ASIAN DEVELOPMENT BANK

RRP: KGZ 28395

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON A

PROPOSED LOAN

TO THE

KYRGYZ REPUBLIC

FOR THE

RURAL FINANCIAL INSTITUTIONS PROJECT

July 1997

CURRENCY EQUIVALENTS
(as of 15 June 1997)

Currency Unit	–	Som
Som 1.00	=	$0.0575
$1.00	=	Som17.40

The exchange rate of the Som is determined on a managed float basis through periodic foreign exchange auctions. The calculations in this Report are based on an exchange rate of Som17.40 to $1.00.

ABBREVIATIONS

AGPB	-	Kyrgyzagroprombank
AKBK	-	AKB Kyrgyzstan
CU	-	Credit Union
DITAC	-	Directorate of Investment and Technical Assistance Coordination
EU TACIS	-	European Union Technical Assistance for the Commonwealth of Independent States
FCSCU	-	Financial Company for the Support and Development of Credit Unions
FINCA	-	Foundation for International Community Assistance
FINSAC	-	Financial Sector Adjustment Credit of the World Bank
GDP		Gross Domestic Product
IMF	-	International Monetary Fund
KAFC	-	Kyrgyz Agricultural Finance Corporation
KGZ	-	Kyrgyz
MAF	-	Ministry of Agriculture and Food (until 31 December 1996)
MAWR	-	Ministry of Agriculture and Water Resources
NBFI	-	Nonbank Financial Institutions
NBKR	-	National Bank of the Kyrgyz Republic
PCFs	-	People's Credit Funds (Viet Nam)
PPTA	-	Project Preparatory Technical Assistance
PSB	-	Kyrgyzpromstroybank
RFP	-	Rural Finance Project of the World Bank
SCRF	-	State Committee on Rural Finance
SSC	-	Settlement and Savings Company
TA	-	Technical Assistance
UNDP	-	United Nations Development Programme
USAID	-	United States Agency for International Development

NOTES

(i) The fiscal year (FY) of the Government ends on 31 December.
(ii) In this Report, "$" refers to US dollars.

CONTENTS

LOAN AND PROJECT SUMMARY

Borrower	:	Kyrgyz Republic
Project Description	:	The Project will establish a credit union (CU) system comprising a network of about 280 individual CUs, and develop an apex union, the Financial Company for the Support and Development of Credit unions (FCSCU), to mobilize rural savings and provide smaller-sized and generally short-to-medium term loans. The individual CUs will offer both savings and lending services. FCSCU will promote, develop, monitor, and supervise the CUs. The National Bank of the Kyrgyz Republic (NBKR) will be responsible for overall supervision and regulation of the system. The Project will include a credit line of $8.4 million to equally match the total contributions of CU members. The Project will also provide training and technical support to build the capability of FCSCU, NBKR, and the CUs.
Classification	:	Economic Growth
Environmental Assessment	:	Category B. An initial environmental examination was undertaken.
Rationale	:	The rural sector is expected to lead the economy's recovery and growth through the transition. The Government's macrostabilization, and structural and sectoral reform efforts are beginning to take effect, and investment opportunities are emerging. However, financial services, both savings mobilization and credit delivery, have broken down as two major banks, Agroprombank and Elbank, were liquidated and traditional mechanisms have failed. The nonavailability and inadequate access to rural financial services is a severe limitation on the growth and development of the rural areas. Demand for both savings facilities and loans is far greater than can be supplied. There is a need for self-sustaining institutions, able to provide financial services in rural areas. Moreover, there is a need for new, dynamic, community-linked institutions to overcome traditional social attitudes to credit delivery, and to develop trust and public understanding of financial institutions. It is essential that support be given to the Government by building new institutions that better serve the requirements of a market-based economy. The increasingly liberalized environment facilitated by macro-

stabilization, privatization, and sectoral reforms, particularly in the financial sector, is providing strong incentives to establish a new rural financial system.

The Project is designed to address these needs through the establishment of a CU system. CUs are community-level financial institutions that provide savings and credit services to individual members; are organized and operated on cooperative principles; provide members, who are the owners of the institution, with one vote per member; draw policy-making leadership from the members; and are legally constituted under national cooperative legislation. CUs offer many advantages and have proven that they can be adapted to the special needs of different groups; to different cultures, languages, and religions; as well as to different legal, political, and economic systems. This is already being demonstrated through the relatively successful pilot of three trial CUs under the Project preparatory technical assistance.

Objective : The long-term development goal is to rebuild a sustainable rural financial system. The Project objective is to increase the level and availability of savings mobilization and lending services in rural communities.

Scope : The Project has two components: the establishment of a CU system; and project management. The Project will provide a credit line of $8.4 million equivalent to match CU member contributions. FCSCU, which will provide the services of an apex union, was recently established and will be developed further through technical support, training, and provision of furniture and equipment to promote, develop, and provide regulation and supervision of the CUs. NBKR staff will also be trained in regulation and supervision of the CU system. The CUs will be trained by FCSCU staff in the management and operations of the CUs. The Project will also support the NBKR and FCSCU to strengthen their capacity in project management.

Cost Estimates : The total cost of the Project is estimated at $22.1 million equivalent, of which $8.4 million (38 percent) will be in foreign exchange, and $13.7 million equivalent (62 percent) in local currency.

Financing Plan :

($ million)

Source	Foreign Exchange	Local Currency	Total Cost	Percent
Bank	8.4	4.1	12.5	56.0
Government		1.2	1.2	6.0
CUs		8.4	8.4	38.0
Total	**8.4**	**13.7**	**22.1**	**100.0**

Loan Amount and Terms : The loan will be in an amount of $12.5 million equivalent in Special Drawing Rights from the Bank's Special Funds resources, with an amortization period of 40 years, including a grace period of 10 years, and a service charge of 1 percent per annum.

Relending : The Borrower will bear the foreign exchange risk and relend loan proceeds of $8.75 million to FCSCU in local currency at a variable interest rate for a period of 20 years, including a grace period of 7 years. The interest rate will not be less than the interest rate applicable to dollar loans from the Bank's ordinary capital resources. The Borrower will provide, as a grant to FCSCU, $3.4 million equivalent of loan funds for consulting services and a portion of the recurrent costs of FCSCU.

FCSCU will onlend $8.4 million equivalent to the individual CUs for a period of 10 years, including a grace period of 3 years, at a rate not less than the rate of inflation (current inflation rate 31 percent; current onlending rate to CUs 32 percent). The onlending rate to CU members will be at market interest rates (45 percent at present).

Period of Utilization : Until 31 March 2005

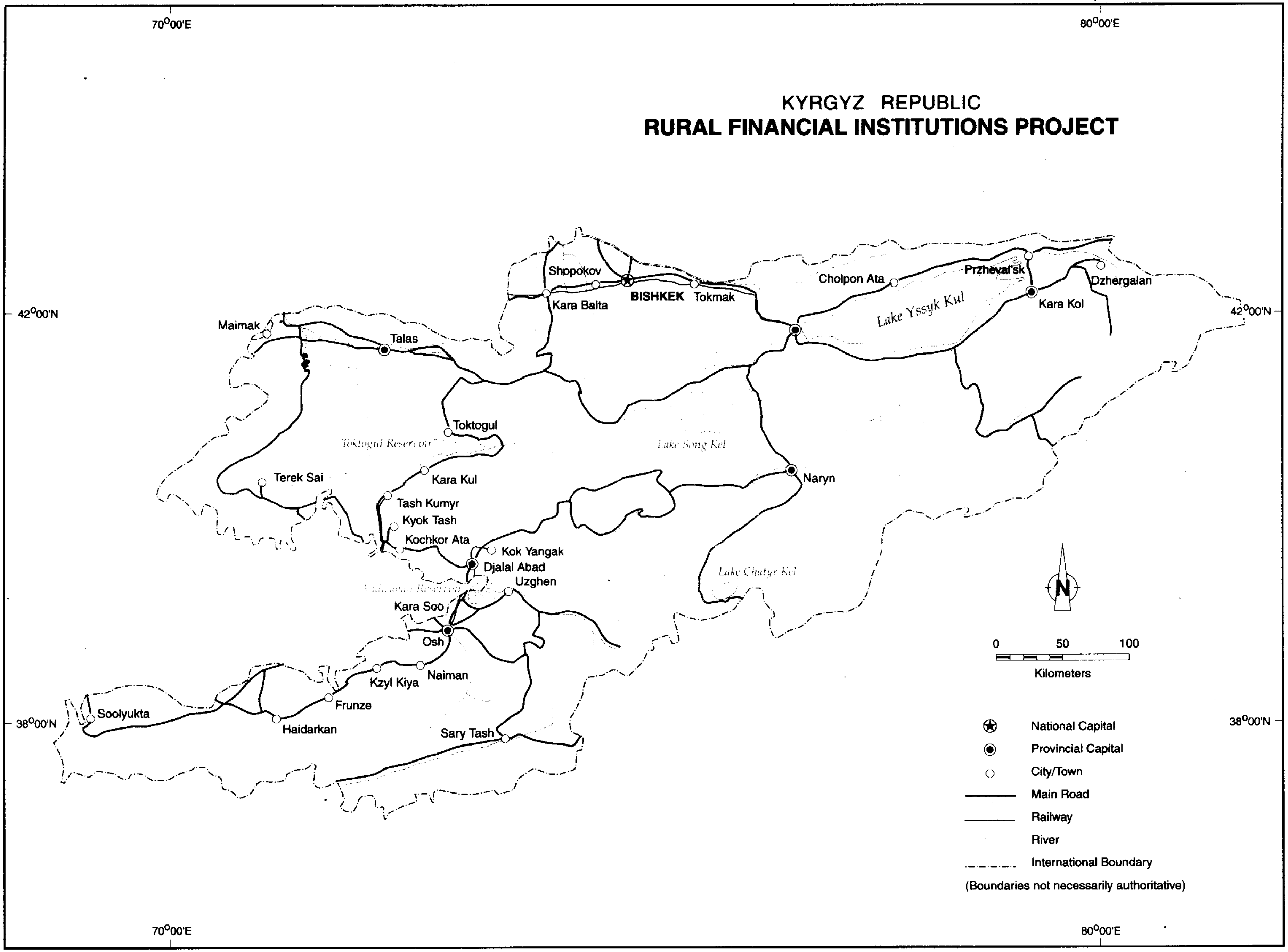
Implementation Arrangements : The Directorate of Investment and Technical Assistance Coordination in NBKR will be responsible for the overall coordination of the Project. FCSCU will be responsible for the promotion, development, monitoring, and supervision of the CUs. NBKR in turn will be responsible for the overall supervision of FCSCU and the CUs.

Executing Agency : National Bank of the Kyrgyz Republic

Procurement : All procurement will be carried out in accordance with the provisions of the Bank's *Guidelines for Procurement*.

Consulting Services :	A total of 70 person-months of consulting services, comprising 55 person-months of international consulting services and 15 person-months of domestic consulting services, will be required for Project implementation. An international firm will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants*.
Project Completion Date :	30 September 2004
Project Benefits and Beneficiaries :	The Project is expected to finance the establishment of about 280 CUs across all six regions of the country, with an average of about 100 members per CU. The CU members, estimated to number 28,000, are expected to mobilize about $11 million equivalent in share capital and retained earnings by the end of the Project. Also, the individual CUs are estimated to provide loans amounting to a total of about $19 million equivalent. The Project's nonquantifiable benefits will include (i) development of a rural financial system, including the establishment of a financially self-sustaining system of CUs that will provide essential financial services to rural areas; (ii) increased competition in the provision of rural finance that will promote efficiency in the delivery of services; (iii) increased trust by the general population in financial institutions; and (iv) strengthening of NBKR's and FCSCU's capacity to regulate and supervise the CUs. The economically active population in the rural areas, including farmers, households, and small rural enterprises, are the most probable member customers of the CUs, given the large element of savings mobilization in the Project.
Risks :	There are several risks associated with the Project: The FCSCU and individual CUs are new institutions. However, substantial consulting services and training is being provided to ensure these institutions are effectively established. Low loan recovery should be limited through the peer pressure of CU members and the training proposed under the Project. Competition from other services on a noncompetitive basis, such as credit at below market interest rates, could affect the attractiveness of CUs and, hence, their profitability. Only through continued policy dialogue with the Government can this be mitigated against. Genuine competition from other services will strengthen the overall financial system.

