998. APB has also met the Basle capital requirement. The difference between the April and August numbers is a result of the decrease in un-funded provisions from 737 million to 67 million Tenge. Table 5 shows the capital structure of the bank as of August 1996.

Table 5

Adjusted Capital Structure of APB According to Examination Results As of August 1996 (Tenge '000)

Loan Classification	Balance	Provision	Weighted Total Value or Change
Standard	2,192,524	1-3%	29,075
Non-Standard	253,561	5-10%	15,547
Unsatisfactory	93,518	20-25%	16,964
Doubtful	11,781	50%	4,600
Loss	522,712	100%	388,258
Weighted Total			454,444
Reserve Deductions			386,879
Capital Adjustment			67,565
Tier 1 Capital			687,032
less: adjustment			67,565
Total Assets			5,827,717
Amount of Adjusted Tier 1 Capital			619,467
Amount of Adjusted Fixed Capital Ratio as % of assets			10.6%
Adjusted Amount of Total Capital			1,238,934
Total Weighted Risk Assets			2,828,379
Adjusted Amount of Total Capital as % Ratio to Total Weighted Risk Assets			43.8%

c. Recapitalization

80. In 1995, the bank increased its statutory capital from 80 million Tenge to the present level of 200 million Tenge. Paid in capital is composed of 196 million Tenge in standard shares and 4 million Tenge in preferred stock. Based on the "Recapitalization and Improvement Plan of APB Activity for 1996-98", the bank proposed to increase the size of the authorized fund by issuing new shares to legal entities, individuals, non-residents, and employees of the bank and by retaining profits and issuing bank securities. This schedule was established:

- Increase by 300 million Tenge in 1996
- Increase by 500 million Tenge in 1997
- Increase by an additional 500 million Tenge in 1998

The capital formation plan is aggressive but unrealistic. APB does not appear to have identified any investors or stockholders who are willing to increase their shares in the bank.

81. Two preconditions under ADB Loan 1406-KAZ which affect the recapitalization of APB are the requirements that the Government determine the value of their remaining shares in APB and the MOF prepare a timebound plan of privatization for these shares. On 16 July 1996, the State Property Committee submitted a letter to APB which restated the percentage of Government ownership from the previous agreed upon amount of 28.20 percent to the new figure of 33.42 percent. As a result of talks with ADB officials, the Government issued the resolution, "Concerning the Sale of State Shares of the Kazak Joint Stock Bank (Agroprom)," which stated that the State Committee on Privatization sell the state shares by 30 September 1996. A resolution was issued on 25 September 1996, which stated that the Government had swapped the 33.42 percent ownership in APB for 47 branch buildings, valued at 67 million Tenge. The GOK plans on renting these buildings to Credit Partnerships or CUs.

82. One of the problems that is being overlooked by the APB in its plan for recapitalization is the realization that attracting fresh capital will require the bank to offer significant incentives to new investors. Based on history and performance of the bank, investors will require a substantial return on their investment. This could entail granting the new investors seats on the supervisory board and senior management positions at the bank. In addition, any new capital will require the issuance of additional shares which will dilute the existing shareholders' ownership.

83. As of 20 January 1997, the bank indicated the number of shareholders at 11,904. This is a increase of over 5,000 shareholders from early 1996 and was a result of the bank's recent offering of new shares. The register of shareholders is maintained by the bank's central office and is submitted to the NBRK for review.

d. Governance

84. The Supervisory Committee for APB is comparable to what western banking institutions call the Board of Directors. This committee is composed of 16 outside directors and 4 persons from the management team of the bank. They are responsible for overseeing the management of the bank and executing decisions that affect long-term operations. It is the Consultants' view

that the committee's structure should be modified to comprise eight members elected by shareholders and the President of the bank. The bank's statutes should include detail of procedures of nomination, election, rotation and re-election. Clear criteria and mechanisms of enforcement of their accountability for the bank's performance are needed. All committee members should be confirmed by vote at the annual shareholders' meeting. The committee may be re-enforced to give it a broader range of commercial skills and experience by the appointment of external directors. Again, the statutes should include detail of the procedures for such appointments and of the duties, rights and obligations of external directors.

85. Defense against political intrusion from Government ministries is critical, especially from the MOA, which seems concerned with loan targeting and seldom with the promotion of viable lending institutions. No government official should be appointed to the Supervisory Committee, except possibly a representative of NBRK.

e. Credit Portfolio

86. In April 1996, the APB Supervisory Committee issued two sets of policies concerning lending which appear to strengthen loan underwriting; Guidance on Lending Policy of APB for 1996 and Regulations on Lending Committees of APB and its Branches. A loan offering report has been developed and is required to be submitted to the appropriate lending committee prior to funding. NBRK lifted the lending restriction during the second week in August, and thus, the bank is now able to resume its lending operations. The NBRK has allowed the bank to participate in three separate NBRK credit auctions in 1996 for the support of the agricultural sector. These loans were fully collateralized and scheduled to mature in December 1996.

87. APB's current portfolio as of April 1996 is broken down into 16 sectors. Peasant farm loans make up only one to two percent of the total value of the portfolio (2.20 billion Tenge), as can be deduced from the data summarized below.

Sector		As Percent of Total Current Portfolio
1.	Agro-Industrial	19.0
2.	Privatized State Farms	21.0
3.	Tenants, Peasant Farms, Agricultural Cooperatives	5.0
4.	Agricultural Industry	4.0
5.	Agro-Industrial Construction	1.0
6.	Trade and Procurement	1.0
7.	Misc.	1.0
8.	Sales/Supplies of Agro-Indus.	2.0
9.	Bakery	7.0
10.	Fishing	1.0
11.	Water Construction	1.0
12.	Kazak Consuming Unit	3.0

13.	Joint Stock Companies	11.0
14.	Small Enterprises	9.0
15.	Cooperatives	1.0
16.	Others	13.0

88. Based on the April 1996 audit report that was produced by NBRK, adversely classified assets (non-standard to loss), represent 48 percent of the total credit portfolio of 2.28 billion Tenge. Loans classified as loss account for 37 percent of the total portfolio. Comparing required reserves of 971 million Tenge to actual reserves of 203 million Tenge, leaves a difference of 738 million Tenge in un-funded reserves. Significant deterioration still exists in the portfolio and 14 percent of the adversely classified assets are close to being classified as loss. At this point, earnings are not strong enough to support the capital required to meet NBRK norms concerning full provisioning of assets. The NBRK auditors' classification as of April 1996 is listed in Table 6.

Table 6

APB Loan Classification
April 1996
(Tenge '000)

	As Classified by APB			As Classified by NBRK		
Credit Classification	Principal	Required Reserve	Actual Reserve	Principal	Required Reserve	Additional Reserve Required*
Standard	1,160,041	21,822	20,896	1,102,43 4	20,658	-238
Non-Standard	137,917	12,282	5,505	164,854	14,484	8,979
Unsatisfactory	95,908	23,337	6,873	95,995	23,273	16,400
Doubtful	56,914	28,457	2,459	75,000	37,500	35,041
Loss	837,867	837,867	167,635	845,364	845,364	677,729
Total	2,288,647	923,765	203,368	2,283,64 7	941,279	737,911

* ABP actual reserve less required reserve by NBRK

89. Loan classification data in Table 7 that was submitted by APB in August 1996, shows a reduction of 38 percent in the amount of loans classified as loss since April 1996. The bank received loan payments of 100 million Tenge and wrote off over 210 million in uncollectable debt. Un-funded reserves amount to 67 million Tenge. The huge increase in standard loans was a result of APB receiving NBRK credit auction funds for the support of the agricultural sector. If the short term support credits are deducted from the total amount of loans, the bank would still have 37 percent of their portfolio classified as loss. This amount is considered excessive and additional loans should be charged off as soon as earning recover. The Consultants recommend

that the NBRK conduct loan examinations twice a year to determine the status in the bank's loan portfolio.

Table 7

APB Loan Classification
April 1996
(Tenge '000)

Credit Classification	As Classified by APB Principal	Required Reserve	Actual Reserve	Additional Reserve Required
Standard	2,192,524	29,075	78,677	(49,602)
Non-Standard	253,561	15,547	17,886	(2339)
Unsatisfactory	93,518	16,964	11,895	5,068
Doubtful	11,781	4,600	3,475	1,125
Loss	522,712	388,258	274,945	113,312
Total	3,074,096	454,444	386,878	67,564

90. APB directs 100 percent of its credit toward agriculture. Because of the seasonal nature of agricultural credit, the bank is dependent upon the success of the yearly harvest. Based upon results from previous years, estimations of crop yields have been overstated and as a result the bank continues to incur significant amounts of bad debt. Conversations with the bank confirm that over 50 percent of the total loans classified as loss are loans two to three year old that are fully collateralized and dependent on the success of the borrowers' fall harvest. The bank is confident that they will collect a majority of these loans and is unwilling to foreclose on the collateral or write the loans off.

91. At this point, because of the excessive amount of adverse classifications and the poor quality of lending practices over the last two years, it will take at least another 8-10 months before a determination can be made whether or not the new loan policies and procedures will have had a direct impact on the quality of the loan portfolio.

92. In talks with APB bank officials, the Consultants have learned that the bank has no set formula for loan pricing. Pricing depends upon whether the funds are NBRK auction funds, which have a 5 percent margin cap, or Inter-Bank funds, which APB sets a 10 percent margin cap, and finally deposits, which are floating and negotiable. For the bank to accurately price its loan products, it must make an effort to determine the direct and indirect costs of delivering credit, factor in the credit risk and determine an expected profit margin. At this point, it is unlikely that the bank is pricing its loans at a profitable level due to artificial caps and the lack of knowledge concerning the cost of funds.

93. Because of these deficiencies, it is not recommend at this time to install any type of term lending program in the bank without significant technical assistance being provided to the bank before the start up of the program.

f. Financial Performance

94. Reported net income for first quarter 1996 was 40.7 million Tenge, which was a 70 percent decrease from 1995. Interest income decreased by 20 percent from first quarter of 1995 to first quarter of 1996. This decrease can be attributed to the lending restrictions NBRK placed on the bank during the second half of 1995 through the first quarter of 1996 and the decrease in refinancing rates. WB examination consultants observed instances where interest income was being booked when the loan had no chance of being paid and was scheduled to be refinanced at maturity. This raises doubts on the integrity of the interest income figure. Because of the run-off of deposits, the bank tapped the inter-bank lending market during the second half on 1995 and continued to use the inter-bank market through the first quarter of 1996. Even though the bank has undergone substantial personnel reductions over the past year, non-interest expense continues to push net operating income down. Additional overhead reductions need to be made by the bank in order to increase long-term profitability. Table 8 shows the income statement for the bank as April 1996.

Table 8

Consolidated Report on Earnings and Losses
For 12 Months Ending
(Tenge '000)

	End of April 1995	End of April 1996
Interest Income:		
on loans	462,926	379,130
on securities	0	628
other	14,389	5,714
Total Interest Income	477,315	385,472
Interest Expense:		
on inter-bank loans	2,950	18,501
on deposits	104,774	64,036
other	2,236	118
Total Interest Expense	109,960	82,655
Net Interest Income	367,355	302,817
Non-interest Income	71,828	157,862
Non-interest expense	272,982	262,618
Provision for bad debts	0	142,633
Taxes	31,392	10,780
Net Operating Income	134,809	44,678
Extraordinary charges, net	2,141	3,957
Net Income	132,668	40,691

g. Liquidity

95. As of 1 April 1996, APB does not meet the NBRK liquidity norm of maintaining a current liquidity coefficient of 20 percent. Loans continue to outweigh deposits by a three to one ratio and short term assets (excluding short term loans) as a percentage of total assets is significantly low. As reflected by the ratios, the bank had a low amount of liquid assets in proportion to overall assets and this could effect the ability to meet short term obligations and restrict entry to formal credit markets. Table 9 lists the liquidity ratios calculated by the NBRK audit team.

Table 9

Liquidity Funds Management
(Percent)

Ratio	April 1996	January 1996	January 1995
NBRK Required Reserve Ratio	0.97	N/A.	N/A.
Asset Liquidity Required Ratio	1.60	1.57	1.47
Loans and Advances / Total Deposits	3.63	3.42	47.16
Loans and Advances / Total Assets	0.46	0.44	0.76
Short-term Assets / Total Assets	0.12	0.12	0.04
Short-term Assets / Total Deposits	0.99	0.91	2.27
Short-term Assets / Total Deposits and Borrowings	0.65	0.51	0.05

* N/A = not available

h. Management

96. Bank management has taken steps within the last year to implement new underwriting procedures, introduce a certification process of regional and oblast management, reduce personnel by 26 percent and develop a system for monitoring costs of oblast branches. While some significant changes have taken place, the bank continues to have poor earnings and weak financial health. Non-interest expenses continue to drive down the earnings of the bank and additional reductions in staff and closure of unprofitable branches need to be made. The bank has developed a complex branch analysis tool, but the results have been negligible. Management oversight of adherence to procedures and policies has been weak, as reflected in the excessively high rate of default in the bank's credit portfolio.

97. Based on the bank's progress in restructuring over the last two years and the current financial position, it appears unlikely that the bank's financial situation will improve over the next few years making it difficult for the bank to achieve the transformation from a state-owned

institution to a financially viable bank, capable of responding to the credit and savings demand of people and private enterprises in the rural sector.

98. An audited balance sheet for APB as of 1 April 1996 is included in Table 10 in Appendix 4.

i. Recommendations

99. The following recommendations are intended to improve operational efficiency at Kazagroprom Bank:

Pricing for Profitability

100. This can only be accomplished if the bank has a full understanding of its cost of funds. The bank should obtain technical assistance from USAID or TACIS programs in developing a Profitability Measurement System. This is a system that attempts to determine cost and profitability to a bank of all of its products. To the extent the product involves funds raised or funds dispensed, the system would place a value on those funds. The costs include the allocation of expenses, direct and indirect, associated with delivering the product. A fully implemented system attempts not only to measure product profitability but also customer and sector profitability.

Diversify the Loan Portfolio

101. Risks and cash flows need to be spread out over various sectors. This does not mean expanding lending operations into sectors in which the bank does not have experience, but should include non-agricultural small and micro businesses. This will enable the bank to overcome the seasonal cashflows associated with agricultural lending. A one year pilot model should be developed by the bank in one oblast. If the pilot program is successful the bank can then apply the model throughout the remaining oblasts. Technical assistance should be obtained from donors to help the bank design, implement and monitor the pilot project.

Improve Oversight of Branches

102. The bank has developed the basis for a decentralized decision making process, but in order for it to be successful, the central office must develop procedures for examining and auditing branch compliance with main office policies and procedures. This will entail setting up branch inspection teams that report directly to the Chairman. A team should consist of one person responsible for examining lending, one accountant and one operations specialist. Each team will be given the power to access all information in the branch. They should make scheduled and non-scheduled examinations. The team will conduct a financial audit of the bank's accounts and examine the operating procedures of personnel. Weaknesses/strengths and deficiencies of the branch would then be reported directly to the Chairman.

Continue Training and Upgrading of Employee Skills

103. The bank has shown improvement in the last year by sending employees to donor-funded bank training schools. This trend should continue and expansion of the training budget for 1997 should be considered. In addition, the bank should take advantage of the donor programs that provide hands-on technical assistance, since this type of training is invaluable and will soon dry up.

Continue Reduction in Overhead

104. If the bank does not expand its client base through small and micro business, excess staff that are presently performing support functions, will need to be reduced. These support staff should be re-trained to provide an income producing function instead of their present status. This training should be apart of the bank's pilot project.

Increase Attention to Past Due Accounts

105. The pursuit of past due loans and loan losses should be strong and immediate. There has been a tendency of the bank in the past to let the borrower dictate the terms of repayment. As part of the loan agreement, the bank should require the borrower to sign a document that explains to the borrower in simple terms what the bank intends to do if the borrower defaults on the their loan obligation. This will include dates on which specific actions will be taken against the borrower. Then if the borrower defaults on a loan, both parties know exactly what steps that will be taken. If the loan is a loss and collateralized, the bank should take all necessary steps to perfect the collateral. This should include lawsuits, forced bankruptcy and even liquidation of the borrower. Any type of leniency sends the wrong message to the borrowers. The bank expects the borrower to abide by the loan agreement and thus the borrower must also believe that the bank will abide by the loan agreement.

2. Narodny Bank

106. Narodny Bank was not specifically mentioned in the Consultants' terms of reference as a bank that was required to be examined, but the Consultants believe the bank has the ability to reach a large percentage of the rural population through its existing outlet network and thus able to provide a range of financial services to the rural areas.

107. Narodny Bank is the former State Savings Bank for the RK. Its primary purpose was to attract personal savings from individuals and make social payments to citizens. The bank was registered with the NBRK on 23 August 1995 as Joint Stock Halyk Savings Bank of Kazakstan. It is still 100 percent owned by the Government of Kazakstan and is the only bank in Kazakstan whose 4,000 outlets reach into remote rayons and villages. The bank has over 15,000 employees and current management has begun to cut staff at many of the larger branches due to computerization.

108. In order to cut costs and increase operating efficiency, the bank's management team has recently begun a restructuring that curtails staff and disposes of 500 outlets through closure,

lease or sale. The Government has authorized the elimination of more outlets if the bank finds it necessary. This downsizing should be completed by the end of 1996.

109. As stated in the WB Financial Sector Adjustment Loan Report dated 31 May 1996, the authorities permitted the bank to close such outlets as it wishes. They also developed a program to offer the bank financial incentives for continuing service in remote communities. Indeed, any bank is eligible for incentives for operating a minimum number of hours per week in areas defined as remote settlements.

110. Also, as part of the 1996 WB Financial Sector Adjustment Loan, the bank and NBRK are required to take the following four actions before the release of the second tranche:

- Approve the strategy and restructuring plan for the bank, including the timing of eventual privatization;
- Substantially complete the rationalization of the bank's staff and branches;
- Instruct state organs to desist from demanding the provision of financial services from the bank or any other bank without charges that reflect market conditions or costs; and
- Consider introducing financial incentives to any bank operating a minimum amount of hours per week in areas defined as remote settlements.

111. As part of the bank's restructuring, new management is entering new markets where its branch network has a competitive advantage, such as currency exchange, foreign currency deposits and basic capital market service. Tighter internal discipline and a comprehensive public relations effort have been giving the bank a new image and restoring goodwill.

112. The NBRK on-site supervision team, under the guidance of the WB consultants, completed the audit of Narodny Bank in July 1996. Format of the audits conforms in principle to international standards and the CAMEL rating system. All areas are examined in detail and narrative conclusions are developed, but at this point, no numeral rating is assigned to the institution. The Consultants examined the following areas and information was obtained from the NBRK audit report, NBRK 1995 year-end reports, and talks with Narodny officials and WB consultants. Due to the high rate of inflation in 1994, no meaningful comparative data exists.

a. Deposit Mobilization

113. The bank continues to dominate the collection of deposits and as of 30 April 1996, the bank controlled 53 percent of the total deposits in the country, 76 percent of the demand deposits, 36 percent of the time deposits and 35 percent of foreign currency deposits. Total deposits increased from 18.7 billion Tenge as of year end 1995 to the April 1996 level of 20.6 billion Tenge. Beginning in the second half on 1995, the bank has gradually reduced rates on deposits because of the slowdown in inflation and the reduction of the NBRK refinancing rate. This decrease in rates did not cause a reduction or outflow of deposits, thus the public confidence in the stability of the bank is high. It should be noted that all former state-owned banks were once covered by an unlimited state guarantee for their deposits. This explicit guarantee was eliminated by LAW.

114. In conversations with the bank, pricing of savings instruments was based on a formula that considers the following conditions; current refinancing rate at the NBRK, inflation rate, supply and demand of soft and hard currencies, and rates from other banks. Because the bank only lends short term-less than 3 months-they don't match inflows with runoffs. Table 11 shows data as of November 1996 that was supplied by the bank for savings instruments and average interest rate on loans in Tenge and foreign currencies.

Table 11

Narodny Bank Interest Rates on Credits and Deposits As of October 1996

Types of Deposits:	*12/95*	*1/96*	*2/96*	*3/96*	*4/96*	*5/96*	*6/96*	*7/96*	*8/96*	*9/96*	*10/96*
Demand Deposits	6.0	6.0	6.0	6.0	6.0	5.0	5.0	4.0	4.0	4.0	4.0
Indexed Deposits	6.0	6.0	6.0	6.0	6.0	5.0	5.0	4.0	4.0	4.0	4.0
Savings Deposits	28.0	28.0	28.0	28.0	28.0	24.0	23.0	22.0	22.0	22.0	22.0
Time Deposits:											
1 to 3 years	28.0	28.0	28.0	28.0	28.0	26.0	25.0	23.0	23.0	23.0	23.0
3 to 5 years	28.0	28.0	28.0	28.0	28.0	26.0	25.0	23.0	23.0	23.0	23.0
over 5 years	29.0	29.0	29.0	29.0	29.0	27.0	26.0	24.0	24.0	24.0	24.0
Children Deposits	32.0	32.0	32.0	32.0	32.0	30.0	29.0	27.0	27.0	27.0	27.0
Pension Deposits	31.0	31.0	31.0	31.0	31.0	29.0	28.0	26.0	26.0	26.0	26.0
Foreign Currency Deposits	18.0	16.0	16.0	15.0	15.0	14.0	14.0	14.0	15.0	15.0	17.0
***Loan Rates:* (Avg. Weight)**											
Inter-bank		58.3	54.2	44.5	41.7	41.3	32.3				
Commercial		62.3	62.5	45.4	51.6	45.9	43.8				

b. Capital Adequacy

115. Per NBRK capital adequacy norms, which require banks to maintain a minimum 4 percent ratio, tier one capital to total assets, Narodny Bank maintained a 4.45 percent capital adequacy ratio. The second capital requirement is the internationally approved Basle 8 percent capital ratio, tier one plus tier two to total risk weighted assets, which all banks must meet by 1998. Narodny exceeded the 8 percent requirement. Table 12 shows the capital structure of the bank.

116. While the bank presently meets the stated capital norms, of concern is the provision granted by the NBRK that allowed the bank to contribute 78 percent of paid-in capital with fixed assets. The Consultants believe that the NBRK should require a phase-in of monetary capital contributions over a one year period or upon privatization of the bank.

Table 12

Adjusted Capital Structure of Narodny According to Examination Results As of April 1996 (Tenge '000)

Tier 1 Capital	**Amount**
Authorized Fund	169,873
Premium on Stocks	844
Approved Reserves	1,127,212
Retained Earnings	0
Less:	
Intangible Assets	14,892
Year to Date Loss	0
Unformed Provisions	162,747
Tier 1 Capital Total	**1,120,290**
Tier 2 Capital	
Year to Date Earnings	0
Net Profit	633,930
Revaluation of Fixed Assets	632,455
General Provisions for loans	178,696
Tier 2 Capital	**1,145,081**
Total of Tier 1 and Tier 2 Capital	2,240,580
Net Assets less Loan Provisions Formed	25,174,070
Tier 1 Capital as % of Total Assets	4.45%
Total Risk Weighted Assets	10,206,164
Risk Weighted Assets less Provisions for Loan Loss	9,701,838
Total Capital as % of Risk Weighted Assets	23.09%

c. Governance

117. The Supervisory Committee for Narodny Bank is similar to APB's in that the committee is composed of six outside directors from the Ministry of Finance, NBRK, Committee for Management of State Property and the Chairman of the Bank. The current composition of the Supervisory Committee is a result of the bank being 100 percent owned by the Government. The Board of Directors of the bank is responsible for the running the day to day operations and is composed up senior management at the bank. Because of the bank's centralized management hierarchy, regional directors have little input in determining the direction and planning of their operations.

118. Until the bank is fully privatized, it will continue to be subjected to political intrusion from government officials. It is the Consultants' view that the committee's structure should be modified at the time of full privatization and should comprise eight members elected by shareholders and the President of the bank. The bank's statutes should include detail of procedures of nomination, election, rotation and re-election. Clear criteria and mechanisms of enforcement of their accountability for the bank's performance are needed. All committee members should be confirmed by vote at the annual shareholders' meeting. The committee may be re-enforced to give it a broader range of commercial skills and experience by the appointment of external directors. Again, the statutes should include detail of the procedures for such appointments and of the duties, rights and obligations of external directors.

d. Credit Portfolio

119. The bank's credit portfolio for year end 1995 is broken down into five sectors. It can be assumed from the loan data that the bank is mobilizing savings throughout the country and lending these funds to other banks through the inter-bank market. Deposits are being mobilized from rural areas to fund huge industrial complexes and urban trading. Because of the bank's centralized credit decision making process, the branches have limited input on the direction of lending operations and all loan decisions are made in the Almaty office.

Sector	As Percent of Total Current Portfolio
1. Small	1.0
2. Medium Businesses	4.4
3. Foreign Currency Loans	1.7
4. Individuals	0.9
5. Industry	24.6
6. Banks	67.4

120. The bank has indicated that new credit procedures and policies are in draft form and will likely be approved by the Supervisory Board in late December 1996. These will replace the current centralized credit procedures that restrict all decisions to the central office. The bank has spoken about the need to expand their credit operations to include small business but because they have never considered small business to be a profitable sector, it will be important for the new policies to address the issues of decentralized credit decision making, diversification and uniformity of methods and procedures. The Consultants were not able to obtain a copy of procedures in draft form because it had not been approved.

121. Based on the April 1996 audit report that was produced by NBRK, adversely classified assets (non-standard to loss), represent only 6 percent of the total credit portfolio of 8.10 billion Tenge. Un-funded reserves amounted to 246 million Tenge. The bank's loan portfolio was composed of the following; inter-bank loans 60 percent, loans to legal entities 38 percent and loans to individuals 2 percent. Ninety percent of the total loans outstanding were for 3 months or less. Table 13 shows the loan classification for the bank as April 1996.

Table 13

Narodny Bank Loan Classification
As of April 1996
(Tenge '000)

Loan Classification	According to Narodny Bank	According to NBRK Exam
Standard	6,420,698	4,328,800
Non-Standard	1,095,171	3,012,543
Unsatisfactory	219,765	258,322
Doubtful	1,235	137,204
Loss	367,120	367,120
Total Principal	8,103,989	8,103,989
Required Provisions	1,297,507	1,470,394
Actual Formed Provisions	1,224,226	1,224,226
Unformed Provisions *	**73,281**	**246,168**

* Narodny actual reserve less required reserve by NBRK. Includes interest of 85 million Tenge.

122. The bank's risk exposure to inter-bank lending is significant and could have a negative impact on capital should the borrowers default on the inter-bank loans. WB examiners looked at the credit underwriting procedures for inter-bank lending and found the bank to be deficient in establishing and maintaining proper lending controls. Outside influence was a predominant factor in the flow of funds. As a result of the deficiencies, the examiners made a significant amount of recommendations to improve the bank's inter-bank lending procedures.

123. In talks with the bank, the Consultants have learned that the bank prices its loan products based on a complex format that encompasses inflation, profit, expense, and risk factors. This format is only used as a basis and each client is offered a different rate depending on their status at the bank.

124. Based on the Consultants' review of the banks lending department, it is not recommend at this time to install any type of term lending program in the bank without significant technical assistance being provided to the bank before the start up of the program.

e. Financial Performance

125. Reported net income for first quarter 1996 was 477 million Tenge, which was an increase of 97 percent compared to second quarter 1995 income. Interest income has shown a declining trend since the second quarter 1995 and this decrease can be attributed to the deterioration in the bank's credit portfolio as evidenced by the 30 percent decrease in loan interest income and the downward drifts in rates with decreasing inflation. Because the bank is

the market leader in the purchase of Government Treasury Bills, income derived from these instruments has shown an upsurge since the beginning of the year 1995. Non-interest expense, which had a one time net increase in the second quarter due to costs associated with upgrading management information systems, still represents a problem for the bank because of the substantial amount of overhead from maintenance of the bank's vast branch and outlet network. Reductions in the network will required the closure of outlets and layoffs of personnel, which is unlikely at this time due to the political nature of these decisions. This additional overhead reductions need to made by the bank in order to increase long-term profitability. Finally, the bank should be aggressive in 1997 and write off a large portion of its loan losses and fund the required loan loss reserves. This will have negative effect on first quarter profitability. Table 14 shows the income statement for the bank as April 1996.

Table 14

Narodny Bank
Consolidated Report on Earnings and Losses
(Tenge '000)

Item	2nd Qtr. 1995	3rd Qtr. 1995	4th Qtr. 1995	1st Qtr. 1996
Interest Income:				
on loans	929,156	1,027,308	911,065	642,933
on securities	50,100	210,160	179,633	407,195
other			.	35,554
Total Interest Income	979,256	1,237,468	1,090,698	1,085,682
Interest Expense:				
on inter-bank loans			8,441	25,938
on deposits	418,130	368,221	231,193	191,991
other				
Total Interest Expense	418,130	368,221	239,634	217,929
Net Interest Income	561,126	869,247	851,064	867,753
Non-interest Income	274,640	372,321	872,909	674,469
Non-interest expense	790,441	809,351	1,277,399	1,064,812
Reserve deductions on bad debts		300,000		
Taxes	34,427	13,723		
Net Operating Income	10,898	118,494	446,574	477,410
Extraordinary charges, net				35
Net Income	10,898	118,494	446,574	477,375

f. Liquidity

126. As of 30 April 1996, the bank had sufficient liquid assets as a percentage of total liabilities to cover any sudden liquidity crisis. This is a result of the bank's substantial amount of short term deposits and government debt instruments. Of concern to the Consultants is the low percentage of loans to total assets which affects the ability of the bank's earning capacity to pay

non-interest expenses. This is reflected in the declining value of the bank's loan portfolio. Table 15 lists the liquidity ratios calculated by the Consultants.

Table 15

Narodny Bank
Liquidity Funds Management
In Percent

Ratios	December 31, 1995	April 30, 1996
NBRK Required Reserve Ratio	0.03	0.21
Short-term Assets/Liabilities	0.73	0.63
Loans and Advances / Total Deposits	0.42	0.39
Loans and Advances / Total Assets	0.30	0.26
Short-term Assets / Total Assets	0.58	0.50
Short-term Assets / Total Deposits	0.82	0.75

g. Overall Views

127. As a result of the bank being 100 percent owned by the Government, political intervention and influence affect the operations of the bank. The key objective of this bank does not seem to be profitability through revenue enhancing pricing policies and efforts to reduce costs but rather the pursuit of broadly defined development objectives that are set by the government. Centralized decision making stifles the development and expansion of lending operations in the rural sector and thus medium, small and micro rural entrepreneurs are without access to credit. The vast network of branches and outlets of the bank must be transformed from savings deposit gatherers to full-service branches that are willing to provide financial intermediation to customers.

128. The bank needs to change its image of strictly being a deposit taking institution to become a rural financial intermediary with a diversified portfolio, based on locally mobilized deposits, and with a substantial downsized staff that is trained to serve its customers. Such a restructuring will not be easy given its present governance structure and action will required to develop a new bank mission statement and corresponding lending policy that will adequately support its new role as a rural financial intermediary.

129. An audited balance sheet for Narodny as of April 1996 is included in Table 16 in Appendix 4.

h. Recommendations

130. The following recommendations are intended to improve operational efficiency at Narodny Bank.

Privatization of the Bank

131. The GOK must move forward with the privatization of the bank in 1997 as recommended by WB. Until that time, the bank should prepare itself for entry into the private sector by restructuring operations to meet the needs and demands of its customers. The following recommendations apply to restructuring.

Pricing for Profitability

132. Please see paragraph 100 on the recommendations for APB.

Develop New Loan Procedures and Policies that Include Decentralized Lending

133. The bank should take advantage of its huge network of branches and deposit base and develop new lending policies that give responsibility to each of the regional operations. These procedures should be based on sound underwriting techniques and include controls over branch lending operations that will enable the bank to expand its loan portfolio to include small and micro business. Regional credit committees should be established with lending limits and limits on loan sizes. Technical assistance should be sought to prepare a western plan of decentralized lending.

Expand and Diversify the Loan Portfolio

134. Risks and cash flows need to be spread out over various sectors. Small and micro business should comprise a larger percentage of the bank's loan portfolio. A one year pilot model should be developed by the bank in one oblast. This pilot model will develop a loan program that promotes small and micro-business. If the pilot program is successful, the bank can then apply the model throughout the remaining oblasts. Technical assistance should be obtained from donors to help the bank design, implement and monitor the pilot project.

Continue Training and Upgrading of Employee Skills

135. Sending key staff to donor training schools should be increased. Also, the bank should take advantage of the donor programs that provide hands-on technical assistance.

Continue Reduction in Overhead

136. If the bank does not expand its client base through small and micro business, excess staff that are presently performing support functions, will need to be reduced. These support staff should be re-trained to provide an income-producing function instead of their present support status. This training should be a part of the bank's pilot project.

Decrease Inter-Bank Lending

137. The bank's risk exposure to inter-bank lending is excessive. Expansion of the bank's loan portfolio to other sectors should offset the lending risk associated with the inter-bank market.

3. Other Banks with Rural Operations

138. Since September 1995, twenty-five financial institutions have provided financing to the agricultural sector. Eleven are located outside of the Almaty Oblast and the remaining banks are headquartered in Almaty. The majority provided small, one-time credits. Presently, only five banks other than APB are actively lending to the agricultural sector and a very limited number are lending to micro enterprises or small businesses. Information on those banks is given below: Altynden Bank, Igilik Bank, Kustani Bank, Sesna Bank and Pana Bank. As a result of the April 1996 NBRK credit auction for spring planting, five banks received 650 million Tenge in short term credits. Five of the above institutions took part in the auction. At the end of July 1996, the NBRK held a credit auction for the fall harvest and only APB and Center Bank took part in the 325 million Tenge auction.

a. Altynden Bank

139. Altynden Bank was formed in 1991 as an alternative source of agricultural credit for local farmers. It is 100 percent owned by private shareholders with six branches operating in the Almaty Oblast. The bank is technically bankrupt and seeking investors for recapitalization. Deposit and loan repayments constitute its only funding sources. The bank has no fund capacity to extend loans to the agricultural sector. The Altynden Bank has one hundred employees; at least thirty of these at the central office. Four of the six branches own their buildings while the central office owns the building where it is currently operating. The State Appraisal office estimates that the building is worth USD $1.5 million. The bank considers peasant farmers to be its main clientele.

140. In 1995, the Agricultural Support Fund removed 500 million Tenge of directed loans from the bank's books. Thus, its present portfolio consists of only 66 million in loans, with 40 million past due and repayments scheduled for this fall. In April 1996, the bank received 9 million Tenge from the spring planting credit auction at the NBRK. Currently, 8.8 million is outstanding from this spring planting loan. The bank has elected not to take part in other NBRK credits to support the agricultural sector because of lack of collateral to secure the credits as well as restrictive rates and maturities. The bank will probably not make it through the next two years if fresh capital is not formed or infused.

b. Igilik Bank

141. Igilik Bank was registered as a bank by the NBRK in 1991. It is 100 percent owned by over 1,000 private shareholders and has 95 branches located throughout RK. The bank has authorized capital of 150 million Tenge and stated capital is 300 million Tenge. As of July 1996, the bank had a total credit portfolio of 1.65 billion Tenge, of which 11 percent was directed

towards the agricultural sector and 26 percent was over 90 days past due. NBRK Banking Supervision stated that the bank meets all capital requirements and prudential norms. No on-site examination has been conducted at the bank during 1996 but the NBRK is planning on one before the end of the year. The bank's resources were composed of 10 percent inter-bank loans, 77 percent deposits, and 13 percent centralized resources. Currently, the bank has 80 million Tenge in past due loans to the NBRK which had been extended during February 1996. The bank took part in the April 1996 NBRK credit auction for the agricultural sector and received 120 million Tenge, of which 80 million is outstanding.

c. Kustani Bank

142. Kustani Bank was registered as a bank by the NBRK in 1994. It is 100 percent owned by private shareholders composed of small enterprises and small joint-stock companies and has four branches located in Kustani Oblast. The bank has authorized capital of 72 million Tenge and stated capital as of June 1996 was 138 million Tenge. As of June 1996, less than 10 percent of the total loan portfolio of 543 million Tenge was lent for agricultural purposes and less than 3 percent of the loan portfolio was over 60 days past due. NBRK Banking Supervision Department stated that the bank meets all capital requirements and prudential norms. No on-site examination has been conducted at the bank during 1996 but the NBRK is planning on one before the end of the year. The bank's resources were comprised of 63 percent inter-bank loans, 20 percent deposits, 10 percent centralized resources and 7 percent from profits. The bank took part in the April 1996 NBRK credit auction for spring planting and received 10 million Tenge, of which 9 million is still outstanding.

d. Sesna Bank

143. Sesna Bank was registered as a bank by the NBRK in January 1992. It is 100 percent owned by private shareholders composed of three large joint-stock holding companies and a few individual shareholders. The bank is located in the Akmola Oblast and has one branch in Akmola and one in Almaty. The bank has authorized capital of 66 million Tenge and stated capital as of June 1996 is 100 million Tenge. As of June 1996, less than 8 percent of its total loan portfolio of 154 million Tenge was for agricultural purposes and less than 2 percent of the loan portfolio was over 90 days past due. The NBRK Banking Supervision Department stated that the bank meets all capital requirements and prudential norms. No on-site examination has been conducted at the bank during 1996 but the NBRK is planning on one before the end of the year. As of 1 July 1996, the bank's resources were comprised of 20 percent deposits, 73 percent centralized resources and 7 percent inter-bank credits. The bank took part in the April 1996 NBRK credit auction for spring planting and received 100 million Tenge, of which 80 million is still outstanding.

e. Pana Bank

144. Pana Bank is a joint-stock bank that received its general banking license in May 1996 and is located in the Jezkejan Oblast. Share capital is at the minimum, which is USD $500,000, and 100 percent of the shareholders are farmers' organizations as well as farmers from the oblast. Talks with the bank indicate that the Chairman has seventeen years of work experience

with APB and that their strategic lending plan calls for 30 percent of the portfolio guaranteed for private farm lending; 70 percent, for commercial purposes.