KYRGYZ REPUBLIC
RURAL FINANCIAL INSTITUTIONS PROJECT



97-1436 HR

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on a proposed loan to the Kyrgyz Republic for the Rural Financial Institutions Project.

II. INTRODUCTION

2. During the Country Programming Mission in September 1994 the Government requested technical assistance to help prepare a rural finance project. A Bank-financed feasibility study,[1] which was completed in September 1996, assisted the Government in the preparation of a Project to establish viable and sustainable financial institutions servicing the broad rural community. A loan Fact-finding Mission visited the Kyrgyz Republic from 30 September to 18 October 1996 to discuss the final report of the Project preparatory technical assistance (PPTA) with the Government and other concerned agencies. An Appraisal Mission[2] was undertaken from 24 February to 21 March 1997. During the preparation of the Project intensive discussions were held with members of three trial credit unions (CUs) to adequately consider their experiences with the trial phase and their views on the design of the Project. This report is based on the report of the PPTA; the discussions with the beneficiaries and an assessment of the trial CUs established as part of the PPTA; a review of various studies; the findings of the loan Fact-finding and Appraisal missions; and detailed discussions with the National Bank of the Kyrgyz Republic (NBKR), the Central Bank, other Government agencies, and representatives of bilateral and multilateral funding agencies. Close coordination has been maintained with other agencies involved in providing assistance for developing rural financial services, particularly with the World Bank on its proposed Rural Finance Project (RFP).

III. BACKGROUND

A. Economy in Transition

3. The Kyrgyz Republic, which became independent in December 1991, is in the midst of an all-out approach to transform the economy from a centrally planned to a market-based system. Despite the deteriorating economic and social conditions, the Government has continued the early and active commitment to the reform process, simultaneously adopting policies for macroeconomic stabilization and comprehensive sectoral and structural reforms.[3] The broad sectoral and structural reform measures have included (i) enterprise reform and privatization; (ii) industrial and trade policy reform; (iii) promotion of private sector development, including encouragement of direct foreign investment and eradication of monopolistic markets; (iv) financial sector reform; and (v) social safety net reform. At the October 1996 Consultative Group Meeting, the aid community strongly endorsed the Government's macroeconomic stabilization and structural reform program efforts and achievements, considered perhaps the most advanced among the Central Asian republics.

---

[1] TA No. 2453-KGZ:*Agriculture Credit Pilot Project*, for $910,000, approved on 27 November 1995.

[2] The Mission comprised J. Whittle, Project Economist/Mission Leader; R. Hartel, Rural Development Specialist-Finance; G. Atay, Counsel; M. Culligan, Consultant-Credit Union Specialist; and C. Moreau, Consultant-Legal Specialist.

[3] For further discussion of the economy, the reform process, and more recent economic developments, see the STS KGZ 96029:*Country Operational Strategy Study:Kyrgyz Republic*, December 1996; and ECR KGZ:*Country Economic Report*, July 1997.

4. The Government has achieved significant success in macroeconomic stabilization, especially in combating inflation.[1] Inflation declined from over 1,000 percent in 1993 to 30 percent in 1996, and is targeted to fall to 16 percent per annum in the medium term. The continued contraction in the economy since independence in 1991 now appears to be abating. Real gross domestic product (GDP) fell by about 45 percent during 1991 to 1995. The contraction in economic output appears to have ended in 1995. In 1996 GDP increased by an estimated 5.6 percent per annum, evidence of the start of a broad-based recovery.

B. The Rural Economy and Rural Financial Services

1. The Rural Economy

5. The Kyrgyz Republic is predominantly a rural economy. The rural areas provide a livelihood for more than 60 percent of the population, with agriculture and related enterprises the most significant areas of activity. The agriculture sector accounts for more than 40 percent of GDP,[2] 50 percent of export earnings, and 43 percent of the workforce. Since independence, the agriculture sector has increased its contribution to GDP, relative to the industry sector, which has declined significantly.

6. From independence the Government has been steadily implementing a program of agriculture sector reforms focusing on (i) land reform and privatization of state and collective farms; (ii) liberalization of commodity prices and trade; and (iii) demonopolization and privatization of input supply, and output marketing and processing enterprises. In 1995, the Government, in recognizing that agriculture will be the basis for the economy's recovery and development through the transition process, accorded significant priority to accelerating the reform program for the sector. Both the Bank and the World Bank subsequently supported the Government's program. The World Bank support was through the Agriculture Privatization and Enterprise Adjustment Credit, approved in June 1995. The Bank provided further support through the Agriculture Sector Program Loan approved in November 1995.[3]

7. Under these two programs, the Government undertook measures to (i) support land reform, in particular, by limiting undue restrictions on the transfer of land or its use as collateral, to accelerate land titling and registration, and to establish transparent procedures for adjudicating land disputes; (ii) improve the use of irrigation, particularly by encouraging the formation of water user associations; (iii) increase the competitiveness of the input supply system through privatization of State-owned enterprises and attached agencies to the Ministry of Agriculture and Food; (iv) provide for the restructuring and privatization of state-owned enterprises involved in marketing

---

1 The Kyrgyz Republic was the first country of the Commonwealth of Independent States to receive access to the International Monetary Fund's Systemic Transformation Facility (in 1993) and to receive a three-year Enhanced Structural Adjustment Facility (in July 1994).

2 Authorities have estimated about 19 percent of GDP, which is attributed to the shadow economy, of which agriculture is a substantial part, is not reflected in the official GDP estimates. Since 1995, about 6 percent of this estimated 19 percent is included in the official GDP estimates.

3 Loan No. 1407-KGZ: *Agriculture Sector Program Loan*, for $40 million, approved on 22 November 1995. The first tranche of about $19.4 million was released in April 1996 upon loan effectiveness, and was liquidated by 20 October 1996. The second tranche of about $18.5 million was released and liquidated in May 1997.

and processing; (v) reduce restrictions on the export of such products as cotton and wool; (vi) enhance social protection through support for social assistance funding; (vii) protect the environment by focusing on managed grazing of natural pastures and forested areas, and reintroducing biological control measures for cotton pests; and (viii) enhance the capacity of selected Government agencies to implement the reform program and provide the required support for a market-based agriculture sector.

8. There has been substantial progress to date in trade and price liberalization and privatization. The system of state orders was eliminated in 1993, prices for all agricultural commodities were liberalized in 1994, and export taxes on all agricultural products were abolished by February 1996. At the beginning of 1996, of the more than 86,000 registered businesses, 75 percent were in the private sector. More than 50 percent of all medium and large enterprises were privately owned. Considerable progress has also been made in the privatization of State and collective farms with about 82 percent of all collective and State farms (477 farms) having been reorganized into about 27,000 peasant-type and other private farms, 687 agricultural cooperatives, 73 joint-stock companies, and 226 amalgamations and associations of peasant farms.[1] With the increasing pace of land reform and privatization, the number of private subsistence farms in the country is expected to have increased markedly during 1996 and 1997. Furthermore, land use rights have been extended from 49 to 99 years, and legislation for the establishment of a land registration system has been submitted to Parliament. A Law on Pledge, that includes provisions on land to be used as collateral has been approved by Parliament.

9. Agricultural output declined continuously from 1990, in parallel with the general economic contraction, falling by over 26 percent by the end of 1994. This decline has been uneven across subsectors and over time. However, as early as 1995 there was some evidence that the reforms in the agriculture sector were beginning to take effect. In 1995[2] total output fell only 2 percent, following on from a 19 percent fall in 1994. In 1996, agricultural output increased by an estimated 13.1 percent over the 1995 level. The increase is partly attributable to favorable weather conditions and partly in response to the reforms that have allowed farmers the freedom to change their crop mix in response to emerging urban markets. According to the International Monetary Fund (IMF), this growth in agricultural production resulted in increased private consumption, particularly in consumer durables, and together with light industry production contributed significantly to a 15 percent increase in the volume of exports, particularly fruits and vegetables. Government forecasts do not expect a further large production increase in 1997.

10. While the Government has been pursuing reforms, the supply-side responses in the agriculture sector have, until recently, generally been less than expected due to (i) the extent of the reform measures relative to the immensity of the challenges facing the Government; (ii) the length of time required for the reforms to diffuse through the sector; (iii) the relatively ineffective implementation of some reforms at the local level; and (iv) increasing poverty and limited income opportunities in the rural economy. As a result of the ongoing difficulties with independence and the transition to market-based institutions, agricultural producers have tended to retreat from commercial production to subsistence operations and barter exchange, and agroprocessing, storage, and distribution facilities operate significantly below capacity.

---

1 UNDP. 1996. *Kyrgyz Republic - National Human Development Report*. Bishkek, p.23.

2 The IMF estimates that agriculture output in 1995 actually increased by 4 percent in real terms.

11. The ongoing economic transition has also resulted in a sharp decline in the active working force engaged in the formal (officially registered) economy; considerable hidden unemployment; a growing informal sector; and a change in the composition of jobs provided by the economy. By mid-1996, registered unemployment was 3.6 percent of the labor force, while the overall rate of unemployment and underemployment, respectively, amounted to about 20 percent. Unemployment among the young and women is a particularly serious problem, with 54 percent of the unemployed being women, about 44 percent of women under 29 years of age (1995). For nonfarm residents of rural areas, employment opportunities declined not only in the agribusiness sector but also in the public sector.[1]

12. The deterioration in labor market conditions and the severe inflation has resulted in real wages and incomes declining substantially since independence. In 1996 the average monthly wage in the formal sector was about Som495, which was more than one third below the minimum consumption basket. Often salaries and related payments are paid several months late.[2] There has also been a gradual reduction in the relativity of wages in different sectors. By mid-1995, wages in agriculture represented only 41 percent of the national average wage.

13. Social services have also deteriorated considerably in both quantity and quality because of the lack of budget resources, with the severest effects being in the poorer provinces and in rural areas. There has been an increase in the incidence of poverty from 39.7 percent of all families in 1993 to almost 50 percent in March 1996, and in rural areas from 48.1 percent to 58 percent over the same period. Overall, income inequality has worsened with the Gini coefficient rising from 0.3 in 1990 to 0.437 in late 1995. The deteriorating economic and social conditions are reflected in the United Nation's Human Development Index falling from 0.908 in 1990 to 0.664 in 1993, and 0.618 in 1995. The per capita income in the country has fallen from $1,020 in 1992 to $690 in 1995. Reform and restructuring of the agriculture sector and the rural economy is key to the recovery and future growth of the economy, and to the livelihood and reduced incidence of poverty among the rural population.[3]

2. The Rural Financial Sector

14. Until 1991, the financial system in the Kyrgyz Republic was a part of the financial system of the Soviet Union. Since independence the Government has undertaken several major reforms in the financial sector. In June 1991, NBKR was established. In 1992, a two-tier banking system was established and the national currency, the som, was introduced in May 1993. NBKR with the assistance of the World Bank, through its Financial Sector Adjustment Credit (FINSAC) approved in June 1996, is undertaking a comprehensive reform of the financial sector.

15. Until recently, the financial sector consisted of 17 commercial banks including the four large "system" banks: Agroprombank, Elbank, AKB Kyrgyzstan, and Promstroibank, which dominated the financial system. Eleven of these banks had Government ownership ranging from 4 to 32 percent. In accordance with the FINSAC

---

1 At the time of independence in 1991, the public sector, including collective farms, provided about 86 percent of all jobs. Currently, only 40 percent of employment is provided by the public sector.

2 As of 31 March 1997, the wage payment arrears totaled Som72.6 million, or 6 percent of the 1996 budgetary expenditure on wages.

3 Asian Development Bank. 1997. "Women and Gender Relations, the Kyrgyz Republic in Transition."

program both Agroprombank and Elbank have been liquidated, after collapsing under the burden of massive debt, and inappropriate interest rate structures, respectively. As of April 1996 these four banks had performing loans representing only 5 percent of their gross loan portfolios. Most of their loan portfolio was extended as directed credit to the State sector. On the positive side, there are several profitable private banks: Maksat, Kurulush, Alniyet, Mercury, and Kramds banks. A new private bank, Demir Kyrgyz Bank was recently established by the Turkish Demir Bank, the International Finance Corporation, and the European Bank for Reconstruction and Development. More information on the financial sector is contained in Appendix 1.

16. The Kyrgyz financial sector is also hampered by other constraints. These include (i) a low level of bank capitalization; (ii) inadequate risk management; (iii) inadequate loan loss provision; (iv) low deposit growth as most liquidity remains outside of the banking system, despite positive real interest rates since mid-1993; (v) an inadequate accounting system; (vi) inadequate training of bank staff at all operational levels; (vii) inappropriate banking practices, that discourage the use of banks, such as charging fees for savings withdrawal; (viii) lack of public confidence in the formal financial system because of the erosion of the real value of savings due to inflation, seizing of deposits for tax arrears, and the recent poor performance of banks; (ix) lack of a customer-service orientation, for instance long waiting times are required to complete financial transactions; and (x) lack of understanding of credit as a contract requiring repayment, due to the Soviet legacy of using banks as conduits for state subsidies.

17. The rural sector in the Kyrgyz Republic had been entirely dependent on the four system banks for the supply of banking services. For example, the reduction of the number of commercial banks from 18 in 1995 to 15 in 1996 has seen a corresponding reduction of branches from 170 to 70.[1] Together, the system banks previously operated in 38 of the country's 42 raions (districts). Agroprombank was the predominant rural lender, and its lending activities were estimated at 90 percent of all lending to the agriculture sector. Since Agroprombank's collapse, 25 raions now lack banking services. These raions, with a total of 1.6 million people, comprise 35 percent of the population. In addition, the two remaining system banks and other commercial banks are now lending to only a few rural businesses, due to their reluctance to increase their rural and agricultural loan portfolios because of the perceived high risk, high administration costs, and lack of communication with rural clients. As a result, an estimated 39 out of 42 raions, or 73 percent of the country's population, are without full banking services.

18. Credit cooperatives were established under a Presidential Decree dated 3 November 1995. The Ministry of Agriculture and Food (MAF)[2] was authorized to assist in their creation. These cooperatives exist as a conduit for the channeling of in-kind assistance to farmers and offer no deposit mobilization facility. Limited quantities of in-kind items such as farm machinery, fertilizers, chemicals, and seed have been distributed to the cooperatives, which in turn allocate these as loans to selected farmers. Only a minority of members have received these loans. Farmers usually have ten months to repay at zero interest, either in-kind or in cash.

---

[1] See World Bank. 1996. "Financial Sector Adjustment Credit, " President's Report No. P-6891-KG.

[2] Effective 1 January 1997, MAF has merged with the previous Ministry of Water Resources and been renamed the Ministry of Agriculture and Water Resources.

19. The formal financial system is incapable of performing the fundamental role of mobilizing deposits and transforming these into loans, particularly in rural areas. There are virtually no options for rural dwellers to obtain adequate financial services. NBKR established the Settlement and Savings Company as a special financial institution, exempt from selected prudential regulations, with Som1.0 million capital. The Company commenced operations on 28 July 1996 and provides treasury, money transfers, and savings services through a network of former Agroprombank and Elbank branches covering all raions and a regional office in each of the six oblasts (regions). It also makes payments to beneficiaries through 1,000 post offices. All mobilized funds are invested in treasury bills and the Company is not authorized to provide lending services. Other small aid-assisted finance programs are providing only localized pilot services, and the informal financial sector in the country is relatively insignificant. The PPTA feasibility study survey indicated that only 5 percent of households and 2 percent of nonfarm enterprises have loans from informal sources of finance. None of the households interviewed had loans from moneylenders. There seems to be no significant informal financing of trade. [1]

20. In 1995, the nonbanking financial sector included several hundred currency exchange shops, more than 30 insurance companies, 24 investment funds, 18 pension funds, and a stock exchange. Under FINSAC, legislation for nonbank financial institutions is to be prepared for insurance companies and pension funds. These institutions function in a formal sense, but they do not form competitive markets, except the foreign currency exchanges.

3. Development Potential and Constraints

21. There is considerable potential for growth and development in the rural economy. The economy, in general, and the agriculture sector, in particular, are beginning to benefit from the early macrostabilization and sectoral reform programs. An important feature of the sectoral reform process is the increasing emergence of private enterprises, particularly private farms and the changing farming practices beginning to emerge, particularly in fruits and vegetables. The substantially completed privatization of State and collective farms, the input supply, and processing and marketing agroenterprises is also increasing the number of private entities. There is also a growing number of private small-scale and microenterprises appearing in rural areas, including some small-scale farm-based processing. For existing and new private entities to benefit from the expected recovery in the agriculture sector and to respond to further opportunities, these entities require technical and financial support.

22. Farmers' access to major inputs such as seed, livestock feed, fertilizer and chemicals, spare parts, and general support services has been considerably reduced. This situation is in part caused by the reduced availability of inputs, but also by falling incomes and the absence of finance for farmers to make essential purchases. As a result, the volume and quality of farm production has been largely in decline, except in 1996. The absence of definable markets, credit, market information, and the lack of cash income has seen increased barter trading and on-farm storage.

23. The provision of financial support to the rural sector is substantially hampered by the dysfunctional financial sector. This is creating severe financial difficulties for the rural areas generally, and the agriculture sector in particular.

---

1 A survey of 140 farms, 140 enterprises, and 140 households was conducted in the oblasts of Naryn, Djalal-Abad, Osh, and Chui.

Following the failure of directed credit through Agroprombank, the Government in 1995 commenced distribution of credit through MAF, administered by oblast and raion authorities. In 1995 Som258 million and in 1996 Som276 million from the State budget were provided in loans at interest rates of between 0 to 30 percent per annum. Many of these loans have been considered as grants by the recipients, and the results in outreach and loan recovery are poor. The demand for credit continues to substantially exceed the available supply. With the failure of the banks and MAF to effectively deliver and recover agriculture loans, alternative financially viable mechanisms are needed.

24. There are indications that substantial savings exist throughout the country but are neither being deposited in banks nor circulating in the economy. However, with proper incentives, these savings could be deposited with strong and sustainable financial institutions. Moreover, as the economy continues to recover, rural incomes and hence potential savings can be expected to increase.

25. The rural areas are faced with limited availability of funds and also inaccessibility to needed financial service outlets. Neither problem is helped by the complete absence of financial intermediation in the rural areas. Thus, to further facilitate the transition to a market-based economy it is necessary to establish a competitive rural financial system that is capable of providing both savings mobilization and loan services at a reasonable cost to financially autonomous enterprises and households. While attempting to find mechanisms to meet the need for emergency funds in the short term, it is equally if not more critical that effective financial institutions be developed to continuously meet the needs of the rural community in the medium to long term. Given the present state of the rural financial system, new institutions will have to be established and nurtured to develop into strong, viable, and competitive financial institutions.

C. Government Policies and Plans

26. The Government's current policies and plans are reflected in its *Public Investment Programme Review and Update for 1997-99,*[1] which was accepted at the Consultative Group Meeting held in October 1996. The six main strategies aimed at supporting economic recovery and growth, and providing for the basic institutions and public services of a modern state are identified as (i) modernize infrastructure to support a modern market economy; (ii) sustain existing infrastructure in support of economic recovery and maintain essential services; (iii) support financial recovery in the agriculture sector; (iv) ameliorate adverse environmental legacies; (v) invest in the recovery of the industrial enterprise sector; and (vi) support policy and institutional reforms necessary to facilitate economic growth and development.

27. In support of the agriculture and natural resources sector, the Government has adopted the following five policy objectives: (i) establish an incentive framework for the sector through promotion of competitive input and product markets; (ii) establish efficient farm units through the completion of land reform, farm restructuring, and creation of a land market; (iii) complete the privatization of agribusiness and agro-processing industries; (iv) ensure the availability of seasonal and medium-term credit; and (v) ensure sustainable management of natural resources.

---

[1] State Commission on Foreign Investment and Economic Assistance. 1996. *Public Investment Programme Review and Update for 1997-99*, September.

28. Rebuilding the financial sector, including access of the rural population to financial services, is now a key policy concern of the Government.[1] It recognizes that the supply-side response to market reforms cannot be expected without access to the required finance for investment in the new opportunities presented. As previously mentioned, the Government's continuing reform efforts in the financial sector are being supported by the World Bank-funded FINSAC program. The key elements of this program are (i) creation of a policy and regulatory environment conducive to the sound growth of a competitive and efficient private banking system; (ii) liquidation of the Agroprombank and Elbank, which has been completed; (iii) downsizing and financial restructuring of Promstroibank and AKB Kyrgyzstan banks; (iv) creation of a temporary debt resolution agency to help collect, restructure, sell, or write-off the old nonperforming loans, and thus accelerate enterprise restructuring or liquidation in the process; and (v) the creation of a regulatory and supervisory framework, and supporting policies and infrastructure, for the development and growth of emerging nonbank financial institutions.

29. Two critical issues face the Government in the area of rural finance: (i) the immediate need to ensure the availability of emergency seasonal credit in the absence of functioning commercial institutions; and (ii) the need to develop an efficiently functioning rural financial system to provide financial services in the rural areas in the medium to long term. The Government established an inter-ministerial Working Group on Rural Finance in 1995 to deal with these issues. The Government recognizes that while searching for appropriate mechanisms for delivery of seasonal credits is an immediate and short-term concern in the agriculture sector, it also is aware that the long-term solution to the provision of rural financial services will lie with the development of effective rural financial institutions and an efficient rural financial system. The Government policy is clear: to avoid the proliferation of Project-dependent credit schemes and to rely on the banks and other financial institutions for rural financial intermediation.

30. In April 1996, the Government's Working Group on Rural Finance submitted a proposed strategy for rural finance to the State Commission on Rural Finance.[2] This strategy, with minor amendments, has been in general, adopted by the Government. With the liquidation of Agroprombank, alternative mechanisms for providing financial support to agriculture are needed. In determining these mechanisms the strategy has been influenced by four key issues: (i) imperfect information about borrowers in rural areas; (ii) the general low profitability of farming; (iii) underdevelopment of agribusiness; and (iv) nascent private farming. The objectives of the strategy are (i) in the short term to provide financial support (subsidized credit) and credit (on a commercial basis) to emerging private farm and agribusiness enterprises, and rationalize the provision of both Government and aid-assisted financial support and credit to agriculture and agribusiness; and (ii) in the medium-term to provide support for the promotion and development of commercially viable financial institutions and markets in rural areas, and the gradual replacement of Government subsidies on rural credit programs with commercial sources of funding. The institutional framework for implementing the strategy includes the State Committee on Rural Finance (SCRF); a Rural Fund; and rural financial institutions. The SCRF was established by Government

---

1 At the Consultative Group Meeting in Tokyo in September 1996 aid agency representatives agreed with the Government's emphasis on the importance of ensuring that all sectors and regions of the country have access to a full range of financial services.

2 Information has been based on World Bank. 1996. *Rural Finance Program, October 1995-September 1996*. Final Report, September, Washington, D.C.

Order No. 582 of 29 December 1995 and comprises the Prime Minister (chair); Vice-Prime Minister, Agrarian Policy (vice-chair); minister of Finance; chairperson of NBKR; chairperson of the State Property Fund; and minister of Agriculture and Food. SCRF is to formulate rural finance policies and oversee the implementation of the strategy through the proposed Rural Fund. The Kyrgyz Agricultural Finance Corporation (KAFC) was established in 1996 and will perform the functions of the Rural Fund. KAFC has financial and operational autonomy under the control of its Board, the SCRF.