4. International Financial Agencies

a. Central Asian-American Enterprise Fund

145. The Central Asian-American Enterprise Fund (CAAEF) was established in 1994 by the U.S. President and Congress to promote the development of private enterprises in Central Asia. CAAEF provides loans and investment capital to private enterprises in all Central Asian Republics. The Asian Cross-Roads Loan Company (ACLC) is a subsidiary of the CAAEF and distributes loans through two commercial banks in order to promote the development of small business in Central Asia. The ACLC targets small manufacturing and service firms which are currently having difficulty borrowing money under terms appropriate for productive investments. Loans range from USD $1,000 to $100,000, repayable in monthly installments for maturities of less than 3 years, and carry interest rates of 12-18 percent.

146. Since the inception of CAAEF and ACLC, they have been able to fund only five agricultural projects. Not unlike commercial banks, these two funds are wary of the inherent risks associated with agricultural lending. The ACLC receives numerous applications every month from farmers requesting funding for inputs and working capital. CAAEF is only interested in funding processing projects with western capital and western partners. To date, the following projects have been funded in USD.

- Loan for flour milling equipment in Kustiniv for low six figures;
- Loan for flour milling equipment in Urals for high five figures;
- Equity position for modern dairy plant in Chilik for low seven figures;
- Equity/Debt position for macaroni plant in Almaty for medium seven figures; and
- Equity position for modern meat plant in Akmola for low seven figures.

b. European Bank for Reconstruction and Development

147. In 1994 the EBRD set up a USD $100 million credit facility program to develop small and medium sized enterprises (SME) in Kazakstan. The EBRD loan was initially channeled through three participating financial institutions but has since been scaled back to one institution because two of the banks had insufficient capital to meet EBRD requirements. As a result of the risk sharing requirements for project funding, no projects have been funded in the agricultural sector.

148. In December 1995, the EBRD approved a proposal to remodel the SME Credit Line to provide funds to recapitalize the participating banks prior to a twinning arrangement with a foreign bank.

5. Agricultural Support Fund

a. Background

149. In December 1994, the GOK-owned Agricultural Support Fund (ASF) was established by Resolution 1447 of the Cabinet of Ministers, to provide long term credit and debt resolution to farms. A subsequent Cabinet Resolution in March 1995 provided for the transfer of 31 billion Tenge of debts from the APB to the ASF. The major share of this debt was due from agricultural enterprises that received directed credits from the Government—through APB prior to 1994. To date, 21 billion Tenge in interest, fees and fines have been canceled. With respect to the remaining 10 billion Tenge in principal, the Government has offered to cancel 5 billion Tenge if the farms repay 5 billion Tenge by the end of December 1996. So far farmers have repaid only 20 million Tenge. The prospects of speedy resolution are negligible if the pace is to be determined by farmers' efforts to repay.

150. To obtain grants and credits, peasant farms, non-state agricultural enterprises and state agricultural enterprises submit applications, business plans, and marketing plans to the regional Oblast office of the ASF. Procedures and guidelines for disbursement of funds are given in the ASF Blue Book. In every Oblast, there is a representative office of the ASF which is responsible for accepting the requests for and submitting them to the Regional Board of Directors of the ASF. The Board of Directors-composed of 9 members who are representatives from the regional branch of APB, MOF, MOA, State Property Fund, AGRO Farmer Organization, and the Agricultural Academy-is the first group that reviews the projects for funding. Applicants approved at this stage are then submitted to the Board of Directors in Almaty who make the final decision on funding. The process is long and very political with too many people involved in decision-making. In our focus group interviews, few peasant farmers were aware of the ASF and those who were knew only a few farmers who had received any grants or credits.

151. The terms of the loans are 5 year maturities, 10 percent interest and a three month grace period before the first interest payment is due. The borrower is required to make a lump-sum payment of the principal at maturity and interest is to be paid annually or when the farmer is able. The grace period for the loan program has just ended and the ASF had not received any payments as of the 1 October 1996.

152. Table 17 below shows that as of October 1996, 1.96 billion Tenge has been disbursed to the agricultural sector. Peasant farms received a total of 145 million Tenge or 7.4 percent of the total disbursements.

153. For additional background information concerning the amount and type of disbursements of ASF, please refer to *An Evaluation of the Impact of the Agricultural Support Fund Upon Farmer Beneficiaries*, which was prepared under ADB TA-2448-KAZ.

Table 17

Agricultural Support Fund Disbursements From January 1996 to 7 October 1996
In Million Tenge

Purpose See Below	#1	#2	#3	#4	#5	#6	#7	#8	#9	#10	#11	#12	#13	#14	#15	#16	#17	Total
Akmola	25.0	4.6		35.0			7.0	4.0	6.0		6.4		2.0					45.5
Aktubinsk		3.2		2.9		2.0	7.0	4.0	3.50	2.4	15.1		33.5					61.9
Almaty ob.		22.7	2.5	9.3		8.25	7.0	5.0	10.5		13.2		34.9				2.0	104.6
Atyrau				3.9		55.0	4.0	25.0			4.1		22.5					31.7
Eastern Kazakstan	1.0	6.9		2.0			5.0	4.0	7.2		2.9		9.0					28.1
Jambyl		24.4		1.8			9.0	5.0	6.6		6.3		29.0				1.0	70.5
Zhezkazgan				4.0			5.0	25.0			8.4		13.5					23.1
Western Kazakstan		1.8		1.5		1.2	7.0	4.0	3.1		11.9		33.5					54.1
Karaganda		2.5		7.0		.05	5.0	4.0	14.3	35.5	2.7		12.0					68.7
Kzyl-Orda.	6.0	34.4		1.45		25.0	1.0	5.0	2.8		5.9		21.5					73.8
Kokshetau.	10.0	6.9					7.0	4.0	18.0	1.8	3.3		3.6					44.7
Kostanai	16.0	8.6		1.0			7.0	5.0	50.1		6.4		7.0					90.3
Mangystau.				1.6			3.0	25.0			9.0		13.0					16.1
Pavlodar		3.4					7.0	4.0	6.5		6.2		8.0					25.2
Northern Kazakstan	33.3	6.2					5.0	4.0	1.5		7.6		1.0					50.5
Semipalatinsk		3.8		1.0			5.0	5.0	21.8		3.1		23.5					54.2
Taldykorgan	6.0	31.7	34.0	2.0			4.0	4.0	20.0	13.5	7.1	2.5	2.5				2.0	141.6

Purpose See Below	#1	#2	#3	#4	#5	#6	#7	#8	#9	#10	#11	#12	#13	#14	#15	#16	#17	Total
Torgai ob.		4.5					7.0	1.1	4.1	5.6	5.3		10.5					31.8
Southern Kazakstan		75.0		9.6		2.4	7.0	4.0	8.4		21.7		35.0				4.4	157.6
JS "Agrochimservice	89.0																	89.0
JS "Asyl"				52.7	61.3	77.35								25	16.5			232.9
University of Agriculture								1.5										1.5
JS "Zoovetsnab"								85.5										85.5
JS "Auyl Zhastary"											6.0							6.0
LLP "Step"																5.0		5.0
LLP "Nur-bios"																5.0		5.0
Chemical Plants	251.4																	251.4
TOTAL	**437.7**	**240.6**	**36.5**	**90.4**	**61.3**	**90.25**	**11.8**	**95.35**	**184.4**	**58.8**	**144.5**	**2.5**	**335.0**	**25.0**	**16.5**	**10.0**	**9.4**	**1,850**

1. Plant Protection
2. Fertilizer Price Subsidy
3. Corn-seed Production
4. Livestock Breeding
5. Pedigree Development
6. Animal Feed Price Subsidy
7. Administrative Support
8. Animal Health Measures
9. Grain Seed Price Subsidy
10. Potato Seed Price Subsidy
11. Support to Peasant Farms
12. Sugar Beat Purchase
13. Wool Sales
14. Artificial Insemination of Livestock
15. Donation of Pedigree Eggs
16. Introduction of New Procedures in Development
17. Restoration of Gardens

JS joint stock company
LLP limited liability partnership

b. Effects of Agricultural Support Fund on Rural Finance

154. The ASF has clearly helped a small number of borrowers and at considerable cost. The amount of funds that will be recovered, based on ASF loan underwriting procedures could be small because of the following factors.

- ASF Blue Book procedures for disbursement do not meet minimal standards required for screening, processing, appraising and recovering loans;
- eligibility requirements are weak and do not include proper business plan preparation by the borrowers;
- staff do not have the skills required to underwrite sound loans;
- cash flow analysis to determine the debt capacity of the farm is not calculated;
- borrowers are not required to provide equity, and security terms and conditions are unknown;
- appraisal of the loan is not always completed prior to funding; and
- ASF has no loan monitoring and supervision system that will enable ASF to see if farms are meeting the targets outlined in their business plan.

155. If these deficiencies are not corrected, continued operation of this program will create additional losses. The more it lends, the more its loses because:

- borrowers have no incentives to establish good repayment histories; and
- credit is allocated as political patronage rather than on the basis of commercial performance.

156. This in turn will:

- impose substantial cost to the government to continue to support non-viable farming entities;
- destroy the incentive of local banks to expand lending operations to the agricultural sector; and
- discourage savings mobilization;

157. The Project Proposal will supplement the current activities of the ASF in debt restructuring by providing additional funds and by upgrading the quality of the assessment of farm capacity to return to profitability. The project management unit in conjunction with the ASF will review existing debt restructuring plans and modify the plans accordingly and new applicants will undergo a thorough review of the enterprise and a detailed remedial work-out plan will be developed.

158. For further explanation of the role ASF should play in debt restructuring, please refer to the Part III: Project Proposal.

B. Critical Issues in Rural Finance

1. Financial Institution Strengthening

159. During the course of the Study the Consultants visited 15 rural branches from 8 separate banks and found all of the institutions to have the same basic institutional weaknesses: lack of knowledge in financial and funds management, inability to assess the risks associated with project finance, lack of technical expertise in term lending, inexperience in portfolio management and inconsistent supervision and monitoring of their portfolio.

160. Management and staff in a majority of the regional branches have limited financial institution management experience and staff have difficulty in understanding policies and procedures. This has created the problem of limited involvement of staff in decision making and as a result the staff are relegated to support positions as opposed to income producing positions. These deficiencies, combined with the excessive risks that the banks tend to incur, are in large measure due to weak internal bank structures, policies and skills.

161 Lending operations in the banks visited were limited and basic. The average number of loans per employee was in some instances two, and the maximum was 10. All of the institutions had credit underwriting procedures, but most of the lending personnel were not able to locate them upon request and there was usually only one copy per branch. A clear understanding of the steps required to review, appraise and disburse credit was basic. Little use is made of cash flow analysis and product market analysis; loan appraisal was short-term and did not take into account the real costs and prices and often over-estimated output. There was little understanding of the differences between permanent working capital financing and fixed asset financing and their respective needs. Collateral is the predominant factor in loan decision making and banks are willing to accept the collateral only if its value is 150-250 percent of the loan. Cash flow generation is often subordinate to the collateral decision.

162. Loan files that were reviewed did not meet the requirements of the NBRK regulation on maintaining loan documentation and often lacked a copy of the basic loan agreement, collateral agreement and loan monitoring reports. Most of the files contained the original loan documents, though no procedure had been established to ensure the safety of these documents. Loan follow-up and customers contact appeared to be insufficient to monitor outstanding loans, and in some instance, branch personnel made pre-loan approval visits to verify collateral and business plan data, but follow up after distribution and thoughout the term of the loan did not occur. Banks explained the lack of follow up as being due to the absence of transportation and the short-term maturities of the loans.

163. Management information and loan systems were very basic and often manual. Each branch has an adequate number of computers but with the low number of loans that are managed in the rural branches, the use of these computers was not evident. If loan volumes were to increase, these systems would be adequate to meet the needs of the branch. Most of the branches sent status reports on operations, expenses and loan payments to the head offices on a daily or weekly basis. Loan data sent to the head office tended to be simple and not in a format that would enable the head office to properly monitor the loan operations of the branch. Some of the branches had appropriate telecommunications equipment such as telex, modems and fax

machines. However, the poor quality of the phone lines often inhibited them from sending daily trial balances and weekly reports.

164. Rural bank branches are reluctant to move away from traditional ways of doing business and to explore new ways of serving the emerging private sector. This is partly due to the discomfort with the emerging private sector and to lack of loan resources. When funds are available for on-lending, they tend to go to established customers and better known enterprises. Because local deposit resources are limited, branches often have to request the head office to locate or buy credit funds from other sources. Numerous branches were not able to fund specific projects because the central office could not locate the resources needed. With resource limitations, banks have little incentive or ability to expand their client base. Thus, credit is rationed to borrowers with formal connections squeezing out the emerging private sector.

165. Development of customer and client relationships is a major constraint to the re-development of rural branches. Lack of information concerning the bank's products and available services was not assessable to new customers or existing clients. The complicated procedures for opening an account, the excess time needed to withdraw or make deposits, the practice of deferring withdrawal until the availability of funds and a generally unfriendly attitude are all widespread practices that discourage funds, especially in the form of small savings, from entering the banking system.

166. Cost cutting measures have resulted in the banks closing in-house training schools and the excessive cost of sending employees to donor sponsored bank training schools has resulted in a limited number of banks taking advantage of the training. Rural bank employees are particularly hard hit because of the distance to Almaty for the schools. The bank training schools have yet to expand outside of the capital. Much of the training that banks provide is to ensure compliance with new procedures rather than to improve analytical skills. Training needs to be provided in the following areas; bank financial management, asset/liability management, credit analysis, accounting, credit portfolio management, marketing and management information systems.

167. Banks need to develop training strategies that identify the purpose and goals that will be achieved through a specially designed training program. Emphasis should be placed on the indicators that will be used to monitor and measure the success of the training programs. Post-training performance goals should be clearly stated by management prior to the commencement of the training. Meeting the performance indicators will enable personnel to participate in further training initiatives. Each training component needs to be designed based on an analysis of current practices so that trainees receive assistance in developing new skills necessary to meet post-training performance goals. While training will increase learning capacity it should also have an indirect effect on the performance of the bank.

168. As a result of the overall skill deficiencies of bank personnel, the Consultants have included technical and training assistance to rural banks as a part of the Project Proposal which is included in Part III of the final report. Without specific bank training, it would be extremely difficult for any of the financial institutions the Consultants visited to implement, supervise and monitor a term lending program. The premise behind the proposed training assistance is the use of the two existing donor funded training programs in Almaty; USAID sponsored Kazakstani

International School of Banking and TACIS sponsored Almaty Banking College. Presently these programs do not offer courses in the oblast centers. Cost sharing could be arranged with banks and other donors who are in need of this type of training. A list of specific courses that would be required is shown in paragraph 90 of the Project Proposal. These include; development of business plans, enterprise accounting, information systems, credit operations that include short, medium, and long term credit evaluation, portfolio management, law related to banking and general customer/client development skills.

169. Further analysis of risk management as it applies to banks and NGOs is discussed in Section V of Part II: Micro-Finance, beginning in Paragraph 86.

2. Coverage of Rural Financial Institutions

170. The transition from a command economy to a market-oriented one has witnessed a gradual withdrawal of banks from the rural sector. Rural communities have been hit hard, as the low volume, high risk and costly servicing of rural branches have led many banks to close or reduce the number of branches serving rural customers. The banks that are still operating in the rural areas have been forced by financial difficulties to drastically reduce the amount of credit disbursements and many are simply making payment transfers.

171. The decline in banking services in general, the absence of financial intermediation in rural areas in particular, and the reduction of government subsidized loans and services, has created a severe liquidity problem in the rural sector. The absence of disposable income has reinforced the dependence of the rural population on government supplied goods, services and inputs, which has stifled the emergence of new commercial enterprises and competitive markets. At the same time there is reported to be substantial savings throughout the country that are not deposited in banks due to distrust, low rates of return and reluctance to bring attention to themselves or their businesses to tax authorities. These savings are being held in non-monetary assets.

172. Presently, there are only three banks in Kazakstan (APB, Narodny, KazaPost) with branch networks that extend into the smallest rayons and villages throughout the country, and only one is providing significant financing to the rural sector. Due to the great distances between the lender and the potential borrower and the costs associated with lending in the rural communities, the majority of banks in Kazakstan are reluctant to establish branches in remote areas. The need for increased attention to the rural communities comes at a time when all large financial institutions are analyzing the cost effectiveness of their existing branch networks and closing non-viable units. Two of the largest banks with branch networks (APB, Narodny) are currently implementing retrenchment strategies that plan for the closure of a substantial number of rural branches.

173. In the absence of formal sector financial services, especially for poorer people in the society, a variety of non-banking financial institutions has begun to provide small credit lines to the rural communities. Non-banking financial institutions engaged in supplying credit and other financial services fall into two categories: non-governmental organizations and donor-financed projects. Non-governmental organizations (NGOs) are largely represented by international organizations with local operations in Kazakstan and focus primarily on poverty alleviation. These include UNDP, Mercy Corps, VOCA and HIVOS. The donor-financed programs deal with larger credit disbursement programs and are active in the industrial and agricultural sectors. The largest

of these programs being the Mercy Corps Farmer Credit Fund in Kaskelin. While these programs have been effective in providing financial intermediation to the rural communities, their impact has been limited by client remoteness, bureaucratic inefficiencies and funding constraints.

174. At this point it is not recommended to redirect market forces and create formal rural based financial institutions by donor or government directive. Banks will only begin to reestablish operations in the rural communities when they have determined that rural based lending is remunerative. While the overall reduction in the supply of rural financial institutions has affected the rural population's ability to choose from a number of banks, it has not resulted in a complete abandonment. Narodny Bank has over 4,000 outlets throughout the country that offer limited financial services and KazPost Bank sells postal money orders at every post office in the country. Postal money orders are predominately used in rural areas for settlement of accounts.

3. Unrefined Legislation

175. The best method of delivering financial services to the rural sector is through the development of sustainable financial institutions. This development is unlikely without a sound legal basis for these institutions and for their operations. The Consultants are proposing that rural financial services be provided through existing rural banking institutions, second tier rural banks with limited activities, NGOs and Credit Unions (CUs).

176. Each of these delivery methods is discussed in detail in Section VI on Proposals for Specialized Rural Financial Intermediaries, Part II; Micro-Finance and in Part III: Project Proposal.

4. Secured Lending Framework Initiatives

177. Loan collection is a key problem for Kazakstan banks. This is due to the unexpected distress of borrowers, but often also to willful default. In 1995, significant progress was made in improving property rights legislation and in 1996 attention shifted to making those rights more enforceable through reporting and registration systems and judicial reform.

178. As noted in the ADB Report, *Strengthening the Implementation of Agricultural Reforms*, the principle of pledging land as collateral was recognized in 1994 and further clarified by the revised *Land Code of December 1995* (Presidential Edict "Concerning Land"). It is now legally possible to pledge land as collateral and capitalize it as an equity contribution to a business venture.

179. In 1995, the Constitution was amended to allow private ownership of land. This amendment allowed the introduction of limited private ownership of land for gardens, personal household plots and dacha construction through the revised Land Code of 1995. Article 33 of the Land Code states that land of agricultural value, except for the plots previously mentioned, including peasant or family farms may not be granted private ownership status. Legally, peasant farms fall under the category of permanent use, however, they are not considered private. Because of the changes in the Land Code of 1995 and the December 1995 law on "*Mortgage of Real Estate,*" the basis for a property market for the above mentioned land was created. The legal basis of private property, although not entirely convincing, is such that financial institutions should be able to translate the perceived risks into acceptable collateral or mortgage conditions.

180. With respect to permanent use status, including agricultural land, the position is more problematic. Although land pledges under permanent use status are lawful, it remains a significantly higher risk. Banks place a negligible value on agricultural land, thus it is unlikely that potential borrowers would accept the terms of the pledge agreement as offered. Banks also attach an insignificant value on agricultural lands due to the uncertainty of permanent use, poor status of existing farm structures, low credit worthiness of most farms, vast areas of unused land and the lack of an agricultural land market.

181. With respect to private or peasant farms, land assets remain of little value as a means of raising capital. The gap between intrinsic land value and the ability of owners to raise capital against that value remains large. In addition to the lack of an agricultural land market, banks lack confidence in the current legal structure to enforce the perfection of a lien, pledge or mortgage. Additional legislation cannot make lending secure if the law cannot be effectively and efficiently enforced in court.

182. Another consideration is that the last thing a bank would want to do is foreclose on a piece of land and incur the additional expenses of maintenance and asset disposal. In this respect, banks are more reluctant to use agricultural land as the main factor in assessing the credit worthiness of a project. Larger banks in Almaty require applicants to pledge collateral that is 150-250 percent of the value of the loan; with capital purchases accounting for only 60 percent of the required collateral amount.

183. The practical application of pledging land as collateral has been hindered by administrative control of transactions and restricted definitions of ownership. In addition, there was no market for land and no basis for assessing its potential value.

184. Security in lending will be improved if borrowers use western style accounting systems appropriate to a market economy. The *Decree on Accounting of 1995* establishes a legal basis for professional accounting bodies and country-wide standards. A new chart of accounts and accounting standards for enterprises are currently being implemented with technical assistance being provided by USAID.

185. Registries on borrowers, their real property, their pledges of property and their borrowing are also keys to enhancing security in lending. USAID has been supporting the strengthening of company registration that is enforceable by the 1995 *Decree on Registration System for Economic Units,* and preparations are underway within the framework of a proposed Land Registration Project by the WB for a modern registration system of land and other non-movable property. The registration system for collateral on non-movable property will be included in the WB registry system project. Plans are being made to set up a credit information bureau and credit rating system that would initially record mainly bank loans before the end of 1996. The efforts to establish these various registration systems are being supported by advisory teams funded by USAID, the European Union and the WB.

186. Legislation cannot make lending more secure if the law cannot be effectively and efficiently enforced in court. The judicial system is currently being reformed on the basis of the

Constitution. The Ministry of Justice has drafted *Codes on Civil Procedures and Criminal Procedures* for submission to Parliament by the end of 1996. The WB is providing advisory teams to help make judicial procedures for bankruptcy more speedy and transparent. However, the proposed bankruptcy law has some serious shortcomings regarding loan security.

5. Rights of Secured Creditors

187. **Secured Creditors:** Of concern to the Consultants is the recent draft of the new Kazakstani Law on Bankruptcy that has been passed by the lower house of Parliament and is now seeking approval in the upper house. USAID's Bankruptcy & Restructuring Project has indicated that the GOK is pushing for the law to be enacted in January 1997. Several provisions of the draft law are likely to jeopardize the rights of secured creditors once a company comes under bankruptcy protection. The draft law curtails the rights of a secured creditor to full payment in a liquidation and fails to give secured creditors a sufficient voice in voting procedures among creditors. Further, the draft law threatens the validity of foreclosure sales of seized property made four months prior to a bankruptcy proceedings. A recent policy paper on the new law was issued by the USAID Bankruptcy & Restructuring Project and the following four points were made:

188. The draft law prohibits a secured creditor from seizing and selling pledged property of a defaulting debtor under bankruptcy protection. Instead, the bankruptcy manager, or appointed liquidator, sells this property as he would any other property of the debtor for purposes of paying off creditors. After selling the property, the bankruptcy manager according to Article 75, must pay in the following order.

1. Administrative costs;
2. compensation to individuals harmed by the debtor's activities;
3. wage arrears;
4. claims secured by pledge;
5. debts to the government budget; and
6. unsecured creditors.

189. A secured creditor falls in the fourth category to the extent that the value of the secured property covers the claim. The portion of the claim that is not covered by the value of the secured property is treated as an unsecured claim.

190. If the proceeds from the sale of the debtor's property are not sufficient to pay the claims of the first three categories in full, the secured creditors receive nothing. If the sales proceeds are insufficient to pay the entire amount of claims secured by pledge in full, the pledge holder would apparently share the remaining proceeds pro-rata.

191. The absence of the right to separate satisfaction threatens the interests of secured creditors in either a rehabilitation or a liquidation. If the debtor company undergoes rehabilitation, the secured creditor cannot opt out by taking his property and selling it separately. If the bankruptcy results in a liquidation, the bankruptcy manager may fail to sell the secured property in a transaction separate from other sales of property. In such cases, the valuation of the secured portion of the claim would be left to a third party assessment. Because the unsecured

portion of a secured creditor's claim is often likely to result in little, if any, compensation in a liquidation, an accurate valuation is crucial.

192. Further, according to Article 79 of the draft law, the liquidation payment rights of first pledge holders of a particular piece of property are equal to those holding secondary pledges. By contrast, in non-bankruptcy situations, secondary pledge holders are clearly subordinated (Law on Mortgage, Article 36; Civil Code, Article 311). The lack of clarity regarding payment priorities could result in instances where the rights to full payment of primary secured creditors are significantly diluted.

193. This subordination of secured creditors is apparently unique among the bankruptcy regimes of developed market economies as well as those in central and eastern Europe.

194. **Voting Procedures in Creditors' Meetings**: The draft law explicitly states that decisions in creditors' meetings are determined by the vote of both secured creditors and bankruptcy creditors. Article 14 appears to call for a tally of votes by secured and bankruptcy creditors together. This threatens secured creditors because their interest are often divergent from their unsecured counterparts. Further, bankruptcy creditors are likely to outnumber secured creditors in most bankruptcy cases for the foreseeable future. Given the potential for significantly divergent interests between these two classes, there is a great potential that bankruptcy creditors will dominate meetings, pushing an agenda favorable to them at the expense of the interest of unsecured creditors.

195. **Voting Procedures for an Amicable Agreement:** The draft allows for settlement of a bankruptcy case by agreement. Such agreements may bind minority, dissenting secured creditors and bankruptcy creditors with regard to payment schedules. There thus exist the potential that bankruptcy creditors, in an attempt to avoid liquidation, will force minority, secured creditors to accept significant delays in payment.

196. **Validity of Pre-Bankruptcy Foreclosures**: The draft law gives interested parties the right to petition the court for return of transferred property if the sale was at an amount "significantly lower than market prices" and if the transfer occurred less than four months before initiation of the bankruptcy case. This provision threatens the validity of foreclosure sales made by secured creditors within four months prior to a bankruptcy case. Foreclosure sales are almost always concluded at prices far less than the supposed market value of the property. As a result, such sales could come under attack from the liquidator or administrator, even if they comply with the mortgage execution provisions under the Law on Mortgage or the Civil Code provisions on pledge.

197. If this law is passed in full without changes made to the above mentioned, the Consultants are recommending that any type of ADB funds allocated for lending projects be delayed until changes to the law are made that protect secured creditors.

198. A copy of the draft law on Bankruptcy is attached in the Arch Clip File along with another position paper from an advisor to the Rehabilitation Bank.

6. Interest Rates

199. Sustainability of a financial institution relies on the ability to manage liquidity, interest rate risk and product pricing. These particular areas of financial management pose significant problems for all banks and non-bank lenders in Kazakstan. Because of lack of technical banking skills, pricing of savings and loan instruments does not appear to be based on the market conditions which determine the time value of money. Asset Liability Management Committees are non-existent in banking institutions the Consultants have visited. Specific topics which the banks need training in are:

- determining an adequate spread for banking products;
- loan interest rates and methods of calculation;
- interest paid for deposits and other sources of funds;
- ability to protect spreads in changing market conditions; and
- measurement of profitability of portfolio segments.

200. Both the capacity to make good loans and the ability to manage risks are essential for lender sustainability.

201. **Interest Rates and Rural Finance:** Interest rates have been erratic with the impact of inflation in Kazakstan. Interest rates prior to mid-1995 were distorted as a result of subsidization and inflation. For these reasons, the Consultants choose to examine interest rates and their effects as of late 1995 and 1996.

202. With increasing control over monetary aggregates, interest rates have become more stable and rational. Inflation is being brought under control: the three-month treasury bill rate fell from around 200 percent on an annual basis early in 1995 to about 30 percent in late 1996, while six-month t-bill rates fell from around 60 percent in September 1995 to less than 40 percent in September 1996, when inflation approximated 28 percent at an annualized rate while the change for the month was at an historic low of 0.5 percent. Local currency deposits have trended upward: deposits by households doubled from the beginning of 1995 through mid-1996. Likewise, time deposits rose sharply through mid-1996 and grew faster than aggregate deposits, accounting for about 10 percent of total deposits at the end of 1995 and about 16 percent of the total by August 1996.

203. During this period a smoother yield curve has developed, suggesting more rational intertemporal decision making. As of August 1996 the average rates offered by second tier (commercial) banks on Tenge deposits held by households was 6.3 percent for demand deposits and 32.1 percent on time deposits (Data is from the NBRK *Statistical Bulletin*). The low rate paid on demand deposits reflects the 4 percent offered by Narodny Bank, which is the former savings bank. APB, by contrast, offers 15 percent on demand deposits.

204. Average rates for one-month, 1-3 month, 3-6 month, 6-9 months, 1 year and 1-3 year time deposits were: 32.9, 36.0, 33.5, 34.1, 36.5 and 36.0 percent, respectively. The flatness of this yield curve suggests that depositors do not expect inflation to increase. The cumulative maturity composition of Tenge time deposits held by households is about 45 percent for up to 3 months, about 55 percent for up to one year, and 75 percent for up to three years, which appears

to support the contention that household savers believe the worst of inflation is over. Table 18 displays the SLBs' average weighted rates for savings and credit instruments.

Table 18
SLBs Interest Rates on Credits and Deposits As of August 1996

	Currencies					
	Tenge		CC		ICC	
	Non Financing Sector	*House holds*	*Non Financing Sector*	*House holds*	*Non Financing Sector*	*House holds*
Credits:						
total	54.80	29.10	20.60	0.00	64.40	0.00
1 month	59.20	74.00	21.90	0.00	150.00	0.00
3 months	69.60	63.30	31.30	0.00	96.00	0.00
6 months	68.10	54.70	31.20	0.00	158.30	0.00
9 months	69.80	47.20	25.30	0.00	0.00	0.00
1 year	46.50	19.20	23.60	0.00	0.00	0.00
1 to 3 years	25.70	18.10	23.70	0.00	0.00	0.00
5 to 10 years	11.30	4.40	11.40	0.00	0.00	0.00
> 10 years	6.10	4.90	6.00	0.00	0.00	0.00
Deposits:						
total	33.70	19.40	7.00	8.30	0.00	63.10
demand	24.00	6.30	1.80	2.60	0.00	8.60
time	35.60	32.10	7.40	11.00	0.00	64.20
1 month	20.60	32.90	2.80	8.30	0.00	0.00
1 to 3 months	33.90	36.00	8.20	8.90	0.00	64.80
6 to 9 months	44.70	34.10	3.40	13.80	0.00	70.00
1 year	39.70	36.50	5.30	14.60	0.00	32.70
1 to 3 years	27.50	36.00	18.10	30.00	0.00	0.00
3 to 5 years	29.70	21.00	0.00	0.00	0.00	0.00
5 to 10 years	25.20	19.30	7.10	26.30	0.00	0.00
> 10 years	0.00	20.20	12.00	0.00	0.00	0.00

*** weighted average based on all SLBs**
**** data supplied by August 1996 NBRK *Statistical Bulletin***
CC = Convertible Foreign Currency (Hard Currencies, i.e. USD, DM)
ICC = Inconvertible Foreign Currency (Soft Currencies, i.e. Kyrgyz Som, Uzbek Ten)

205. The interest rate structure on loans from second tier banks is similar, and averages 54.8 percent for borrowers other than households and financial institutions. For maturities of 1, 3, 6, 9, 12 months and up to 3 years rates as of August 1996 were 59.2, 69.6, 68.1, 69.8, 46.5 and 25.7 percent, respectively. There is some reason to suspect the rates attached to the longer maturities as being older and special situations. No data are readily available on the composition of portfolios by maturity. Even if there were, interpretation could be difficult because of roll-overs

or renewals that would mask what are in effect longer term loans with variable rates. Banking offices in Almaty account for more than 60 percent of short-term loans outstanding. Rural deposits are likely to be relatively small, as is rural credit.

206. The interest rate spread between deposit rates and lending rates was 21.1 percent overall in August 1996, and the difference between three-month deposit and loan rates was 33.9 percent. This is incredibly high by international standards. However, large spreads can be expected and possibly even welcome as banks attempt to build capital and manage risk following several years of inflation and economic restructuring. As noted elsewhere, though, a large spread would also be required to cover inefficiencies in bank staffing as well as problematic credit decisions and a credit culture in which many borrowers are reported to believe that they do not have to repay. These inefficiencies are likely to be reduced only as banks have better management information systems so that they can more closely manage their costs and risks, and as banking becomes more competitive, which should occur in the long run, or as banks fail, as occurs currently. Failure and its consequences may encourage banks that have not yet failed to become more efficient.

207. The impact of high real rates of interest on loans varies greatly across the farm sector. In general their impact has been to discourage borrowing, which is consistent with the quest for stable monetary aggregates. APB as opposed to other commercial banks operating in the rural sector give each regional branch manager the ability to determine interest rates on loans based on their knowledge of the oblast economic situation and the client. Naradony Bank and other commercial banks set their lending and deposit rates in the main office located in Almaty. Large farms in the north have suffered the most as a result of high interest rates because so much of their operation is monetized and credit would normally be used to cover many of the costs of getting from harvest to harvest. In the peer group discussions with farmers from Akmola and Aktubinsk many of the farmers were offered loans from local banks but refused to take the loans because the high interest rates would result in a substantial operating loss. Small farms or peasant farms which were visited in the south, however, wanted to borrow proportionately less because their overheads are lower and because family labor does not have to be paid monthly. But they also did not want to borrow at the offered rates. Interest rates to peasant farms were in some instances double what the large farms were paying.

208. The rural survey data confirms that the number one reason why private, rural enterprises did not apply for a loan from a bank is because of high interest rates. Additionally, 17 percent of the surveyed peasant farmers said they also did not take a loan from a bank because of high rates and preferred to sell produce and livestock for operating funds. Of the 200 low income households that were surveyed not a single family received a loan from a bank. Over 78 percent of their loans came from relatives.

209. The spread between rural and urban lending rates was on average about 125 basis points. This was a result of the inefficiencies of branch banks and the inherent risks associated with rural lending. This spread had a negative effect on the ability of rural farmers and enterprises to operate efficiently and create opportunities through the expansion of their operations.

210. **Determining and Protecting an Adequate Spread:** Loan and deposit pricing and the management of spreads are relatively new challenges for Kazakstani bankers and an area where

there is little experience. As local banking becomes more competitive and the huge spreads found today are compressed, loan and deposit pricing will assume much more importance. This will lead eventually to a quest for better management information systems that will provide cost accounting data for the pricing of services. This will be important because of its impact on the profitability of the bank concerned. Incorrect pricing policies were observed in all of the institutions the Consultants examined.

211. The basic considerations in pricing a bank's earning assets is to cover all costs. Costs include:

- the cost of funds adjusted for required reserves;
- overheads including administrative expenses;
- a profit target; and
- a bad debt allowance.

212. All of these values should be in nominal terms, i.e., not adjusted for inflation.

213. The profit target is important so that the bank can grow. Profit is required so that capital can increase to support growth of the bank: if the target capital ratio is 10 percent, growth of deposits by 100 would require increased capital of 10. The bad debt allowance is also important and required because not all loans will be good, and returns on the good loans have to cover the bad.