D. External Assistance to the Sector

31. Several efforts by multilateral and bilateral funding agencies are providing assistance to develop rural financial institutions. These include the Bank; the World Bank; the United States Agency for International Development (USAID); the European Union Technical Assistance for the Commonwealth of Independent States (EU TACIS) and several bilateral donors. The focus of this external assistance is both the delivery of rural credit and the development of financial institutions.

32. Bank assistance to the financial sector has included two advisory technical assistance (TA) grants. The Bank funded a rural credit adviser to MAF, as part of the PPTA for the Agriculture Sector Program Loan, to address the critical issues of providing emergency seasonal credit and the development of a rural financial system. The Adviser worked in cooperation with a World Bank-funded adviser and the inter-ministerial Working Group on Rural Finance, to help design policy mechanisms for emergency credit and develop an overall strategy for the development of a rural financial system. An advisory TA[1] also assisted the Government to undertake a diagnostic and audit study, and a restructuring plan for Promstroibank and provided advice on the legal framework for the banking sector, particularly the banking law, and on a strategy for the restructuring of the commercial banking sector. Many of the recommendations have been incorporated into the FINSAC program.

33. The World Bank RFP was approved in June 1997 and includes the development of KAFC, which was established by Government Decree on 3 July 1996, and a pilot outreach program targeting poor farming households at or slightly above the poverty line. The RFP will also be supported by technical assistance from the Swiss Development Cooperation and EU TACIS. KAFC is a non-bank financial institution and has no authority to take deposits. Instead, it will provide credit to meet the immediate and urgent credit needs of farmers and agribusiness enterprises. The resources will come from the Government and from the International Development Association (IDA) credit of $13 million. Positive real interest rates, but possibly below market rates, will be charged. The minimum loan size is $1,000. KAFC was registered as a joint stock company in December 1996, initially with the Government as sole shareholder. It is envisaged that KAFC will be eventually privatized with private farmers, agribusiness enterprises, and regional authorities being given the opportunity to purchase KAFC shares.[2]

34. The RFP is seen by Government as complementary to, rather than competitive with, the Bank's Project because of the different market segments/clientele. The RFP is targeted at medium-to large-scale agricultural producers, while the Bank Project is focused on micro to small and medium loans to rural households, and on-

---

1 TA No. 2220-KGZ: *Strengthening of the Banking System*, for $600,000, approved on 5 December 1994.

2 Further details on the policy and operations of KAFC are provided in Appendix 1.

farm and off-farm enterprises. The RFP does not include savings mobilization. Discussions with the World Bank continued during Project processing to ensure both projects remain complementary.

35. The World Bank is also preparing the Kyrgyz People's Initiative Fund project, which follows on from a pilot demonstration project. The project is experimental and aims to build nationwide institutions to assist low income communities and disadvantaged groups. The project will have four components: capacity building for about 1,200 subprojects; microcredit; basic social services; and institutional support for the establishment and management of the Fund. The total project cost is tentatively estimated at $10 million of which $6 million will be from the International Development Association.

36. USAID is supporting the Foundation for International Community Assistance (FINCA), a United States-based nongovernment organization with a grant of $6.2 million for both TA and credit funds. Since beginning operations in the country in 1995, FINCA has organized groups of mainly rural women (88 percent of members) into mutual lending and savings societies based on a village-banking model. The program has concentrated mainly in urban areas in the Chui Valley and Osh, but is now beginning to expand into the rural areas. The activities financed are rural, and off-farm micro and small enterprises on very short (16 weeks) credit terms. Loans start at $65 per person, 5 percent monthly interest, with interest, principal, and savings paid weekly in supervised meetings. There is no collateral and 20 percent of the loan value must be held in mandatory savings. $900,000 has been lent through more than 1,200 loans. It is feasible that some of these village banks could become CUs and benefit from the Project.

37. EU TACIS has commenced preparations of the Issy-Kul Regional Agricultural Credit Project that will provide a revolving credit fund to support the Pilot Agricultural and Food Development Programme in Issy-Kul. It is proposed to establish a revolving credit fund for targeted and supervised credit through a commercial bank for farmers associations to improve agricultural and livestock production.

38. These efforts, with the exception of the FINCA program, are providing only credit targeted to specific clientele. The FINCA program includes savings mobilization but is limited geographically, to focus on Bishkek and Osh, and has only recently ventured into rural areas. There is very limited effort to develop alternative rural financial intermediaries to address the provision of long-term, sustainable financial institutions to meet the broad demands of the rural sector for both savings mobilization and lending services. Strong self-sustaining financial institutions are key to ensuring the continued supply of rural financial services to households, agriculture, and rural enterprises, and to enable them to respond to emerging market opportunities. The proposed Project will provide the first major step forward in assisting the Government to meet its medium-to longer-term strategy to push the frontiers of development and finance in building appropriate rural financial institutions.

E. Lessons Learned

39. The Bank has not funded any rural finance projects in the Kyrgyz Republic or other Central Asian republics, but has in the other transition economies of the People's Republic of China, and Viet Nam. Lessons are drawn from the Bank's many rural credit projects in various member countries, the experience from successful

rural financial institutions in other countries, the experience of CUs in other countries, and some early lessons from the trial CUs under the PPTA.

40. Two important lessons from the Bank's credit projects in other countries are (i) the lending institution should adopt an interest rate policy that ensures the financial viability of the institution; and (ii) because rural financial markets consist of different market segments with markedly diverse characteristics, a multiagency approach is necessary to better meet the demand for financial services from different segments.

41. There are some essential lessons to be learned from the review of the Bank for Agriculture and Agricultural Cooperatives Thailand; the Village Bank (Unit Desa) of Bank Rakyat Indonesia; and the Grameen Bank Bangladesh. All three are widely regarded as successful based on the criteria of outreach and self sustainability.[1] The principal features attributed to their success include (i) favorable macroeconomic, agricultural, and rural policies; (ii) adequate investment in the physical and social rural infrastructure; (iii) a high degree of management autonomy in the formulation of operational policies; (iv) staff policies that stress training, accountability, and reward through monetary incentives and promotion; (v) innovative, low-cost distribution systems, and mobile banking; (vi) innovative and flexible loan terms and conditions; (vii) close monitoring of loan performance, high collection rates, and low arrears; (viii) domestic savings mobilization as a growing source of funds, resulting in diminishing or eliminating the need for aid funds; (ix) real positive and often relatively high onlending interest rates covering costs; (x) control over administrative expenses; and (xi) advanced management information systems that facilitate effective planning, control, and timely monitoring of loan repayments.

42. Lessons concerning CUs were identified during the processing of the Bank's recently approved loan for Viet Nam to further strengthen the People's Credit Funds (PCFs),[2] or credit unions. The PCFs are legally constituted, commune-level, autonomous, small-scale financial institutions based on voluntary membership. The State Bank of Viet Nam (the Central Bank) introduced them in 1993 to increase institutional diversification and competition in rural financial markets dominated by the Viet Nam Bank for Agriculture. In July 1995, the State Bank of Viet Nam established and issued an operating license for the Central People's Credit Fund as the apex organization of the PCF network. Regional peoples credit funds have also been established as second-tier institutions in the PCF network. From the original 15 provinces piloted in 1993, there were 596 PCFs in 37 provinces with a membership of 221,426 by the end of April 1996. About 10-20 percent of members are poor, and women account for about 39 percent of total membership. The State Bank of Viet Nam provides initial support for their establishment and growth, and supervises their operations. Up to the end of 1995, the PCFs had made nearly 400,000 loans and disbursed about $109 million, an average loan size of $272. Loan recovery is very good with overdue loans less than 1 percent of total outstanding loans at the end of 1995. The average loan size of the PCFs varies from about $50 to $1,600, with a large share of loans in nonfarm activities. The lessons from the PCF experience in Viet Nam include the need (i) for closer attention to mobilizing savings, particularly from low income groups; (ii) to substitute interest-bearing savings deposits for share savings as

---

1 See, Yaron Jacob, McDonald Benjamin, and Gerda Piprek. 1996. "Rural Finance: Issues, Design and Best Practices," draft, Environmentally Sustainable Development Studies and Monograph Series, World Bank, Washington, D.C.

2 Loan No. 1457-VIE: *Rural Credit Project*, for $25 million, approved on 12 September 1996.

the primary source of funds to meet the increasing demand for credit; and (iii) to expand the range of loan services to meet the needs of a wider variety of members, including those in low income groups.

43. The CUs are community and village-level financial institutions that provide savings and credit services to individual members. They are organized and operated on cooperative principles, usually have no external shareholders, the members are the owners of the institution with one vote per member, and the policy-making leadership is drawn from the members. The CUs are usually legally constituted under national cooperative legislation.

44. As part of the PPTA for the preparation of this Project, a Seed Fund of $50,000 was established to trial three CUs to demonstrate an alternative approach to savings mobilization and credit delivery. The CUs were established in Kara-Balta in Chui oblast and Aravan, and Kadamjai in Osh oblast. These raions were selected on the basis of interest expressed by potential CU members and also, in the case of Kara Balta, proximity to Bishkek and the opportunity to work in conjunction with the European Union supported Agri-Business Center. The trial is being managed by NBKR and will continue until the start-up of the proposed Project when the three trial CUs will be included in the Project. The operations of the CUs are carried out using the voluntary labor of members. The Seed Fund is used to equally match the total of member's own contributions (share capital) to the CU up to a limit of $10,000 per CU. All three CUs commenced operation in late August 1996. At the time of the Appraisal Mission there were 76 members: Kara-Balta (25); Aravan (28); and Kadamjai (23), with average share capital per member of Som3,225 ($185) and matching Seed Funds of Som186,250 ($10,704). Total loans outstanding were Som431,350 ($24,790) by March 1997. These loans have been made available in two cycles to 74 borrowers for an average loan size of Som10,278 ($590). Lending terms are for three to four months, and the interest charge is 3 percent a month. Members receive a 2 percent a month dividend on their contributions. The interest rate on the borrowed seed funds is 26 percent per annum. The activities financed include working capital for agriculture and rural enterprises, traders, transport, and professions such as doctors and teachers.

45. The performance of the three trial CUs showed a loan recovery rate of 100 percent on the first cycle of the loans. All loans were recovered within a week of the expected payment date. Table 1 summarizes the performance of the three CUs.

Table 1: Summary of Trial Credit Unions Operations
September 1996 - March 1997
(Som as of March 1997)

Item	Kara Balta	Aravan	Kadamdjai	Total
Members				
Members No. (Women) March 1997	25 (6)	28 (3)	23 (4)	76 (13)
Share Capital				
Member Share Capital (March 1997)	32,500	82,000	130,600	245,100
Matching Fund Loans (March 1997)	34,750	30,000	121,500	186,250
Capital/ member (March 1997)	1,300	2,928	5,678	3,225
Loans				
Borrowers, first loan cycle	12	8	12	32
Borrowers, second loan cycle	13	14	15	42
Loan Size Range	3,000-6,700	3,000-6,000	5,000-51,000	3,600-21,230
Average Loan Size, first loan cycle	4,750	6,250	20,800	11,143
Average Loan Size, second loan cycle	5,500	7,300	17,200	10,278
Loan Purpose (March 1997)				
Agricultural Production (%)	100	60	80	78
Agricultural Processing (%)		20		5
Others (teachers, doctors, business) (%)		20	20	17
Ratios (March 1997)				
Average Loan Size/average capital per member (March 1997)	2	2.5	3.0	3.2
Maximum Loan Size/total capital (%)	21	7	39	9
Loan Recovery (interest and principal), 1st cycle (%)	100	100	100	100

46. There are already a number of indicative lessons arising from these trial CUs. In general (i) while the number of members at start-up could be less than 20, an average size of about 100 within a range of 50-200 will be an acceptable size;[1] (ii) members are attracted by a deposit facility conveniently located and offering reasonable interest rates; (iii) there is interest in having savings and deposit facilities in addition to share capital; and (iv) members appreciate having control over their own financial institution. In terms of overall operation and performance at the time of appraisal: (i) 100 percent of the first cycle of loans was recovered; (ii) overall membership had increased marginally; (iii) the CUs require more guidance and training; (iv) increased emphasis needs to be placed on the mobilization of members' savings as the primary resource for credit; (v) a clear distinction between savings deposits and share capital is required; (vi) application of collateral rules is varied and sometimes restrictive; (vii) membership needs to expand and become more diversified; (viii) the loan terms are too short for agriculture; (ix) payment of interest on both deposits and borrowings should be more disciplined and closely monitored; (x) accounting practices are variable and inconsistent; (xi) prudential regulations need to be applied and supervised more rigorously; and (xii) board and committee roles and functions need clarification and strengthening.

[1] These numbers can be compared to 350 in Viet Nam and 550 in Indonesia for similar types of institutions.

47. The above experiences, particularly the findings of the three trial CUs, have been taken into consideration in the design of the Project.

F. The Bank's Sectoral Strategy

48. The Bank's country operational strategy emphasizes (i) support for the Government's reform activities and strengthening of its development management; (ii) encouraging the creation of a new structure for output and capacity by the private sector through investment and job creation; and (iii) arresting the rapid deterioration in the long-term potential of the country by investing in physical infrastructure and human resource development, but also by selective interventions to protect and rehabilitate the environment. Within this strategic framework, the Bank's program in agriculture, of which rural finance is a key element, requires an integrated mix of policy reform, capacity building, and selective key investments.[1] The proposed Project, the objective of which is to increase the level and sources of savings mobilization and lending services in the rural community, incorporates policy development, capacity building, and key investments. The Project is consistent with the country operational strategy and the Bank's strategic development objective of economic growth. The Project also meets the operational priorities of the Government, which as part of the medium-term rural finance strategy, identify the development of an independent rural financial system including the development of commercially viable financial institutions and markets in rural areas. Such a development is seen as essential to the overall recovery of the agriculture sector and the future development of the rural economy.

G. Policy Dialogue

49. Since the Kyrgyz Republic became a member of the Bank in 1994 the Bank has maintained a continuous dialogue with the Government on its general reform program for transition and on the agriculture and financial sectors specifically.

50. The Bank has strongly influenced the policy of the Government to consider mechanisms for moving away from the traditional approach to rural finance. The traditional approach relies mainly on supply-led, state-owned, agricultural credit institutions mainly delivering credit. The new more systematic and institutional approach establishes private institutions providing both savings and lending services to the broader rural community, not just agriculture. In recent years, the Government's focus has been on the delivery of limited resources for emergency credit to a limited number of farmers. The Government now, in addition to trying to address emergency credit, is also pursuing a longer-term strategy to develop self-sustaining rural financial institutions. The Bank's funding of three trial CUs is demonstrating the benefits of such an approach.

51. The legal, regulatory, and policy environment for the financial sector is being supported by the FINSAC program. The Bank has further assisted the Government in developing the appropriate legal, regulatory, and policy conditions for the operation of the CUs through the drafting of a Credit Union Decree. This Decree has been developed further by the Government, and a draft Law on Credit Unions has been prepared. The Appraisal Mission reviewed both the draft Decree and draft law, and provided further recommendations.

---

[1] See, STS KGZ 96029: *Country Operational Strategy Study*: Kyrgyz Republic, December 1996.

52. There are several micro policy areas the Bank has successfully discussed with the Government. A key feature has been the elimination of direct subsidies and the adoption of market interest rates in the operations of the CUs. Policy dialogue has continued in several key areas with agreements reached with the Government that (i) the voting rights of CU members be one member one vote; (ii) there be an option for the CUs to waive collateral for loans less than Som7,000 ($410); and (iii) internationally recognized accounting practices be adopted by the CUs. On the tax status of the CUs, it has been agreed with NBKR that the Law on Credit Unions will provide for the CUs to be tax exempt. Regarding the inclusion of savings deposits in addition to share capital as a savings mechanism for members, NBKR has agreed that deposits could be introduced for mature CUs and that provision will be made for savings deposits in the Law on Credit Unions.

IV. THE PROJECT

A. Rationale

53. The rural sector, including agriculture and off-farm rural enterprise, is expected to lead the economy's recovery and growth through the transition period. There are strong indications that the Government's macrostabilization, and structural and sectoral reform efforts are beginning to take effect. Growth in the economy, in general, and the rural areas, in particular, turned around and showed positive growth in 1996. With continued growth will come considerable opportunities. However, financial services, both savings mobilization and credit delivery, have rapidly broken down as two major banks and traditional mechanisms have failed. This is a major constraint to rural sector development.

54. Based on the findings of the PPTA and the trial CUs, there are reported to be substantial savings throughout the country that are not deposited in banks and that are not circulating in the economy, but that with the proper incentives would enter the formal financial system. Distrusting the banks, reluctant to deposit savings in institutions paying interest rates below the rate of inflation, and with present levying of charges on withdrawals and taxes on deposits, the people are holding savings in nonmonetary forms. A demand analysis survey undertaken as part of the PPTA concluded that less than 10 percent of the demand for savings and credit services for all private enterprises and households is being met by the banking sector. It is estimated that agricultural enterprises require at least an additional $20 million for working capital and $30 million for longer-term investments. Other small enterprises in rural areas need $30 million in credit. The total demand for such credit, excluding households, is about $80 million. The PPTA estimated that savings from households could be up to $84 million and from small enterprises $8 million.

55. To continue to channel only credit to rural areas would simply reinforce the current poor deposit and credit repayment practices. Given the failure of the formal financial institutions to reach the rural population and the minimal informal sources of credit on which the population can rely, special financial schemes have to be introduced. There is a need for long-term self-sustaining institutions able to provide financial services in rural areas into the future. Moreover, there is a need for new, dynamic, community-linked institutions to overcome traditional social attitudes to credit delivery, and develop trust and public understanding of financial institutions. It is essential that support be given to the Government not to continue dismantling the institutions of the previous system, but to commence pushing the frontiers of

development and finance by building new ones that better serve the requirements of a market-based economy. The relatively liberalized environment provides strong incentives for new institutions to be created to reestablish a rural financial system.

56. The CUs in other countries have proven that they can be adapted to the special needs of different groups; to different cultures, languages, and religions; as well as to different legal, political, and economic systems. They offer a number of advantages: (i) they are owned by the members, and the policy-making leadership is drawn from the members themselves; (ii) local ownership reduces credit risk and provides peer-pressure incentives to repay loans; (iii) they improve access to financial services for the local people; (iv) their proximity to potential clients can facilitate mobilization of small deposits; and (v) they can offer services at low transactions costs, because of their proximity to, and familiarity with, members, and their small size that permits the adoption of simple procedures. In addition, the local ownership will exert pressure on the CU managers to be both responsive to local requirements, and efficient in their operations.

57. Monetizing savings and providing local financial intermediation are as much a prerequisite to developing the rural economy as increasing the supply of credit available to farmers and other rural residents. Community-derived savings are an essential step toward improving the loan recovery rate of rural lending. Therefore, the Project will emphasize rural financial market development, focusing on the process of intermediation, whereby rural deposits are mobilized and channeled into activities in the rural areas. The institutional capability and financial viability of these financial intermediaries is the priority focus.

B. Objectives and Scope

58. The long-term development goal is to rebuild a sustainable rural financial system. The immediate Project objective is to increase the level and sources of savings mobilization and lending services in rural communities. A Project Framework is shown in Appendix 2.

59. The Project will be implemented nationwide, but excluding Bishkek. This coverage will include oblast and raion urban areas that provide essential services to the rural population.

60. The Project has two components:

1. Establishment of a Credit Union System

61. A CU system, comprising a network of about 280 individual CUs and an apex union (i.e., a federation or league of CUs) will be developed to provide savings mobilization and lending services for smaller and generally short- to medium- term financial transactions.

62. The Project will build upon the recent experience with three trial CUs. Under the Project, each licensed CU will offer both savings and lending services, with savings being initially in the form of only share capital, and savings deposits being

introduced once the CU has matured.[1] The Project will provide a credit line of $8.4 million to match the total contributions (share capital and retained earnings) of each CU. This credit line will provide an incentive to the establishment and growth of the CU, and will supplement the available resources for lending to members. Loans to members will be generally provided for a variety of activities in rural areas, but are expected to be mainly for working capital and other investments in small agricultural and rural enterprises. The Project will not restrict the types of activities to be financed through subloans so that the development of the CU as a financial institution is not constrained, and a flexible lending service to support development in the rural areas is provided.

63. The Project will also support the further development of the Financial Company for the Support and Development of Credit Unions (FCSCU), which will provide the services of an apex union. FCSCU was registered on 9 April 1997 as a limited-liability company with the Ministry of Justice, and has been located on the former Agroprombank premises. FCSCU was established with initial paid-in capital of Som3 million ($175,000) and will initially be wholly owned by NBKR. Ownership will be gradually transferred to the CUs. The FCSCU will be responsible for the promotion and development of the CU network, including the channeling of matching loan funds to individual CUs, and their regulation and supervision.

64. A major part of the CU system is the building of the capability of the CUs, FCSCU, and NBKR to operate effectively in their respective roles. The Project will provide consulting services and training to build and sustain this capability. Consulting services will provide management advice, training of trainers, and assistance with the development of an appropriate accounting system, and product development for FCSCU. FCSCU staff will then carry out training of the voluntary staff of the CUs.

65. Proper supervision and regulation of the CUs will be essential to the success of the CU system. The Project will provide technical support and training for staff of the Supervision Department of NBKR to establish appropriate and effective systems and procedures for the effective regulation and supervision of the CUs and FCSCU. As NBKR will delegate part of the regulation and supervision work to FCSCU, the staff of FCSCU will also be trained in regulation and supervision. The Project will also provide, furniture, computers, other equipment, and vehicles to support the development of the CU system (see paras. 72 and 73 for more information on FCSCU).

2. Project Management

66. This component covers the FCSCU and NBKR. The successful implementation of the Project will depend, among other factors, on effective Project management. The Project will support both the Directorate of Investment and Technical Assistance Coordination (DITAC) of NBKR and FCSCU, to strengthen their capacity in Project management, monitoring, and evaluation through technical support and training.

---

[1] Mature CUs will be those operating for a minimum of three years, having consistent compliance with the required prudential regulations, and having loan recovery rates of at least at 90 percent.

C. Cost Estimates

67. The total cost of the Project is estimated at $22.1 million equivalent, including physical and price contingencies, service charge during implementation, and contributions of CU members. Of this amount, $8.4 million (38 percent) will be in foreign exchange, and $13.7 million equivalent (62 percent) in local currency cost. A summary of cost estimates is given in Table 2 and detailed cost estimates in Appendix 3.

Table 2: Summary of Project Cost Estimates
($ million)

Item	Foreign Exchange	Local Currency	Total Cost
A. Base Costs			
1. Establishment of CU System			
Establishment of CUs Subloan Activities[a]	5.9	10.9	16.8
Institutional Strengthening	1.4	2.2	3.6
2. Project Management	0.4	0.2	0.6
Subtotal (A)	**7.7**	**13.3**	**21.0**
B. Contingencies[b]			
Physical Contingencies	0.2	0.2	0.4
Price Contingencies	0.2	0.2	0.4
Subtotal (B)	**8.1**	**13.7**	**21.8**
C. Service Charge	0.3		0.3
Total	**8.4**	**13.7**	**22.1**

a This item includes the Bank's matching loan credit line of $8.4 million.
b Contingencies have not been calculated for the matching funds.