214. Well-managed banks in competitive markets apply this general approach to each income-earning service the bank offers, with specific overhead proportions, profit targets and bad debt allowances for each. This does not mean that a bank has complete freedom in pricing. Rather, a bank has to price according to what the market or competitive situation will permit and what an acceptable borrower is able to pay. The borrower's ability to pay is based on reasonable cash flow projections. These calculations enable a bank to know, at the least, when a price is too low and offers a guide for strategic planning regarding which services to promote and which to de-emphasize or discontinue.

215. Once a price is established for a service and a spread is thereby determined, continued review of pricing is required because market conditions change. In addition, these data are essential parts of the bank's larger strategy of asset/liability management (ALM). ALM is designed to ensure liquidity and solvency within profit and risk ranges regarded as acceptable by the bank's senior management and owners. Liquidity requires some matching of the maturities of assets and liabilities. Solvency requires the ability to price products rationally and to protect spreads from changes in market conditions. The preferred means of doing this is by matching duration's, which is balancing assets and liabilities according to the term of their zero-coupon value equivalents, a mathematically complex procedure. New calculations have to be made whenever interest rates or asset and liability composition change. Efforts to price rationally provide building blocks for ALM adoption in the future.

216. The following recommendations are intended to improve Kazakstani banks abilities to determine and protect an adequate interest margin.

- obtain western training in asset-liability management. This training should be included as part of any term lending project and is included in the Project Proposal;
- create cost accounting system that gathers cost data for pricing of loan or deposit instrument. Without accurate cost data, banks cannot rationally determine whether a bank instrument is profitable.
- create asset-liability management department that is responsible for determining rates for bank instruments and managing liquidity risk.

217. **Subsidies and Credit Availability:** The following section is a theoretical perspective on the effects of subsidized credit and interest rates. The Consultants believe that there exists a general misunderstanding amongst Kazakstani bankers concerning the downstream effects subsidized credit and interest rates have on financial intermediation. This is evident based on the current credit operations of the ASF and ongoing agriculture credit auctions at the NBRK.

218. It has been documented in prior sections of this report as well as previous WB and IMF reports the amount of subsidized credit prior to 1995 that has either been written off or transferred to loan-workout banks. Additionally, the NBRK puts out a monthly statistical bulletin that has tracked interest rates on loans and deposits since early 1994. Analyzes of these subsidized amounts and rates would be academic and not meaningful in the present context.

219. Subsidized agricultural credit is available from most governments, and for many years development assistance agencies generally agreed with this state of affairs. Experience has demonstrated, however, that these subsidies have a number of unfortunate effects that are not readily apparent and that impose great costs on agriculture in the long run. These can be summarized as decreasing both the quality and the quantity of financial intermediation and investment.

220. Major development assistance agencies are now reluctant to participate in subsidized credit operations other than those in which the subsidy is clearly only temporary or when it is used for the creation of human capital rather than for lending. Temporary subsidy may assist a credit operation to become established and reach a size where economies of scale are achieved. Human capital development may occur through training that accompanies credit, as in the case of small business development loans.

221. Subsidy occurs in credit projects in three ways. The first is the visible interest rate subsidy. This is achieved by providing cheap official funds to lenders dealing with farmers on the condition that the subsidy be passed along to farmers in the form of loans bearing interest rates that are below those on alternative, unsubsidized sources of funds. The second form of subsidy, which is potentially much larger than that transferred through low interest rates, is represented by large bad debt losses borne by the lender. Borrowers default and the lender is unable to recover unpaid amounts because collateral is insufficient or cannot be seized and sold by the lender. The third occurs when the spread does not permit the lender to cover administrative costs. In this case the transfer is from the lender to the farmer in the form of a price for a service that does not cover the cost of providing the service.

222. The effect in all three cases is to distort financial markets, to restrict the supply of credit in the long run and to limit the number of borrowers. One reason why this occurs is because the

amount of subsidy is limited to the budget provided. While budgets may be ample at certain times, priorities change and adversity occurs, which tend eventually to reduce or eliminate the subsidy. Market-based pricing covering lenders' costs, however, attracts funds from a large pool, i.e., the financial market. Lenders are more likely to compete and to mobilize resources when they can employ them profitably. The size of the market is not limited by government budget considerations and can expand rapidly.

223. Subsidized interest rates, especially those that are imposed in the form of an interest rate ceiling, tend to keep deposit rates low. If lending rates are below deposit rates of interest, subsidized borrowers could simply take loans and place the proceeds in savings accounts and profit from the difference. If they do not use the funds directly for this purpose they may borrow to finance activities that they would have undertaken in any event, use the loans as promised, and put their own funds into savings accounts that yield more than the loan costs. An even larger effect of low rates of interest on savings is that they discourage resource mobilization, keeping financial markets smaller than they would otherwise be. An indication of the forces at work is given by increases in the deposits of households in Kazakstan banks as inflation came under control with higher interest rates that provided more protection against devaluation. Balances as of August 1996 were more than three times as large as they were at the beginning of 1995.

224. Subsidized interest rates tend to restrict the number of borrowers in other ways, too. This is summed up by the Iron Law of Interest Rate Restrictions, which says that the greater the subsidy the higher the concentration of the subsidy. This occurs because banks have an incentive to issue larger loans rather than smaller loans. Because the costs of issuing a loan do not vary greatly with loan size, bankers have an incentive to minimize the number of transactions, favoring larger borrowers. Also, larger borrowers may be preferred because they are perceived by bankers as being safer risks and because they may be a source of other income for banks, such as through transfers and uses of other banking services. At the same time, borrowers will compete for subsidized loans, which again gives larger borrowers an edge. This occurs because larger borrowers are often politically better connected than small borrowers are, and they may also have other means of influencing bankers to route subsidized credit to them. Thus, the interests of the lender and the borrower coincide to concentrate subsidized credit in the hands of relatively few borrowers who are often large. This is especially ironic and unfortunate when subsidies are provided to improve equity in society by helping the poor, the small or the weak. In addition, an effect of the efforts of the big and the strong to obtain subsidized credit contributes to a more corrupt society in general.

225. Subsidized credit also tends to retard financial market development because it loses money for lenders. These lenders are consequently unable to provide the services that they would be able to if they operated profitably. Borrowers have an added incentive to default on subsidized loan programs because these schemes are fundamentally political. As such, lenders are less likely to be able to make good contracts or to enforce them because of actual or potential political interference. Another effect occurs where subsidies are concentrated in term lending, causing long-term interest rates to be lower than short-term ones, as is presently the case in Kazakstan. This discourages the development of long-term markets for savings and for loans, making it difficult to finance fixed assets and public infrastructure for development.

226. The Consultants recommend that the NBRK reevaluate its policy of requiring on-lending institutions who are recipients of agriculture support auctioned credit funds to impose an interest rate ceiling on these funds. Current NBRK policy on these auctioned funds allows the on-lending institution a margin of less than 5 percent. In the current operating environment, it is highly unlikely that this margin can cover the costs of lending to a high risk sector. Unfortunately, APB which is the major recipient of these funds, currently does not have the capability to determine whether they are covering their lending costs. A more logical approach would be to allow the spread to be determined by the bank. Excessive abusive of this privilege would prevent that institution from participating in future auctions.

7. Farm Insolvency and Debt Restructuring

227. The impact of the contraction of the agricultural sector on the rural economy has been severe over the past few years. Rural enterprises, farms and agri-enterprises have suffered from a lack of profitability and the terms of trade for the sector as a whole have deteriorated. Most farms whether restructured or not, have seen a marked decline in their liquidity, value of assets and profitability. Machinery has not been renewed, livestock have either been disposed of or are in poor condition, and fixed assets have become dilapidated. Many of the farming structures are encountering extreme difficulty in maintaining their current level of operations.

228. The majority of farms that have been privatized, but not restructured into economic farming units, are unprofitable. In 1995, the Ministry of Agriculture (MOA) estimated that 80 percent of all farming enterprises were unprofitable. Until farms develop profitable structures, their ability to qualify for credit will remain severely constrained. Many farming enterprises are encumbered by past due debts, too many employees and shareholders, social costs, inadequate machinery, lack of control over storage facilities, and restricted marketing outlets. In addition, many farmers find themselves locked into a situation where the only way to finance their working capital is to contract their future crop, i.e., sell them before harvest. To date, few farms have managed to generate sufficient cash flow to finance their working capital, and most barter their rights to future produce to obtain inputs. All these make sector growth in agriculture extremely difficult.

229. It is no secret that the vast majority of rural privatized entities and former state farms have considerable amounts of debt that were passed down through privatization. Much of the debt is old, unsecured and non-collectible. The Government created the Agricultural Support Fund (ASF) to manage the debt resolution of more than 4,000 farms. To date, the ASF has been unsuccessful in restructuring or forcing the liquidation of farms.

230. As outlined in the Final Report of TA-2356-KAZ: *Strengthening the Implementation of Agricultural Sector Reforms*, the process of restructuring farms should be left to market forces. Some farms will be successfully restructured by their management and shareholders and a proportion of farms will face bankruptcy and liquidation. The remaining farms will continue to operate at a low level of performance, resulting in subsistence standards of living. For farms which want to be successful in restructuring, one component that is needed is the development of a farm business plan. New farm business plans would include revised farming systems, investment plans, projection of cash flows from salable commodities, projected profit and loss statements and plan for restructuring current debt. Without a restructuring plan that

encompasses realistic and achievable projections, financial institutions will continue the trend of limited lending to the agricultural sector.

231. Details on the process of farm restructuring are beyond the scope of this Study and would require additional work to be done in analyzing gross margins, yields, prices, costs and results of incremental inputs and new cropping patterns. Additional work will also need to be done on examining the rationalization of operations, sale of unproductive assets, effects of changes in management, forced liquidation and bankruptcy and the social costs associated with displacement. The Consultants consider farm restructuring as an integral part of the overall plan to revise the agricultural sector and thus have integrated farm restructuring in the Project Proposal.

8. Alternative Financing Mechanisms

232. The following three forms of alternative financing mechanisms do not presently exist in Kazakstan and establishment of these would enable farms to free-up existing working capital that is presently needed for inputs and fixed asset investment. Secondly it will limit the direct reliance on bank financing, and finally it will provide opportunities for the establishment of farm support services which are critical for a properly functioning agricultural sector.

233. **Finance Leasing:** Leasing in Kazakstan is based on the draft *Decree on Leasing* and on the rights allowed between lessor and lessee in the *Kazakstani Civil Code*. The draft is expected to be passed by Parliament in early 1997. Of concern to the Consultants and a potential problem that will affect the establishment and operation of leasing companies is the way taxes are treated in the draft decree. In the United States the major advantage to leasing is that the lessee is able to expense the lease payment. However, in the proposed decree, leases will be treated like a capitalized asset and must be amortized, thus are subject to taxes. If this portion of the decree is not changed, it is unlikely that leasing will be used as an alternative financing method for agriculture.

234. The following is an explanation of leasing as it is applied in western countries. Leasing enables lessee to use equipment belonging to the lessor. Types of equipment that are frequently leased include construction machinery, vehicles, farm machinery, machine tools and many others. The lessor remains the owner of the leased equipment and is responsible for its maintenance. The lessor borrows to purchase equipment selected by the lessee. The lease charge paid by the lessee covers the lessor's debt service, risk and administrative costs. The advantages of leasing stem primarily from tax treatment: the lessor's interest cost and equipment depreciation expense are operating expenses, as are the lessee's lease payments. Another possible advantage is that lease obligations do not have to be reported as liabilities by the lessee under accounting rules followed in many countries, although accounting and disclosure "loopholes" such as these are rapidly being closed in OECD countries.

235. In addition to the tax and debt reporting considerations, leasing offers an alternative to lending and borrowing that benefits both lessor and lessee. Because the lessor owns the equipment used by the lessee and is responsible for maintaining it under a finance lease, the lessor has more control over the equipment. Repossession of equipment pledged to secure a loan that is in default requires judicial approval in many countries, and may be impossible to achieve

without incurring relatively high transaction costs. In most countries a lessor can take back equipment relatively easily if lease payments are not made on time.

236. Leasing can give a lessee access to assets that could not otherwise be obtained, or obtained only at a higher costs. Lessors can provide better services than lenders when borrowing equipment is more advantageous for the lessee than borrowing cash. Lessors may be able to obtain equipment and equipment financing on better terms than the lessee could, due to size, reputation and location. The lessor may also be able to provide better maintenance of the equipment than the lessee would provide or could obtain locally.

237. Leasing may work best at the outset for standardized equipment such as trucks, tractors, electric motors, pumps and combine harvesters that enable the lessor rather easily to find alternative uses if they have to be taken back before the expiration of the lease agreement because of default by the lessee.

238. Finance leasing permits great flexibility and can provide access where credit institutions may have difficulty doing so.

239. Attempts at setting up leasing companies for agricultural equipment have been unsuccessful in Kazakstan due to high start up cost, lack of dealer financing and a general misunderstanding by the parties involved in a lease agreement of the basic concepts concerning leasing.

240. **Out-Sourcing and Tied Financing:** Agricultural finance in many countries includes important elements of non-institutional credit. One form of this is custom hire service. An example is the harvesting of grain by independent operators who go from farm to farm with large combine-harvesters, harvesting crews that include drivers, mechanics and others, plus spare parts and fuel. They harvest on a contract basis, providing the service to the grower within a specified time period for a specified cost. This service relieves the grower of a great financial burden that would have to be incurred if the grower purchased his own harvesters. These important pieces of equipment represent a large investment and they are used only for a few weeks each year. The custom service provider can obtain economies by buying several pieces at once and by using the equipment for a longer period. This is achieved by harvesting around the clock where conditions permit and by moving with the harvest, starting in the geographic zone where the crop ripens earliest and ending a number of weeks later in the zone where the crop ripens last. The risk to the grower is that the contractor may not be able to meet his promise to harvest at the time specified, which could result in the loss of the crop. Competition in the custom business is the best way to avoid this problem.

241. Tied financing or pre-financing has several forms. One is provision of inputs by crop buyers. For example, a sugar beet processor may be willing to advance planting materials to growers on the condition that they deliver the sugar beets at a specified time to the processor. The processor deducts the advance from the payment made to each grower following delivery of the crop. Two international companies have had limited success in pre-financing and have cut back their operations (par. 41 Part II: Micro-Finance). Marketing cooperatives may also provide the same service to their members. In certain countries tree crops are purchased on the tree at the time of germination. The buyers often take responsibility for harvesting.

242. Enforceability is a major factor that determines the success of tied financing. In some cases the grower may try to avoid repaying the advance by delivering to another party. This can also be accomplished by delivering under a different name. These types of problems are most likely to arise if growers suspect the processor of not giving them fair value. In certain cases the processor may offer a specified delivery price early in the season when credit is advanced. If this price turns out to be lower than the prevailing market price at harvest, growers have an incentive to evade their delivery contracts. In other cases processors may have a bad reputation because they are accused of incorrect weighing of deliveries, of incorrect quality evaluation (such as moisture content in grain, sugar content in sugar beets or fat in milk), which complicates the operation of tied credit arrangements.

243. In other cases it may be possible to bribe the person accepting the delivery so that no deduction is made for the advance, possibly by overstating the amount delivered. For the system to work, the processor doing the lending has to have good internal controls and good information about the production performance of debtors.

244. One new financing technique used in the US is the sale of delivery rights to new processing factories or storage facilities operated on a cooperative basis. Farmers interested in having such a facility in their area and in delivering to it are offered delivery rights, which entitles them to deliver a stated number of tons. The sale of these rights is similar to the sale of shares of stock in the facility, in that the sale provides the initial capital for construction of the facility and the owners of the delivery rights are the owners of the facility. The understanding is that those holding delivery rights will deliver their produce to the facility.

245. The delivery rights are negotiable: they can be sold at any time to anyone. Their price varies with farming conditions and market conditions and with the efficiency of the facility. This procedure, permitting appreciation in the value of membership in and ownership of the facility avoids problems associated with cooperative shares, which are not negotiable and can be purchased and redeemed only at face value. Owners of negotiable delivery rights have a greater incentive to ensure the efficient operation of the facility they own because this will be reflected in the price of the delivery right.

246. A contracting scheme has been developed in Akmola by the TACIS project, *Improvement of Farm Machinery and Agricultural Equipment Manufacturing and Servicing in Kazakstan*, in collaboration with joint stock company, Kazagroemmash. The idea is based on setting up a contracting center in Akmola for agricultural services that is equipped with Russian combines and equipment. The center would provide on a fee basis or through forward contracts planting or harvesting services to farms within 200 kilometers of the center. The TACIS technical assistance project finished at the end of October 1996 and the contracting project had not been funded.

247. **Warehouse Receipts**, discussed in detail in paragraph 131 of Part II: Micro-Finance, provide an additional financing mechanisms that is currently not available in Kazakstan.

248. One of the Proposed Project aims will be to develop these three types of alternative financing mechanisms.

9. Oblast Administration Intervention

249. The status and relative independence of the Governor of each oblast plays an important role in the distribution of credit. Political connection to the Governor is important for any farm or business that wishes to do business outside of their respective oblast and to be in a position to receive quasi-directed credits from government bodies such as the ASF. Oblast administrations have been reported to use strong arm tactics to force private banks to lend to unqualified borrowers.

250. As noted in the ADB Report, *Strengthening the Implementation of Agricultural Reforms*, the oblasts in conjunction with the rayon administrations are presently indirectly affecting the delivery of rural financing by exercising functions similar to those undertaken during the command economy, on farms within their jurisdiction. These functions include:

> 1. Securing the supply of different production inputs and related services; such as fuel, spare parts, repair services and construction materials. The majority of the supply is obtained against future delivery of agricultural produce. Farm enterprises are often unable to obtain essential inputs and services because of their lack of working capital, indebtedness and the limited supply of rural financing. So, they are forced to purchase, trade or barter with the oblast administrations at reduced prices for their produce;
>
> 2. Establishing production targets and sowing areas for important crops in coordination with national authorities. This reflects that command of production has not been relinquished;
>
> 3. Securing sufficient food supplies through what is termed a program of self-sufficiency. This has allowed oblast interventions in designing and implementing marketing mechanisms;
>
> 4. Assuring marketing of some agricultural produce in the context of its self-sufficiency program. To meet internal consumption requirements, the oblast enters into barter deals to secure production inputs and to obtain agricultural commodities, which are not produced in sufficient quantities by the region.
>
> 5. Pricing at the farm gate, as well as the retail level, through its involvement in marketing and the work of the Oblast Pricing Commission;
>
> 6. Collecting and analyzing, on principle, the accounts from all farming enterprises on a compulsory basis; and
>
> 7. Setting technological standards that have no foundation in explicit public interest except to set specific production standards.

251. Because of oblast interventions, farmers' access to inputs at market prices is restricted and they are unable to sell their products at reasonable and fair prices nor service their bank debts.

252. Oblast Governors and officials will play an integral part in implementation of the Project Proposal. They will be responsible for monitoring the implementation of the project, facilitating operations and establishing a wholesale marketing operational framework. Their role is explained in Part III: Project Proposal.

10. Effects of Low Rural Savings Mobilization

a. Background

253. The following section is a theoretical perspective on the effects of low rural savings mobilization. The Consultants believe that there exists a misunderstanding amongst Kazakstani bankers that the rural population does not have the ability to save because of their economic status. As explained in the preceding paragraphs, savings mobilization is an important aspect to rural finance.

254. *The New World of Microenterprise Finance*, edited by Maria Otero and Elisabeth Rhyne, demonstrates that people of all income classes and all countries save. Their motives for savings include protection from emergencies, accumulation for investment opportunities, to maintain consumption when income streams are irregular, to meet social obligations, and to realize long-term goals such as the education of children, acquisition of land and housing, and retirement. The poor have a special desire to save because they face enormous risks and live at the periphery of the modern economy.

255. Farmers, likewise, want to save because of agricultural risks. They must save from one harvest to the next in order to survive. All people living on the earth today are the descendants of successful savers. People who did not make it from harvest to harvest in the past or who did not manage the risks of pastoral activities or hunting did not survive and are not represented by descendants today.

256. Evidence collected since the 1960s attests that households will save in financial form if appropriate institutions and instruments are available. Moreover, households are not the only savers; although rarely considered or recognized by policy makers, local enterprises, groups, organizations and institutions also save. These savings are potentially available to financial institutions which offer security, convenience, liquidity, and returns.

257. Despite this evidence, there is a common myth that the poor cannot save. This is reflected in the view that there is pervasive "rural undersavings," and that demand for financial savings instruments is low in rural areas of developing countries. Savings have been rightly called the "forgotten half of rural finance". Assumptions are that low institutional deposits in rural areas demonstrate that rural households cannot save because they are too poor, or will not save because they prefer to use their incomes for consumption, or choose to save in other forms. As a result, savings mobilization and the creation of sustainable rural financial institutions have not been given priority either by the governments of most countries or by most donor agencies. This is unfortunate because most people want to save most of the time, while some people want to borrow some of the time. More people can be served by savings deposits than by credit.

258. The widespread myths often stem from a faulty definition of savings as something that occurs in the long run and for major purposes only, such as the purchase of a costly asset or for the *hadj* or for important social occasions. Bankers view saving in an entirely different way, and developers should do likewise: savings are any funds that are not spent the moment they are received. Savings may constitute "working balances" in transaction accounts; they may consist of money kept at home. The question then becomes one of the length of the holding period or the rate at which balances turn over. With development and with the accumulation of savings, the holding period lengthens and the rate of turnover decreases on individuals' savings accounts.

259. Savings may also be represented in things that are purchased but not used, or not used for some time. In many developing countries merchants have inventories that are large in relation to their sales, manufacturers hold large amounts of raw materials, and households own livestock as savings or invest in prestige items (such as enamel trays and basins in West Africa) or consumer goods (including bottles of vodka in Kazakstan) that can be sold or bartered during emergencies.

260. Mobilization of deposits and development of rural financial institutions are interdependent, and savings are crucial for households and enterprises in developing countries. However, projects promoting financial market development are typically concerned with credit, usually subsidized credit. The low interest rates that characterize subsidized credit programs discourage savings mobilization because interest rates that banks can offer are influenced by their lending rates. Subsidized loans to the rural sector easily destroy opportunities for savings mobilization, at least in the long run. Organizations dispensing subsidized credit are normally forbidden to mobilize savings or do not collect voluntary savings because financial regulations make deposit mobilization unprofitable.

261. The lack of rural banking institutions adversely affects savers, in general, and small-scale farmers and businesses, in particular, for two primary reasons:

1. Self-finance is especially important for small and microenterprises. However, savings options are often restricted. Informal deposit-takers offering high returns may not offer much safety; those that are safe may offer limited returns. A crucial requirement for small enterprise finance is liquidity. Banks are often the only mechanism that could provide the saver the combination of security, liquidity and a fair return.

2. Small enterprises are typically bypassed in subsidized credit programs in transition economies and unsubsidized institutional credit is often not available to them. Creditworthy small firms can benefit from the expanded volume of institutional lending made possible by deposit mobilization. Substantial growth in institutional deposits can both significantly increase the amount of credit available to small enterprises and provide loans at interest rates much lower than those available from informal markets.

b. In Kazakstan

262. The reason for low institutional deposits in Kazakstan is neither undersavings nor lack of demand for savings instruments. Kazakstani people are not adverse to borrowing from banks they may not trust, but they will not place deposits with such banks. Lack of trust in banks is one reason why people will not save in banks. This is confirmed by data from the rural survey that showed 37

percent of the survey population said that banks are not safe places to hold surplus cash. Additionally, the recent failure of a large Almaty bank only reaffirms the public's perception of financial institutions.

262. Another important reason is that depositors may want to avoid taxes or they fear that they may be unfairly taxed or required to show how they acquired their funds. As of 1 July 1996 the Kazakstan Tax Authorities and the NBRK have required Tax Registration Numbers on all banking transaction documents. Banks are subjected to a penalty of 5 percent of the amount of the transaction if they fail to comply with this requirement. While this regulation supports the collection of taxes, it will affect the citizens' willingness to use financial institutions.

263. A third factor that discourages savings is the legacy of hyperinflation, which makes it very difficult to protect the purchasing power of savings. In all countries which have experienced hyperinflation it has taken time for people to regain confidence in the currency as a store of value. In some instances real interest rates remain negative for short term demand deposits.

264. Finally, 24 percent of the rural survey population said that they considered access to their deposited funds a reason for not placing surplus cash in financial institutions. This continues to be a major problem for rural banks and confirmed during a peer group meeting in Chimkent that local residents had not been able to withdraw their deposited funds for one month.

265. The top ten banks in the country have extensive branch networks reaching into the rural communities. However, they are mobilizing savings from rural communities and lending them in the urban cities or to other banks through the inter-banking lending market. Few of these institutions return rural deposits in the form of loans. Narodny Bank controls over 50 percent of the total deposits in the country but SME lending accounts for less than 5 percent of their credit portfolio. Additionally, 68 percent of their loans are made to other banks. Loan-to-deposit ratios are typically low in banking offices in rural locations.

266. There are several aspects of the movement of funds from rural to urban areas. First, it is important to note that this flow is common in financial markets. In fact, it is one of the main reasons for extensive branch networks. Financial centers from London to New York to Almaty always obtain funds from their hinterlands. One reason for this pattern is that returns to investment are often higher and transaction costs for lenders are often lower in urban areas. Thus, the flow is rational economically. Second, the higher returns on financial intermediaries' uses of funds in urban areas may enable rural depositors to receive more interest income than would be possible if their funds were loaned locally. However, it is also highly possible that the large financial institutions located in Almaty are not sensitive to investment opportunities in rural areas because they have not developed any specialization in rural lending. The result is that rural development is constrained and rural welfare is not promoted as rapidly as it could be. This creates opportunities for rural-based and decentralized lenders that develop expertise in dealing with rural households and enterprises, or for decentralized credit decision making systems in urban-based institutions having a presence in rural areas. Rural credit unions may offer scope for such specialization in Kazakstan. Even when such institutions function well, however, they typically move some of their funds out of rural areas. These funds take the form of required reserves with the central bank, investment in government securities for liquidity management, and balances held with banks for transaction purposes.

c. Recommendations

268. As a result of the above mentioned systemic factors that discourage savings, the Kazakstani population is unwilling to use financial institutions for savings purposes. If public perception of these constraints can be overcome in the near future, the following strategies may be used to increase savings mobilization.

269. **Creation of Public Trust in Banks:** This is by far the greatest constraint to mobilizing savings and affects not only rural banking institutions but the whole banking sector. The recent failure of Kramds bank, which was one of the largest banks in the country, has only contributed to perceptions that banks are not reliable institutions in which to place money. Citizens will deposit their savings only when they have trust in the banking system, a particular banking institution and in the broader political and economic system. Viable financial institutions serving rural areas depend on savings mobilization, the success of which depends heavily on trust.

270. Government officials and donors talk about developing deposit insurance schemes in Kazakstan. These have historically proven to improve public trust in banks, but are costly to taxpayers, and possibly also to borrowers and depositors, where an insurance premium is required. By some estimates the FDIC in the USA ran up USD $500 billion in losses in the 1980s. The NBRK should take an active role in promotion of the banking sector and increase public awareness of the positive aspects of the sector in order to increase public awareness and trust in banks. Customer service techniques that put the client first and not vice-versa need to be developed in every bank. The Kazakstan Bankers Association has done very little to promote its members and improve public trust in the system. Without a concentrated and intense effort by the NBRK, the Kazakstan Bankers Association and individual banks to promote the sector, the population will continue to resist the use of banks.

271. **Strengthening the Confidence in Tenge Deposits:** The decline in inflation from hyperinflation levels in 1993-94 to the 1996 estimated level of 27.5 percent has permitted a stabilization of the exchange rate. This has resulted in a slow depreciation rate of the Tenge against the USD in 1996. In turn, the improved confidence of the public in the national currency reinforced the effectiveness of stabilization policies. The demand for Tenge balances grew by 25 percent in 1995. As noted in paragraph 35, the use of the Tenge as a means of exchange has improved, but public confidence in it as a store of value remains limited. This is reaffirmed by a quote from a recent Reuters article by a 60 year old woman which stated, "I personally buy dollars and put them aside."

272. **Positive Real Interest Rates:** Positive real interest rates are interest rates that exceed the rate of inflation. When rates are negative in real terms deposits lose purchasing power. This leaves depositors poorer in real or purchasing power terms. Banking systems that do not offer positive real rates of interest, except for short periods of time, are unlikely to be socially beneficial. Of course, some deposits will always be kept with banks for transaction purposes or when the depositors' costs of banking are less than their costs of keeping money or other valuables outside banks. But when real rates are negative for any length of time the banking system tends to contract in real terms. This is exactly what should not happen, because

development is accomplished more easily when banks are growing and becoming more efficient at mobilizing deposits, in making good loans, and in managing risk generally.

273. The importance of maintenance of real value was demonstrated by the Ministry of Finance when it issued National Savings Bonds targeted at small investors seeking a hedge against inflation. The twelve-month bonds bear an annual coupon rate of 27.4 percent, a yield equivalent to 6.85 percent per quarter, and are adjusted every quarter. The bonds offer a return about equal to inflation, but better returns than bank accounts that carry fixed interest rates as low as 6 percent. It may be assumed that the Government did not offer bonds with a rate exceeding the rate of inflation because that would make it extremely difficult for banks to compete with these bonds in mobilizing savings. The signal seems to be that banks should be offering rates greater than those paid on the savings bonds for savers who would be interested in the yields and conditions attached to the savings bonds. This means that banks' lending rates should exceed the rate of inflation by a significant margin.

274. **Low Transaction Costs:** Transaction costs are non-interest costs of bankers and of their clients. Depositors' transaction costs include the opportunity cost of their time in traveling to a banking office, waiting for their transaction to be processed and completed, plus any out-of-pocket costs for transportation and other expenses related to the transaction. Banks' transaction costs include those of operating branches, including salaries, stationery, and related non-interest expenses.

275. Transaction costs are the admission tickets to financial institutions and markets. When they are high, citizens and businesses are less enthusiastic about dealing with banks. At the same time, high transaction costs discourage banks from dealing with small deposits and loans. This is because many transaction costs do not vary greatly with the size of the transaction. For example, the cost of processing a Tenge 10,000 deposit or withdrawal is not greatly different from the cost of processing a Tenge 1,000,000 deposit or withdrawal; nor would it be for making loans of these different sizes. Yet, the larger depositor and borrower are more attractive to a bank because their transaction costs are spread over larger amounts of funds.

276. Competitive banking systems aggressively seek to reduce their own transaction costs and, more importantly, those of their clients. One bank, for example, takes a long time to process a deposit or withdrawal and requires customers to wait in two queues, one for a teller and one for a cashier, while another operates a unit teller system in which one bank staff member can process the entire transaction promptly. Of course, the unit teller system requires more extensive controls than the teller-cashier system, because the latter has a built-in check against fraud and error. However, in many countries the economies of the unit teller system have prompted banks to move away from the teller-cashier system.

277. Likewise, competitive banks seek to keep their staff costs to the minimum because these are the major source of a bank's transaction costs. In most cases the most efficient compromise between numbers and salaries seems to be to pay bank workers fairly while employing the right number. This means that ways should be sought to simplify procedures, eliminate duplication, except where required for financial control, and make certain that bank staff are productive throughout the work day. There are numerous areas in Kazakstani banks that would lend themselves towards significant economies in transaction costs.

278. **Sufficient Liquidity for Payouts:** Depositors want a safe place for their funds. They want convenience, in the form of banking locations that are reasonably close to where they live, work or shop, and services that are prompt and efficient. They also want to have confidence in their bank, which means that they can get their money back as specified in the terms and conditions governing each type of deposit account, and that deposits are generally protected from inflation. A bank's first priority in maintaining confidence is being able to make payments as promised, which is often on demand. This means that banks must have sufficient cash on hand at all times, as well as sufficient balances with other banks, including the central bank, to cover their obligations in the clearing system every day.

279. Liquidity requirements are especially high when confidence in banks is low and when banks cannot efficiently provide noncash payment instruments. When confidence is low, customers will be more likely to make frequent withdrawals. When instruments such as checks, credit cards, or other forms of payment order are not readily acceptable in trade, customers will prefer to deal in cash. Some of the preference for cash as a form of payment may reflect legal problems in obtaining recourse against fraudulent payment orders. This has been addressed in a number of ways in different countries, the extreme case being South Korea, where passing a check that is not supported by sufficient funds is a criminal offense that is easily and routinely enforced with fines and jail sentences.

280. In other cases, traders and their clients prefer to deal in cash in order to avoid creating a paper trail for tax authorities. Where as this would be expected for illegitimate transactions, it is also found in a number of countries for commonplace transactions. In these situations there may be little confidence in the fairness of the tax authorities in their enforcement of the law, or taxes may simply be excessive.

281. High levels of cash transactions may reflect low bank transaction costs, since so many real transactions are not conducted through the bank accounts but by cash. However, this is not the case because having to keep high levels of cash means that banks have high levels of non-earning assets in the form of cash, possibly reducing the portion of bank assets that are placed in interest-earning loans and investments. In addition, the costs of counting cash are often high, and in countries where cash is greatly preferred, many of the banknotes become worn and difficult to count rapidly.

282. Interest rates that reward savers by giving them a return greater than the rate of inflation, plus convenient service in banking offices, help to mobilize deposits. Efforts to encourage noncash transactions are also rewarding to banks and their clients when they reduce transaction costs. As systems evolve in this direction, more money is deposited in banks, permitting banks to make more loans and to contribute to more efficient markets throughout the economy by lowering transaction costs. Maintaining sufficient liquidity is required for these developments to occur.

V. Demand for Rural Credit

A. Uses of Credit Demand Data: Public Policy Options

283. There is always considerable official interest in credit demand data. In mixed economies this dates at least to the 1950s, when the All-India Rural Credit Survey results were published in several volumes. In centrally planned economies the history is much longer because of the nature of the planning process and the use of the banking system for the implementation of planning priorities.

284. Similar concerns motivate banking legislation and regulation in many countries. In the United States, for example, banks are expected to meet the "credit needs" of the communities in which they are located. The term "credit needs" is widely used in discussions of financial intermediation in the multilateral development banks and also in casual English.

285. From the technical point of view, however, credit demand and credit needs are deficient concepts. There are several reasons for their shortcomings. The first is their subjective nature. The All-India Rural Credit Survey, for example, listed at least ten definitions of credit needs, some of which are mutually exclusive. In more recent times, credit needs and credit demand have been used for political purposes to promote large credit programs, as in India and elsewhere, that have not been sustainable financially due to bad debt losses that were tolerated politically.

286. Second, demand is difficult to define. One popular definition equates demand with the sum of loan applications received. This typically results in a very large number, which suggests a tremendous demand for credit, especially when three conditions apply. The first occurs when interest rates are subsidized, giving borrowers some "free money." The second occurs when it is difficult to collect arrears, as, say, in the absence of effective bankruptcy laws that are widely applicable to all borrowers. This invites default, providing defaulters yet more "free money."

287. The third reason why credit demand can be large occurs when borrowers are able to finance a substantial part of the investment from sources other than their own earnings or savings. This happens in many countries where official agencies use "formula lending." In 1970's in Bangladesh, industrial development banks and commercial banks financed 80 percent of an investment if the borrower financed 20 percent. The 20 percent did not have to be in the form of new money or cash, often taking the form of land. Lots of relatively wealthy people got loans which were not repaid. With so little of their own money at risk, investors' search for good investments was not very thorough. Lenders, however, had great difficulty taking the land that was used as collateral.

288. The problem of credit demand was first dealt with in the development finance literature by Sayre Schatz, an American professor working with the Regional Loans Boards in Nigeria in the 1960s. Schatz divided loan applications into two classes consisting of "false demand" and "true demand." True demand consists of bankable proposals. Bankable proposals are those submitted for good projects by credible applicants for amounts of money that are reasonable. They almost always require that the borrower put up sufficient investment in the business to

make the deal worthwhile for the lender. The borrower's financial stake is extremely important because it reduces the lender's risk.

289. The rest of the loan applications received represent "false demand;" bad and highly risky investments, unreliable or inexperienced borrowers, and unreasonably large loan requests make up this set of applications.

290. From this perspective, the function of the financial system is to differentiate between true demand and false demand. This requires expertise in saying "No" to bad applications representing false demand as well as skill in identifying and responding appropriately to true demand represented by good applications.

291. Another deficiency in the concept of credit need is that it overstates the problem because it assumes there is some absolute amount of credit without which nothing will happen. This view works against the fact that there are always a number of alternatives in finance when the underlying purposes for which funds are sought are viable. These include different sources of credit, the accumulation of savings to finance investment, and varying the proportions of debt and equity provided for a given purpose. Credit "need" presupposes that the loan purpose and application are good proposals, backed by credible applicants and for loans properly structured.