Source: Staff estimates

D. Financing Plan

68. It is proposed that the Bank provide a loan of $12.5 million equivalent from its Special Funds resources, with an amortization period of 40 years, including a grace period of 10 years, and a service charge of 1 percent per annum. The Borrower will be the Kyrgyz Republic. The proposed Bank loan is 56 percent of the total cost of the Project and will finance the total foreign exchange cost of $8.4 million, including service charges during implementation, and $4.1 million equivalent of the local cost (see Table 3). The Bank loan includes the matching fund credit line to CUs ($8.4 million); vehicles, training, equipment, and furniture costs ($352,000); consulting services ($2.362 million); and a portion of the recurrent costs ($1.036 million). The Government will finance $1.2 million equivalent of local costs (6 percent) and the CUs will finance $8.4 million equivalent of local costs (38 percent of the total costs).

Table 3: Financing Plan
($ million)

Source	Foreign Exchange	Local Currency	Total	Percent
Bank	8.4	4.1	12.5	56.0
Government	-	1.2	1.2	6.0
Credit unions	-	8.4	8.4	38.0
Total	**8.4**	**13.7**	**22.1**	**100.0**

Source: Staff estimates

E. Implementation Arrangements

1. Project Management

69. NBKR will be the Executing Agency. NBKR established DITAC to manage projects and technical assistance for which NBKR is the executing agency. DITAC currently has a staff of eight and manages credit lines for the European Bank for Reconstruction and Development, Turkish Exim Bank, and Kreditanstalt fur Wiederaufbau, and provides education and training programs, and procurement of consulting services.

70. DITAC will be responsible for overall coordination of the Project and for (i) disbursing Bank loan proceeds to FCSCU; (ii) maintaining records on withdrawal applications and disbursements under the Project and consolidated Project accounts; (iii) preparing and submitting progress and other reports to the Bank; (iv) ensuring timely submission of audited accounts of the Project to the Bank; and (v) serving as the focal point for the Bank's Project review and administration activities, and between the Bank, FCSCU and other Government agencies. As the representative of the Executing Agency, the chairperson of NBKR will liaise with the SCRF on this Project.

2. Establishment of a Credit Union System

a. Institutional Structure

71. The CU system includes FCSCU, a Consultative Committee, and the individual CUs. See Appendix 4 for further details.

i. FCSCU

72. FCSCU has been established and will operate as a nonbank financial institution. Its primary function is the promotion, development, monitoring, and supervision of the CU system. Ownership of FCSCU will be gradually transferred from NBKR to the CUs.[1] The FCSCU staff will include a general director and up to 22 staff (including 5 regional coordinators) recruited as needed. The general director of FCSCU will report to its shareholders, initially represented by the Chairperson of NBKR. The organization structure is shown in Appendix 4.

[1] It is expected that each CU will invest the equivalent of 5 percent of its capital to purchase shares in FCSCU. CUs will be given priority to acquire the full ownership of the FCSCU. In the event that such an ownership structure cannot be attained, other specialized financial institutions may be allowed, as agreed between the Borrower and the Bank, to acquire shares in FCSCU.

73. The operations of FCSCU will be funded by the Government, the Bank, and membership/service fees by the CUs. NBKR has nominated the general director and two additional management staff of FCSCU. The general director will, in cooperation with NBKR, recruit the additional staff. FCSCU management are former NBKR staff with legal, banking supervision, and commercial banking experience.

ii. Consultative Committee

74. The Consultative Committee will have 7-10 members elected by the individual CUs at the annual general meeting. These elected members will then elect a chairperson. The Committee will be established by the end of year one or when there are a sufficient number (a minimum of 10) of individual CUs to participate in the nomination and election of the Committee members. The functions of this Committee are to (i) represent the interests of the CUs; (ii) serve as a reference committee for the FCSCU management; and (iii) provide operational feedback on the development of the CU network. The Committee will be consulted by FCSCU concerning all policy matters. It will terminate upon the acquisition of majority ownership of FCSCU, by the CUs.

iii. Individual Credit Unions

75. Each CU will be governed initially by a Decree on Credit Unions, prudential regulations issued by NBKR, and its own individual Charter, which provides for a common structure and procedures. By the end of the first year of Project implementation the Government will submit a draft Law on Credit Unions to Parliament for its consideration and approval. This Law, when approved, will replace the Decree as the legal framework for the CU system.[1]

76. Each CU will have an organizational structure comprising a board of directors (not less than three members), a supervisory committee (three members), credit committee (three members) and treasurer/secretary (member of the board). This will be in accordance with the Charter for each CU, which will be approved by NBKR. The staffing of the CU will be initially voluntary labor. As the CU develops and expands its membership and the size and diversity of its portfolio, the CU will need to employ permanent and well-trained staff. It is expected that permanent staff might be required as each CU reaches about 100 members. At this stage, one permanent staff member would be necessary.

b. Operational Arrangements

77. Individual CUs will require a minimum of ten members and share capital of Som30,000 ($1,724) before being eligible for a license from NBKR to operate as a CU. While the decision on membership share size is the responsibility of the members, the initial share capital will not be less than Som1,000 ($57) per member. The maximum share capital of any single member will be 10 percent of the total capital of the CU. Each member in a CU will have one vote. Following licensing, the CU will increase its share capital to Som50,000 ($2,874) and establish appropriate lending arrangements before being eligible to apply for accreditation with FCSCU. The CU will attract funds from members as share capital; borrow funds externally, initially from the Bank credit line; and provide loans to members. All services will be restricted to members only.

---

1 The issuance of the Decree and prudential regulations for the CUs are conditions for loan effectiveness.

78. Once accredited, the CU will receive initial matching loan funds[1] equal to the total share capital at the date of accreditation. Subsequent disbursements of matching loan funds will be subject to the CU performing satisfactorily according to prudential requirements set by NBKR and will match the total contribution (share capital plus retained earnings) of each CU. Matching funds to the CUs will be at two rates: (i) up to $250 equivalent per member for up to 50 members; and (ii) up to $350 equivalent per member from the 51st member until a maximum of $35,000 equivalent per CU is reached, at which time the matching funds will terminate. This limit is designed to encourage the development of larger CUs rather than promote the extensive development of a large number of small CUs. Over the Project period it is estimated that about 280 CUs will be established with an average size of 100 members.

79. The CUs will lend to individual members under the following conditions: (i) the maximum loan size per member will not exceed 15 percent of the total share capital of the CU, or exceed a loan/share capital ratio of 3:1; (ii) collateral requirements for loans less than Som7,000 ($402) will be optional for each CU but about Som7,000 collateral will be required; (iii) the terms and conditions for, and approval of, loans will be determined by the credit committee of each CU, but the charges on such loans will cover all costs and provide members with an adequate return on their funds to be attractive to new members; and (iv) there will be no restrictions on the types of lending activities. Initial loans to a member will be short term (up to 4 months) and for small amounts to test the financial viability and discipline of the borrower to repay. This will also ensure that the credit committee obtains suitable experience before approving larger loans.

80. The CUs will be under the general supervision of NBKR. NBKR will hire two additional staff in the Banking Supervision Department to work with FCSCU on the regulation and supervision of CUs. Because of the expected growth and number of the CUs, and the importance of self regulation and supervision for CU system stability, NBKR will devolve supervision responsibility to FCSCU. FCSCU will also be under the direct supervision of NBKR. Each CU will be required to comply with the prudential reporting, and financial accounting requirements specified by NBKR. These requirements will include (i) the classification of the loan assets on the basis of quality and making loan loss provisions on the basis of asset quality; (ii) maintenance of an adequate liquidity ratio; (iii) a capital adequacy ratio larger than for banks (or a debt/equity ratio of 5:1; and (iv) a return on total assets of not less than 1 percent. Due to the small size of the CUs these ratios will be different from the current ratios for the banking industry. The CUs will be required to report monthly to FCSCU, including financial statements, loan classification, and asset-liability ratios. Accounting will be in accordance with international standards for financial institutions. The FCSCU staff will regularly visit the CUs to advise on managerial, procedural and financial matters, with the frequency of visits declining as the CUs mature. FCSCU similarly will report monthly to NBKR, which will retain responsibility for overall supervision of all CUs. All rules and regulations pertaining to the operations of the CUs will be included in regulations issued by NBKR.

[1] The matching loan funds will be paid from the credit line provided through the Bank loan.

3. Relending and Onlending Terms and Conditions

81. The Borrower (Kyrgyz Republic) will bear the foreign exchange risk of the loan and will relend the proceeds of the loan to FCSCU. FCSCU will onlend the matching funds (credit line) to the CUs under separate loan agreements acceptable to the Bank. The relending and onlending rates and other terms and conditions will be as follows (see Appendix 5):

(i) Borrower to FCSCU: The Borrower will relend the loan proceeds to FCSCU in local currency for the matching loan funds (credit line of \$8.4 million) and other investment costs (\$352,000) at a variable interest rate for a period of 20 years, including a grace period of 7 years. The relending rate will not be less than the interest rate applicable to dollar loans from the Bank's ordinary capital resources (currently 6.79 percent per annum). The Government will provide \$3.398 million equivalent of loan funds to FCSCU, as a grant, for consulting services (\$2.362 million) and a portion of the recurrent costs of FCSCU (\$1.036 million).[1]

This relending arrangement is required to strengthen the financial position of FCSCU, particularly in the initial years of operation, to cover the significant costs of promotion and establishment of the CUs, institution building of FCSCU, and loan loss provisions of 10 percent of the outstanding loan portfolio.

(ii) FCSCU to CUs: FCSCU will onlend the funds to the individual CUs for a period of 10 years including a grace period of 3 years, and at a rate not less than the rate of inflation (current inflation rate 31 percent; current onlending rate 32 percent). This will result in a relatively high interest rate spread of about 25 percent for FCSCU which is required to cover the costs of promotion and establishment of the CUs, institution building, and loan loss provisions as mentioned in (i).

(iii) CUs to Members: The onlending rate to the members will be determined by the credit committee of each CU. However the rate should be variable and at market levels (currently about 45 percent). The spread for the CUs of about 13 percent is required to cover loan loss provisions of 10 percent, administration costs, and a small profit.

82. The relending arrangements will be reviewed jointly by the Government, NBKR, FCSCU, and the Bank every six months or as needed, and the arrangements adjusted in accordance with the financial position of the FCSCU.

4. Period of Implementation

83. The Project will be implemented over a period of seven years from the time the Bank loan becomes effective and the loan will be completely drawn down by 31 March 2005. The Project Implementation Schedule is provided in Appendix 6.

---

[1] The total loan amount is \$12.5 million of which \$350,000 are capitalized service charges during Project implementation.

5. Procurement

84. The procurement of vehicles, equipment, and other goods for NBKR and FCSCU will be carried out in accordance with the provisions of the Bank's *Guidelines for Procurement*. The vehicles required for the Project will be procured through contracts awarded on the basis of international shopping in accordance with procedures acceptable to the Bank. For contracts below $50,000 equivalent, including items such as computers, printers, and photocopiers that are locally available, prior agreement with the Bank for direct purchase procedures will be required. The procurement of goods and services to be financed by subloans will be purchased from member countries of the Bank.

6. Consulting Services

85. A total of 70 person-months of consulting services, comprising 55 person-months of international, and 15 person-months of domestic consulting services, will be required for Project implementation. The expertise required includes management; training; accounting and financial analysis; and product development and marketing. In addition, six person-months of unspecified short-term consulting services have been included. International consultants will be supported by domestic consultants. The consulting services will be phased over the first three years. NBKR will recruit an international firm in accordance with the Bank's *Guidelines on the Use of Consultants*. Advance selection of Consultants has been approved. The terms of reference for the consultancy services are given in Appendix 7.

7. Disbursement Arrangements

86. An imprest account will be established at NBKR to facilitate the timely release of loan proceeds. The Bank's statement of expenditures procedures will be utilized for reimbursement of expenditures for eligible items from the imprest account. The account will be operated and maintained in accordance with the Bank's *Loan Disbursement Handbook*.

8. Revolving Funds

87. FCSCU will establish and maintain a revolving fund to allow proceeds from repayments of CU loans to be used to support additional lending activities similar to those under the Project. The individual CUs will also establish and maintain similar revolving funds to use proceeds from repayment of subloans by members.

9. Accounts, Audit, and Report

88. NBKR and FCSCU will (i) maintain separate accounts for the Project, and (ii) have such accounts and related financial statements audited annually by auditors acceptable to the Bank and in accordance with sound international auditing standards. Within six months after the close of each related financial year, the Government will submit to the Bank certified copies in the English language of such audited accounts and financial statements, and the reports of the auditors relating to them. For the purpose of complying with the requirement for annual audited financial statements, the proceeds of this loan may be used to finance expenditure for private sector auditors and translations of auditors reports into English.

89. NBKR will submit consolidated quarterly progress reports to the Bank, in the English language, on all aspects of Project implementation. The reports will include details on overall progress in implementation, and problems and issues encountered during the quarter under review; measures taken or proposed to be taken to remedy these problems; and the proposed program of activities during the following quarter. Within three months after the closing date of the loan, NBKR will prepare and submit to the Bank, in a format acceptable to the Bank, a Project completion report on the utilization and impact of the loan, the performance of the CU system, the economic and social benefits generated, and the impact of the CU system on the overall financial sector.

10. Benefit Monitoring and Evaluation

90. The benefit monitoring and evaluation of the Project will be carried out by DITAC in accordance with the guidelines specified in the Bank's *Handbook on Benefit Monitoring and Evaluation*. The Project Framework will be used to monitor overall progress and benefits. DITAC will submit to the Bank a brief monitoring and evaluation report on Project benefits at the end of each Project year.

11. Project Reviews

91. Comprehensive reviews of the Project will be carried out jointly by NBKR, FCSCU, the Consultative Committee, and the Bank after 18 months and at the end of the third year of the Project. These reviews will, among other things, assess the overall performance of the Project and the need for changes in its design. The review will include the progress in the development of the network, the relending and onlending terms and conditions, and the transfer of ownership of FCSCU to the CUs, and will make recommendations, if any, for changes in Project design and implementation arrangements.

F. The Executing Agency

92. NBKR was established in 1991 as the Central Bank and its role is principally that of a traditional banking institution of a market-based economy, but also it has had to undertake a development function as well.

93. NBKR has a head office in Bishkek and a regional office in five of the six oblasts, with Chui oblast being serviced by head office. The oblast offices are responsible principally for carrying out the polices of NBKR and performing supervisory functions. The management of NBKR is under the direction of the chairperson who is assisted by deputy chairpersons. The departmental structure includes economic research, credit, foreign exchange, foreign relations, financial institutions, legal, accounting, and finance and audit.

94. There are 361 staff in NBKR of whom 262 are university graduates. The head office has 275 staff and there are 86 staff in the six oblasts. Training of staff has been an important aspect of the development of NBKR. In 1995, 115 head office and 39 regional staff participated in training programs in Almaty, Tashkent, Vienna, and Moscow. All of this training was grant funded from a range of aid agencies including IMF, World Bank, Bank of England, and a Swiss Bank. During 1996, training was in bank supervision, foreign exchange operations, payment systems, computerization,

bank management, and market economy related issues. Under the Project, NBKR will receive training in regulation and supervision of the CUs, and project management.

95. NBKR has, and continues to receive assistance in several areas: review and preparation of legislation, international accounting standards, bank supervision, and payments systems. NBKR has played an important role in coordinating this assistance as well as technical assistance for the preparation of this Project. Staff are increasing their experience in project processing and negotiations, and some staff have participated in the Bank's loan disbursement and project administration seminars. NBKR's commitment to this Project is evidenced by the establishment of a Project working group specifically for the Project, and NBKR's appointment of three members to FCSCU management. NBKR's capacity to implement the Project is currently being developed with their continuing management of the trial CUs without any consultant services.

G. Environmental and Social Measures

1. Environment

96. The Project is environment category B, and an initial environmental examination was conducted for selected subloan activities. The examination of seven activities found that (i) there would be generally few problems resulting from environmental effects due to the location of the activity; (ii) environmental effects resulting from design were minimal; (iii) effects due to construction may include small effects from problems with provisions for monitoring compliance with environmental regulations during construction, and dust and fumes; and (iv) some environmental problems might occur from regular operations in terms of occupational health and safety programs, inadequacy in quality control and hygiene, and, maintenance and operation monitoring. Overall there is not expected to be any significant environmental effects due to the very small size of the subloan activities. Since the CUs are small-scale local financial institutions it is not feasible for them to establish environmental assessment and monitoring facilities to ensure members comply with environmental regulations. However, under the Project some environmental awareness training will be provided to CU staff to enable them to increase their awareness and that of their members.

2. Social Analysis

97. The Project design reflects the intensive discussions with beneficiaries of the three trial CUs set up by the beneficiaries with the assistance of NBKR and the consultants under the PPTA. The design also reflects the key reasons for the success of the CUs and savings and credit cooperatives worldwide. These have voluntary membership, and ownership and control is by the members, not by share capital. This voluntary membership allows individuals to form CUs for their own goals and defined purposes. A CU can be formed by the population of a village, a profession, or by women or ethnic groups. There are no restrictions on the beneficiaries in determining access to membership.

98. According to a recently published Bank study, women in the country have equal rights to own and use land and other property, and to access financial

services.[1] While household heads are usually men, the study indicates that due to the Soviet legacy the whole family benefits equally from household income. The nine-month experience with the three trial CUs shows that women are adequately represented with 13 of the 76 members or 23 percent. As usually the head of the household and not all beneficiaries of a family register for CU membership, the registered female members represent household heads. As the family of the CU member is the beneficiary, the level of women benefiting from the trial CUs is considerably higher than the number of female household heads. The representation of women in the trial CU control organs is also significant. Nine of the 13 women, or 69 percent, are represented on all three committees (board of directors, supervisory committee, and credit committee), except for the board in Kadamdjai. In all trial CUs, the accountants are women. Seven women, representing more than 50 percent of the female members have benefited from loans. This represents the same proportion of borrowers to beneficiaries as in the second loan cycle.[2] The director general of FCSCU is also a woman. Women have adequate access to the services of the Project and are expected to benefit considerably from it.

99. The preliminary experience of the three trial CUs also provides some indication of typical CU members under the Project. Of the 76 members, 58 are farmers or in agricultural activities (76 percent); the balance are other entrepreneurs and professionals, including traders, drivers, nurses, doctors, and teachers. Some of the farmers also own small bakeries and some, with trucks, buy produce from neighboring farmers to sell in the markets. Most CU members are 40-50 years old, with an average of four dependents. All own a house and more than half have livestock in addition to arable farmland.

100. A survey, undertaken as part of the PPTA, provides additional indications on the profile of possible CU members and the demand for financial services from households and enterprises.[3] As the Project is expected to mobilize significant capital and savings contributions from its members, the economically active population will represent a significant proportion of CU membership. According to the survey one working household member supports two nonworking members. There are other nonworking people, such as pensioners, who have significant potential to become members of the CUs as net depositors but less as borrowers. According to the survey economic activities in rural areas include (i) farms, usually one-family farms of more than 1 hectare; (ii) peasant enterprises that include extended farms (multifamily farms); (iii) households that own less than 1 hectare of land around their house; and (iv) rural enterprises, delivering and processing agricultural products, and involved in construction, trade, food catering, and consumer goods production. Among the surveyed households, 14 percent were headed by women.

101. While Kyrgyz, who represent about 60 percent of the population, traditionally concentrate on livestock breeding, Uzbeks from Osh and Djalal-Abad, and Dungans, Uigurs, and Koreans, and to a lesser extent Russians and Ukrainians in Chui are the most active farmers. Villages and small rural towns tend to be monoethnic and

---

1 Asian Development Bank. 1997. "Women and Gender Relations, the Kyrgyz Republic in Transition."

2 Forty-two of the 76 members borrowed in the second loan cycle (55 percent) . The respective portion of women is 6 out of 13 or 53 percent. See Table 1 of this Report.

3 A survey of 140 farms, 140 enterprises, and 140 households was conducted in the oblasts of Naryn, Djalal-Abad, Osh, and Chui.

it appears possible that the CUs will form along ethnic and kinship principles in such areas.

102. About 70 percent of the 140 rural families surveyed strive to develop businesses to improve their income. The survey indicates that family farms and households have a great interest in creating CUs. The demand of farmers is expected to be for small capital investments and working capital; whereas that of householders will be for developing small businesses and for private purposes.

V. PROJECT JUSTIFICATION

A. Financial Analysis

1. Financial Viability and Benefits

103. The Project is expected to finance the establishment of about 280 CUs across all regions of the country with an average membership of 100. An estimated 28,000 members are expected by the end of the Project. It is estimated that these members will collectively mobilize about $11 million in contributions and the network of the CUs will have an outstanding loan portfolio of about $19 million at the end of the Project.

104. Financial statements have been prepared for both the individual CU and FCSCU, and are presented in Appendix 8. The individual CU financial performance is shown in the summary performance indicators in Table 4. The individual CU is financially sound, primarily because of the high portion of paid-in capital by members, the interest spread covering loan loss reserves, low administration costs, and low fixed costs of operations.

Table 4: Key Financial Performance Ratios for Individual CUs

Year	1	2	3	4	5	6	7
Net Worth/total av. assets (%)	50	50	50	50	56	62	67
Performing Loans/total loans (%)	90	90	90	90	90	90	90
Net Income after Tax/total av. assets (%)			0.6	2.1	2.8	3.5	3.8
Annual Growth Rates (%)							
Loans		238	88	33	16	15	15
Equity		238	88	33	30	27	24
Profit					65	45	27

Source: Staff estimates

105. The projected performance indicators of FCSCU are presented in Table 5.

Table 5: Key Financial Performance Ratios for FCSCU

Year	1	2	3	4	5	6	7
Net Worth/total av. assets (%)	-16	-38	-24	-12	-2	7	14
Performing Loans/total loans (%)	90	90	90	90	90	90	90
Net Income after Tax/av total assets (%)				0.1	1.3	2.0	2.0
Net Income after tax/net worth (%)						59.9	17.7
Annual Growth Rates (%)							
Loans		388	165	90	53	31	16
Equity							144
Net Profit after tax					1811	139	25

106. The financial performance of FCSCU is less robust than that for individual CUs with profitability being particularly volatile due to high start-up costs for the CU promotion, development, and supervision; and the low income base of FCSCU.

107. A sensitivity analysis was conducted assuming a reduction in CU size by 50 percent. For the individual CU this has no real effect on its financial soundness and hence the network as a whole. However, for FCSCU, the lower uptake will have a negative, but not substantial impact on the financial situation.

108. The trial CUs have given priority to farmer members providing subloans for the purchase of inputs such as seed, fuel, fertilizer, and pesticide; the rental of tractors, combines, and vehicles; and the purchase of livestock for resale. Subloans for nonfarming purposes have included the purchase of inputs such as grain and flour for bakeries; small garment enterprises; and trading and commerce activities, e.g., shop owners and cafeteria. The subloans have ranged in size from Som3,000 ($172) to Som51,000 ($2,930), and an average loan size of Som12,317 ($707). Given the diversity of membership, the wide potential of rural activities for which subloans can be extended, and the authority of the credit committee of each CU to determine its own loan portfolio, it is difficult to present a representative set of subloan activities likely to be financed under the Project. Nevertheless, the PPTA identified seven typical subloan activities to illustrate the scope of activities that could be financed by the CUs. They include crop production on three farm sizes, wheat seed farm, dairy herd, tomato ketchup production, and teashops. These activities are of a short- term nature with loan amounts varying from $2,300 to $19,000. All subloan activities showed profitable returns as shown in Appendix 9.