292. Credit demand figures and concerns about credit need almost always lead to activities that destroy finance. Destruction occurs through bad loans, amounts that are not repaid because their purposes were unremunerative, their sponsors were not competent, or lenders were inept in not evaluating risks properly. This is basically the history of development finance, with relatively few widely-known exceptions. In developing countries in Asia these include the village units of Bank Rakyat Indonesia, the Grameen Bank in Bangladesh, the Bank for Agriculture and Agricultural Cooperatives in Thailand, the Korea Long-term Credit Bank and a handful of others.

293. In view of these shortcomings associated with common approaches to credit, what public policy options can be selected that will avoid the problems associated with credit "need" and credit "demand"? The answer is not difficult and has two parts. *The public policy imperative should be to make good loans*, defined as those that are remunerative to the lender. This usually requires that they be repaid as promised. Without remunerative loans, lenders will not be sustainable and they will contribute poorly to the identification of good projects, to the identification and support of good borrowers, to the security of depositors, and to reasonable returns to their shareholders.

294. The first imperative, making good loans, leads to the second, which is identification and management of risks. This requires intensive efforts to determine what is likely to go wrong in any loan and investment proposal, and to take steps to be prepared for risk when it occurs, with responses thought out well in advance. One means of doing this, as noted above, is to ensure that the borrower has sufficient funds invested in the project to cushion the risks of the lender. This division of risk is fair, because the lender's returns from the loan and project are limited only to interest income from the loan and the prospect for future business. In contrast, the borrower has the opportunity to profit greatly when the purpose of the loan turns out favorably. Appropriate loan size also means that the borrower is not greatly burdened by servicing debt.

295. Most credit demand studies in developing countries are either useless or harmful. However, a certain type of credit demand study could be valid and helpful. Such a study would identify how financing works in different economic activities and sectors, how profitable these activities and sectors are, and the constraints they face. In other words, the study would focus on how different firms and industries are presently financed. Where borrowing is involved, the study would investigate how loan size is determined, the repayment terms and conditions, repayment performance, and the basis for credit. The basis for credit may include links with non-financial flows, established commercial relationships and reputations, etc. This type of analysis challenges the investigator or the user of the study to devise means of financing that would be more efficient and productive than present ones. The supply of loanable funds is not terribly important in most cases in which this approach is taken.

B. Survey

296. The results of the rural survey are included in Appendix 9.

VI. Proposals for Specialized Rural Financial Intermediaries

A. Outline of Delivery Systems

297. The rural development process is accelerated when there are financial services that cover a broad spectrum of sizes of financial transactions, a wide range of sector activities and a population base that includes sparsely populated as well as densely populated rural areas. These services need to encompass economic enterprises, as well as households. It is not advisable to provide such a broad range of services through a single type of financial institution. Rather, it is better to have an overlap of services among institutions to encourage competition and efficient provision of services.

298. Banks can provide a limited range of financial services in rural areas by expanding their branch networks and by using mobile banking units. The outreach and sustainability of these efforts are constrained by high staffing costs, and by the use of procedures consistent with the banks' systems of operations. In addition, the volume of business in many rural areas is often insufficient to cover the overhead costs of banks operating in these communities.

299. The development of savings mobilization is either prohibited by law or ignored because of savings misconceptions and as a result the opportunity for financial intermediation across whole communities is not realized. However, forms of informal financial intermediation have evolved to meet small-scale rural financial needs. These services tend to be limited to small- sized loans over very short time periods..

300. Now there is a widespread acceptance of the role of and need for both informal and formal suppliers of financial services. Informal suppliers, such as credit unions (CUs) and Non-governmental organizations (NGOs) must be given the opportunities and incentives to organize groups and associations that will allow them to facilitate rural financial intermediation. These organizations have a cost structure different from banks that allows them to be competitive in rural

communities, and they are able to provide effective and wide reaching rural financial services through operating and financial linkages with urban financial institutions.

301. For these reasons, the Consultants envisage support being provided to banks, CUs and NGOs. NGOs are discussed in Part II of the Final Report on Micro-Finance.

B. Second Tier Banks

302. There are three basic approaches to improving rural financial services through a banking network. One approach is to provide policy, operational and financial assistance to a viable national bank with rural branches. The assistance would initially be targeted at pilot projects in specific oblasts, with the goal of replicating the successful aspects of the pilot operation throughout the bank's remaining branches. A second approach is to allow undercapitalized rural financial institutions to operate as second-tier banks by limiting the scope of their activities. The final approach is to offer incentives to financial institutions operating in rural communities. Whatever approach is taken, the financial institutions concerned could, additionally, provide services to remote villages using mobile banking or links with larger institutions. Any type of credit delivery mechanism specifically related to the agricultural sector would need to be tied to farm restructuring.

C. Second Tier Rural Banks

303. During 1996, the NBRK Supervision Department has been aggressive in closing financial institutions that do not meet the stated minimum capital requirement for SLBs and NBRK prudential norms. It is the Consultants' opinion, that if a banking institution meets all of the requirements under the LAW and conforms with NBRK prudential norms, it should not be penalized for being small, rural and undercapitalized, not in the financial sense of capital adequacy but in the legal sense of having capital of less than the minimum required for SLBs. Liquidity in rural communities is very limited and it would very difficult to organize or increase an existing bank's capital to meet the minimum requirement of USD $500,000. Secondly, is there really a need for, and could the community support, an institution of this size? Rather than closing these banks, a sounder approach would be to limit their activities though restrictions on their operations. Based on this approach, the Consultants propose the following framework for establishing second-tier rural banks with limited activities.

1. Purpose

304. The purpose is to promote the establishment of rural banking institutions and non-banking financial institutions that will provide financial services to the rural population.

2. Qualifications

305. Any new banking institution or conversion of existing banking institution, located outside of Almaty, and in an area classified as rural by NBRK could become a second tier rural bank with limited powers. When considering what constitutes a rural area, the NBRK should look at the proximity to rayons and villages and the current supply of banking services in the location requested.

3. Licensing Requirements

306. A new bank that wants to be classified as a second-tier rural bank with limited activities must obtain a license as outlined in the LAW. Any existing bank that wishes to convert to a second-tier rural bank with limited activities, must submit a request to NBRK, as stipulated in the LAW, asking permission to be re-classified as a second-tier rural bank.

4. Restrictions

307. These second-tier rural banks will have the right to conduct the following operations as stipulated in Article 30 of the LAW:

- Acceptance of deposits from physical and legal entities;
- Ability to make loans in local currency to physical and legal entities that hold deposits in the bank; the bank is not allowed to lend to other banks or non-banking financial institutions;
- Transfer of funds in local currency;
- Purchase of NBRK and Government debt instruments; and
- Establishment of branches with NBRK prior approval, based on the expected profitability of offering banking services in that location.

5. Regulations

308. Banking activities of these second-tier rural banks would be regulated by NBRK and subject to all actions and requirements under the LAW.

6. Prudential Norms

309. Second-tier rural banks would have to comply with prudential norms in accordance with Article 42 of LAW. The following exceptions would be allowed:

a. Minimum Charter Capital

310. The Consultants believe that there should be no minimum statutory capital. The decision to license should be based on the quality of the business plan, proposed management structure and the financial stability of the organizing parties.

b. Capital Adequacy

311. The bank's capital ratio should not be less than 20 percent. Based on a minimum USD $60,000 start-up capital, the bank would be allowed a ceiling of USD $300,000 in risk-based assets. The capital ratio was set at a high rate based on the high amount of risk concentration the banks will incur. The 20 percent requirement will also restrain growth within prudent levels. These banks could subsequently increase their capital as profits increase. The capital ratio would decrease by 1 percentage point each year the bank earns a profit, until it reaches 10 percent, which is the minimum recommended by the consultants. No additional banking activities will be given to any of these banks until they reach the current minimum capital of USD $500,000 .

c. Maximum Risk Per Borrower

312. Maximum exposure to one borrower and their related interests must not exceed 10 percent of total capital and there should be limits placed on insider and special relationship loans as determined by NBRK regulation. This restriction should encourage the bank to diversify its portfolio.

d. Liquidity

313. The banks must maintain not less than a 20 percent liquidity ratio as stipulated by the NBRK.

e. Foreign Exchange Exposure

314. Second-tier rural banks will not be allowed to operate in foreign currencies.

7. Other Restrictions

315. The banks should comply with NBRK loan classification and reserve procedures and meet the NBRK timetable for implementation of the new chart of accounts and internationally accepted accounting standards.

8. Incentives

316. Any new institution qualifying as a second tier rural bank should be allowed a one-year tax holiday if it can show proof to the NBRK that the branch has an average level of month end loans outstanding to month-end deposits of at least 50 percent. The loans would have to originate in the bank's surrounding areas. This incentive will discourage the current practice of moving rural funds into urban areas. This incentive would not apply to existing rural financial institutions.

D. Credit Union System

1. Outline

317. There is also a potential role for credit unions (CUs) in the delivery of rural financial services. These CUs, however, must be established as a result of the efforts of the community in which they are located. CUs will fail if they are imposed on a community or established as a means of channeling targeted credits to end-users. Properly established and supervised, CUs are an efficient way of providing a broad range of smaller-scale saving and lending services to a limited group of people. They also provide healthy competition for banks, resulting in generally better financial services for rural communities.

318. There currently does not exist any type of CU in the RK. This can be explained by the following factors.

- lack of institutional legislation that allows the formation, operation and regulation of CUs;
- lack of Government and western donor support for CUs;
- lack of public knowledge and information concerning CUs; and
- lack of interest from rural associations, farmer groups and other savings and credit groups.

319. Credit unions or savings and credit cooperatives, are base-level financial institutions that provide savings and credit services to their individual members. As cooperatives, they are organized and operated according to basic cooperative principals: (1) there are no external shareholders; (2) the members are the owners of the institution and (3) each member has the right to no more than one vote in the organization. The policy-making leadership is drawn from the members themselves, and in most CUs these positions are unpaid. Larger CUs, however, tend to have paid managers and staff.

320. Membership eligibility in a credit union has traditionally been defined in terms of a common bond that restricts membership to a group of people who have some natural affiliation with one another. The argument is that restricting membership to people who are known to other members of the group reduces credit risks and provides peer-pressure incentives to meet loan payment obligations. Closed common bonds limit membership to a clearly defined group of people; the bonds may be in the form of employment, occupation, community, trade union or local area of residence.

321. Several potential bonds exist in rural Kazakstan: private farmers' associations; cooperative farm groups; members of collective farms; residents of rural communities and their surrounding areas. The stronger the bond the more successful the CU is likely to be. Successful financial intermediation requires diversity to spread risk and mange seasonal and cyclical variations in borrowing and savings patterns. Farmers tend to have similar seasonal borrowing and savings patterns and are subject to the same risk factors. Thus, limiting the CU to a specific bond could have adverse affects on the ability of borrowers to repay loans if all of the members face the same risk.

322. CUs tend to serve low-income people, providing a basic set of services that low-income members find valuable because they do not have access to these services through existing formal-sector alternatives. CUs are single-purpose cooperatives that specialize in providing financial services to members. Savings and relatively short-term installment credit are the two principal financial services offered by credit unions.

323. CUs develop both a savings and a loan relationship with their members. The savings relationship is the key to the eventual loan relationship. Although savings have been the entry point for credit union members, provision of low-cost loans is the predominant credit union philosophy. Savings are made in the form of local currency shares and nonshare savings funds from members. Shares can be redeemed only when the member withdraws from the credit union itself. Dividends, rather than interest, are paid on these shares and only at the end of the fiscal year.

324. The role of the credit union is to attempt to serve the members' requests, not to evaluate them, except as they relate to the members' ability to repay the loan. Credit union financing serves the entire spectrum of member activities; it is not targeted toward specific ends or limited as to purpose. Demand for credit in such situations is inevitably for a mixture of family and enterprise purposes. Loan decisions are based on character. Because loans tend to be small, they tend to be treated as personal rather than business loans and require little collateral. Most loans are limited to a multiple of a member's savings, so that at least part of the loan is guaranteed by the savings balance. The use of other members as cosigners is the other principal guarantee mechanism.

325. As cooperatives, credit unions are owned and operated by their members, who are also the beneficiaries or clients. The people who are saving and borrowing are also those making the basic decisions on interest rates, terms and other policies.

326. Recognizing the fact that the current banking system in Kazakstan has been slow to respond to the rural sector and will not increase its awareness in the foreseeable future, there is considerable interest in the promotion of CUs as an alternative to other formal sector financial institutions.

2. Proposed Draft Decree on Credit Unions

327. In response to the request of the NBRK, the Consultants have prepared a draft decree on CUs and model bylaws. These two documents are attached in Appendix 5. The proposed decree is based on the *Content Guide for Laws Governing Credit Unions*, which was published by the World Council of Credit Unions in 1994 and adapted to the situation in Kazakstan. Additional information was obtained from the *International Digest of Laws Governing Credit Unions*, published by the World Council of Credit Unions in 1993. The remaining items will need to be developed in Stage 1 of the Proposed Project implementation.

- Standard Forms;
- Chart of Accounts; and
- Regulations under the Decree.

328. Credit Unions will be required to register as Consumer Co-operatives as established by the *Kazakstan Civil Code*. This form of legal entity was chosen because it was the closest legal entity that resembled the requirements, organization and actions of a CU. The following two amendments to article 108 of the Civil Code will need to be made in order for CUs to qualify as consumer co-operatives.

- Section 2 needs to be removed because losses are addressed in Section 7.15 of the proposed Decree on Credit Unions; and
- Section 4 needs to be changed to read; income received by a consumer co-operative *may* be distributed amongst its members in the form of dividends or it may be used to increase charter capital.

The legal definition of Consumer Co-operatives as it appears in Article 108 of the Civil Code is included in Appendix 6.

3. Strategy for Developing CUs

329. The formation of a CU system should be a long term goal in the rural financial sector reform policy of the NBRK and the organization of CUs should not be forced upon associations and other small consumer organizations to meet target or project goals. In the Consultants' Project Proposal there are specific stages of implementation that will need to followed in order for CUs to have a lasting, long term effect on rural financial intermediation.

VII. Legal Dimensions of Rural Finance

A. Effect of the Banking Law on Development of Rural Financial Institutions

330. In order to promote growth in the rural sector and to combat the scarcity of rural finance, the NBRK and the government have made it a priority to promote the establishment of rural banking institutions and non-banking financial institutions (NBFI). Each of these institutions will be regulated by LAW and must comply with stated prudential norms. Legislation concerning non-banking financial institutions is currently being developed by an ADB technical assistance project at the NBRK. The definition of NBFI as stated in Article 5 of the LAW is as follows:

> *"A non-banking financial institution is a legal entity that is not a bank, but on the basis of receiving a license from the NBRK, is authorized to perform certain banking operations."*

331. Article 5, as envisioned, includes pension funds, insurance companies, credit unions, credit co-operatives, and all other forms of non-banking financial institutions. The purpose of Article 5 should be examined as it relates to the NBRK's supervision of these entities. The NBRK is attempting to avoid the creation of third-tier financial institutions that operate outside of the allowable banking activities stipulated in Article 30 of the LAW. The key activity that ties all banks and non-banking financial institutions together is the ability to accept deposits from physical persons and legal entities. A deposit as defined in Article 2 of the LAW refers to:

> *"... a sum of money given by one entity to another entity on the condition that the given sum must be returned in its nominal form with the addition of an increment that was agreed upon at the time of exchange.*
>
> *Irrespective of the name of the transaction and the intentions of the parties, the receipt of a deposit is:*
>
> *(1) The issue of documents in confirmation of the monetary means received, not connected with the sale of goods, the performance of work or the rendering of services and on the conditions of the prompt return of the monetary means in exchange for the given documents; and*
>
> *(2) The sale of securities on the conditions of obligation to repurchase them."*

332. If a non-banking financial institution is structured to accept deposits as defined above, it must comply with all articles and regulations under the supervision of the NBRK. The NBRK is empowered to regulate the activities of these non-banking financial institutions for the protection of depositors.

333. The statutory capital required from banks affect the development of rural financial institutions. As of January 1996, all new banking institutions applying for a banking license were required to have a minimum statutory capital of USD $3 million. All banks currently licensed were not required to comply with the new statutory requirement but were grandfathered to the 1995 regulation that stated that all banks must have a minimum of USD $500,000 in statutory capital to conduct restricted operations in Tenge. In addition, these banks were restricted from opening or operating any branches. All banks not meeting the minimum capital requirement of USD $500,000, must submit plans to the NBRK that illustrate methods to increase their statutory capital. This plan was a part of the International Standards Program Plan (ISP). All banks headquartered in Almaty had until 1 July 1996 to submit their ISP to the NBRK and banks located outside of Almaty were required to submit by 1 October 1996.

334. Since September 1994, the number of banks has decreased from a high of 191 to the present level of 102. The number of banks remaining which had headquarters outside of Almaty is 45. The decrease can be attributed to more stringent bank supervision and reporting requirements, as well as the ability of the NBRK to invoke conservatorship, receivership and liquidation procedures on banking institutions. The NBRK's goal is to continue prudential norms enforcement through strict supervision in order to continue the closing of non-sustainable and non-competitive banking institutions and to reduce the number of institutions to a manageable level.

335. The increase in the statutory capital requirement for new banks, rigid licensing requirements and the lack of liquidity in rural communities, have contributed to the lack of investor interest in starting a new bank with the primary purpose of providing banking services to the rural sector. As confirmed by the NBRK banking supervision department, 26 banks located outside of Almaty did not meet the new capital requirement of USD $500,000. These are small institutions with only one office located a rural community.

B. Other Legislation Affecting Rural Finance

336. Over the past four years, the government has drafted numerous laws and regulations governing the financial sector. Appendix 7 lists all government legislation that the Consultants have referred to for the Study.

VIII. Rural Banking Experiences in Selected Countries

A. Rural Banking

337. The usefulness of comparative experiences rests on the fact that finance has universal characteristics and financial markets have similar problems, regardless of location. Best practices similar around the world, and failure shares common characteristics. However, there does not seem

to be any ideal institutional structure for financial intermediation that is suited to all countries and all financial markets. Local adaptations and variations, reflecting historical factors and market characteristics, have to evolve, and discoveries have to be made on how best to survive and prosper.

338. Experiences with rural banking in most countries have not been entirely satisfactory. Most countries have been afflicted by crises that have undermined the sustainability of rural financial arrangements. While in many cases systems have worked reasonably well for certain periods of time, they have often been overtaken by risk. The risks rural lenders face consist of those associated with rural production as well as political risks. Examination of successes provides some useful information, but investigation of risks and failures offers insights that are essential for the design of durable financial institutions.

B. Summary

339. A number of important lessons can be drawn from the experiences cited in Appendix 8 and other experiences in rural banking. These are summarized as:

1. credit project failures outnumber successes: starting is easy, sustainability is hard;
2. many credit schemes begin well but deteriorate over time;
3. repayment discipline can be difficult to establish and sustain;
4. credit systems may suffer in economic crises or times of rapid change;
5. political intervention usually makes things worse;
6. good banking practice can be applied in rural areas;
7. savings-funded systems offering a variety of financial services seem sustainable if they achieve economic scale;
8. group lending is a popular mechanism for reaching poor borrowers; and
9. women are generally more reliable borrowers than men.

IX. Summary of Recommendations for Rural Finance

Constraint	Recommendation	Action Needed	Implementation Results
Capacity of Financial Institutions	• training as identified in Table 2, Part II: Micro-Finance, business of banking, law of banking, credit operations, business plans, enterprise accounting, MIS, management in banking and supervision • privatization of Narodny Bank	• ADB funding for Proposed Project • participation in existing donor training • individual bank initiative	• better skilled bank staff • improved assessment of risks in lending • enhanced agri-lending • sector diversification of loan portfolio • improved portfolio quality • resumption of term lending • improved loan supervision and recovery methods
Lack of Rural Financial Institutions	• encourage second tier banks with limited activities • facilitate formation of CUs • create sustainable NGOs • promote new associations of farmers and entrepreneurs	• NBRK approval for second tier banks with limited activities • NBRK approval for CU legislation • ADB support for viable NGOs though Proposed Project • ADB support for Proposal Project	• increased rural lending • growth in savings mobilization • additional rural access to financial services • growth in rural and agricultural sector • attention to disadvantaged groups • functioning CUs
Unrefined legislation	• formation of CUs • provisions for alternative financing mechanisms	• NBRK approval for CU legislation • ADB technical assistance to develop legislation for alternative financing mechanisms	• legal basis for sustainable institutions • expand local and national tax base
Framework for Secured Lending	• change new bankruptcy legislation to protect secured creditors • create registries of borrowers, property and pledges	• GOK review and approval of the changes • Donor support for establishment of registries	• certainty of collateral • certainty of ownership • reliable and accurate information • mechanism for enforcement
Interest Rates	• determine and protect an adequate spread • loan and deposit instrument pricing • establishment of ALM • decrease subsidized lending through GOK or NBRK policies	• ADB funding of Proposed Project • participation in existing donor training • bank initiative in MIS • use of market rates and eliminating ceiling on credit auction rates	• sustainable institutions • increased savings mobilization • development of term lending • decreased incentive for default • increased income potential for institutions • rationality in short term and long term rates

Constraint	Recommendation	Action Needed	Implementation Results
Insolvent and Illiquid Farms	• detailed restructuring plans • assistance in resolving technical and commercial problems	• ADB funding of Proposed Project • GOK support for reforms and farm restructuring	• improved farm viability • creation of farm support services • expansion of tax base • decrease in GOK subsidies • swifter return to bankability
Lack of Alternative Financing Mechanisms	• finance leasing • out-sourcing • tied financing • warehouse receipts	• ADB funding of Proposed Project • GOK support for mechanisms	• free-up working capital • reduce reliance on bank financing • provide opportunities for farm support services • new security instruments
Oblast Administration Intervention	• formalize as Project steering committee • facilitation of wholesale marketing operational framework	• Implementation of ADB Project Proposal	• decreased influence on distribution of credit • increase access to inputs for farmers • market directed forces increasingly dictating farm gate prices • decrease in self-sufficiency program
Insufficient Savings Mobilization	• create public trust in banks • strengthen confidence in Tenge deposits • maintain positive real interest rates • reduce transaction costs • provide sufficient liquidity for payouts • create CUs	• ADB funding for Project Proposal • bank training • promotion by NBRK and Kazak Bankers Association • NBRK approval for CU legislation • GOK macro-economic policies	• increase in savings balances • lending to rural micro and small enterprises • sustainable financial institutions • rational interest rate incentives • decrease in non-interest costs for banks • more rural savings invested in rural activities
APB (Kazagroprom Bank)	• rationalize pricing of loan and savings instruments • diversification of loan portfolio • improve oversight of branches • continue training of staff • continue reduction in overhead expense ratio • increase supervision of past due accounts • reorganization of Board	• participates in ADB Project Proposal • bank initiatives • donor training • pilot project developed by bank	• increased income potential • reduction in bad debt • upgrading of bank staff skills • improved assessment of risks in lending • enhanced specialization in agri-lending • diversification of loan portfolio to different sectors • improved quality of portfolio • term lending • improved supervision and recovery methods

Constraint	Recommendation	Action Needed	Implementation Results
Narodny Bank	• privatization of bank • rationalize pricing of loan and savings instruments • expand and diversify lending portfolio • develop new loan procedures and policies • continue training of staff • continue reduction in overhead expense ratio	• participates in ADB Project Proposal • bank initiatives • donor training • pilot project developed by bank	• upgrading of bank staff skills • improved assessment of risks in lending • enhanced specialization in agri-lending • diversification of loan portfolio to different sectors • improved quality of portfolio • term lending • decentralized lending • increased income potential
ASF (Agricultural Support Fund)	• removal of credit granting privileges • upgrading the quality of assessment of farms • training of staff	• participating in ADB Project Proposal	• reduced subsidy cost • formal repayment schedules based on cashflow • earlier retirement of debt • regularized repayments of loan principal and interest • regular income to meet costs • upgrading of staff skills

Appendices to Final Report Part 1: Rural Finance

Appendix 1 - Technical Assistance Matrix for Financial, Agriculture and Rural Sectors

Technical Assistance Matrix for the Financial, Agriculture and Rural Sectors

Area of Assistance	Donor	Project
Report on Agricultural Sector Reforms	ADB	Complete
MOA Re-organization	ADB	Follow up assistance planned
Land Reform	World Bank	Assist in creating a legal register of land and real estate, training and legislation
Irrigation	World Bank	Support of irrigation and drainage rehabilitation and improvement
	ADB	Development of new irrigation systems in South Kazakstan
Farm Restructuring	World Bank	Planned assistance in farm restructuring and support of private farms and rural enterprises in 1997
	ADB	Pilot Project planned for 1997
	EU-TACIS	Pilot development of private farming and food processing in Akmola
Agricultural Markets	ADB	TA for development of market mechanisms
	EU-TACIS	Support for reorganization of food processing in Akmola Oblast
	EU-TACIS	Pilot projects with agricultural enterprises in animal production and fresh produce
	Netherlands Foreign Assistance	Assistance in development of potato farming. Operated by HIVOS
Private Farmers	USAID	Farm planning assistance to private farmers in Taldy-Korgan and South Kazakstan. Operated by VOCA
	EU-TACIS	Support for private farmers through Farmer Credit Fund
Agricultural Equipment Supply	EU-TACIS	Improvement and reorganization of production and servicing of farm and agro-industrial equipment.
Micro-Credit	UNDP	Aral seashore rehabilitation and capacity building program
	USAID	Micro-credit program in Taldy-Korgan. Operated by VOCA
Rural Credit	ADB	Study on rural credit & savings
Non-Bank Legislation	ADB	Assistance in developing legislation for non-banking financial institutions
Banking Supervision	USAID	Assistance in developing bank supervision department and NBRK supervision regulations
	World Bank	Assistance in developing training bank examiners

Appendix 2
SLBs: Number and Branch Offices, By Regions and Grouping of SLBs by Capital

Table 1

SLBs: Number and Branch Offices, By Regions

	November 1995		March 1995		April 1996		October 1996	
	Banks	Branches	Banks	Branches	Banks	Branches	Banks	Branches
Akmola	5	49	5	49	5	49	5	50
Aktubinsk	7	63	7	63	7	63	6	60
Almaty	2	44	2	44	2	44	2	43
Almaty (City)	68	49	67	45	67	45	56	42
Atyrau	1	37	1	37	1	37	1	36
East Kazakstan	2	53	2	53	2	53	2	52
Jambyl	7	65	6	61	3	61	3	58
Jezkazgan	3	40	4	40	4	40	3	38
Karaganda	3	54	3	54	3	54	2	52
Kyzylorda	1	35	1	34	0	34	0	33
Kokshetau	1	52	1	51	1	51	1	50
Kostanai	4	61	4	60	4	60	3	60
Mangistau	1	25	1	25	1	25	1	23
Pavlodar	6	64	6	63	6	63	6	60
Semipalatinsk	1	59	1	59	1	59	1	58
North Kazakstan	0	46	0	46	0	46	0	45
Taldykorgan	5	52	4	52	2	52	1	50
Torgai	1	33	1	32	1	32	1	32
West Kazakstan	1	55	1	55	1	55	1	51
South Kazakstan	11	100	10	90	7	86	7	83
Total for Republic	130	1036	127	1013	118	1009	102	976

*NBRK Statistics from November 1996

Table 2

Grouping of SLBs, By Actual Capital

Actual Capital Composition	# of Banks			
	February 1996	March 1996	April 1996	October 1996
< 1 million Tenge	21	24	24	11
1 to 5 million Tenge	27	27	22	13
5 to 10 million Tenge	8	7	9	4
10 to 15 million Tenge	3	3	3	2
15 to 20 million Tenge	9	5	4	4
20 to 25 million Tenge	5	4	5	5
25 to 30 million Tenge	3	4	3	3
30 to 80 million Tenge	17	21	19	21
80 to 130 million Tenge	21	20	23	22
>130 million Tenge	16	16	15	17
Total	130	131	127	102

Appendix 3 - International Standards Program (ISP)

International Standards Program

The International Standards Program requirements and the phased-in benchmarks for all banks are set forth below. Banks that demonstrate the ability to meet international standards and have their improvement plan approved by the NBRK will be eligible to apply for a license for expanded banking activity prior to actually meeting the international bank standards. The program is intended to bring the banks to the international level in the following areas:

- Capital Adequacy
- Asset Quality
- Quality of Management
- Accounting Systems

The improvement plan mentioned above must address all areas of a bank's operations that currently exhibit any weaknesses and lay out a realistic plan to eliminate these weaknesses, including specific time frames to reach the required condition by the end of 1998. Once approved by the NBRK, compliance is mandatory and non-compliance will result in enforcement actions.

Beginning 1 August 1996, all banks complying with the below prudential ratios and who are enrolled in the 3 year program of transition to international standards will be allowed to participate in the following activities:

- Own stock in investment banks
- Accept deposits from individuals
- Participate in NBRK credit auctions
- Conduct international operations
- Participate in foreign loans that are guaranteed by the government
- Issue bonds, certificates of deposit, and checks
- Act as custodian in corporate securities market

Banks which are not in compliance with NBRK established standards and which are not included in the program, are deprived of the right to perform the above specified activities effective 1 August 1996. Failure of a bank to be included in the program to implement the improvement plan may result in the suspension of its license to conduct the above specified activities as well as other enforcement actions as provided by law.

Accounting Standards:

By 1 July 1996, implement the new chart of accounts for commercial banks and submit audited financial statements as of end of December 1996. These financial statements must be verified by an NBRK licensed auditor and based on prudential norms and the new chart of accounts.

Capital Adequacy:

All banks shall maintain not less than 4 percent tier one capital to assets; and not less than 8 percent tier one capital plus tier two to risk-weighted assets. Risk weights for various classes of assets follow the international standard.

Liquidity:

All banks shall maintain a current liquidity coefficient, defined as the ratio of the sum of cash and high liquidity assets to the sum of demand liabilities of not less than 20 percent.

Asset Classification:

All banks must implement and fully provision based upon standards established by NBRK.

Loan Portfolio Diversification:

All banks shall limit loans to one borrower and their related entities to 25 percent or less of the bank's Tier I and Tier II capital. If the borrower is an insider or affiliated with the bank, then the maximum exposure cannot exceed 10 percent of the bank's capital.

Approval Process:

All banks that desire to participate in the program will make application to the NBRK. The application can be made at any time prior to 1 July 1996 for banks in Almaty and 1 October 1996, for banks outside of the city. Each such application will be accompanied by a bank improvement plan that describes in detail how the bank's management will achieve the international bank standards of the NBRK. Each plan will be reviewed by the Bank Supervision Department of the NBRK for its viability and reasonableness. The primary purpose of the plan is to cause management of the bank to focus on how the bank will accomplish the goal of meeting international bank standards, to set benchmarks for partial compliance and to establish a reporting system, and as an early warning device through which the NBRK banking supervision department can monitor the progress of the banks.

NBRK shall have the right to ask for additional information concerning any bank's improvement plan and to request that a plan be modified or amended. No bank will be permitted to engage in any of the expanded banking activities until its improvement plan has been approved by the NBRK.

Appendix 4 - APB and Narodny Bank Balance Sheet as of 1 April 1996

Table 10

APB Balance Sheet as of 1 April 1996

Assets	Balance
Cash assets	108,713
Balances with NBRK	842,677
Due from other Banks	114,998
Securities	18,241
Loans & Leases	2,292,726
less: reserve for loan & lease loss	-203,368
Total Loans and Leases	2,089,358
Tangibles	1,421,784
Intangibles	11,868
Other Assets	405,192
Total Assets	**5,012,831**
Liabilities	**Balance**
Demand Deposits:	
legal persons	1,492,020
physical persons	167,133
Time Deposits:	
up to one year	262,756
over one year	136,628
Owed to NBRK	134,702
Borrowings from other Banks and Financial Institutions	236,549
Other Liabilities	863,209
Liabilities: Subtotal	**3,292,997**
Authorized Fund	200,000
Supplementary Capital	0
Earnings	40,691
Retained Earnings	-963
Other Funds	1,480,106
Total Capital	**1,719,834**
Total Capital and Liabilities	**5,012,831**

Table 16

Narodny Bank Balance Sheet as of 30 April 1996

Assets	Balance
Cash assets	1,417,897
Balances with NBRK	1,984,027
Due from other Banks	12,647,731
Securities	4,928,698
Loans & Leases	8,103,989
less: reserve for loan & lease loss	1,224,226
Total Loans and Leases	6,879,763
Participation in Equities of others	38,948
Tangibles	2,424,040
Intangibles	14,892
Other Assets	493,611
Total Assets	**30,829,607**
Liabilities	
Demand Deposits:	
legal persons	10,863,480
physical persons	6,187,034
Time Deposits:	
legal persons	1,912,897
physical persons	1,609,226
Owed to NBRK	104,640
Borrowings from other Banks and Financial Institutions	
Other Liabilities	3,680,591
Liabilities: Subtotal	**24,357,868**
Authorized Fund	761,797
Premium on Stocks	844
Earnings	3,063,265
Retained Earnings	437,224
Other Funds	2,208,609
Total Capital	**6,471,739**
Total Capital and Liabilities	**30,829,607**

Appendix 5 - Draft Decree on Credit Unions and Model Bylaws

Draft Decree on Credit Unions in Kazakstan

Section 1. Preliminary

Title of Decree

1.1 This decree provides for the registration, operation and supervision of co-operative savings and credit societies to be known as Credit Unions (CUs) and define their powers, and for the registration, operation and supervision of a Federation of CUs and define its powers.

Application to Other Acts

1.2 This decree is issued under the authority of Article 5 of the Law on Banks and Banking Activity in the Republic of Kazakstan.

1.3 The provisions of this Decree are subject to the provisions of the Civil Code insofar as they relate to all business transactions of credit unions. CUs must register as **Consumer Co-operatives** in terms stipulated in the Civil Code. The NBRK may issue regulations providing for the implementation of this Decree.

1.4 This decree takes effect in its entirety upon enactment by NBRK and approval by the President of Kazakstan.

1.5 This Decree repeals the October 1995, "Temporary Regulation Concerning Credit Partnerships" and all provisions relating to Credit Partnerships.

Section 2. Definition of Credit Union

2.1 A CU is a co-operative financial organization, organized for the purposes of promoting thrift and savings among its members, creating a source of credit for them at rates of interest set by their board of directors, and providing an opportunity for them to use and control their own money on a democratic basis in order to improve their economic and social conditions. As a **Consumer Co-operative organization**, a credit union conducts its business for the mutual benefit and general welfare of its members with the earnings, savings, benefits, or services of the credit union being distributed to its members as patrons.

Interpretations and Definitions of Terms

2.2 In interpreting this Decree, the following definitions, which are not intended to be inclusive, shall apply unless such application would produce a result clearly inconsistent with the context of the Decree's provisions:

Capital; the aggregate of all fully or partially paid in full share-saving units, together with all reserves and surplus.

Federation of CUs; a organization whose members consist solely of credit unions and whose purpose is to promote CU interests and co-operation.
Share-saving unit; a balance held by a CU and established by a member.
Shareholding; the ownership of one or more fully paid share-savings units.
Borrow or borrowing; means the incurring of debt by the CU from sources other than its members.
Regulation; a regulation issued by the NBRK.

Section 3. Organizing a Credit Union

Organizational Procedure

3.1 Any twenty or more residents who are physical persons, citizens of Kazakstan and have an additional common bond based on common interests as defined in section 5.3 may organize a CU.

3.2 The founding members must:

- Execute an application for registration in the form prescribed by NBRK; and
- Adopt bylaws consistent with this Decree, and with the Civil Code, to govern the CU.

3.3 The application must state the proposed CUs name, the location of its principal of business, and the names and addresses of the founding members.

3.4 In accordance with sections with sections 6.2 and 6.13, the founding members must select the required number of persons to serve on the board of directors and the supervisory committee. In accordance with section 6.9, the newly formed board of directors must appoint the credit committee. The proposed board and committee members must sign a statement agreeing to join the CU as a member and to serve in the designated positions.

3.5 The founding members shall forward to the NBRK the application for registration, together with the proposed bylaws, the agreements to serve, and a business plan demonstrating the proposed CUs ability to attain economic viability within a reasonable period of time.

Criteria for Registration

3.6 The NBRK must act upon the application for registration within 60 calendar days. A certificate of registration will be issued if the application and bylaws conform with the Decree and the NBRK is satisfied with:

- the characteristics of the common interest described in the application, the proposed bylaws and the business plan, are favorable to the economic success of the proposed CU; and
- the qualifications of the persons who have agreed to serve on the board and committees provide assurance that the CUs affairs will be properly administrated.

3.7 If a certificate is issued, the NBRK shall return a copy of it, together with the approved bylaws, to the founding members for preservation in the permanent records of the CU. If a certificate is denied, the NBRK must notify the founding members and set forth the reasons for denial. Once the objections have been addressed, the application may be filed again. The decision of the NBRK is final.

3.8 No CU may conduct any type of business until a certificate of registration from the NBRK has been received by the founding members and each of the founding members have been fully subscribed for one paid share-saving unit.

Organization Application and Bylaws

3.9 To facilitate the organization of CUs, the NBRK should prepare standard forms of application for registration, agreements to serve as CU officials, and model bylaws.

3.10 Bylaws may be amended in accordance with the procedure specified in the bylaws. Proposed amendments must first be approved by the NBRK, who must act upon the request for approval within 60 calendar days.

3.11 The bylaws of a CU shall bind the CU and its members to the same extent as if every member had subscribed his or her name to the bylaws.

Use of Name, "Credit Union"

3.12 Every CU registered under this Decree must include the words "credit union" in its official name. No CU may adopt a name that is either identical to the name of another CU, or so similar as to be misleading or cause confusion. In such a case, the NBRK shall deny registration.

3.13 Only a CU registered under this Decree may use the name or title containing the words "credit union", represent itself as a CU and conduct business as a CU. However, a Federation of Credit Unions may use the word "credit union" in its name.

3.14 Violations of sections 3.12 and 3.13 constitute an offense punishable by fine and or imprisonment as determined by NBRK regulation.

Fiscal Year

3.15 The financial year of each CU should be determined by the decision of the Board of Directors.

Section 4. Powers of Credit Union

General Powers

4.1 As provided in Section 1.3, CUs must register as **Consumer Co-operatives** and may exercise all powers inherent in such entities and as may be relevant to CU operations. A CU shall have the powers to

- acquire, lease, hold, assign, pledge, mortgage, discount, or dispose of property or assets;
- enter into contracts;
- set interest rates and fees;
- operation of local currency accounts with second tier banks;
- purchase and sale of NBRK and Government debt instruments;
- obtaining, or assisting members to obtain life, property or other insurance issued by insurers licensed to operate in Kazakstan;
- institute and defend law suits and other legal proceedings;
- borrow and give security from any source, subject to the limitation imposed by Section 8.7;
- issue share-saving units and provide loans to members in local currency; and
- exercise those incidental powers as may be necessary to enable it to carry out effectively the purposes for which it is organized.

Section 5. Membership of a Credit Union

Field of Membership

5.1 CUs may serve only its members. A person must be a member in order to save, borrow or obtain other services from the CU.

5.2 The bylaws of a CU will prescribe the requirements for membership, including the common interest, the number of share-saving units to be subscribed, and any membership fees to be paid.

5.3 To become a member of the CU, a person must belong to a common interest group as set out in the bylaws. The common interest must consist of a an existing common bond of association or community of interest among a group of persons who belong to the CU. It may include, but need not be limited to persons:

- who have a similar occupation or profession or are employed by a common employer or within the same business district or market area;
- who have a common membership in an association or organization, including but not limited to religious, trade union, social, co-operative, labor, farming or educational groups; and
- who reside within the same defined community, rural or urban district, or political subdivision.

5.4 Any person who has declared bankruptcy or who has been convicted of financial crimes cannot be a member of a CU.

Others Eligible for Memberships

5.5 Person belonging to the immediate family of a CU member may also be admitted to membership in the CU in their own right by subscribing for at least one fully paid share-savings unit, provided that members who have not yet attained the age of legal majority may not borrow from the CU and may not

vote at any meeting of its members. Immediate family includes spouse, parents, brothers and sisters, and children of a member, and any other relative living together with the member in the same household.
5.6 Societies, associations and partnerships composed primarily of individuals eligible for membership under Section 5.3 may be admitted to membership of a CU.

Admission to Membership

5.7 The board of directors must act upon applications for membership or appoint one or more membership officials to take such action on its behalf. A person denied membership by a membership official may appeal to the board of directors.

Termination of Membership

5.8 The bylaws of a CU shall specify the conditions under which a person's membership in the CU shall cease. The bylaws may permit a member who no longer has the required common interest to retain membership under reasonable conditions.

5.9 Any member may be expelled by a two-thirds majority vote of the members present at an annual or special meeting, but only after proper notice and an opportunity has been given to the member to be heard.

Liability of Members

5.10 A member of a CU is not personally liable for the payment of the debts or liabilities of a CU, except to the extent, if any, of the unpaid balance on shares-saving units held by the member.

General Meetings of Members

5.11 The annual general meeting of the members will be held at the time, place and in the manner indicated in the bylaws, except that the meeting must be held no later than 3 months after the close of the financial year. The bylaws shall also provide for the calling of special meetings by the members, by the board of directors, and by the supervisory committee. The bylaws shall specify the minimum number of members that must be present to conduct the business of any meeting of the members.

5.12 At all such meetings, a member shall have only one vote, irrespective of the number of share saving units owned. No member may vote by proxy, but a member may vote by absentee ballot or other method if the bylaws of the CU so provide. Where an association, organization or partnership is a member, it may be represented and have its vote cast by a designated member.

5.13 Members having arrears at any time during the twelve (24) months prior to a meeting of members are not eligible to vote. Arrears are defined for this purpose as any payment due the credit union that is not received by the due date.

5.14 Following the first twelve (12) months after the date of approval by NBRK of a credit union's charter members' voting eligibility and power is determined by their status as a net borrower or a net

saver. Net borrowers are members whose borrowings from the credit union exceed their savings in the credit union. Net savers own savings held by the credit that exceed their borrowings from the credit union. A member's status is determined at the end of each month as the difference between the value in Tenge of the member's share saving units plus redeemable shares, and the value in Tenge of the member's loans outstanding from the credit union plus any interest due, as recorded at the same month-end. Members who are net borrowers for six months or more during the credit union's previous financial year are not entitled to vote. Otherwise eligible members who were net borrowers for less than six months during the credit union's previous financial year are entitled to one-half of one vote. Otherwise eligible members who are not net borrowers at any time during the credit union's previous financial year are net savers, entitled to one vote.

5.15 In the event that fewer than twenty (20) members are eligible to vote, eligibility shall be expanded to include additional members up to a maximum of twenty (20) persons, excluding members disqualified by arrears, length of membership and age. Selection of additional members shall be determined by ranking members who were net borrowers for more than six months during the credit union's previous financial year. These members will be ranked by their net saving and net borrowing positions at the end of each month during the credit union's previous financial year. Their rank will be determined by the sum of their month-end net savings positions less the sum of their month-end net borrowing positions. Ranked in descending order by the excess (or deficit, if there is no excess) of net savings over net borrowings, additional members will be declared eligible to vote until the sum of those eligible to vote equals twenty (20) persons. Members declared eligible to vote as a result of this procedure may cast one-half of one vote each.

5.16 At the annual general meeting, the members shall elect from among themselves the members of the board of directors and the supervisory committee.

Section 6. Management and Administration

Authority of Board of Directors

6.1 The board of directors is responsible to the members for directing and controlling the business, funds and records of the CU. It reports annually to the members on its management of the CU.

6.2 The board consists of an odd number of directors, not fewer than 5, elected by the members as provided in the bylaws. The term of appointment of directors and the appointment of the chairman of the board shall be determined by the bylaws.

6.3 The members of a CU may by majority vote taken at the annual general meeting, or at a special meeting at which proper notice has been given in accordance with the bylaws, dismiss one or more directors, and appoint another or others in the place of those dismissed.

6.4 Unless otherwise provided by the bylaws, the board meets monthly and on other occasions as is necessary. The bylaws shall specify the quorum required to conduct meetings of the board and of committees.

Executive Officers

6.5 At the first meeting of the board of directors, and at the first board meeting to be held within 30 days after every annual general meeting, the directors shall elect from their own number a chairman, a treasurer and a secretary, who shall be executive officers.

6.6 The terms of executive officers shall be one year or until their successors are chosen. The duties of executive officers shall be set out in the bylaws.

6.7 The executive officers may be designated by the board of directors as an executive committee and be delegated authority to act on behalf of the board between board meetings subject to any conditions or limitations prescribed by the board.

6.8 The board may appoint other officers or committees as necessary to conduct effectively the business of the CU.

Credit Committee

6.9 The board of directors shall appoint a credit committee consisting of an odd number, not fewer than three persons, for such terms as the bylaws provide. The bylaws may provide that a director may also serve as a member of the credit committee. The credit committee is responsible for the provision and supervision of loans to members. It may approve or disapprove loans, subject to policies established by the board of directors, and review loan collections and delinquency.

6.10 The credit committee shall meet as often as required to consider applications for loans. No loan shall be made unless it is approved by a majority of the committee, except if approved by a loan officer as provided in section 6.11.

6.11 The board of directors may appoint one or more loan officers and delegate to them the power to approve certain loans. All actions taken on loan applications by a loan officer shall be reported monthly to the credit committee. A member whose loan application is declined by a loan officer may appeal the decision to the credit committee.

6.12 Approval of loans to officers, committee members, directors and employees is subject to the stipulations in Section 8.9.

Supervisory Committee

6.13 The annual meeting of members shall elect a supervisory committee of not fewer than three persons, which shall make, or cause to make, regular examinations of the accounts, records and affairs of the CU. In addition, the supervisory committee shall review the actions of officers, employees, directors and the credit committee for conformity with the law, regulations, bylaws and policies of the CU. No person who is a director, general manager or member of the credit committee may be appointed as a member of the supervisory committee.

6.14 The supervisory committee shall make a record of all its activities. This record shall be available for inspection by the NBRK and the CU's auditor, where one has been appointed. A report of the committee's activities shall be presented to the board of directors, the NBRK and the annual general meeting of the members.

6.15 The supervisory committee may by unanimous vote recommend to the board of directors that the board suspends or removes any one or more employees, the general manager, any one or more members of the credit committee or any one or more loan officers appointed by the credit committee.

6.16 The supervisory committee may by unanimous vote recommend to the members to suspend or remove any one or more members of the board of directors. A members' meeting must be held not less than 7 or more than 21 calendar days after the committee's recommendation was made. Seven days notice must be given to the director who is subject to the suspension or removal recommendation, and this person has the right to be heard at the meeting called to consider the recommendation. The members by a majority vote must act upon the recommendation at the meeting by approving, amending or declining the recommendation.

6.17 The supervisory committee, by a majority vote, may call a special general meeting of the members to consider any violation of the law, regulations or bylaws, or any practice of the CU deemed by the committee to be unsafe or unsound.

6.18 Before recommending the suspension or removal of any officer, director or credit committee member, the supervisory committee must have substantial reason to believe that such person has knowingly violated the law, regulations or bylaws, or has engaged in unsafe, unsound, or dishonest practices. The supervisory committee must notify the NBRK within 3 calendar days of any such recommendation, and within 28 days of any such recommendation of the action taken at the meeting called to act upon it.

External Audit

6.19 The supervisory committee shall have the financial statements of the CU audited within 60 calendar days of the close of the each financial year by a qualified, independent, professional auditor who meets the standards prescribed by the NBRK, provided that, on application by a CU, the NBRK may absolve the CU from the requirement for an external audit where such an audit is not considered feasible or economical, due to the size or financial position of the CU.

6.20 The auditor shall report on whether the financial statements present a true and fair view of the CU financial position at the end of the financial year, the financial performance for the full financial year, and whether the accounting records meet NBRK standards.

6.21 The auditor shall have access to all books, accounts, receipts, invoices and other documents of the CU. Officers, directors, committee members and employees must furnish the auditor with any information that the auditor may require for the purposes of Section 6.20.

6.22 The auditor shall furnish the audit report and any recommendations to the NBRK, the board of directors, the supervisory committee, and to the members at the annual general meeting.

Vacancies in Office

6.23 The board of directors shall fill any vacancies occurring in the board and supervisory committees until successors are elected at the next annual general meeting. The board shall also fill vacancies occurring in the credit committee.

General Manager and Employees

6.24 The board of directors may appoint a general manager to whom it delegates the authority and responsibility for managing the CU operations. The board may authorize the general manager to employ additional persons needed to administer the business of the CU. The remuneration, if any, of the general manager and other employees shall be determined by the board of directors.

Conflicts of Interest

6.25 No officer, director, committee member or employee of the CU may participate in the discussion of, or vote on, any matter affecting the financial interest of:

- that person;
- that person's immediate family; and
- any group or association in which that person has a direct or indirect interest.

That person must also disclose any conflict, or potential conflict, to the board of directors and the supervisory committee, as may be applicable. Any violation of this section shall be subject to the penalties prescribed by NBRK regulation.

Compensation

6.26 No director, or member of the credit or supervisory committee, may be compensated for services to the CU. Such persons may however be reimbursed for necessary expenses incurred incidental to the performance of the business of the CU.

Insurance on Officials

6.27 The board of directors shall, at the cost of the CU, purchase adequate fidelity bond or other appropriate insurance coverage against fraud, theft or dishonesty, for the general manager, other officers, committee members and employees or agents handling or having custody of CU funds or property. The NBRK may waive the requirements of this section.

Excluded Persons

6.28 A member who is an has or is presently going through bankruptcy procedures may not participate in the management of a CU. The bylaws of a CU shall determine the conditions, if any, under which a member who has been convicted of theft, fraud or any offense involving dishonesty, may participate in the management of a CU. Persons applying to become members of a CU shall disclose to the CU any fact that may limit or preclude their participation in the management of a CU. Non-disclosure of such information may at the discretion of the board of directors, be grounds for refusing membership to the CU or the expulsion of an existing member.

Section 7. Shares

Share Saving Units

7.1 CUs may offer an unlimited number of share-saving units at a par value established in the bylaws. The bylaws shall fix the minimum number of share-saving units to which a member must subscribe, but each member shall hold at least one fully paid share-savings unit. Additional share-saving units may be subscribed in full or by periodic subscriptions, but no share-saving unit shall be allotted to a member until it has been fully paid. Unless otherwise stated by regulation of the NBRK, no member including the immediate family of the member, may in aggregate own more than 10 percent of the total number of share-saving units outstanding at any time.

7.2 The bylaws may classify share-saving units according to terms, conditions, and the rate of dividend permitted.

7.3 The number of share-saving units held by a member, and any other financial transactions a member has with the CU, is a confidential matter between the member and the CU. Except with the written consent of a member, or a court order from any appropriate judicial authority, or request by an auditor or the NBRK. A CU is not allowed to provide any information to any government official or any third party relating to the member's share-saving units or financial transactions with the CU. Failure to comply with this section will render a CU liable to a penalty as prescribed by NBRK regulation.

7.4 Any financial transaction between a CU and a bank or other financial institution is a confidential matter between the bank or financial institution and the CU. Except with the written consent of a CU, or a court order from any appropriate judicial authority, or request by an auditor or NBRK. A bank or financial institution is not allowed to provide any information to any government official or any third party relating to the CUs financial transactions with such bank or financial institution. Failure to comply with this section will render a bank or financial institution liable to a penalty as prescribed by regulation.

7.5 Share-saving units in a CU shall not be transferable and a CU shall not issue to a member a certificate denoting ownership of a share-saving unit.

7.6 Every CU shall set up and maintain a register of members, and the register shall be open for inspection by any member. Any member may inspect the bylaws, financial statements and accounting

books of a CU, provided that unless a member is an officer of the CU, or is so authorized by the CU, the member shall not have the right to inspect any loan account information relating to the loan account of any other member.

Share Withdrawals

7.7 Subject to section 7.8, 8.8 and 13.8, share-saving units may be withdrawn on termination of membership, or in other circumstances, provided that the CU may require not less than 60 days notice. Termination of membership should be set by the bylaws of the CU. Earlier withdrawals may be made under exceptional circumstances with the prior approval of the board of directors. The bylaws may provide that withdrawals can be made in cash or by transferring the amount to be withdrawn to any person or entity so designated by the member. Share-saving units held for a period of three months or less will not qualify for any dividend payment.

7.8 Withdrawals of share-saving units are not permitted where the withdrawal would reduce the member's paid-up shareholding in the CU to less than the member's total liability, including any contingent liability, to the CU as a borrower, guarantor or otherwise. Unless a member terminates his or her membership, any withdrawals are subject to the members retaining at least one fully paid share as provided for in Section 7.1.

7.9 Subject to the provisions of sections 8.7, a CU shall not accept a loan or deposit from any person or member, except by way of subscription for its share-saving unit. This section does not preclude CUs accepting a sum of money paid, or paid in advance, that relates to the provision of property, services or the giving of security.

Dividends

7.10 At the close of a financial year, or at other periodic intervals as provided for in the bylaws, the board of directors may declare dividends to be paid on share-saving units from all available earnings, subject to making the required transfers to reserves and provisions, as set out in Section 10, and subject to the provisions of Section 8.8, and subject to the CU having adequate financial resources to pay the dividend.

Joint Accounts

7.11 A member may designate any person or person to own a share-saving unit jointly with the member. On the death of one of the joint owners, the surviving owner or owners becomes the remaining owner or owners of the share-saving unit. No joint owner, unless a member in his or her own right, shall be permitted to vote, obtain loans or hold office in the CU. Payment of part or all of such joint account to any one of the joint owners shall, up to the amount of the payment, discharge the CU liability to all owners of the share-saving unit.

7.12 Subject to the Civil Code, beneficiaries of a deceased member may inherit the member's share-saving units together with any dividends accrued on these accounts.

Security Against Share

7.13 A CU has a first charge against the share-saving unit of a member for any debt or obligation due to the CU by the member. The CU may offset any sum credited or payable to such a member in or towards payment of any such debt or obligation.

Dormant Accounts

7.14 If there has been no activity on a share-saving unit for one year, the board of directors, after notice to the member's last known address, may impose a reasonable maintenance fee on it. After two years of inactivity and after notice has been given to the member's last known address, the account shall be deemed to be abandoned, and the amount, plus accrued dividends, be credited to a special reserve account. No dividends shall accrue on abandoned accounts and these funds can be reclaimed by a member or other properly authorized person within five years after the funds were deemed abandoned.

Allocation of Cumulative Net Loss

7.15 Whenever the net assets of a CU are less than the aggregate of its fully and partly paid share-saving units, the Board of Directors shall order a reduction in the value of the shares of each of its members, so as to divide the loss proportionately among them and so that the CU's net assets equal the amount of its fully and partly paid share-savings units. For the purposes of this section, "net assets" means the total assets less all liabilities excluding capital.

7.16 If the CU later realizes from those assets a greater amount than was fixed at the time of the reduction, the excess shall be divided proportionally among the shareholders whose shares were reduced, but not exceeding the extent of the reduction.

Redeemable Shares

7.17 Credit unions may provide additional service to their members by accepting redeemable shares intended to assist members in the management of their seasonal household funds flows and working capital invested in income-generating activities and in the safekeeping of cash held in connection with these flows and activities. These shares are created by the receipt of funds by the credit union that are specifically designated for the purchase of redeemable shares.

7.18 The value at which these shares may be redeemed in the name of any member may not exceed the value of that member's share savings-units. Terms and conditions governing any redeemable shares offered by a credit union are as specified in the credit union's bylaws and Board decisions, subject to the limitations that any dividends paid on redeemable shares for any given time period may not exceed one-half of those paid on share-savings units of equal Tenge value and that any other terms and conditions, excepting redeemability, cannot be more favorable to the member than those applied to share-savings units.

7.19 Credit unions issuing redeemable shares may not use more than 20 percent of the balance of these shares outstanding at any time to fund loans to members. At least 80 percent of the balance of redeemable shares outstanding at any time must be held in cash, in deposits with commercial banks or other financial institutions approved for this purpose by NBRK, or invested in securities issued by the Government of Kazakstan.

7.20 During the tenth year that this Decree is in force the Government of Kazakstan will appoint a committee of at least five persons familiar with financial markets, but excluding commercial bankers, to review experience with redeemable shares and recommend amendments, if any, to be made to this Decree with respect to redeemable shares. The committee's recommendations should be communicated in writing to the Government and NBRK by the end of the tenth year that this Decree is in force and subsequently be made available by the Government or NBRK to all interested parties upon request at a reasonable charge.

Section 8. Loans

Purposes and Conditions

8.1 A CU may make loans to members under conditions provided by the bylaws and specified by the board of directors. The board shall establish written policies regarding prudent lending policies, including the terms, conditions of repayment, maximum amounts that may be borrowed, and acceptable forms of security.

8.2 No person shall be granted a loan unless that person has been a member of the CU for a suitable period as provided for in the bylaws. The bylaws shall contain provisions fixing the maximum amount by which the indebtedness of a member may exceed the total amount of the member's paid up share-saving units in the CU, subject to any limits established by regulation.

Loan Limits and Security

8.3 Loans may be secured or unsecured. No member, or members where shares are owned jointly, may borrow in aggregate more than 10 percent of the CU's total capital. The bylaws shall stipulate the maximum amount of the loan as it relates to members' paid in share capital. The maximum loan term shall be five years. The NBRK may vary the terms of this section by regulation.

8.4 The bylaws shall place limits on the proportion of loans, by value and/or number, that are unsecured or partially secured, as a percentage of total loans outstanding. The bylaws shall place limits on the maturity of loans that are unsecured or partially secured.

8.5 The bylaws shall determine the security requirements for the various kinds of loans and the criteria under which unsecured or partially secured loans may be granted. A loan to a member may be secured by a guarantee provided by another member where the guarantor provides security by pledging his or her share-saving unit. All loans must be evidenced by appropriate documentation.

8.6 Where a society, association or partnership has been admitted to membership, such a member may not borrow in excess of the value of its share-saving units in the CU, unless the members of such society, association, or partnership pledge, as security for the loan, property held by them in their individual capacities.

Borrowing by the CU

8.7 CUs may borrow funds from any source, including from the Federation of CUs, the government, any organ or entity controlled by the government, or derived, directly or indirectly, from a bilateral or multilateral donor source, provided that the aggregate borrowings from all sources shall not exceed 50 percent of its paid-in-shares, deposits, and unencumbered reserves and surplus. Notwithstanding any provision in the bylaws or in any loan agreement between the CU and a provider of funds for on-lending to members, the disposition of these funds by way of loans to members shall be governed by the provisions in Section 8.1 to 8.6.

8.8 When a CU is in arrears with the payment of interest or principal amounts due on any borrowing source, the CU is prohibited from making any loans, paying any dividend or permitting the withdrawal or share-saving units, until the amounts in arrears have been settled or paid. Any CU and every director and or officers of the CU that contravenes these prohibitions, commits an offense and shall be liable for the penalties prescribed by regulation.

Loans to CU Officials

8.9 A CU may make loans to its officers, directors, employees, loan officers and members of the credit and supervisory committee(CU Officials) provided that all of the following conditions are satisfied:

- the loan complies with all the requirements of this Decree, and any bylaw regulation in respect of loans to other members and is not on terms more favorable than those extended to other members;
- the provisions of section 6.25 are complied with;
- where the loan or aggregate amount of loans to any CU official exceeds the value of share-saving units held in the CU, the loan must be approved by three-fourths of the members of the credit committee and three-fourths of the board of directors; and
- the aggregate of loans to all CU officials may not exceed 15 percent of the amount of the total loans outstanding of the CU, or such other percentages as may be determined by NBRK regulation. The aggregate of loans to CU officials shall be disclosed to members at the annual general meeting. The external auditor, as part of the annual audit, or the supervisory committee, where an external auditor has not been appointed, shall report on whether each of the provisions of Section 8.9 have been complied with.

Interest and Other Charges

8.10 The interest rates on loans and fees associated with closing, disbursing, extending, collecting, or renewing loans shall be determined by the board of directors.

8.11 The board of directors may authorized any refund of interest on such classes of loans and under such conditions as it prescribes.

Section 9. Investment of Funds

Board Responsibility

9.1 The board of directors shall establish written policies for investing funds of the CU not used in loans to members. The General Manager or other designated official shall make investments of funds in accordance with the written policies.

9.2 The board of directors shall designate commercial banks, or other non-banking financial institutions, approved by the NBRK, to serve as a depository for CU funds. Except as otherwise specified by regulation, the bylaws shall place limitations on the amount of funds that can be deposited with any one bank or financial institution.

Authorized Investments

9.3 Funds not deposited with banks or non-banking financial institutions as provided in Section 9.2 may be invested in short-term government securities or such debt securities approved by NBRK regulation.

9.4 CUs may make interest bearing loans to the Federation of CUs, and/or invest in the shares of the Federation of CUs, and or make contributions to a stabilization fund established by the Federation of CUs, provided that the aggregate investment in loans, shares and contributions shall not exceed 10 percent of CU capital, or such other percentage as may be determined by regulation.

Liquid Funds

9.5 CUs shall maintain liquid funds equal to at least ten percent of the aggregate of its capital, shares from members and borrowings. This required percentage may be changed by NBRK regulation. Convertible assets must be maintained in the form of cash on hand or deposits with banking institutions or short-term government debt instruments.

Fixed Assets

9.6 A CU's total investment in fixed assets including buildings, land, furniture and equipment that are relevant for the purposes of carrying out the business of the CU may not exceed 10 percent of its capital or such other percentage as determined by regulation. The NBRK may waive this limitation where a CU presents reasons justifying a greater investment.

Section 10. Prudential Norms

Loan Loss Reserve

10.1 In this section, "gross earnings" means the gross income received by a CU from interest on loans and investment, and any other forms of income; "assets" means the amount shown in the latest year-end balance sheet of the CU for loans and investments, including funds invested in accordance with Sections 9.2, 9.3 and 9.5.

10.2 At the end of a CU's first fiscal year and subsequent years, an amount equal to 10 percent of gross earnings shall be transferred to a loan loss reserve until the reserve reaches an amount equal to 10 percent of the total assets of the CU.

10.3 After the loan loss reserve reaches an amount equivalent to 10 percent of the total risk based assets of the CU, the amount to be transferred to the loan loss reserve in each subsequent financial year shall be 10 percent of the gross earnings or such lesser amount as necessary to maintain the reserve of 10 percent of the total assets.

10.4 For the purposes of Sections 10.1 to 10.3, the NBRK may by regulation for any CU:

- prescribe that different percentages be transferred to the general reserve;
- vary the formula for the calculation of the general reserve; and
- waive the general reserve requirement in any one or more accounting periods for appropriate cause.

10.5 Transfers to reserves and provisions shall be made before the payment of dividends on share-saving units.

Use of Loan Loss Reserve

10.6 The loan loss reserve may be used only to meet the losses from loans, investments or other losses on assets, and shall not be distributed to members except upon the liquidation of the CU.

Loan Classification

10.7 Credit Unions are required to comply with NBRK loan classification procedures as established by NBRK regulation.

Capital Adequacy

10.8 All partially and fully paid-in-shares, plus reserves and surplus should equal at least 50 percent of a CU's total assets during the first 10 years of operation. After that period members may choose by majority vote to alter the minimum capital base to any level exceeding 20 percent of total assets. Capital ratio should be based on un-weighted total assets.

Accounting

10.9 CUs are required to implement and use the CU chart of accounts specified by NBRK regulation.

Section 11. Federation of Credit Unions

Federation of Credit Unions

11.1 Any CU registered under this Decree may at its discretion become a member of the Federation of CUs by buying shares in the federation. Only registered CUs may become members of the Federation of CUs.

11.2 The Federation of CUs may be organized by any 10 or more registered CUs, or such other number as determined by regulation, for the purpose of any or all of the following:

- fostering the organization and development of CUs and improving their internal operations so that CUs can more effectively serve their members, and providing education and training to CU officers, members and potential members in prudent financial management;
- advocacy of CUs before the government and the general public;
- with the voluntary consent of its members establishing and maintaining a central funding scheme for the benefit of members by accumulating and managing the liquidity of its members through inter-lending and investment services, provided that a separate bank account and separate records be maintained to isolate member CU funds from the other funds of the Federation;
- establishing and maintaining a stabilization fund to be funded by contributions from members to assist member CUs in financial difficulties, provided that a separate bank account and separate records be maintained to isolate stabilization funds from the other funds of the Federation;
- obtaining liquid and other funds from banks, financial intermediaries and other sources for on-lending to members subject to the limitation imposed on members' borrowing as set out in Section 8.7; and
- performing such other related and ancillary service as are set out in the bylaws of the Federation.

11.3 The Federation will register with the NBRK and file a copy of its bylaws that have to be approved by the NBRK. The NBRK can issue regulations providing for the constitution, capital, operations and any other matters relating to the Federation of CUs.

11.4 The Federation shall be directed by a board of directors elected by member CUs at the annual meeting. The bylaws shall prescribe the duties of the officers and the organizational structure of the Federation.

Section 12. Changes in Organization

Merger and Consolidation

12.1 Any two or more CUs registered under this Decree may, with the approval of a two-thirds majority of each of its members present and voting at an annual general meeting, or at a special meeting in accordance with the bylaws, and with the approval of the NBRK, merge into one CU.

Voluntary Liquidation

12.2 A CU may liquidate voluntarily and wind up its affairs only after being approved by two-thirds of the members present and voting at a properly constituted annual general meeting, or at a special meeting in accordance with the bylaws.

12.3 The bylaws of a CU may provide that on a voluntary liquidation, where the net assets, defined in Section 7.15, of a CU exceed the aggregate amount of paid up share-saving units that the excess be distributed in the following sequence:

1st. Secured creditors up to the value of their collateral;
2nd. Costs and expenses incidental to liquidating the CU;
3rd. Wages due employees of the CU; and
4th. Any liability due to general creditors, secured creditors to the extent their claims exceed the value of the collateral.
5th. Members proportionately to the shares held by each member as of the date dissolution was voted or otherwise decided.

12.4 When all assets have been liquidated and distributed, the CU shall execute a certificate of liquidation and file the certificate along with all books and records of the CU, with the NBRK. Upon receipt, the NBRK shall declare the CU dissolved.

Section 13. Supervision and Regulation

Supervisor

13.1 The National Bank of Kazakstan is responsible for the supervision and regulation of CUs and the Federation of CUs registered under this Decree.

13.2 There is to be created within the NBRK a specialized department to which the NBRK delegates responsibility for supervision and regulation of CUs.

General Powers of NBRK

13.3 The NBRK shall prescribe initial and on-going regulations to implement this Decree and shall provide a model set of bylaws for consideration by persons wishing to establish a CU. The NBRK can issue orders relating to the affairs of a specific CU.

13.4 A CU will provide all reports required by the NBRK within the time intervals specified in the regulations. A monetary fine may be imposed for failure to do so in accordance with the regulations determined by the NBRK.

13.5 The NBRK shall on a periodic basis inspect or cause to be inspected each CU.

Enforcement Powers of NBRK

13.6 The NBRK may issue an order terminating any action being planned or undertaken by a CU, having first determined from substantial evidence that the CU is:

- engaged or about to engage in an unsafe or unsound financial practice; or
- violating a provision of any law, regulation, by-law or written order of the NBRK.

The officers and directors of the CU may be fined according to the penalties prescribed by regulation for each day that the CU fails to comply with the order of the NBRK.

Removal of Officers

13.7 On the basis of substantial evidence, the NBRK may suspend or remove from office and prohibit from further participation in the affairs of a CU, any officer, general manager, employee, director or committee member who has:

- violated a provision of any law, regulation, by-law or written order of the NBRK; or
- engaged or participated in any unsafe or unsound practice with respect to the CU.

13.8 The NBRK may restrict the withdrawal of share-saving unit from a CU after having determined that such action is necessary to protect the interests of members.

13.9 The NBRK may institute legal proceedings of either a criminal or civil nature against any officer, director, committee member or employee who has violated a provision of any law, regulation, by-law or written order of the NBRK that relates to a CU.

Special Supervision

13.10 Where a CU is found to be operating in an unsafe or unsound manner or in violation of a provision of any law, regulation, bylaw or written order of the NBRK, the NBRK may issue an order placing the CU under special supervision and appoint a representative to control the CU.

13.11 The representative may recommend to the board of directors any action necessary to improve operations and or cease operations. If any course of action recommended to the board of directors is not implemented, or other directives of the representative are not implemented, the representative may request the NBRK to subject the CU to actions provided in 13.10

Administration

13.12 If the NBRK determines that it is necessary to conserve the assets of the CU in order to protect the interests of the members or to compel compliance with a recommendation of the representative appointed under 13.11, the NBRK may take immediate possession and control of the business and assets of the CU and appoint an administrator to manage its affairs. The administrator may exercise all the powers of the board of directors, which ceases to function until such time as the administrator is discharged.

13.13 The NBRK shall maintain possession and control of the CU and continue the CU's administration until:

- the NBRK permits it to resume normal operations subject to the terms and conditions agreed upon by the board of directors and the NBRK; or
- the NBRK places the CU in compulsory liquidation as provided in Section 13.14

Suspension and Compulsory Liquidation

13.14 If it appears that a CU is bankrupt or insolvent, or that it is willfully violating the provision of any law, regulation, bylaw or written order of the NBRK, or is operating in an unsafe or unsound manner, the NBRK may issue an order temporarily suspending the CU's operations for up to 30 calendar days.

13.15 The board of directors must be given written notice of the reason for the suspension and the board must either request a hearing to present a plan of corrective action, or request that the CU be placed in compulsory liquidation.

13.16 If the NBRK is satisfied that the conditions causing the suspension have been corrected, the NBRK may revoke the suspension notice and permit the CU to resume normal operations.

13.17 If the NBRK reject the board of directors plan to continue operations or accepts the recommendations of the board that the CU be liquidated, then the NBRK shall issue an order of compulsory liquidation.

Section 14. General Provisions

Documents and Records

14.1 A CU shall maintain all books, records, accounting systems and adopt procedures in accordance with sound business practice and the CU bylaws. With the approval of the NBRK, fiscal year records that are more than 10 years old may be destroyed.

Criminal Offenses

14.2 Any CU officer, director, committee member or employee shall be guilty of an offense and be subject to the penalties prescribed by regulation if that person:

- with intent to deceive or falsify any accounting records of a CU;
- provides information to the NBRK that they know is not true;
- knowingly obtains or makes a forged signature to a document;
- misappropriates assets or property of the CU;
- with intention to deceive or destroy CU records or other documents;
- engages in any conflict of interest prohibited by Section 6.25; and
- fails to comply with any order of the NBRK under Section 13.5 where such failure has or is likely to cause loss to the CU.

14.3 Any person or organization shall be guilty of an offense and be subject to the penalties prescribed by regulation if that person violates the provisions of this Decree that confine the use of the words "credit union" to a properly registered CU.

Exemptions

14.4 All CUs and the Federation of CUs registered under this Decree, shall be exempt from tax on any profit that was earned during the fiscal year. CUs are regarded as non-profit organizations because all income after expenses and required reserves is returned to members.

14.5 Apart from the requirement to register as an entity with limited liability and to follow the registration procedure outlined in this Decree. No CU or Federation of CUs registered under this Decree shall be required to register or obtain additional licenses to carry on the trade of a CU or as a Federation with its members.

Disputes

14.6 Any dispute between a member or past member and a CU or an officer of a CU, or any dispute between any officer or employee of a CU and the CU, shall be decided in the manner provided for in the CU's by laws and in absence of any such provision, by arbitration in accordance with the laws of the land.

Change of Name

14.7 Any CU or Federation of CUs may change its name subject to the approval of a majority of its members and the NBRK. No change of name shall affect any right, duty or obligation of the CU, or the Federation, or of any officer or member thereof.

MODEL BYLAWS
of the
_____________ **Credit Union**
Almaty, Kazakstan

ARTICLE I
PURPOSES

Section 1. Purposes. The purposes of this credit union is:

A. To encourage continuing thrift among its members;
B. To create a sustainable source of credit at a fair and reasonable rate of interest;
C. To provide an opportunity for each of its members to improve the member's respective economic and social conditions over the long run; and
D. To perform the functions and exercise the powers designated for credit unions under applicable law.

ARTICLE II
DEFINITIONS

Section 1. Applicable Law. When used in these Bylaws, "applicable law" means the Law on Credit Unions of the Republic of Kazakstan and all applicable rules and regulations issued pursuant to the Law on Credit Unions of the Republic of Kazakstan.

Section 2. Board. When used in these Bylaws, "Board" means the Board of Directors of this credit union, unless the context otherwise requires.

Section 3. Supervisor. When used in these Bylaws, "Supervisor" means the National Bank of Kazakstan.

Section 4. Credit Union. When used in these Bylaws, "this credit union" or "the credit union" means the ______________________________________Credit Union, unless the context otherwise requires.

Section 5. Member of the Immediate Family. When used in these Bylaws, "members of the immediate family" includes, but is not limited to, the spouse, parents, and children of each person eligible to be a member of the credit union under Article III (1)(B), whether or not residing in the same household. The same term also includes any other relative of any person eligible under Article III (1)(B) or the spouse of the eligible person, if the relative resides in the same household as the person.

ARTICLE III
MEMBERSHIP

Section 1. Membership Rights and Eligibility.

A. The rights of members of this credit union shall be determined and exercised in accordance with the applicable law, the Charter of this organization and Bylaws of this credit union and valid resolutions of the Board.
B. Any employee of this credit union, and any member of the immediate family of any other eligible person may become a member of this credit union in the manner provided in these Bylaws. Any organization, association or corporation may become a member of this credit union, if membership of the organization, association, or corporation is authorized under applicable law.
C. The following stated common interest and eligibility requirements must be met to become a member of this credit union:

Section 2. Application for Membership. Any person eligible for membership who completes an application for membership in an acceptable form and purchases at least one (1) share in the credit union shall be admitted to membership, unless the application is rejected by the Membership Officer, if any, or by the Board at either of its next two regular meeting

Section 3. Termination of Membership. A member who withdraws all of the member's shareholdings shall thereby cease to be a member of the credit union and shall be ineligible to hold any form of shares in this credit union. Any person whose membership terminates under this Section may be readmitted to membership, at the discretion of the Board, by purchasing at least one (1) share.

Section 4. Expulsion of Members. The Board may expel a member from the credit union if the member neglects or refuses to comply with applicable law, these Bylaws, applicable policies of the credit union, NBRK regulations, or for any other just cause.

Section 5. Procedures for Expulsion. No member may be expelled from the credit union until the member has been informed in writing of allegations which provide a basis for the initiative to expel the member, and until the member is given an opportunity after reasonable notice to appear before the Board for the purpose of rebutting the allegations.

Section 6. Payments Upon Expulsion or Termination. If a member is expelled by the Board or if the membership is terminated by operation of these Bylaws:

A. The member's account may be continued at the option of the member until the end of the dividend period in which the expulsion or termination occurs.
B. Unless the member elects to defer receipt until the end of the dividend period in which the expulsion or termination occurs under Paragraph (A), the credit union shall pay to the member upon expulsion or termination the funds the member has paid in shares. Payments under this paragraph shall be subject to Article IX (3)(B)(C) and applicable law.
C. Expulsion or termination of membership shall not relieve the member of any existing liability to the credit union.

Section 7. Loss of Qualifying Status. A member who ceases to qualify for membership under Section 1 of this Article may retain full membership in the credit union at the discretion of the Board.

ARTICLE IV
MEETINGS OF MEMBERS - VOTING

Section 1. Voting. Each member shall have not more than one (1) vote, as determined by applicable law.

Section 2. Meetings. The credit union shall hold an annual meeting of the members within five months of the close of its financial year at such time, date, and place as the Board shall designate. Special meetings of the members may be called at any time by order of the Board. Special meetings shall be called by a the Secretary upon the written request of twenty-one (21) members or two per cent (2%) of the total membership, whichever is greater.

Section 3. Notice of Meetings. The Board shall determine the manner in which the membership shall be notified of annual and special meetings. At least twenty (20) days prior to the date selected for any annual or special meeting, the membership shall be given notice of the annual or special meeting in a manner which provides reasonable assurance that members will be made aware of the date, place, time and purposes of the annual or special meeting. Notice of meetings at which elections of directors are scheduled must include the names of the candidates selected by the nominating committee, if a nominating committee has been appointed.

Section 4. Quorum. ____________________ (___) members eligible to vote at meetings of the members shall constitute a quorum at any annual or special meeting. If a quorum is not present on the date specified in the notice of meeting, the meeting shall be adjourned for at lease one (1) week and a second notice shall be mailed to each member at the member's last known address or otherwise delivered to each member. The notice shall specify the date, time, place and purpose of the adjourned meeting. Notwithstanding the other provisions of this Section, the number of members present at the place and time specified in the notice of the adjourned meeting shall constitute a quorum for the transaction of all business appropriate to the purpose of the meeting.

Section 5. Actions by Members.

A. Except as provided in Paragraph (B) of this Section, the members may decide by a majority of the votes including fractional votes cast by the members present any question of interest to the credit union.

B. The members may take one or more of the actions specified in Subdivisions 1 through 5 of this paragraph, but only if the notice of the meeting specified that the question would be considered at the meeting:

(1.) Take by a vote of a majority of the votes, including fractional votes, cast by members present any action which, if approved at the meeting, would dilute the value of a member's share, or which could reasonably be interpreted as jeopardizing the financial interest of those members not present.

(2.) Reverse by a vote of two-thirds (2/3) majority of the votes, including fractional votes, cast by members present any decision of the Credit Committee, a Loan Officer, or the Board, provided fifteen (15) members have requested reversal of the decision.

(3.) Remove by a vote of three-fourths (3/4) majority of the votes, including fractional votes, cast by members present any Officer, member of the Credit Committee, Loan Officer or Director.

(4.) Fill by vote of a plurality of the votes, including fractional votes, cast by members present any vacancy caused by the removal of an Officer, member of the Credit Committee, Loan Officer, or Director.

(5.) Amend these Bylaws by vote of a three-fourths (3/4) majority of the votes, including fractional votes, cast by members present in accordance with Article XIV (2).

ARTICLE V
BOARD OF DIRECTORS

Section 1. Qualifications of Directors. During the first twelve (12) months of the existence of the credit union, any physical person who is a member of the credit union in good standing on the date of election or appointment may be elected or appointed as Director. After the credit union has been in existence for at least twelve (12) months, no person may be elected or appointed as a Director unless the person is a natural person who for at least the three (3) months immediately preceding the date of the election has been a member of the credit union in good standing.

Section 2. Number and Terms of Directors.

A. The Board shall consist of _______________ (____) duly qualified members.

B. At the first meeting of the members, the members shall elect Directors to serve as follows:

_________________________ (____) Directors for one (1) year.
_________________________ (____) Directors for two (2) years.
_________________________ (____) Directors for three (3) years.

C. At each subsequent annual meeting the members shall elect a Director to fill each vacancy on the Board, including any unexpired term occupied by a Director appointed by the Board

under Section 6 of this Article. Each Director shall hold office until the annual meeting of the members held in the calendar year in which the Director's term expires and until his or her successor has been elected and qualified; or until the Director's resignation or death; or until the Director's status as a member of this credit union has ended; or until the Director has been removed from office as provided in Article IV (5)(B) or in Section 5 of this Article, whichever is sooner. A director may resign at any time by filling his or her resignation with the Secretary.

Section 3. Election at Annual Meeting. Directors shall be elected in the following manner by the members qualified to vote who are present at the annual meeting:

A. The Chairman may appoint a Nominating Committee consisting of not fewer than three (3) members of the credit union. If appointed, the Nominating Committee shall nominate one (1) or more candidate(s) for each vacancy on the Board, including any unexpired term occupied by a Director appointed by the Board under Section 6 of this Article. Candidates must be members in good standing and eligible to vote at meetings of the members, or if not eligible to vote disqualified only because they are net borrowers.
B. After the nominations of the Nominating Committee, if any, have been placed before the members at the annual meeting, the Chairman shall call for and accept nominations from the floor. When nominations are closed, the votes shall be taken and tallied by the tellers, and the results shall be announced. Except as provided in Paragraph (C), all elections shall be determined by plurality vote, and shall be by ballot except when the number of nominees does not exceed the number of vacancies to be filled.
C. If two (2) or more candidates for Director receive an equal number of votes, and resolution of the tie vote affects the election of one (1) or more Directors, the members present at the annual meeting and qualified to vote shall either elect by a plurality vote the appropriate number of Directors from among the candidates who receive the equal number of votes in the initial balloting, or shall authorize those candidates to resolve the tie vote by a drawing of lots.

Section 4. Election by Mail Ballot. Election of Directors cannot be conducted by mail ballot.

Section 5. Removal from Office.

A. The Board by majority vote may remove any Officer, Director, Committee member or employee who violates applicable law, the Charter of this credit union, or the Bylaws, or for any good and sufficient cause. No person may be removed under this section until the person has been informed in writing of the reasons for the proposed removal and until the person has been given the opportunity to appear before the Board to rebut the allegations made against the person.
B. Any Director who withdraws or is expelled from membership or whose membership is terminated by operation of these Bylaws shall be removed from the Board, and the vacancy shall be filled by a plurality vote of the Directors then holding office for the balance of the term within thirty (30) days after the date of removal.

C. If a Director is absent without reasonable cause from ______________________ (____) consecutive meetings of the Board, the Director shall be removed from office by resolution at the next meeting of the Board. The vacancy shall be filled by the Board as provided in Section 6 of this Article.

Section 6. Vacancies. Except as provided in Section 5 (B) of this Article, the Board shall by a vote of plurality of the Directors then holding office appoint a member of the credit union to fill any vacancy occurring in the Board. Appointments under this Section shall be valid only until the first annual meeting held after the date of appointment. At the annual meeting, the members shall elect a Director to serve for the balance of the unexpired term. The Interim Director appointed by the board to fill the vacancy may stand for election at the annual meeting.

Section 7. Meetings; Quorum.

A. An organizational meeting of the Board shall be held within ________________ (____) days after each annual meeting, and thereafter the Board shall meet at least monthly, unless an Executive Committee is appointed under Section 8 (B) of this Article. At all meetings of the Board, ____________________ (____) Directors shall constitute a quorum. Except as otherwise provided in these Bylaws, all matters presented to the Board shall be decided by a majority of the Directors present.

B. Except as otherwise provided in these Bylaws, regular meetings of the Board shall be held at the time and place fixed by resolution of the Board. Notice of all meetings shall be given to Directors by the Secretary in such manner as the Board from time to time by resolution prescribes. A Director's attendance at any meeting of the Board constitutes his or her waiver of notice of that meeting unless the Director attends and objects at the meeting to the transaction of business because proper notice was not given. Otherwise, no waiver of notice of any meeting is valid unless made in writing.

C. Special meetings of the Board may be called by the Chairman or by any ____________________ (____) Directors upon at least three (3) days' prior notice to all Directors.

Section 8. Powers and Duties of the Board. The Board shall be responsible for the management of the affairs of the credit union in accordance with applicable law, the Charter of this credit union, and these Bylaws. Subject to limitations established in these Bylaws, the Board shall have all of the powers and duties established under applicable law of credit unions. Each Board member shall have one vote in decisions voted upon by the Board.

A. The Board shall:
   - (1.) Act upon all applications for membership, unless a Membership Officer is appointed;
   - (2.) Act upon the expulsion of members;
   - (3.) Annually establish standards and guidelines governing the compensation of employees, if any, in accordance with these Bylaws;

(4.) Fill vacancies in the Board, the Executive Committee, if any, the Executive Offices, the Credit Committee, if any, and Loan Officers, if any, by appointment in accordance with these Bylaws;
(5.) Annually or more frequently review and if required, reverse the lending policies to be followed by the Credit Committee and Loan Officers, including rates of interest on all loans, and determine all other credit union policies, including standards for collateral acceptable for secured loans;
(6.) Annually fix the amount of surety bond, if any can be obtained, which shall be required of each officer and employee having custody of funds;
(7.) Annually or more frequently designate the one or more depositories to be used by the credit union;
(8.) Act on loan applications submitted by any Loan Officers or members of the Credit Committee, if any.
(9.) Make recommendations to the meetings of members regarding matters which in the opinion of the Board should be decided by the members;
(10.) Maintain minutes recording its decisions and decisions taken at meetings of members. Minutes shall be read, amended, if required, and approved not later than, at the regular meeting of the Board or the annual meeting of members, as the case may be, following the meeting at which the minutes were taken; and
(11.) Perform all other duties imposed upon the Board by these Bylaws and applicable law.

B. The Board may appoint an Executive Committee consisting of at least three (3) directors. If appointed, the Executive Committee shall meet a least monthly and shall be empowered to act on behalf of the Board between Board meetings. The Board may delegate all or any part of its powers to the Executive Committee, subject to any conditions or limitations the board may choose to impose. The Executive Committee shall not have the authority to alter, rescind, or modify any action previously taken by the Board, without the express consent of the Board.
C. The Board may by majority vote remove any Executive Officer, member of the Credit Committee, or Loan Officer.
D. The Board may appoint a credit union Membership Officer. If appointed, the Membership Officer shall approve or reject applications for membership, and shall refer rejected applications to the Board. The Membership Officer shall comply with applicable law and perform such other duties as may be prescribed by the Board not inconsistent with applicable law and these Bylaws. Any person whose application for membership is denied by the Membership Officer may appeal the denial in writing to the Board.

Section 9. Compensation. Except as otherwise authorized by applicable law, no Director may receive any compensation from this credit union other than reimbursement for actual out-of-pocket expenses incurred as a result of his or her services as a Director.

Section 10. Equivalent Titles. Any person designated as "Chairman" or as Vice Chairman" may use another equivalent title such as, in the case of the Chairman, "Chairperson," "Chairwomen," "Chair" or other such appropriate title.

ARTICLE VI
EXECUTIVE OFFICERS - MANAGEMENT STAFF

Section 1. Executive Officers.

A. The Executive Officers of this credit union shall be a Chairman, a Vice-Chairman, a Secretary, a Treasurer, and a President. The Chairman, Vice-Chairman, Secretary and Treasurer shall be elected at the organizational meeting of the Board from among the Directors then holding office. Any Executive Officer may be elected to succeed himself or herself. Unless sooner removed as provided in Article V (8)(C), the Chairman, Vice-Chairman, Secretary and Treasurer shall hold office until the organizational meeting of the Board following the next annual meeting of the members and until election and qualification of his or her respective successor.
B. The Board shall appoint a President who may or may not be a Director of the credit union. The President shall serve at the pleasure of the Board.

Section 2. Vacancies. Whenever any vacancy occurs in any of the elected Executive Offices, the Board shall promptly fill such vacancy from among the Directors then holding office. Any person appointed to fill such a vacancy under this Section shall serve until the organizational meeting of the Board following the next annual meeting of the members and until a successor is duly elected and qualified.

Section 3. Chairman of the Board. The Chairman shall preside over all meetings of the members and all meetings of the Board. The Chairman shall also perform such other duties as the Chairman may be directed to perform by resolution of the Board not inconsistent with applicable law and these Bylaws.

Section 4. Vice-Chairman of the Board. The Vice-Chairman shall, in the absence or disability of the Chairman or in case of a vacancy in the office of the Chairman, perform the duties of the Chairman and such duties as may from time to time be prescribed by the Board not inconsistent with applicable law and these Bylaws.

Section 5. President. The President shall be the operating and financial Executive Officer of the credit union and shall manage the affairs of the credit union under the control and direction of the Board. Subject to such limitations and controls as may be imposed by the Board, and subject to delegation by the Board of any of the following responsibilities to other persons, the President shall:

A. Have custody of all funds, securities, valuable papers and other assets of the credit union;
B. Have authority to sign all notes of this credit union, and all checks, drafts and other orders for disbursement of the credit union's funds;
C. Provide and maintain full and complete records of all assets and liabilities of this credit union;
D. Prepare and submit monthly to the Board a complete financial statement showing the condition of the credit union as of the end of the month for which the statement is made, including a listing of delinquent loans categorized according to the period of delinquency. Within fifteen (15) days after the close of each month, the President shall post a current month-ending balance sheet in a conspicuous place in the office of the credit union;

E. Prepare and forward to the NBRK such financial and other reports as the NBRK may require, and maintain all books and records of the credit union in a proper accounting manner as established by the NBRK.
F. Except as provided in Article XIII (4), cause funds deposited in the credit union to be deposited intact in one or more depositories designated by the Board. Unless otherwise determined by the Board, all funds received by the credit union shall be deposited not later than the end of the second business day after their receipt; and
G. Perform such other duties as directed by the Board not inconsistent with applicable law and these Bylaws.

Section 6. Secretary. The Secretary shall prepare and maintain full and correct records of all meetings of the members and the Board, which record shall be prepared within ______________________ (____) days after the respective meetings. The Secretary shall give or cause to be given in the manner prescribed by these Bylaws proper notice of all meetings of the members and of the Board, and shall perform such duties as the Secretary may be directed by the Board not inconsistent with applicable law and these Bylaws.

Section 7. Treasurer. The Treasurer shall prepare and provide appropriate reports to the members of the credit union. The Treasurer shall have authority to sign all notes of this credit union, and all checks, drafts and other orders for disbursement of the credit union's funds. The Board may also designate other persons to exercise the power to sign notes, checks, drafts, and other orders. The Treasurer shall also perform any other duties as directed by the Board not inconsistent with applicable law and these Bylaws.

Section 8. Management Staff. The President may appoint one or more Vice-Presidents. If appointed, the Vice-President shall, in the absence or disability of the President or in the case of a vacancy in the office of President perform the duties of the President and such other duties as may from time to time be prescribed by the Board not inconsistent with applicable law and these Bylaws. The President may hire and discharge the employees of the credit union.

ARTICLE VII
SUPERVISORY COMMITTEE

Section 1. Terms and Conditions. The Supervisory committee shall be appointed by the board from among the members of this credit union. The board shall determine the number of members on the committee, which should not be fewer than three (3). No member who is a director, in executive management, member of the credit committee, or any employee of this credit union may be appointed to the committee. Terms of committee members shall be for one (1) year. Each member of the Supervisory committee shall have one vote in decisions voted upon by the committee.

Section 2. Duties. The Supervisory committee shall make, or cause to be made, such audits, and to prepare and submit such written reports, as are required by the applicable law and regulations. The committee may employ and use such clerical and auditing assistance as may be required to carry out its responsibilities prescribed by this article.

Section 3. Report. The Supervisory committee shall, from time to time and not less frequently than required by applicable law and regulations, cause the accounts of all members to be verified with the records of the financial officer. The committee shall maintain a record of such verification. A report of the committee's activities shall be presented to the board, the NBRK and the annual general meeting of the members.

Section 4. Suspension of Elected or Appointed Persons. By unanimous vote, the Supervisory committee may recommend to the board that the board suspend or remove any executive officers, loan officers, employees or member of the credit committee. In the event of any suspension, the Supervisory committee shall call a special meeting of the members to act on the said suspension which meeting shall be held not fewer than fourteen (14) days nor more than twenty-one (21) days after such suspension.

Section 5. Suspension of Board Members. By unanimous vote, the Supervisory committee may recommend to the members the suspension or removal of any board member. In the event of any suspension, the Supervisory committee shall call a special meeting of the members to act on the said suspension which meeting shall be held not fewer than fourteen (14) days nor more than twenty-one (21) days after such suspension. Fourteen (14) days notice must be given to the director who is subject to the suspension or removal recommendation and the board member has the right to be heard at the requested meeting called to consider the recommendation for suspension or removal.

Section 6. Notice of Meetings. By the affirmative vote of a majority of its members, the supervisory committee may call a special meeting of the members to consider any violation of the provisions of the applicable law or regulations, charter of this credit union or bylaws of this credit union, or to consider any practice of this credit union which the committee deems to be unsafe or unauthorized.

Section 7. Vacancies. Whenever any vacancy occurs in the Supervisory Committee, the Board shall promptly fill such vacancy from among the members. Any person appointed to fill such a vacancy under this Section shall serve until the organizational meeting of the Board following the next annual meeting of the members and until a successor is duly elected and qualified.

ARTICLE VIII
MEMBER SHARES

Section 1. Par Value of Member Shares. On the effective date of __________, the par value of a member share shall be _________________________ Tenge (__________Tenge). Subscription to shares are payable at the time of subscription. This credit union does not allow loans to members for the purchase of shares.

Section 2. Amount of Issued Shares. The initial amount of shares to be issued by this credit union as of ______________ 199_ is ________________. The board shall have the right at any time, to increase the amount of shares in this credit union and have the right to issue separate classes of shares upon approval of two-thirds of the members.

Section 3. Amount of Shares Per Member. The minimum amount of fully paid in shares required per member is one (1) and the maximum amount of paid in shares which may be held by any one member, including the immediate family of the member, may not in aggregate exceed ten (10) percent of the total number of paid in shares issued at any time.

Section 4. Shares Issued to Minors.

A. Shares may be issued in the name of a minor, and may, at the discretion of the Board, be withdrawn by the minor's parent, guardian, or agent in accordance with applicable law, and in either case, payments on such withdrawals shall be valid.
B. Shares issued in the name of a minor shall be non-voting shares until the minor reaches the age of legal majority.
C. Minors who are not the age of legal majority are not entitled to receive loans from this credit union.

Section 5. Joint Accounts. The credit union may establish share accounts, for two (2) or more members and for a member and any other person or persons designated by the member, payable to either or payable to the survivor. The person first named in any such joint account shall be a member of the credit union. Any shares or dividends thereon may be paid to any one or more of the persons named in the account whether the others are living or not, and the receipt or acquiescence of the person so paid shall be valid and sufficient release and discharge of the credit union for any payment so made.

ARTICLE IX
TRANSFERS, FEES AND WITHDRAWALS

Section 1. Transfer of Accounts. No member or employee of this credit union may, as an individual, discount or directly or indirectly purchase any savings, share or other account from any other member.

Section 2. Withdrawals.

A. Except as provided in Paragraphs (B) and (C) of this Section, money paid in on shares may be withdrawn as provided in these Bylaws on termination at the office of the credit union when the credit union is open for the transaction of business.
B. Unless otherwise agreed between the credit union and the member, the Board shall have the right to require a member or other person to give sixty (60) days' prior written notice of intention to withdraw the whole or any part of the amount paid in by the member for shares.
C. Except to the extent that the shares exceed total primary and contingent liability to the credit union, no member or other person may withdraw funds from any share account held by the credit union without the prior written approval of the Credit Committee or a Loan Officer if the shares are pledged as security on a loan made by the credit union; and either:
   (1). The member or any other person named in the account is delinquent as a borrower on a loan made by the credit union; or
   (2). The member or any other person named a co-maker, endorser, surety or guarantor for any borrower is delinquent on any loan made by the credit union.

D. The credit union is not entitled to charge any fee or commission that would reduce the amount of the withdrawal. However, if the member withdraws paid-in shares that have been held in the credit union less than ninety (90) days, the credit union may charge a penalty for withdrawal as stipulated by the Board.

Section 3. Fees. The Board may establish appropriate fees for services provided to members, subject to limitations imposed by applicable law, if any.

Section 4. Statement of Account.

A. Except as provided in Paragraph (B), the credit union shall provide each member at least semi-annually a statement or other record of the member's accounts in which shall be entered all moneys paid by the member to the credit union and all moneys received by the member from the credit union. The statement of account shall be the official receipt of the member, and shall be retained by the member.
B. The credit union shall not be required to provide a semi-annual statement of account to any member who has neither deposited funds into the member's accounts nor withdrawn funds from the member's accounts during the period to which the semi-annual statement applies. However, the credit union shall provide each member with a statement of the member's accounts at least annually, even if no transaction has occurred in the accounts during the twelve (12) months preceding the close of the period for which the statement is prepared.

ARTICLE X
CREDIT COMMITTEE - LOAN OFFICERS

Section 1. Appointment of Credit Committee; Loan Officers. At each organizational meeting of the Board, the Board shall appoint the Credit Committee, or three or more Loan Officers, or both, from among the members of the credit union. Unless sooner removed, each member of the Credit Committee and each Loan Officer shall be appointed to serve until the organizational meeting of the Board following the next annual meeting and until a successor is duly qualified. No Director may serve as a Credit Committee member.

Section 2. Meetings and Records. The Credit Committee shall meet every ____________ week(s) to review and consider loan applications. The Credit Committee and Loan Officers shall maintain a record of all actions taken on loan applications. All records of the Credit Committee and Loan Officers shall be prepared within __________________________ (____) days after the action is taken.

Section 3. Compensation. Board of Directors, Members of the Credit Committee, Supervisory Committee and Loan Officers shall receive no compensation for their services. Necessary expenses incurred incidental to the performance of the business of this credit union will be paid after approval by the treasurer or other designated executive official.

Section 4. Service as Surety. No Loan Officer or member of the Credit Committee shall directly or indirectly co-sign or otherwise guarantee any loan or advance made by the credit union.

ARTICLE XI
LOANS - DUTIES OF CREDIT COMMITTEE AND LOAN OFFICERS

Section 1. Loan Policy; Applications.

A. All loans made by the credit union shall be made in accordance with applicable law, these Bylaws and written lending policies established by the Board.
B. Applications for loans shall be made on forms provided by the credit union and shall state the security or collateral offered, if any, and such other information as may be required by the Credit Committee or Loan Officer.

Section 2. Duties of Credit Committee; Loan Officers.

A. All loans made by the credit union and all of the terms of such loans shall be approved by a majority of the Credit Committee, with each member having one vote, or by a Loan Officer. Any applicant who is denied a loan by the Credit Committee or a Loan Officer may appeal the denial in writing to the Board, and the Board shall affirm, reverse or modify the denial within thirty (30) days after the written appeal is filed.
B. The Credit Committee or Loan Officer shall examine the financial condition of each applicant for a loan and the applicants sureties, if any, to ascertain the ability of the applicant and any surety to pay fully and promptly their respective obligations.
C. The board may appoint one or more Loan Officers and delegate to them the power to approve certain loans. All actions taken on loan applications by a loan officer shall be reported monthly to the credit committee or more frequently if requested by the credit committee. A member whose loan application is declined by a loan officer may appeal the decision to the credit committee.

Section 3. Security for Loans. Within the limits of the written lending policies established by the Board, the Credit Committee and Loan Officers shall determine the security required for each loan. The security furnished shall be consistent with applicable law and sound lending practices.

Section 4. Acceleration of Maturity. The Board may declare any non-consumer loan immediately due and payable if any facts in the loan application are found to have been misstated or if the money borrowed has been used for purposes materially different than those stated in the application.

Section 5. Loans to Insiders. Approval of loans to board members, executive officers, committee members, directors and employees is subject to the applicable law and regulations.

ARTICLE XII
LOANS TO MEMBERS

Section 1. Qualifications. Loans to individuals shall be made only to members, and shall be made for provident or productive purposes in accordance with these bylaws, applicable law and regulations.

Loans to a member other than a physical person shall not be in excess of its combined shareholdings in this credit union.

Section 2. Terms. The board shall fix the interest rates on loans, fees associated with closing, disbursing, extending, collection or renewing loans, the rate of interest refund, if any, to be made to members, and terms of payment or amortization of loans to members and the security taken for the loan.

Section 3. Conditions. No member will be considered for or granted a loan until the member has been a member and saver for three (3) consecutive months, during which the member's paid-in shares exceed his or her liability to the credit union. The amount of a loan to any member cannot exceed three (3) times the amount of the member's paid in shares.

ARTICLE XIII
FINANCIAL MANAGEMENT

Section 1. Dividends. The Board shall establish the dividend period, and the rate and terms of payment of dividends in accordance with applicable law. The rate and terms of payment may be established in advance by the Board. The Board may classify share accounts, and may declare dividends at variable rates for each type of account. Dividends due to a member shall be credited to the member's account.

Section 2. Reserves. The credit union shall establish and maintain reserves in the manner and at least the amounts required by applicable law. The Board may also establish other reserves. The Board shall give priority to reserve payments over the payment of dividends.

Section 3. Fiscal Year. The fiscal year of the credit union shall end on any date approved by the Board of Directors.

Section 4. Excess Funds. The board shall determine written procedures for investing funds of this credit union not used for loans to its members. The board is prohibited from depositing more than fifty (50) percent of these funds in one commercial bank or non-banking financial institution that is approved by NBRK.

Section 5. Auditor.

A. Within two (2) months after the date of each annual meeting, the Supervisory Committee shall appoint a competent and qualified person to audit the operations of the credit union. The auditor shall at least once between consecutive annual meetings of the members make an audit of the affairs of the credit union, including an audit of the books of the credit union. Upon completion of the each audit, the auditor shall provide a written report of the auditor's activities, findings and recommendations to the Board. The auditor's report and any recommendations shall be presented to the NBRK, board of directors, and supervisory committee, and to the members at the annual meeting following the completion of the audit.

B. The auditor shall cause every remaining account to be verified with the records of the credit union at least every three years. The auditor shall verify with the records of the credit union, each year, all accounts in the name of Board members, the President, if any, and employees, if any. Subject to this requirement the auditor may select samples of accounts not verified within the prior three years. If any audit reveals fictitious or unauthorized transactions within the sample, or if the subsidiary records do not agree with the general ledger control accounts by a material amount, the auditor shall promptly verify all member accounts with credit union records.

ARTICLE XIV
AMENDMENT OF BYLAWS

Section 1. Amendment by Board. These Bylaws may be amended, altered, or repealed in any manner not inconsistent with applicable law by a majority vote of the Board at any duly convened meeting of the Board. However, no motion or resolution amending or repealing any Bylaw shall be adopted at a meeting of the Board held on the same day upon which the motion or resolution is offered.

Section 2. Amendment by Members. These Bylaws may be amended by a three-fourths (3/4) majority of the votes, including fractional votes, cast by members present at any annual or special meeting of the members, if all notice and other requirements applicable to amendment of these Bylaws are satisfied.

Section 3. Approval. No amendment, alteration, or repeal of these Bylaws shall become effective until filed with and approved by the Supervisor.

ARTICLE XV
GENERAL PROVISIONS

Section 1. Confidentiality; Oath. Officers, Directors, members of committees and employees of the credit union shall hold in confidence all transactions of this credit union with its members, as well as all information respecting each member's affairs, except to the extent deemed necessary by the Board in connection with the making and collection of loans, the disbursement of the funds of deceased members, the resolution of overdrafts and as otherwise determined by the Board. Immediately following each annual meeting, all Directors, committee members and employees shall take an Oath of Office in the form prescribed by the applicable law, and each oath shall be filed with the other records of the credit union.

Section 2. Pecuniary Interest. No Director, Committee member, Officer, agent or employee of this credit union shall in any manner, directly or indirectly, participate in the deliberation upon or the determination of any question affecting the person's pecuniary interest or the pecuniary interest of any corporation, partnership or association in which the person is directly or indirectly interested. In the event of disqualification of any Director, or member of the Credit Committee respecting any matter presented to the Board or Credit Committee for deliberation or determination, such Director or committee member shall withdraw from the deliberation or determination. If a Director or Credit

Committee member withdraws from any deliberation or determination, the remaining qualified Directors or Credit Committee members present at the meeting may exercise all powers of the Board or Credit Committee, provided the number of Directors or Credit Committee members present, including the disqualified Directors or members, constitutes a quorum.

Appendix 6 - Consumer Co-operatives as Defined in Kazakstan Civil Code

Kazakstan Civil Code: Section 108. Consumer Co-operatives

1. A consumer co-operative shall be recognized as a voluntary association of citizens formed on the basis of membership for the satisfaction of their financial and/or any other needs, which is carried out by way of its members uniting their property in the form of share contributions.

2. Members of a consumer co-operative shall be obliged within three months after the approval of the annual balance-sheet to cover the losses of the co-operative by making additional share contributions. In the case of a failure to fulfill this obligation, the co-operative may be liquidated.in a judicial procedure by demand of the creditors.

   Members of a consumer co-operative shall jointly bear a subsidiary liability in respect of its obligations, within the limits of the unpaid amount of the additional contribution of the co-operative members.

3. The charter of the consumer co-operative must contain, aside from the information indicated in paragraph 5 of Article 41 of this code; the size of the co-operative member shares, the composition and procedure for contribution of shares by the co-operative members and their responsibility for violation of obligations associated with the contribution of the shares, the composition and authority of the governing bodies of the co-operative and the procedure for adopting them by resolutions, including issues. The resolutions whereon are to be adopted unanimously or by a qualified majority of the voting members and the procedure for the compensation by the members of the losses incurred by the co-operative must be included.

4. Income received by a consumer co-operative may not be distributed among its members and it shall be used as contributions toward charter capital.

5. In the case of liquidation of a consumer co-operative or in the case of a member leaving the co-operative the member or members, shall have the right to claim their share in the assets of the consumer co-operative in proportion to their share. In the case of demise of a co-operative member, his beneficiaries shall have the priority right to be accepted as members of the co-operative, unless otherwise stipulate in the co-operative charter. If the latter is the case, the co-operative shall pay to the beneficiaries the share in the property of the consumer co-operative, in proportion to their share.

6. The legal status of the consumer co-operative and also the rights and obligations of its members, shall be determined by the legislative acts in accordance with this code.

7. Rural consumer co-operative may be created for the satisfaction of financial and any other needs of not only their members, but other citizens as well who reside in rural areas. Special considerations in the rural consumer co-operatives shall be determined by special purpose legislation in compliance with this article.

* translated from the Russian language original.

Appendix 7 - Other Legislation Affecting Rural Finance

Other Legislation Affecting Rural Finance

It appears that Government of Kazakstan is making sufficient progress in the development of a legal framework for rural finance. As a result of donor support, significant pieces of legislation have been developed and put into force by decree. Future work is expected to concentrate on land registration, titling, enforcement of lending agreements and additional ownership right provisions.

The following is a list of laws, decrees and regulations that were referred to by the Consultants as they affect Rural Finance. The Consultants reviewed the legislation to determine its ability to provide a legal framework for the establishment and sustainability of rural financial institutions, the protection of financial institutions' rights, the ability to collateralize and perfect, and the ability to own, pledge and mortgage land. All important aspects to rural finance.

The laws and regulations affecting rural finance are contained in the Arch Clip File that will be submitted with the Final Report.

A. Banking Reform Legislation

Banking legislation is initiated by the NBRK legal department and the USAID banking supervision legal advisor, the WB payments systems legal advisor and the ADB non-banking financial institution legal reform team. As noted in paragraph 38-39, the USAID team has been active in developing specific legislation concerning banking supervision and the enforcement of prudential norms.

Resolution of Provisions on Prudential Norms, dated February 1996: This resolution was written by the NBRK in accordance with Article 42 of the Banking Law and defines the compulsory prudential norms that must be meet by second-tier banks. The five norms are; Minimum amount of charter capital, capital adequacy, maximum risk coefficient per customer, liquidity and limits of foreign exchange exposure.

Temporary Regulation Concerning Credit Partnerships, dated 19 October 1996: To address second tier banks that cannot meet the minimum capital requirements of USD $500,000, the NBRK approved in October 1995, *Temporary Regulations Concerning Credit Partnerships*. This regulation outlined the framework for the creation, operation, and cessation of activities of credit partnerships as one of the legal types of banking institutions in Kazakstan. A credit partnership is a legal entity formed for the purpose of granting loans to its participants. The NBRK will issue the Credit Partnership a license to allow limited banking operations. All activities of the credit partnership are regulated by the NBRK under the LAW.

The legal form for the credit partnership maybe either a joint stock society of the closed type or a limited liability partnership. Both are legal entities as declared in the Kazakstan *Civil Code*. Minimum capital for establishing the partnership is 10 million Tenge (USD $150,000); and only persons and legal entities from Kazakstan may be participants in the partnership. Furthermore, only small and medium size businesses with asset size of less than 20 million Tenge may be shareholders and participants in the partnership.

The credit partnership has the right to operate in the following areas:

- transfer of transactions;
- accounting/book-keeping operations;
- loan transactions;
- securing of valuables;
- factoring;
- forfaiting of operations

No rights are granted for the partnerships to accept deposits and they may not create affiliates, representations, or subsidiaries in Kazakstan. Acceptance of deposits is extremely important for the establishment and ongoing viability of rural financial institutions.

As a result in the deficiencies in the *Temporary Regulation Concerning Credit Partnerships*, the Consultants have prepared a draft decree on Credit Unions for NBRK consideration. In addition to the decree, the Consultants have prepared model Bylaws. This decree will form the basis for CU operation in Kazakstan .

Regulation concerning *The Amortization by Banks of Losses on Loans to State Enterprises*, dated 23 February 1996: This regulation issued by the NBRK establishes procedures for amortization of loan losses, accounting for such amortization, as well as the procedure for granting and deprivation of the authority to amortize such losses. Of interest to the Study was Section 1 which concerns the conditions and percentages for amortization of loan losses.

Regulation on *Procedures for Maintaining Loan Documentation by Banks*, dated 1996: The regulation on procedures for maintaining loan documentation establishes requirements for banks on maintaining loan documentation, with the objective of ensuring uniform conditions for the inspection of bank activities by NBRK examiners. The list of required documents that have been included in the regulation meets international standards and represents another step forward in the development of uniformity and transparency in the banking sector for credit granting guidelines. The procedures will not apply to loans made prior to the regulation's approval, except during instances when the loan is restructured or refinanced.

Law on Banks and Banking Activity in Kazakstan, dated August 1995: The objectives of the law on banks and banking activity was to define the types, legal status, procedure for foundation, functioning and termination of activities for all second tier banks. This law provides a comprehensive basis for the delivery of financial services by banks.

B. General Legislation

Civil Code of the Republic of Kazakstan, dated December 1994: The civil code regulates all contractual and financial transactions between two or more parties, non-proprietary transactions which are associated with business transactions, personal non-proprietary transactions, family relations, labor relations, natural resource use and protection of the environment.

Specific articles of the civil code that are relevant to the Study are:

- Paragraph 1 which defines physical persons in Kazakstan;
- Paragraph 2 which states the various legal form of entities;
- Article 117-118 concerning movable and non-movable assets and registration;
- Chapter 8 concerning the right to own;
- Chapter 9 concerning the right to conduct business;
- Chapter 11 concerning the right to common property; and
- Chapter 18 concerning pledge, warranty, guarantee and other agreements.

Draft Decree on Bankruptcy, dated October 1996: This proposed decree on bankruptcy as discussed in paragraph 187.

Decree Concerning Business Partnerships, dated 2 May 1995: The edict concerning business partnerships regulates the activities of the creation, operation and cessation of commercial organizations which are established in the form of a business partnership. This decree further defines fundamental provisions for general partnerships, limited partnerships, limited liability partnerships, partnerships with additional liability and joint stock societies. Initial legislation concerning business partnerships can be found in the *Civil Code*.

Specific articles of the business partnership legislation that are relevant to the Study are:

- Article 3 and 4 concerning participants of a business partnership and foundation documents; and
- Section 2 concerning the five individual types of business partnerships.

Social Doctrine of the Republic of Kazakstan, dated May 1996: The social doctrine is not an official law or decree but a statement of purpose by the Government that identifies policy goals and objectives, main areas, priorities and activities of the state social policy, important indicators of social development and an organized action plan for implementing the social doctrine. Relevant sections included the plan for social welfare and poverty alleviation.

Decree on Taxes and Obligatory Payments to the Budget, dated 24 April 1995: This tax legislation sets forth the compulsory tax payments to the federal and local budgets and governs all taxation relations in the RK, with the exception of custom duties, levies and payments, which are governed by the customs legislation of RK, acts of the Cabinet Ministers and acts of the main tax inspectorate of the MOF.

Specific articles of the tax code that are relevant to the Study are:

- Article 16 which concerns the deduction of interest on bank credits from taxable income based on the refinancing rate set by the NBRK and increased by 50 percent of the stated rate;
- Article 17 which allows specific loan loss provisioning on all classified loans before tax and up to 50 percent of the book value of all outstanding loans from 1995;

- Article 32 which allows interest paid on bank accounts to be subject to a 15 percent tax withheld at the source; and
- Article 147 which concerns the tax inspectorate's right to seize and freeze bank accounts.

Decree on Formation of Agricultural Support Fund, dated December 1994: This decree was developed in accordance with the 1994 Government program of actions for increasing reforms and overcoming economic crisis. It establishes procedures for forming and rendering financial support to agricultural commodity producers and implementation of agricultural development programs. As a result of this decree, all past due directed debt of agricultural enterprises from APB and other banks was transferred to the ASF balance sheet for loan workout.

C. Land Reform Legislation

Edict of the President Concerning Land, dated 22 December 1995: The objectives of the land legislation is to regulate land relations of the purpose of providing for rational use and protection of land, recovery of fertile soils, protection and improvement of the environment, creation of conditions for all forms of land ownership, protection of the rights of land owners whether they are citizens or legal entities, creation and development of a market for immovable property and strengthening of legality in the area of land relations.

Specific articles of the land code that are relevant to the Study are:

- Article 8 which states conditions for lease payments for land and payments for transfer of land plots;
- Section 2 concerning the right of ownership and other material rights relating to land;
- Chapter 4 concerning the rights and obligations of owners of land plots and land users;
- Chapter 5 and 6 concerning the right and use land;
- Chapter 7 concerning the rights of passage;
- Chapter 8 concerning the right to pledge land and right of use of land;
- Chapter 10 concerning lands of agricultural designation; and
- Chapter 18 concerning land tenure, monitoring and state land cadastre.

Resolution 625 of the Cabinet of Ministers concerning the approval and the procedure for the purchase and sale by citizens and legal entities of the Republic of Kazakstan of the right to life hereditary tenure, the right to use or the right to lease land plots.

This resolution preceded the Land Law of 1995 and addressed the right to use and lease of peasants' farms, private auxiliary farms and gardens.

Edict of the President, Concerning the Mortgage of Immovable Property, dated December 1995: This law regulates activities which emerge in applying the mortgage of property as a means of securing obligations. The general rules legislation concerning pledging is contained in the Civil Code.

Specific articles of the law that are relevant to the Study are:

- Chapter 2 concerning the mortgage agreement;
- Article 14 concerning the terms for exercising the rights and the execution of the mortgage; and
- Chapter 4 concerning the realization of a mortgage.

Resolution 401, 402, 403 of the Government about procedures for providing land plots to citizens and legal entities, distribution of certificates on the right of land plot ownership and the right of permanent land use among citizens and legal entities, and procedures of application and redemption of land plots for state needs. To implement the following three laws; Land Law, Law on State Registration of Immovable Property and Law on Mortgage of Immovable Property, resolutions 401,402, and 403 were drafted.

Law on the Mortgage of Real Estate, dated 23 December 1995: The law on the mortgage of real estate was written to regulate all transactions that take place when real estate is used as an instrument for securing obligations. The general rules concerning pledges, as stipulated in the Civil Code, shall apply to the mortgage of real estate unless stipulated in this law. This law is important to the banking sector because it allows a borrower to pledge real estate as collateral for a loan. Real estate (property) as defined in this law includes land plots, buildings, structures and other property that is securely attached to the land. It does not include land that is designated for agricultural purposes.

D. Farm Privatization Reform Legislation

Law on Peasant Farms, dated 1990: This law determines the main principles of peasant farm development and its legal basis for organization and operation. In addition it creates conditions for the development of peasant farms, guarantees the protection of their rights and legal interests. Since the date of inception, few changes have been made to the law. A peasant farm is not a legal entity as defined in the Civil Code.

Resolution #611 of Cabinet of Ministers, concerning the approval of rules of transfer of rights to land shares. This resolution allows the holder of land shares to sell or transfer their rights to a second party or contribute this land share to the authorized capital of economic partnerships and production co-operatives.

Presidential Decree #2486, Concerning Production Co-operatives, dated September 1995: This decree was written to regulate the activities of voluntary associations of citizens with the purpose of conducting joint entrepreneurial activity based on labor participation and the joining of personal property shares of the members. USAID legal experts describe this decree as a modern version of the former collective farm system. The Consultants reviewed the law as a possible form of a legal entity necessary for a rural financial institution.

Appendix 8 - Selected International Rural Banking Experiences

Selected International Rural Banking Experiences

The Farm Credit System in the United States

In the United States, for example, the cooperative Farm Credit System, which has traditionally accounted for about one-third of farm credit, suffered a severe crisis in the early 1980s. The estimated cost of this crisis was USD $60 billion; the largest disaster affecting financial institutions ever experienced in the US up to that time.

The beginnings of the Farm Credit System were based on a financial innovation pioneered by the US Government in 1916. The System was based on the issue of bonds on the nation's capital markets. This permitted agriculture to tap the huge pool of funds provided by investors, including pension funds. This enabled farmers to obtain longer-term mortgages, stabilizing the agricultural sector and land ownership. The bonds were not guaranteed by the government, but because of the political nature of the Farm Credit System these bonds were regarded as having government backing and were traded at very small premium over US Treasury securities.

During the Great Depression of the 1930s, the System shifted to its present form through the addition of short-term lending facilities. Over time, ownership of the System passed entirely to farmers, although it has remained closely tied to government through the Farm Credit Administration and the interests of members of Congress from farm states.

The debacle of the 1980s began with increases in the prices of farm land resulting from increases in the prices of agricultural produce. To facilitate the operations of the market for agricultural land, and especially to respond to the desire of operators of family farms to acquire more land, Congress increased the proportion of the value of land purchases that could be financed by mortgages issued by the Farm Credit System. Financing could be obtained for more than 90 percent of the value of the land being purchased. The desire of many operators of family farms to increase their landholdings reflected the economics of agriculture: larger farms were more economic than smaller ones for production of basic grains because owners could spread their fixed costs over a higher volume of sales.

Family farms constitute the backbone of American agriculture. They consist of land operated by the family that owns the farm, possibly with the assistance of a small number of hired laborers. Farm size in grain-growing areas would rarely be less than 400 ha. Other types are "week-end farms," smaller land areas operated on a part-time basis by people with other jobs outside agriculture, and a relatively small number of corporate farms that operate on an industrial scale. Accordingly, family farms as a group have the greatest political power.

The crisis eventually occurred when agricultural prices declined and land values fell. Incomes of farmers were reduced, and these who had purchased land during the boom had trouble servicing their debt. In many cases the amount of their loans exceeded the market value of their land. This led to a decline in the number of farmers since those who were over-indebted lost their lands and went out of business; and to the impairment of the capital of the lending institutions composing the Farm Credit System, which was reorganized as a result. One casualty was the cross-guarantees provided by different regional organizations within the Farm Credit System. When the crisis hit, some of them refused to honor their guarantees.

The farm credit crisis also resulted in the closure of many small banks in rural areas. Traditionally, commercial banks also provided about one-third of agricultural credit. The capacity of the Farm Credit System to provide very high levels of financing enabled the System to increase its share of farm credit to 50 percent, from its previous market share of about one-third. Banks that wanted to compete and retain clients who would otherwise be attracted to the Farm Credit System had to offer similar credit terms. When crop prices declined and land values fell, many banks also incurred losses that forced them to close.

The lessons are that: a) Political involvement in rural finance has immediate benefits but long-term costs that can be massive. These costs include amounts borne by taxpayers through government actions to rescue major financial institutions, the bankruptcy or loss of land by farmers who become over-indebted, and the closure of failed financial institutions. b) Increasing farm size through the debt-financed purchase of land has risks when produce prices, farm incomes and land values change. Family farm operators who increased the scale of their operations by renting or leasing land, often on a crop sharing basis, were relatively unaffected by the crisis. c) Different types of operators have different economic considerations, financing preferences, and risks. Week-end farmers and corporate farms were largely unaffected by the crisis because they were not interested in borrowing to increase their operations.

Rural Banking in Indonesia

In the 1970s the Government of Indonesia channeled proceeds from the sale of oil through the banking system for lending to small rural businesses including agriculture. Interest rates in the banking system were fixed and low, and those for rural activities were also subsidized. Rates paid on deposits were below those charged on loans. This contributed to capital flight and to increased government reliance on foreign borrowing.

A major government program called BIMAS provided input credit to farmers through the 3,600 village units of the Bank Rakyat Indonesia (BRI), a very large state-owned commercial bank. The farm credit program was designed to promote Green Revolution rice cultivation using modern inputs. After the mid-1970s the number of farmers participating in this program began to decline because of crop failures, the exclusion of farmers who did not repay, and more convenient alternative sources of input credit. Bad debt losses rose to 20 percent of total loans in 1983. Many of the remaining borrowers were quite wealthy by local standards.

By 1983 oil revenues had fallen and the government could no longer afford to subsidize interest rates and to bear the losses from low collection rates on subsidized loans. Financial markets were liberalized: many regulations were dropped, interest rates increased and deposit growth expanded significantly. BIMAS was virtually discontinued, and the future employment of the 14,000 BRI staff serving in rural areas was in doubt.

BRI management decided that it would continue its rural operations on a commercial basis, retaining most of the staff who had administered BIMAS who would offer full service rural banking. The Minister of Finance authorized "break-even" interest rates for rural banking operations, and the initial interest rate on loans was about 3 percent a month. Each rural unit was reorganized as a semiautonomous profit center

based on its own accounts, permitting evaluation of unit performance based on profitability rather than to money lent or hectares covered as under BIMAS.

In 1984, BRI village units lost more than USD $24 million; in 1989 they produced a profit of more than USD $25 million. By the mid-1990s, the village units contributed about 90 percent of BRI's overall profits. By 1990, almost 2 million loans were outstanding, averaging about USD $440. Bad debt losses amount to less than 4 percent of loan amounts disbursed. Several hundred thousand loans are made each month. By 1993, more than 11 million people have savings accounts at village units, while the number of borrowers approximated 2 million. Deposit balances not used by a village unit to fund loans are transferred to the rest of the BRI system, and earn interest for the unit generating these funds.

The smallest village unit is staffed by four persons: manager, loan officer, bookkeeper, and cashier. As the volume of business increases, more staff are added. A village unit that has 11 staff is split into two, adding a new village unit. New units are often formed from village posts that are two-person banking offices that accept savings and loan repayments but do not make loans. Applications submitted at posts are referred to a village unit for action, and the village unit manager and loan officer have the authority to approve or deny most applications that are likely to be received at village posts or at their units. Village units are monitored by BRI branches that have business managers who visit village units periodically. All staff have high school diplomas and many are also college graduates; in 1990 village unit staff were upgraded and became regular employees of BRI, with increased wages and benefits.

Village units were capitalized by a government grant connected with earlier directed credit programs that were discontinued. By 1990 the cost of funds and operating expenses of village units were no longer subsidized, and deposits exceeded loans outstanding. Their return on assets has been as high as 4.9 percent, an exceptionally good performance relative to the 1 percent return earned by many large banks in developed countries. Loan loss reserves of up to 6 percent of loans outstanding are considered satisfactory. The loan portfolio is diversified by purpose, including microenterprise, agriculture, purchase of motorcycles for transport, and home improvement.

The lessons from BRI village unit operations are that: a) Market-based rural banking has a much greater capacity for growth and sustainability than subsidized credit programs. b) Subsidized credit schemes accumulate losses and eventually have to be shrunk or discontinued, while profit-oriented rural banking has great capacity for growth. c) Rural savings capacity and the demand for savings deposits with competitive rates of interest exceed the demand for rural credit at market rates of interest. d) Government control of interest rates usually retards rural finance. e) A good institutional framework is required for successful operations involving a large number of branches nationwide.

Experience in Indonesia demonstrates that good commercial banking practice can be applied with excellent results in rural areas. An unanswered question is whether Indonesian practice, developed in densely populated rural areas, can be replicated with equal success in sparsely populated areas.

Rise and Fall of Rural Credit in Malawi, 1972-1995

Group credit to small farmers for the purchase of inputs got off to a very good start in Malawi in the 1960s, with participation of large numbers of farmers and repayment rates of 98 percent and above. By

1995 repayment rates had fallen to single digit percentages and the program was discontinued, leaving farmers with no access to formal credit.

Group credit began as a means of selling fertilizers to villagers. Farmers were urged to form groups, often consisting of family members with different plots of land, to gather a downpayment equal to 10 percent of the cost of the fertilizer the group wanted to buy, and to sign a loan agreement for the remaining 90 percent. The supplier of credit and fertilizer was ADMARK, the government monopoly supplying agricultural inputs. The scheme was especially interesting to farmers because the fertilizer would be delivered to their village or another place designated by the group. Delivery by ADMARK truck replaced headloading and bicycle transport of sacks of fertilizer to villages. Groups that did not repay their loans and interest due were denied credit the following season or until the overdue amount was cleared by the borrowers. Repayments of 98 percent and above were recorded for several years.

Groups never became permanent as some development assistance officials had hoped they would, possibly as a sort of pre-cooperative organization. Groups never left their 10% on deposit, as these officials hoped they would, so that a larger balance could be built up each year that would eventually enable them to obtain fertilizer for cash rather than on credit. Groups preferred to disband and reform each season so that members who were bad risks could be excluded, making it easier to manage the joint liability all members had for the entire amount due ADMARK following harvest.

After a number of years the government became more intent on increasing crop production to satisfy local demand and for export (maize, groundnuts, cotton and tobacco were major crops). It was decided that repayment in full was too harsh a criterion, and it became possible for groups to obtain more fertilizer on credit even if they had not repaid in full the loan taken the previous season. Defaults quickly spread, and these could not be effectively checked by lenders. Finally the system simply collapsed as repayments fell to single-digit percentages and the government decided it could no longer supply fertilizer essentially for free.

Credit Union Reform in Guatemala

Credit unions serving rural borrowers developed in Guatemala well in the 1960s and 1970s, but experienced declines in repayment performance in the 1980s. Several features led to this decline. One was that credit unions can easily become borrower-dominated. This occurs as borrowers become the majority of the membership and use their influence to keep interest rates low. Returns to savers of course are then even lower, so members are less willing to deposit money with their credit union. One reason that borrower domination occurred was that development assistance agencies such as USAID used the credit unions to make loans to small farmers. Many of these loans supported activities that were not profitable to borrowers or that otherwise led borrowers to default.

The country had also experienced instability that diminished faith in financial institutions and in the currency. Credit unions often became inefficient as staff were hired who were really essential to the good operation of the credit union. These were frequently relatives or friends of prominent members. Little new investment was made in credit union offices, which became dilapidated and not attractive for new members. The leaders of the national credit union league were not always willing to address serious

problems such as profitability and capital adequacy, hoping that adherence to cooperative principles and promotion of solidarity would provide the basis for good operations.

As problems such as these occur, many credit unions die a slow death. Credit union members can almost always borrow against their deposits, which are called shares. As people lose interest and as services become less attractive, borrowing against shares tends to increase. This permits people to remain members, maintaining solidarity and avoiding the formalities of withdrawing outright. As more and more members borrow against their shares, the credit union loses liquidity and ceases to grow. It continues to exist, but handles fewer and fewer transactions because members no longer have confidence in it.

The movement, consisting of about 36 credit unions, began to restructure itself in the 1980s under a new leader of the national league who was highly respected. USAID assisted this effort after it had been started by the credit unions themselves. The national credit union apex organization and its share insurance fund were restructured in the effort to recapitalize credit unions. Credit unions' balances in the share insurance fund were returned to them so that they could use these assets to serve their members directly. Staffing levels were reviewed and some nonessential staff were fired. Credit unions were urged to repair their offices to make them attractive, which would help to attract new members. Efforts were made to offer new services. The results have been highly successful and credit unions have once again become an extremely important, growing source of financial services for people in rural areas and others with modest incomes.

Transition in Laos

The Central Bank provided all banking services in Laos until 1989. Its specialized departments and provincial offices that provided state funds to state enterprises. In 1989, provincial offices became autonomous government banks. Each inherited a loan portfolio dominated by bad debts from state enterprises.

Interest rates on deposits and loans were distorted by government regulation. Rates on agricultural loans were below rates offered on deposits. Banks made few agricultural loans and concentrated on short-term commercial credit at lending rates more favorable to the banks. The Central Bank funded agricultural lending at confessional rates, but this lending did not result in increased production because the supply of funds shrank because of budgetary problems faced by the government. The provincial banks remained undercapitalized, had little incentive to mobilize savings, and concentrated their lending in urban areas. The little agricultural lending that was undertaken was in villages on main roads.

An Agricultural Promotion Bank was established. It quickly formed small sub-units to achieve broad outreach to large numbers of rural people. Sub-units promoted savings and credit, primarily for small farms, using joint liability groups. Group members, under the oversight of Village Heads, developed the capacity to devise farm production plans and budgets. The Bank appraised the groups' plans and conducted socio-economic surveys of villages. Loan supervision was conducted by Bank credit officers with the collaboration of locally respected village leaders. Each credit officer was accountable for the quality of the loans under his supervision and received salary incentives for good performance. Seasonal loan collection ratios exceeded 95 percent.

The Agricultural Promotion Bank continues to expand the number of its sub-units, which are profit centers. With the freeing of interest rates, two other banks have adopted the practice of lending through village groups. A program has been implemented to offer medium-term credit for farm machinery and equipment, fishponds, poultry and piggeries, agro-processing, and for trade and services to agriculture.

The lessons from experience in Laos are that: a) group lending can produce good loans, b) village leaders can be enlisted to assist bankers in providing and using rural financial services, c) successful ideas and models will be copied when pricing permits the provider of services to earn a profit, and d) new financial services can be provided to borrowers who successfully repay their loans.

Appendix 9 - Rural Survey

TABLE OF CONTENTS

I. Background to the Survey

The rural economy of Kazakstan faces difficult times. Agricultural production and income have declined during the 1990's as a result of structural changes required for the establishment of a market economy. These changes have resulted in drastically different agricultural price relationships, land tenure arrangements, marketing and, consequently, income and expenditure flows. These changes only add to the riskiness of agricultural income, which has always been affected in Kazakstan by significant variations in arable crop yields from year to year. Insufficient data are available for a full understanding of the changes and the impact. The survey was undertaken in order to establish profiles of rural enterprise and the environment in which it operates.

A. Objectives

The objectives of the survey were:

- to create a profile of rural business enterprises;
- identify the potential client population for micro-finance in terms of ethnic background and gender;
- prepare a socio-economic profile for the identified client population, including minority groups, women, and the rural poor, that would be served through a properly functioning rural financial system;
- assess the perceptions of people within these various identified groups about constraints to credit access, including perceived difficulties in approaching or dealing with formal financial institutions;
- evaluate rural financial institutions' effectiveness in reaching out to these groups, as well as that of the social organizations assisting in the delivery of rural financial services;
- assess the economic aspirations of the rural poor, their attitudes about perceived economic opportunities, and their assessment of their ability to achieve their aspirations;
- examine opportunities for alternative rural employment, particularly for women, in agribusiness complementary to primary agricultural production, including agri-processing, transport, irrigation, storage operations and input supply; and
- assess and analyze current cash and non-cash income levels of the rural population, as well as farm and non-farm incomes.

B. Methodology

The methodology employed was one of a phased development:

- preparation - preparation included a review of relevant documents, design and printing of questionnaire;
- field survey - undertaken through interviews of the owners of farms and enterprises;
- database creation - the preparation of a FoxPro database and the creation of relevant tables;
- analysis and interpretation of the data; and
- draft report preparation.

C. Target Areas

1. Criteria for Target Area Selection

The sample population was selected according to the number of peasant farms located in five geographic regions of the country. Peasant farms formed the basis for stratification because they were the largest portion of the survey population and were the only survey group included in the population that the Consultants could identify the total number and were represented throughout all geographic regions of the country. It's important to note that peasant farms located within each geographic region are similar in types of production, but very different across geographic region. Twelve oblasts from each of the geographic regions were selected based on the percentage of peasant farms located in the region.

2. Division by Regions

Although the fieldwork was conducted in oblasts, the focus was regional; final data was to be examined by concentrating oblast data in relevant regional aggregates. The regions were as follows:

- Northern Region
- Eastern Region
- Southern Region
- Western Region
- Central Region

3. Oblasts Selected

The oblasts selected were the following (shown by region):

Table 1. Selected Oblasts

Region:	Oblasts Surveyed
Northern	North Kazakstan, Pavlodar, Torgai
Eastern	East Kazakstan
Southern	South Kazakstan, Almaty, Taldy-Korgan, Jambyl, Kzyl-Orda
Western	Aktubinsk, West Kazakstan
Central	Jezkazgan

4. Inner and Outer Circle Methodology

There was anecdotal and general evidence of a marked difference in the economic and social environment related to distance from oblast centers. To explore this more empirically, it was decided to stratify the survey focus in two concentric circles around the oblast administrative center, the radius of the first circle (the inner circle) being 50 kilometers and that of the second circle (the outer circle) being 100 kilometers. The survey results are reported on the basis of these two geographical strata.

D. Definitions of Sample Enterprises and Farms

1. Farms

The survey of farms concentrated solely upon peasant farms. Peasant farms as defined by the 1990 Law Concerning Peasant Farms in the Republic of Kazakstan:

1. A peasant farm is a family-labor association of people who are responsible for joint farming and production is based on private labor contribution of the peasant farm members. Each member of the farm has a joint-ownership over the production output of the farm and other property on the farm;
2. The members of a peasant farm can include; spouses, children, adopted children, parents, and other relatives who are responsible for working on the farm;
3. In the composition of a peasant farm, people who work under a labor agreement are not members of the peasant farm. Relatives may work under a labor agreement and not be members of the farm; and
4. Peasant farm is established on a free-will basis and is considered set-up from the moment the certificate of land use-right is submitted and signed.

2. Enterprises (other than farms)

The survey was designed to examine rural enterprise. Farms, the dominant rural enterprise were surveyed separately. The 'enterprise' focus was essentially off-farm enterprise and, for the purpose of the survey, comprised two categories:

- **agribusiness:** enterprise engaged in the processing and marketing of agricultural produce and in supplying goods and services directly relevant to agricultural production; and
- **non-agribusiness:** enterprise offering goods and services not directly related to agricultural production but that are dependent upon the prosperity of farming: such enterprise would include general merchandise and grocery stores, clothing, buses, etc.

E. Sample Size and Distribution

The survey was based upon a sample of 600 respondents, the breakdown of the sample being:

- peasant farms (PF) 200 respondents
- agribusiness (ABE) 100 respondents
- non-agribusiness (NABE) 100 respondents
- low income households (LIHH) 200 respondents

The primary basis for proportional distribution was peasant farm population in each oblast, adjusted for the distribution of respondents in the other groups (ABE, NABE and HH). This led to a small reduction in the number of respondents in oblasts with a larger number of PF and a corresponding rise in the number of respondents in oblasts with fewer PF. The PF sample distribution is shown in Table 2 below:

Table 2. PF Sample Distribution

	Oblasts in Regions	Quantity of PF in Region	Oblasts in the Survey	Oblast Sample (%)	Number of PF Respondents
Eastern Kazakstan					
1	Eastern Kazakstan	992	yes	3.9	23
2	Semipalatinsk	750	no	-	-
Central Kazakstan					
3	Jezkazgan	2,058	yes	8.0	48
4	Karaganda	412	no	-	-
Western Kazakstan					
5	Aktubinsk	803	yes	3.1	19
6	Western Kazakstan	622	yes	2.4	14
7	Atyrau	565	no	-	-
8	Mangystau	171	no	-	-
Northern Kazakstan					
9	Northern Kazakstan	2,153	yes	8.4	50
10	Pavlodar	1,872	yes	7.3	44
11	Akmola	1,520	no	-	-
12	Torgai	905	yes	3.5	21
13	Kustenai	1,189	no	-	-
14	Kokshetau	534	no	-	-
South Kazakstan					
15	South Kazakstan	7,297	yes	28.5	172
16	Almaty	4,038	yes	15.8	95
17	Taldy-Korgan	2,116	yes	8.2	49
18	Jambyl	1,711	yes	6.7	40
19	Kzyl-Orda	1,077	yes	4.2	25
	Totals/Overall	30,785	12	**1.9**	600

F. Fieldwork Preparation

1. Enumerator Training

Six enumerators were selected from academics and other persons with a suitable research background. Each was required to have had previous practical survey experience.

Time constraints and the demands of enumerators' permanent employment made pre-field training not possible. To compensate, the enumerators selected all had previous experience in conducting field interviews and the completion of questionnaires.

2. Pilot Testing of the Questionnaire

Pilot testing of the questionnaire was not done due to the above mentioned time constraints. However, by use of the selected enumerators' professional and survey experience, it was possible to test the questionnaire and to make compensating modifications prior to fieldwork.

G. Data Collection

1. Fieldwork

Fieldwork was undertaken between 20 July and 20 August 1996. 623 respondents were interviewed. For reasons of distance and cost, there was no supervision of fieldwork.
Field work was carried out in 12 oblasts. In each oblast the survey covered 2 rayons, except in South Kazakstan where 4 rayons were surveyed.

2. Post Fieldwork Review

A post-fieldwork review session was held on 21 August. The purpose of the review was to determine the constraints experienced in the field and the impact upon data collection; the constraints are identified in Section H below.

3. Data Entry

Prior to the return of the enumerators, the data processing team had set up the tables for data entry using FoxPro. Data entry was completed by 15 September and the tables derived from query were completed by 30 September.

H. Constraints Experienced

The constraints that most affected the outcome of the survey were:

- the absence of enumerator training: it would have been preferable if enumerators had been engaged at the start of July and had been given training and then run a test of the questionnaire;
- the size of the sample: the sample might have been larger, given the size and varied nature of the country;
- business respondents: as a result of the recession in rural areas many businesses are closed, making it difficult to identify and find operating firms;
- assets and values: many respondents were unable to identify with sufficient clarity the assets they own and to give a reasonable monetary value to those assets that were identified; and
- income and expenditure: respondents were uncertain about many aspects of their income and expenditure, in part because they did not wish to be too detailed lest the information reach the tax authorities and others; much of the data was aggregated and not itemized.

II. Survey Results

A. Overall

1. Ethnic Origin

National statistics show that the ethnic origin of the population of Kazakstan is as shown in Table 3; the survey results show that in rural areas, particularly in the outer circle, Kazaks tend to predominate.

Table 3. Ethnic Origin (percent of population)

		Survey Results		
Ethnic Origin:	**National Statistics**	**Overall**	**Inner Circle**	**Outer Circle**
Kazak	74.2	58.0	50.0	66.0
Russian	11.5	17.0	21.0	13.0
Other (comprising)	14.3	25.0		
German		1.0	2.0	
Ukrainian		3.0	4.0	2.0
Uzbek		7.0	7.0	7.0
Uigur		3.0	1.0	5.0
Turkman		2.0	3.0	1.0
Other		9.0	12.0	6.0

The higher percentage of persons of Kazak origin in the outer circles reflects the traditional pastoral farming, in which Kazaks predominate, in the remoter areas.

A feature of the survey results pattern is the near reflection of national data; for example, the land use pattern that evolved from the survey matches that found in national statistics:

Table 4. Land Use Pattern

	use of arable land			
	all arable land in Kazakstan		land of survey respondents	
Crop:	**hectares**	**percentage**	**hectares**	**percentage**
cereals	909,321	81.82	79,199	87.67
potatoes	3,570	0.33	151	0.17
vegetables	4,410	0.41	251	0.28
watermelons	6,212	0.56	329	0.36
forage	153,795	13.81	8,454	9.36
other (orchards, cotton, etc.)	34,027	3.07	1,956	2.16
Totals	1,111,335	100.00	90,340	100.00

Given the coincidence of the two sets of data, there are grounds for assuming that the results of the survey will be a broad reflection of the characteristics and situation of the rural community and its enterprise.

B. Peasant Farms

1. Land Title

Two hundred and fifteen peasant farm households were interviewed. Of these 91 percent had certificates of land use right, 4 percent were in the process of obtaining the certificates. Two percent of those who were interviewed did not have certificates. At two farms the head of the family was not present and title was not seen. Two percent of those approached were unable to answer the question of title.

Possession of certificates of land use right and farm households in the process of obtaining the certificates were almost equal in both circles:

- **possession** inner circle 92 percent
- **possession** outer circle 90 percent

- **processing** inner circle 4 percent
- **processing** outer circle 3 percent

2. Land Use

The pattern of land use by region is shown in Table 5 on the next page. The range of crops is limited in Eastern, Central and Western Kazakstan.

3. Cost of Production

Cost per centner of output is shown in Table 6 on the next page. One center is equal to 100 kilograms. The highest costs occur in Central Kazakstan and in the outer circles of Western and Southern Kazakstan.

4. Sale of Agricultural Produce

For many peasant farmers the inability to move produce to market is a significant constraint to land exploitation. The presence of collectors/market intermediaries offers the means of disposal of volume but uncertainty about intermediary reliability is a restraint to enterprise and the amounts being consigned to market through intermediaries remain low. Procurement agency, state farm and canteen purchases were small.

Table 5. Land Use Patterns by Region and Circle (hectares)

Crop:	Overall			East Kazakstan		Central Kazakstan		West Kazakstan		North Kazakstan		South Kazakstan	
	total	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
cereals	74,905	28,465	46,440	76	201		4,190	20,555	17,502	8,560	27,205	414	496
vegetables	146	104	42			9		6	5	5	10	89	27
potatoes	244	129	115			14		13	102	82	1	27	12
water melons	329	256	73		3	4		5	20	230	15	17	35
fruits	386	369	17							330		40	17
cotton	234	50	184							50	100		84
forage	8,413	6,692	1,721			45		4,995		509	1,097	1,144	664
other	1,335	1,103	232	13	28	800		20		230	93	40	111
totals	85,992	37,168	48,824	89	232	872	4,190	25,594	17,629	8,856	28,521	1,771	1,446

Table 6. Costs of Production (Tenge per-centner)

Crop:	Overall			East Kazakstan		Central Kazakstan		West Kazakstan		North Kazakstan		South Kazakstan	
	average	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
cereals	221	188	255	264	77		585	155	248	312	38	207	329
vegetables	283	367	200			500		576	447	463		295	555
potatoes	270	399	141			959		225	230	455		357	478
water melons	227	331	123			545			492	933		180	126
fruits	100	100								471		31	
cotton	1,369		1,369										1,369
forage	38	56	21			104		6		74	13	97	28
other	136	170	102			111		115		531	376	92	137

5. Output Disposal

Table 7. Disposal of Output (percentage of output)

	Home Consumption	Sold for Cash	Bartered
overall	52.18	35.80	12.02
inner circle	11.96	65.01	23.03
outer circle	76.00	18.18	5.82

Table 8. Market Delivery (percentage of output sold by channel)

Method:	vegetables	potatoes	cotton	cereals	w/melons	other crops
own delivery	55.0	69.0	74.0	69.0	64.0	66.0
intermediary	39.0	12.0	15.0	15.0	33.0	32.0
procurement	0.0	4.0	2.0	6.0	-	-
state farms	4.0	13.0	9.0	10.0	2.0	2.0
canteens	2.0	2.0	-	-	1.0	-

Intermediary purchase of cereals is strong in Eastern and Western Kazakstan, whereas all agricultural produce is sold in the market in Central Kazakstan. In Northern Kazakstan large agribusiness and state farms are the main purchasers, buying two thirds of the cereal output and a quarter of potato and other produce output of peasant farms surveyed. Thirty-nine percent of forage and only 1 percent of cereal output goes directly to the market. In Southern Kazakstan output is shared about equally between intermediaries and direct market delivery.

Table 9. Overall Purchase of Agricultural Produce (percentage acquired)

	Eastern Kazakstan		Central Kazakstan		Western Kazakstan		Northern Kazakstan		Southern Kazakstan		Nationally (average)	
Buyer:	Inner	Outer	Inner	Outer	Inner	Outer	Inner	Outer	Inner	Outer	Inner	Outer
intermediary	14.0	57.0		87.0	32.0	1.0	21.0	50.0	104.0	139.0	34.2	66.8
procurement					2.0	57.0	15.0		1.0		6.0	11.4
state farms							124.0		7.0	37.0	27.2	47.4
market			313.0			55.0	141.0		77.0	94.0	106.2	29.8
canteens			41.0			300.0	3.0		1.0	4.0	9.0	60.8

The percentages shown represent the acquisition by each of the buyer groups of the total range of produce.

For inner circle farms the market and the intermediary are the two principal outlets but for outer circle farms in Western Kazakstan the principal buyer is canteens (in which are included small stores) and in Southern Kazakstan the principal buyers are the procurement agencies.

6. Profitability

Respondent information suggests that cereals, potatoes and other crops are profitable. The net profit levels reported are:

- cereals Tenge 345 per hectare
- potatoes Tenge 834 per hectare
- horticulture Tenge 4,780 per hectare
- cotton (Tenge 2,220 per hectare)

Cotton showed a loss for 1995 even though the price for cotton was good. The reason attributed for this loss is that in 1995 cotton sales, by government instruction, had to be made in the commodity exchanges where the minimum consignment was ten tons. Only the larger enterprises were able to comply. Seventy-six percent of peasant farmers who grew cotton used their production for home consumption.

Around 48 percent of farmers produce forage crops to feed livestock on their farms. Forage production also shows as a loss, at Tenge 10 per hectare. Ninety-three percent of forage output was used to feed home farm livestock and, because neither the forage nor the livestock was sold, the farmers deem the expenditure on forage production as a monetary loss.

7. Livestock

a. Livestock Holdings

Livestock holdings on peasant farms was recorded as shown in Table 10 on the next page.

b. Livestock Sales

Livestock sales by peasant farms were:

- sold for cash 11,006 head
- bartered 9,060 head

Home consumption was recorded as 16,134 head.

Table 10. Livestock Holdings

Livestock Type:	Overall			East Kazakstan		Central Kazakstan		West Kazakstan		North Kazakstan		South Kazakstan	
	total	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
Respondents	215	113	102	6	6	8	8	8	7	33	27	58	54
camels	60	26	34								4	26	30
(average)	*0.28*	*0.23*	*0.33*								*0.15*	*0.45*	*0.56*
cattle	14,547	5,593	8,984	19	54	41	293	4,505	4,494	664	3,697	364	446
(average)	*67.7*	*26.0*	*41.8*	*3.2*	*10.8*	*5.1*	*36.6*	*642*	*642*	*20.1*	*136.9*	*6.8*	*8.3*
horses	1,862	1,102	760	4	6	93	63	194	374	731	212	80	105
(average)	*8.7*	*9.7*	*7.2*	*0.67*	*1.0*	*11.6*	*7.9*	*24.1*	*53.3*	*22.1*	*7.8*	*1.5*	*1.9*
sheep	15,536	6,770	8,766	9	101	1,164	1,435	20	2,767	3,606	1,795	1,971	2,668
(average)	*72.3*	*59.9*	*80.2*	*1.5*	*20.2*	*145.5*	*179.4*	*2.5*	*395.3*	*109.3*	*66.5*	*37.3*	*49.4*
pigs	730	506	224	33	43			148	16	155	165	170	
(average)	*3.4*	*5*	*2*	*5.5*	*8.6*			*8.5*	*1*	*4.7*	*6.1*	*3.3*	
poultry	2,647	1,390	1,257	60	415			265	70	685	462	380	310
(average)	*12.3*	*12.3*	*12.4*	*10*	*83*			*33.1*	*10*	*20.7*	*17.1*	*7.3*	*5.7*
other	687												687
(average)	*3.2*												*12.7*

c. Profitability of Livestock

The economic crisis has affected agricultural production in all CIS countries and Kazakstan in particular. In Kazakstan livestock maintenance costs exceed sales income. According to the survey, livestock maintenance costs exceeded income from livestock sale. In part this is due to the low price of meat but farmers in the inner circles have livestock maintenance costs of about two times those for farmers in the outer circles and it is the inner circle farmers who supply the urban areas. However, inner circle farmers could not offset their maintenance costs by bringing outer circle cattle to urban markets because of the cost of transport. In parts of Torgai Oblast for example, transport cost is equal to the market price of the animal transported.

The regional profitability of livestock farming is shown in Table 11 below:

Table 11. Profitability of Livestock Farming by Region (Tenge'000) (Per farm)

	Eastern Kazakstan		**Central Kazakstan**		**Southern Kazakstan**	
	inner	**outer**	**inner**	**outer**	**inner**	**outer**
expenditure	126	1,001	574	890	993	1,015
income	156	490	590	1,003	1,078	1,220
surplus	30	(511)	16	113	85	205

Livestock is unprofitable in Western Kazakstan and in the outer circle in Eastern. However, on mixed production farm units, which includes most peasant farms, aggregate income offsets the losses on livestock and leaves most peasant farms with a small annual surplus, see Table 12.

Table 12. Aggregate Surplus on Peasant Farms (Tenge'000)

		Eastern Kazakstan		**Central Kazakstan**		**Western Kazakstan**		**Northern Kazakstan**		**Southern Kazakstan**	
	Activity	inner	outer	inner	outer	inner	inner	inner	outer	inner	outer
expenses:	crops	130	256	909	12,900	9,285	9,806	12,262	8,174	45.291	5.704
	livestock	126	1,001	574	896	12,179	3,896	1,920	9,492	993	1,105
income:	crops	800	292	2,670	18,600	7,564	10,034	29,948	18,164	6.798	12.703
	livestock	156	490	590	1,603	8,859	3,679	2,667	5,155	1.878	2.220
surplus:	crops	670	36	1,761	5,700	(1,721)	228	10,686	9,990	2.268	6.999
	livestock	30	(511)	16	707	(3,320)	(217)	747	(4,337)	885	1,205
surplus:	all output	700	(475)	1,777	6,407	(5,041)	11	9,939	5,653	1,383	8,204

On the basis of aggregate surplus it would appear that mixed farming for peasant farms is not profitable in the inner circles of Eastern and Western Kazakstan, whereas such farming is profitable in most outer circles, although only marginally so in Western Kazakstan.

8. Use of Cash Surpluses

Use of cash surplus varies. Only 8 percent of respondents put money in banks, while 13 percent keep surplus earnings in cash at home. Twenty-one percent of respondents stated that they use surplus cash to purchase livestock. Thirty-six percent gave 'other purpose' for the use of their surplus and 22 percent were unable or unwilling to answer.

In response to inquiry about the reasons for not using banks for holding surplus cash, the answers were:

Table 13. Reasons for not using Banks for Surplus Cash Holding (percent)

	Overall	Eastern Kazakstan		Central Kazakstan		Western Kazakstan		Northern Kazakstan		Southern Kazakstan	
Reason:		inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
banks not safe	36	-	40	35	40	50	-	13	-	38	41
interest too low	30	-	20	35	40	-	-	25	-	29	41
access uncertain	24	-	40	18	10	17	-	38	50	29	18
bank too distant	2	-	-	12	-	-	-		-	-	-
other	8	-	-	-	10	33	-	25	50	4	-

Uncertainty about the safety of money deposited at banks predominates; 'access uncertain', meaning that the prospects of being able to withdraw savings is uncertain, is as negative as 'banks not safe' in the sense that the overall perception is that it would be unwise to put money in a bank.

9. Borrowing from Banks

Seventeen percent of farmer respondents took a loan during 1995. Banks were the predominant source - recourse to relatives and to money-lenders was almost negligible. The average loan size was Tenge 495,000. Details of peasant farmer borrowing are:

Table 14. Peasant Farmer Borrowing in 1995 (Tenge in Thousands)

	Overall	Eastern Kazakstan		Central Kazakstan		Western Kazakstan		Northern Kazakstan		Southern Kazakstan	
		inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
Borrowing Detail											
no of borrowers	36			1	1	3	3	5	6		
%of respondents	17			6	10	33	38	14	16		
total borrowed	17,805			1,400	502	8,000	680	525	198		
per borrower	495			1,400	502	2,667	227	105	33		
term (months)	7			3	1	5	36	19	7		
interest % p.a.	52			56	75	10	47	52	49		
Reasons for not Borrowing from a Bank (percent of respondents)											
difficult to find	17		25		18	25		19	22		
bribe required	9			13			25				
bureaucracy	19		13	13	9	25	25	19	22		
term too short	19	50	38	25	27			11	13		
interest too high	17	50	25	13	36			15		13	

10. Use of Loans

The purposes for which the loans were taken were:

- purchase of equipment (for which the 36 month term was given);
- purchase of seed and other inputs;
- purchase of poultry;
- purchase of fuel and lubricants;
- hire of machinery;
- construction; and
- land purchase.

Other purposes included household expenditures such as family celebrations and medical treatment.

Inner circle farmers borrowed seven times as much as those from the outer circles but this may be more a reflection of proximity to a bank than any judgment of the eligibility of the farmer or his/her farm business. It is interesting to note the comments of those who did not borrow in the reasons for not taking a loan:

Reason Given	Percentage
high interest rates	18.0
did not find an appropriate loan	16.0
sold livestock	13.0
did not need a loan	13.0
used my savings	11.0
sold farm produce	9.0
bureaucratic procedures required to apply for a loan	6.0
difficult to repay, even with low interest rates	3.0
did not have sufficient collateral	2.0
could not find a guarantor	2.0
no opinion	7.0

Sources of urgent cash would be sale of produce and livestock (42 percent) and borrowing from family and friends (23 percent); 8 percent said that they would use cash held at home and 4 percent stated that they would borrow from a moneylender. Hopes of being able to borrow from a bank in times of urgency were small, at 1 percent of the respondents. Twenty-two percent had no idea what they would do if in urgent need of money - a sad commentary on the rural community's solvency.

11. Future Borrowing Intentions

Eighty-two percent of respondents would apply for loans, if these were more readily available, and would seek a term of seven years, with an annual interest rate of 12 percent. Average loan size, on the basis of respondent indications of investment intentions, would be T 3,100,000 (USD $44,285 equivalent). At this level of investment the total loan request for peasant farms in the three oblasts identified in the proposal would be: T 3,100,000 * 13,451 peasant farms = T 35,397,427,450 (USD $ 505,677,535 equivalent).

12. Peasant Farm Assets

Peasant farms assets were recorded at the levels shown in Table 15 below:

Table 15. Peasant Farm Assets (In Tenge)

Asset:	Overall total value	Overall average per farm	Inner circle total value	Inner circle average per farm	Outer circle total value	Outer circle average per farm
buildings	67,642	314.6	50,478	446.7	17,164	168.3
machinery	137,818	641.0	75,543	668.5	62,275	610.5
equipment	35,695	166.0	25,556	226.2	10,139	99.4
vehicles	53,542	249.0	25,240	223.4	28,302	277.5
raw materials	28,486	132.5	12,226	108.2	16,260	159.4
finished goods	4	0.2	4	0.4		
other	28,151	130.9	17,711	156.7	10,440	102.4
Total	351,338	1,634.2	206,758	1830.1	144,580	1,417.5

If we apply a security margin to these asset values and assume that collateral cover is 1.5 times the loan value, a hypothetical maximum credit absorptive capacity of the peasant farm sector can be derived. Assuming the security margins below, the collateral worth of the assets in thousands of Tenge is:

• buildings	60 percent	40,585.2
• machinery	50 percent	68,909.0
• equipment	50 percent	17,847.5
• vehicles	40 percent	21,416.8
• stocks (raw materials)	50 percent	14,243.0
• stocks (stored output)	70 percent	2.8

		163,004.3

Equals T 758,160 per peasant farm (USD $10,830 equivalent) making the hypothetical maximum credit absorptive capacity for peasant farms in the three oblasts selected in the Project Proposal. (Outlined in page 1 of Part III of the Final Report, Project Proposal).

USD $10,830 * 13,451 = USD $145, 674,330 or Tenge 10,197,203,100.

C. Private Enterprise

1. Classification

Private enterprise was the critical focus of the survey. Rural enterprise, excluding the private peasant farms, was classified in two categories: agri-processing and enterprise engaged in activity not directly related to agriculture (non-agribusiness).

According to information available in the 26 rayons covered by the survey, private enterprise in the rural areas is numerous, although many have ceased to operate due to the financial and economic difficulties facing the rural community. The principal activities undertaken by non-agribusiness enterprise are

general stores, canteens and public services. It had been the intention to survey 100 agribusiness and 100 non-agribusiness enterprises but it was possible to interview only 95 agribusinesses. 105 non-agribusinesses were surveyed.

Of the enterprises surveyed, percentages able to produce evidence of registration were:

Table 16. Percent of Registered Enterprises That Are:

Inner circles:		Outer circles:	
agribusiness	**non-agribusiness**	**agribusiness**	**non-agribusiness**
46	16	62	23

by comparison, peasant farms with documentary evidence of registration were:

92 percent	90 percent

2. Sector and Form of Ownership

Table 17. Distribution of Private Rural Enterprise by Sector (percent of enterprises)

Sector/Sub-Sector:	Overall	Inner Circles	Outer Circles
Agribusiness			
agri-processing	53	53	53
input supply	6	5	7
agricultural marketing	24	24	23
produce transport	6	5	7
other	11	12	10
Non-Agribusiness			
manufacture	12	12	13
construction	10	10	9
transport	3	2	4
general trading	31	37	26
public services	30	31	30
other	13	8	17

Table 18. Distribution of Private Rural Enterprise by Form of Ownership (as a %)

Form of Ownership:	Overall		Inner Circles		Outer Circles	
	ABE	NABE	ABE	NABE	ABE	NABE
individual trader	78	73	78	72	79	73
partnership	6	1	8	-	3	2
limited partnership	-	-	-	-	-	-
limited liability partnership	6	16	6	15	5	17
joint stock company	1	3		2	3	4
limited liability company	-	3	-	6	-	-
co-operative	7	4	4	4	11	4
other	2	-	4	-	-	-

The predominance of individual trader operations might have been expected since it is the least demanding financially and suits the nature of the communities in which the businesses are active.

3. Employees

Table 19 on the next page presents data on the level of employment in rural enterprise. The interest is in the ratio of full time to part time employees and male to female employees in both full and part time employment. The categorization of employees by cadre level, i.e. management, technical, supervisory, skilled, semi-skilled and unskilled, has not yet been adopted and, therefore, it was not possible (within the time constraints of the fieldwork) to review staff appointments and make this separation. The aim would have been to identify the ratio of male and female employees by cadre level and determine the degree to which women occupy senior positions.

The ratio of female to male employees in full time employment is slightly higher in non-agribusiness than in agribusiness but this might be expected since the physical nature of the work in agribusiness enterprises is probably a key factor. The part time employee is seasonal and, again, the stress on physical strength in moving agricultural produce may be a significant factor. Impact studies of any particular credit project would need to examine the effect on female employment opportunity of additional non-agribusiness as a result of improved credit access.

4. Enterprise Expenditure

Enterprise expenses are listed in Table 20.

Table 19. Employment

	circle	full time employees			part time employees			total employees		
		total	male	female	total	male	female	total	male	female
agribusiness	inner	1,183	913	270	436	425	11	1,619	1,338	281
	outer	1,020	940	80	225	205	20	1,245	1,145	100
sub total ABE		2,203	1,853	350	661	630	31	2,864	2,483	381
percentage of totals		100	84.11	15.12	100	95.31	4.69	100	86.70	13.30
ratio of male to female employees			5.29	1		20.32	1		6.52	1
non-agribusiness	inner	535	405	130	62	52	10	597	457	135
	outer	938	647	291	82	78	4	1,020	725	295
sub total NABE		1,473	1,052	421	139	130	14	1,617	1,182	430
percentage of totals		100	71.42	28.58	100	93.53	6.47	100	73.10	16.90
ratio of male to female employees			2.50	1		9.29	1		2.75	1
total ABE + NABE		3,676	2,905	771	800	760	45	4,476	3,665	811
percentage of totals		100	79.03	20.97	100	95.0	5.0	100	81.88	22.12
ratio of male to female employees			3.88	1		190	1		4.52	1

Table 20. Enterprise Expenditure (Average per farm in Tenge'000)

Item:	Overall Average			Eastern Kazakstan		Central Kazakstan		Western Kazakstan		Northern Kazakstan		Southern Kazakstan	
(# of farms)	total -98	inner-57	outer-41	inner-4	outer-4	inner-0	outer-6	inner-3	outer-4	inner-15	outer-7	inner-30	outer-20
Agribusiness													
materials	410.5	539.2	231.6	10.0	7.5	-	416.7	12.8	73.5	533.7	828.6	743.5	43.6
labor	153.7	181.2	115.5	9.2	-	-	143.3	126.7	77.2	127.8	215.3	158.2	113.8
packaging	2.4	0.7	4.7	-	-	-	-	-	-	1.3	27.6	0.7	0.1
transport	35.9	41.4	28.4	3.7	0.4	-	103.3	2.7	3.7	5.1	4.6	8.6	10.3
utilities	29.2	31.1	26.5	15.7	-	-	27.6	78.2	14.1	40.7	67.0	25.4	19.8
fuel and lubricants	170.1	259.6	45.6	22.5	2.5	-	72.5	207.0	30.0	23.7	-	85.3	65.2
repair/maintenance	5.7	9.0	1.1	15.0	2.5	-	5.0	29.7	0.2	13.8	-	5.3	0.2
communications	0.7	0.7	0.6	-	-	-	-	-	-	0.2	3.3	1.3	0.3
other	166.0	236.1	68.4	3.5	-	-	33.3	-	-	583.3	271.1	26.0	35.4
total	974.2	1,299.1	522.5	79.6	12.9	-	801.7	572.2	198.8	1,329.6	1,428.1	1,054.3	288.7

Non-Agribusiness													
(# of NAB)	total -105	inner-52	outer-53	inner-6	outer-	inner-3	outer-2	inner-4	outer-4	inner-12	outer-16	inner-28	outer-28
materials	397.2	528.4	263.5	548.3	10.0	2,433.3	800.0	25.7	725.7	1,231.8	353.8	90.5	125.7
labor	209.6	278.4	139.5	180.0	-	-	70.7	39.5	106.5	746.8	171.2	162.7	141.1
packaging	1.2	2.4	-	-	-	-	-	-	-	6.7	-	1.8	-
transport	50.1	79.1	20.5	10.8	-	59.3	12.5	6.4	170.0	256.4	1.9	30.3	3.6
utilities	92.8	93.7	91.8	50.8	10.5	2.3	2.5	5.1	3.5	331.0	79.6	31.0	123.2
fuel and lubricants	53.5	58.6	48.3	15.7	-	71.0	-	24.9	10.0	167.4	10.1	24.6	82.5
repair/maintenance	130.3	53.8	208.4	6.7	3.5	-	-	7.7	10.0	213.2	9.0	7.9	380.2
communications	10.5	11.1	9.8	-	-	-	-	-	-	36.7	7.9	5.2	13.8
other	111.5	202.2	19.1	3.8	2.5	-	-	-	-	677.1	45.6	91.7	9.4
total	1056.8	1307.7	801.0	816.2	26.5	2566.9	1002.5	109.3	1026.7	3,649.7	679.1	445.7	879.3

5. Profitability

The comparative profitability of agribusiness and non-agribusiness is shown in Table 21 below:

Table 21. Profitability of ABE and NABE (Tenge, 000)

		gross output	expenditure	income	surplus
ABE	overall	935,870	31.45	58.95	27.50
	inner	803,475	27.72	40.72	13.00
	outer	132,395	54.08	169.57	115.49
NABE	overall	5,100	1,747.06	2,834.90	1,087.84
	inner	3,600	2.400.00	3,480.00	1,080.00
	outer	1,500	180.00	1,286.67	1,106.70

6. Use of Cash Surpluses

Table 22. Cash Surplus Use (percent)

	Agribusiness			Non-agribusiness		
Use:	**overall**	**inner**	**outer**	**overall**	**inner**	**outer**
placed in a bank	8.5	7.0	10.0	12.0	8.0	16.0
placed in a co-operative	5.0		10.0			
individual shares				4.0	8.0	
keep in cash	15.5	21.0	10.0	8.5	17.0	
lend to others	12.0	14.0	10.0			
purchase precious metals				8.5		17.0
purchase goods for trade	7.0	4.0	10.0	33.5	17.0	50.0
purchase livestock	2.0	4.0				
other	50.0	50.0	50.0	33.5	50.0	17.0

Table 23. Reasons for not Placing Surplus Cash in Banks (percent)

	Agribusiness			Non-agribusiness		
Reasons:	**overall**	**inner**	**outer**	**overall**	**inner**	**outer**
safety of banks suspect	38.0	33.0	43.0	37.0	32.0	42.0
interest rates too low	26.5	23.0	30.0	28.5	26.0	31.0
difficult to withdraw cash	24.0	28.0	20.0	30.0	37.0	23.0
bank too distant	3.0	6.0	-	4.5	5.0	4.0
other	8.5	10.0	7.0	-	-	-

The opinion expressed by peasant farm owners matches that of business: it is not safe to put your money in a bank. Not being able to withdraw deposits suggests that a bank has liquidity problems and, therefore, the safety of deposits is dubious.

7. **Assets**

The assets held are identified in Table 24.

Table 24. Enterprise Assets (Tenge'000)

Item:	Overall (95)		Inner circle (56)		Outer circle (39)	
	total value	per enterprise	total value	per enterprise	total value	per enterprise
agribusiness						
buildings	68,758.4	723.8	23,746.4	424.0	44,512.0	1,143.3
machinery	72,234.3	760.4	38,410.3	685.9	33,824.0	867.3
equipment	53,837.0	566.6	11,420.0	203.9	35,407.0	907.9
vehicles	34,282.6	360.8	18,228.2	325.5	15,154.4	388.6
stock (raw)	7,354.4	77.4	3,784.0	67.6	3,570.4	91.5
stock (f.g)	2,825.0	29.7	1,900.0	33.9	925.0	23.7
other	13,335.0	140.4	13,085.0	233.7	250.0	6.4
totals	252,626.7	2,659.1	110,573.9	1,974.5	133,642.7	3,426.7

Item:	Overall (103)		Inner circle (51)		Outer circle (52)	
	total value	per enterprise	total value	per enterprise	total value	per enterprise
non-agribusiness						
buildings	108,776.0	1,056.1	59,348.0	1,163.7	49,428.0	950.5
machinery	35,855.5	348.1	17,240.5	338.0	18,615.0	358.0
equipment	44,856.0	435.5	22.816.0	447.4	22,040.0	423.8
vehicles	53,053.4	515.1	28,702.5	562.8	24,350.9	468.3
stock (raw)	19,445.0	188.8	6,768.0	132.7	12,677.0	243.8
stock (f.g)	13,948.0	135.4	11,029.0	216.2	2,919.0	56.1
other	6,533.2	63.4	4,338.0	85.1	2,195.2	42.2
totals	282,467.1	2,742.4	150,242.0	2,945.9	132,225,1	2,542.8

D. Borrowing during 1995

Borrowing during 1995 was not very heavy but this may be accounted for by the strategic decisions of many banks to restrict lending to rural enterprise and by the general shortage of funds in banks. The details of borrowing by respondents during 1995 are as follows:

Table 25. Enterprise Borrowing in 1995 (Tenge'000)

Purpose:	Overall		Inner circle		Outer circle	
	total value	per enterprise	total value	per enterprise	total value	per enterprise
agribusiness						
capital investments	4,150.5	43.7	1,295.5	23.1	255.0	6.5
working capital	8,023.0	84.4	1,555.0	27.8	6,465.0	165.8
other	1,914.0	20.1	500.0	8.9	64.0	1.6
totals	14,087.5	148.2	3,350.5	59.8	9,384.0	248.6
non-agribusiness						
capital investments	2,275.0	22.1	2,140.0	42.0	135.0	2.6
working capital	1,390.0	13.5	1,310.1	25.7	80.0	1.5
other	1.814.4	17.6	1,496.4	29.3	318.0	6.1
totals	5,479.4	53.2	4,946.5	97.0	533.0	10.2

The amounts per enterprise, very small in many cases, average less than USD $1,000; whether this was by borrower choice, by lender assessment of enterprise absorptive capacity or by a rationing imposed for reason of limited cash resources available was not identified. Opinion on access to credit declared by respondents is shown in a later table.

1. Sources of Credit

Table 26. Sources of Borrowed Funds 1995 (Tenge'000)

	Agribusiness						Non-agribusiness					
	overall		inner		outer		overall		inner		outer	
Source:	Tenge	%	Tenge	%	Tenge	%	Tenge	%	Tenge	%	Tenge	%
banks	18,265	88	3,641	67	13,274	95	11,470	76	11,470	79		
suppliers							215	1	90	1	125	22
friends	434	2	130	2	304	2	1,507	10	1,281	9	226	40
relatives	1,622	8	1,197	22	345	3	1,313	9	1,100	8	213	38
lenders							540	4	540	3		
other	465	2	465	9								
totals	20,786	100	5,433	100	13,923	100	15,045	100	14,481	100	564	100

2. Access to Credit

Respondents were asked to identify positive and negative aspects of access to credit; the negative aspects featured more prominently than the positive aspects:

Table 27. Access to Credit (number of respondents)

Aspects:	Agribusiness			Non-agribusiness		
	overall	inner	outer	overall	inner	outer
positive aspects						
easy to obtain	5	5	6	4	-	6
simple documentation	3	5	-	-	-	-
requested amount given	3	5	-	-	-	-
term appropriate	3	-	-	-	-	-
interest rate low	3	5	-	-	-	-
other	-	-	-	4	-	-
negative aspects						
hard to obtain	8	5	12	15	-	24
bribes needed	5	5	6	15	11	18
bureaucratic	11	5	18	19	22	18
term too short	24	26	24	15	22	12
interest rate high	32	26	35	23	22	24
other	5	11	-	4	11	-

E. Investment Intentions

Respondents were asked to declare investment intentions, identifying what assets would be acquired and for how much. The results are given in Table 28:

Table 28. Enterprise Investment intentions (Tenge'000)

Item :	Overall	Eastern Kazakstan			Central Kazakstan			Western Kazakstan			Northern Kazakstan			Southern Kazakstan		
	total	total	inner	outer	total	inner	outer	total	inner	outer	total	inner	outer	total	inner	outer
agribusiness																
	335,800	26,000	4,000	22,000	35,500	18,000	17,500	8,100	3,600	4,500	55,500	34,500	21,000	210,700	112,900	97,800
non-agribusiness																
	253,090	4,700	3,700	1,000	5,050	5,000	50	9,250	5,650	3,600	56,350	30,400	25,950	177,740	73,840	103,900

Table 29. Reasons for Not taking a Loan (percent)

	Overall		Eastern Kazakstan				Central Kazakstan				Western Kazakstan				Northern Kazakstan				Southern Kazakstan			
	ABE	NABE	ABE		NABE		ABE		NABE		ABE		NABE		ABE		NABE		ABE		NABE	
Reason:			in	out	in	out	in	out	in	out	in	out	in	out	in	out	in	out	in	out	in	out
do not need	14	17			50	100	10				33				36	40	27	36	15	10	13	11
use savings	13	12					10	9		20		50	20		27		9		15	14	6	2
sell livestock	6	5			13		10	9					20	25	9			7	9	5		5
sell produce	6	1		25			10								9				6	5		3
no appropriate loan	14	19		50				18								20	18	36	9	33	23	20
no collateral	6	2	22		13		20		33	20	33		20							5		
high interest rate	24	22	33	25			30	36	67	20			40	25	18	20	18	21		14	26	20
cannot repay	1	2	11																		10	
no answer	16	20	34	-	24	-	10	28	-	40	34	50	-	50	1	20	28	-	46	14	22	39

Fifty-two percent of agribusiness's and 54 percent of non-agribusiness's would apply for loans if credit were more readily available and if the terms and conditions were deemed adequate.

F. Urgent Cash Sources

Respondents were asked where they would expect to be able to obtain cash if in urgent need; the responses were:

Table 30. Urgent Cash Sources (percent)

	agribusiness			non-agribusiness		
Source:	**overall**	**inner**	**outer**	**overall**	**inner**	**outer**
bank loan	12	11	11	9	8	11
loan from friend	8	8	9	1	24	14
loan from relative	12	10	14	19	22	15
moneylender	10	11	9	10	9	11
loan from supplier	2	1	3	3	3	3
pawnshop	1	1		1	1	2
savings	2	2	3	1	1	2
cash at home	12	11	13	10	9	11
sell produce	13	17	9	6	5	6
sell livestock	16	16	17	8	5	12
sell precious metals	2	1	3	6	3	11
other	7	6	7	7	9	2
do not know	3	5	2	19	1	-

It is evident that those engaged in enterprise other than farming are more self-sufficient than peasant farmers and have little need to go to banks, moneylenders and friends when in need of assistance. This presents an interesting question: If these two groups have access to funds, as they suggest, what level of equity are they willing to commit to the business when borrowing or is the perception that the lender should finance 100 percent of the investment cost ?

III. Credit Absorptive Capacity

A. Asset-based Absorptive Capacity Ceiling - Single Enterprise

Table 31. Asset-based Absorptive Capacity Ceiling

Asset:	security margin (percent)	owner valuation (Tenge'000)	SRV (Tenge'000)
agribusiness			
buildings	60	723.8	434.3
machinery	50	760.4	380.2
equipment	50	566.6	283.3
vehicles	40	360.8	144.3
raw material stocks	50	77.4	38.7
finished goods stocks	50	29.7	14.9
other	50	140.4	70.2
	Totals	2,659.1	1,365.9
Asset:	**security margin (percent)**	**owner valuation (Tenge'000)**	**SRV (Tenge'000)**
non-agribusiness			
buildings	60	1,056.1	633.6
machinery	50	348.1	174.1
equipment	50	435.5	217.8
vehicles	40	515.1	206.0
raw material stocks	50	188.8	94.4
finished goods stocks	50	135.4	67.7
other	50	63.4	31.7
Totals		2,724	1,425.3

* SRV = Safe Realizable Value

Assuming that collateral requirement is 150 percent of the loan value, the loan ceiling for a single unit of agribusiness and non-agribusiness enterprise is as follows:

- **agribusiness enterprise**

  total SRV = Tenge 1,365,900 * 0.75 = Tenge 1,024,425 (USD $14,635 equivalent)

- **non-agribusiness enterprise**

  total SRV = Tenge 1,425,300 * 0.75 = Tenge 1,068,975 (USD $15,270 equivalent)

These ceilings are indicative of the rural private enterprise sector's capacity to carry loans. The ceilings would not be rigidly applied in assessing a proposal - there would be loans in excess of these indicators and there would be many below the line. However, the average loan size in the portfolio for these two categories of private enterprise would be expected to be below the indicative ceiling level.

B. Investment Intention based Ceiling

The total value of investment intentions declared by respondents is:

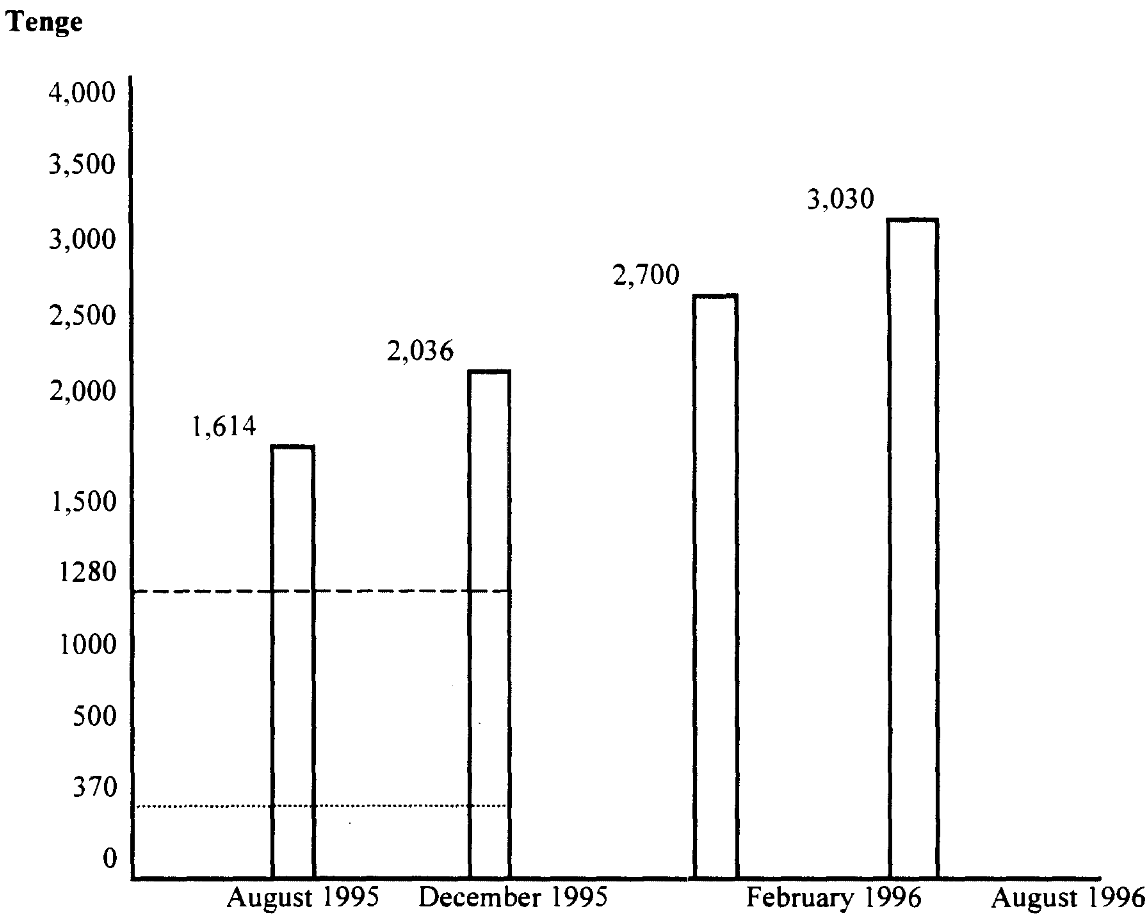
- agribusiness: Tenge 335,800,000 (USD $4,797,140) or Tenge 3,534,740 (USD $50,500) per enterprise
- non-agribusiness: Tenge 253,090,000 (USD $3,615,570) or Tenge 1,687,265 (USD $24,100) per enterprise

IV. Low Income Households (LIHH)

A. Definition of a Low Income Household

In 1995 the Ministry of Labor made an attempt to define the cost of a minimal market basket for low-income population (whose declared income per capita averaged Tenge 640) by determining actual consumption of goods. On 1 January 1995 the cost of the market basket was Tenge 2,000; on 1 December 1995 its value increased to Tenge 2,338 and on 1 February 1996 the price had risen to Tenge 2,700.

A low income household is classified as below the poverty line when total household monthly income is less than the Ministry of Labor's monthly market basket.



------- Inner Circle (Tenge 1,280): Income per person/per household based on 110 families at 5.88 persons per household.

------------- Outer Circle (Tenge 370): Income per person/per household based on 86 families at 5.40 persons per household.

B. Income in Low Income Households

Average household size was found to be 5.88 persons (economically active and dependent adults and children) in the inner circle low income households and 5.40 persons in outer circle low income households. Income levels were:

Table 32. Average Income per Low Income Household 1995 (Tenge)

	inner	outer
average LIHH income 1995	90,300	24,230
average LIHH monthly income	7,520	2,020
average monthly per capita income in LIHH	1,280	370

At these levels of income, households in the inner circles are at the poverty line but those in the outer circles are well below. Some caution is required: a common feature of surveys is that respondents tend to inflate expenditure, not necessarily by design, while age is often inaccurately stated and income is frequently under-declared - all of us prefer not to give too much detail about income levels and sources.

Below is a table about the use of cash surpluses. Forty-seven percent of respondents indicated a cash surplus and, therefore, a certain amount of caution is required in drawing conclusions from the income statements in Table 32 above. Moreover, the value of home consumption of household produced food in low income households is uncertain but in the rural areas it may be assumed that such consumption is the main support and, therefore, the poverty may well be less acute than the figures suggest.

C. Surpluses

Those families with income above the poverty line have small cash surpluses. Forty-seven percent of respondents declared a surplus; 36 percent of those with surplus kept the surplus in cash or precious metals, 28 percent put the surplus to work for extra income through lending and trade and the remaining 36 percent invested in livestock. The details of cash surplus use are given in Table 33 below:

1. Use of Surplus Cash

Table 33. Use of Surplus Cash (percent of respondents)

Purpose	Percentage
keep in cash	13.0
lend to others	4.0
buy precious metal	4.0
buy goods for trade	9.0
buy livestock	17.0
deposit at a bank	0.0
deposit at a co-operative	0.0
no surplus cash	53.0

2. Reasons for not placing Surplus Cash in Banks

Table 34. Reasons for not placing Surplus Cash in Banks

	Percentage		
Reason:	**overall**	**inner**	**outer**
banks not reliable/safe	38.0	34.0	41.0
interest rate is too low	26.0	22.0	36.0
difficult to withdraw money again	22.0	22.0	18.0
bank is too far away	5.0	9.0	0.0
no surplus cash	9.0	13.0	5.0

D. Borrowing 1995

It is interesting to note that 61 percent of funds borrowed was used for productive purpose in the inner circles whereas 100 percent of moneys borrowed in the outer circles was used for household purposes and social demands. This might be anticipated from the income data - outer circle households would seek to borrow to meet extraordinary expenses such as medical attention, funerals and the like. Details of borrowing in 1995 are shown in Table 35 on the next page.

In the inner circles declared loan use is 25 percent less than the amounts borrowed whereas in outer circles declared borrowing is half declared loan use. The discrepancy between declared loan expenditure and declared borrowing probably results from respondents being unable to recall exactly the amount spent on family occasions which accounts for the bulk of outer circle loan use.

Table 35. Sources of Loans for LIHH in 1995 (Tenge'000)

Source:	Overall		East Kazakstan		Central Kazakstan		West Kazakstan		North Kazakstan		South Kazakstan	
	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
banks												
suppliers	5.0								5.0			
friends	119.4	17.0			25.0		26.7		28.0	12.0	39.7	5.0
relatives	538.0	31.0	10.0		10.0			5.0	72.0	14.0	446.0	12.0
moneylenders	26.0	20.0									26.0	20.0
other		3.0						3.0				
total	688.4	71.0	10.0		35.0		26.7	8.0	105.0	26.0	511.7	37.0

Table 36. Purposes of Loans Used by LIHH in 1995 (In Tenge)

Purpose:	Overall		East Kazakstan		Central Kazakstan		West Kazakstan		North Kazakstan		South Kazakstan	
	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer	inner	outer
purchase of:												
vehicles	20.0										20.0	
livestock	14.0								14.0			
land	50.0										50.0	
buildings	160.0										160.0	
total A	244.0								14.0		230.0	
payment of:												
machinery rent	35.0										35.0	
irrigation fees	10.0										10.0	
building maintenance	15.0										15.0	
working capital	118.0						25.0				93.0	
medical treatment		15.0						8.0		5.0		2.0
education	16.0	14.0							16.0	14.0		
food	23.0	17.0					1.0		10.0	7.0	12.0	10.0
family occasions	35.0	85.0									35.0	85.0
furnishing	5.0								5.0			
other	10.7	20.0									10.7	20.0
total B	267.7	151.0					26.0	8.0	31.0	26.0	210.7	117.0
overall total (A+B)	511.7	151.0										