109. The Project's nonquantifiable benefits will include (i) the development of a rural financial system with the establishment of a financially self-sustaining system of CUs that combine resource mobilization with lending services, and that can provide essential financial services to rural areas; (ii) increased competition in the provision of rural finance, which will promote efficiency in the delivery of services; (iii) an expansion of the frontier of formal finance as a result of increased trust by the general population in financial institutions; and (iv) strengthening of NBKR's and FCSCU's capacity to regulate and supervise the Cus.

B. Risks

110. There are several risks associated with the Project. The Kyrgyz Republic is in a state of transition to a market-based economy and has broadly stabilized the macroeconomy and consistently undertaken sectoral reforms. It will be important that the economy remains stable and that reforms, particularly in the financial sector are supportive of the CUs. The Government is committed to doing this as evidenced by its recent record, and the assessment and support of the aid community at the October 1996 Consultative Group Meeting.

111. The FCSCU and individual CUs are new institutions in the Kyrgyz Republic. To ensure these institutions are effectively established, substantial consulting services and training for all institutions is being provided.

112. It is also imperative that CU interest rates on member loans are at market levels to ensure all costs are adequately covered, otherwise their profitability can quickly deteriorate. The Government can ill afford the failing of another system of financial institutions. Poor recovery of subloans is another potential risk due to poor loan appraisal and/or inadequate supervision. This risk should be limited by the member ownership and peer pressure associated with CUs, and the training to be provided under the Project. Also proper supervision by NBKR and FCSCU should identify potential risk problems such as this. Another requirement is that there should also be no significant tax disincentives to savings mobilization. This might not be a consideration given the proposed provision in the Law on CUs to exempt CUs from tax.

113. Competition from other sources on a noncompetitive basis could markedly influence the establishment and growth of the CUs. Availability of significant volumes of credit at below market interest rates will affect the attractiveness of the CUs and hence their overall profitability. This is a risk not easily mitigated against other than through policy dialogue with the Government. The SSC is not a bank and will not have a license to lend, but could provide some limited competition in savings mobilization. Genuine competition from other sources, however, will strengthen the overall rural financial system.

VI. ASSURANCES

114. The Government and NBKR have given the following assurances, in addition to the standard assurances, which have been incorporated in the legal documents:

(i) FCSCU, operating as an apex union, will focus on the development of the CU system.

(ii) Except as the Bank may otherwise agree, FCSCU will have its majority ownership transferred from NBKR to the CUs no later than the third year of Project implementation.

(iii) NBKR will carry out regular reviews of the operations and maintain proper supervision of FCSCU and the individual CUs, including taking necessary steps to ensure all financial requirements are met.

(iv) NBKR will ensure real positive interest rates are charged by CUs and sufficient to cover their costs and make provision for loan losses and other risks.

(v) The Law on Credit Unions will be submitted to Parliament before the end of year one of the Project and provide for

a) mature CUs to accept savings deposits from members;
b) tax exemption for CUs; and
c) the establishment of a comprehensive framework for a CU system, including an apex union (FCSCU).

(vi) The Government will provide as a grant to FCSCU, the equivalent in loans funds for consulting services ($2.362 million) and the Bank's portion of the operational costs of FCSCU ($1.036 million). The Bank will finance 46 percent of operational costs on a declining basis over the Project period.

115. The following will have to be accomplished for the purpose of loan effectiveness:

(i) a Decree on CUs shall have been issued providing for their status as separate legal entities and tax-exempt non-profit organizations;

(ii) the NBKR rules and regulations pertaining to the operations of the CU system shall have been issued;

(iii) the Charter of FCSCU shall have been amended to the satisfaction of the Bank;

(iv) the Strategic Plan for the operation of FCSCU shall have been adopted by FCSCU; and

(v) the Subsidiary Loan Agreement shall have been executed.

VII. RECOMMENDATION

116. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 9,005,000 to the Kyrgyz Republic for the Rural Financial Institutions Project, with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Project Agreements presented to the Board.

MITSUO SATO
President

30 July 1997

APPENDIXES

SUPPLEMENTARY APPENDIXES
(available on request)

THE FINANCIAL SECTOR

A. Institutional Setup

1. The National Bank of Kyrgyzstan

1. In June 1991, a two-tier banking system was established, with the National Bank of the Kyrgyz Republic (NBKR), the Central Bank, created under the supervision of the Parliament. The legal rights and responsibilities of the former Soviet Gosbank[1] were inherited by NBKR. These include functions as the central monetary authority; licensing and supervision of banks and nonbank financial institutions (NBFIs); and the issuance of rules and regulations for these institutions. Furthermore, NBKR is authorized to establish companies to foster financial sector development. NBKR recently established the new Settlement and Savings Company (SSC) as a national savings institution, and the Financial Company for Support and Development of Credit Unions (FCSCU) to be responsible for the implementation of this Project.

2. Supervision of banks is carried out through the Banking Supervision Department. It consists of three divisions: tne Banking Supervision Division with 20 staff, the Bank Activity Analysis Division with 6 staff, the Bank Licensing Division with 6 staff, and the Financial System Restructuring Division tnat will merge with the Banking Supervision Department in mid-1997.

3. The staff allocation indicates that the Banking Supervision Division is the core division of the Banking Supervision Department. Usually one officer of that division performs the off-site surveillance of one bank based on monthly reports. These reports include balance sheets, profit and loss statements, portfolio classification and risk provisioning reports, cash flow statements, and asset-liability ratios. Usually a team of officers of this division performs one on-site surveillance mission per bank every 18 to 24 months. An on-site surveillance mission usually has a duration of one month. NBKR will hire two staff for the supervision of the credit unions (CUs) in coordination with FCSCU.

4. The Bank Activity Analysis Division has the task to develop and update procedures, norms, and regulations for the banking sector, as well as documentation of bank supervision reports and banking licenses. The Bank Licensing Division is responsible for the processing of applications for licensing. It also reviews charters or articles of association and their compliance with the existing banking legislation. It issues licenses for banks, NBFIs, money changers, and pawnbrokers. The Financial System Restructuring Division is responsible for the review of legislation in the financial sector, the restructuring of banks, and the implementation of the World Bank-assisted Financial Sector Adjustment Credit (FINSAC) program.

5. Loan approval limits, differentiated by local branches, and regional branches and head office, are Som50,000 ($2,900) and Som200,000 ($11,500), respectively. Any loans in excess of Som1.5 million ($ 86,200) can only be approved by a bank chairperson.

---

1 Gosbank was the former State Bank of the former Soviet Union which became the central bank in 1988.

6. NBKR has issued norms and regulations for banks to classify their loan portfolios according to five categories and provide respective loan loss provisions as follows:

Classification:	Normal	Satisfactory	Substandard	Doubtful	Loss
Loan loss provisions as a percentage of Loans in category	<= 2	> 2 <= 5	>= 20 <= 25	50	100

7. Additionally, banks have to set aside a general reserve for the unclassified portion of their loan portfolio at 0 to 2 percent for normal loans, 4 percent for satisfactory loans, and 9 percent for watch loans. According to NBKR, banks tend to underclassify their loan portfolios.

2. Commercial Banks

a. Structure and Ownership

8. In December 1991, the Kyrgyz branches of the former Soviet Promstroybank, Agroprombank, and Zhilsotsbank were reconstituted as commercial banks and given the names of Kyrgyzpromstroybank (PSB),[1] Kyrgyzagroprombank (AGPB); and AKB Kyrgyzstan (AKBK), respectively. In addition, Elbank was the national savings institution. These four banks were referred to as the big four "system" banks in the country. Until the closure of Elbank and AGPB in 1996, these four banks dominated the financial system by controlling 80 percent of the banking system's assets.

9. At present, the Kyrgyz financial system consists of NBKR; 17 commercial banks, including PSB and AKBK, and SSC, as the new NBKR-owned savings NBFI. Government-owned enterprises held 19 percent of the total capital in the banking system in early 1996. Eleven banks had Government ownership, ranging from 4 to 32 percent of their capital at that time. Recently there has been some foreign investment in commercial banks. The Demir Kyrgyz Bank was established by the Turkish Demir Bank, the International Finance Corporation, and the European Bank for Reconstruction and Development.

b. Branch Network

10. In 1996 the number of bank branches dropped from 165 to 120. This was mainly caused by the closure of Elbank and AGPB, which had substantial branch networks of 46 and 50 branches, respectively. Most of these branches were in rural areas. The newly created SSC has the strongest branch network with 49 branches, of which 47 are in rural areas. This system is further strengthened through the availability of post office outlets for transfer payments and cash transactions. However, SSC only provides savings and payments facilities. Funds are invested in treasury bonds and no credit business is permitted.

1 In this Report the names of Kyrgyzpromstroybank and Kyrgyzagroprombank appear also without the prefix Kyrgyz.

11. PSB and AKBK have 26 and 25 branches, respectively, of which 23 and 20, respectively, are outside Bishkek. Bank facilities are concentrated in Bishkek/Chui with 35 branches; followed by Osh (27); Jalal-Abad (24); Issyk-Kul (17); Naryn (10); and Talas (7) oblasts (regions). With the collapse of AGPB, rural communities are now deprived of access to full banking services.

c. Deposit Mobilization

12. Deposit mobilization by the banks is extremely low. Reasons for this low mobilization are attributed mainly to concern for the safety of bank deposits, particularly following the closure of Elbank; the access of the tax authorities to bank records on customers' accounts since February 1994; and the authority to seize bank deposits for arrears on taxes payable. Therefore, businesses have been discouraged from keeping more than the absolute minimum amount in their accounts. This decline in public trust will make it difficult for even well-run banks to mobilize significantly more deposits.

d. Loan Portfolio Quality

13. According to the World Bank FINSAC report,[1] the nonperforming loans of the system banks amounted to Som1.4 billion ($128 million) as of March 1995. This represented 92 percent of their outstanding loans. Of that, 64 percent was in the loss category. Overall, the system was reported to have had only 8 percent performing loans at the beginning of 1995.

14. On 8 December 1994, the Government initiated a resolution program for nonperforming directed loans. This program placed many of these accounts with the Enterprise Reform and Resolution Agency. Additionally some of the banks negotiated directly with their clients to reduce their risk exposure. An associated problem is when enterprises are declared bankrupt, the lending bank has automatically lost its collateral over the enterprise.

e. Financial Performance

15. PSB was formed as a privatized joint-stock company in 1991, with the country's largest industrial and construction enterprises as its clients and shareholders. PSB's loan portfolio shows 40 percent of loans classified as performing. PSB's management has been able to improve the financial position of the bank by recovering some of the loans previously classified as lost. PSB was recapitalized in November 1996 to meet the minimum requirements set by NBKR. The share capital amounts to Som24 million ($1.4 million), before any adjustment for loan losses.

16. AKBK was audited in 1996 under the FINSAC program, revealing that 65 percent of the total loans outstanding were nonperforming. If proper loan loss provisioning had been undertaken the net worth would be a negative Som45 million ($2.6 million). NBKR reported that AKBK is expected to recapitalize shortly to meet the minimum capital requirements. Agricultural loans account for 10 percent of its loan portfolio, but these are inherited loans predominately to collective and state farms. All of these loans are nonperforming and are in the process of being reclassified as state debt. AKBK has not experimented with lending to farmers, and has not been a recipient of any

---

1 See World Bank. 1996. "Financial Sector Adjustment Credit," President's Report No. P-6891-KG, May, Washington, D.C.

of the Government-directed agricultural credits for onlending. The management is reluctant to lend to this relatively risky sector.

17. Overall financial performance ratios show satisfactory returns on total assets (at least 1 percent on assets) for eight banks. Only four of these show reasonable returns on equity (close to or exceeding the rate of inflation plus a risk margin of at least 6 percent). As an indication of their relatively high overhead costs, expenses as a proportion of total assets averages 6.3 percent. Banks, individually, need to expand their business to become more cost-effective. Given the small market size of the country, and the shared focus of these banks on urban areas, bank mergers seem inevitable.

2. Other NBFIs

18. The formal financial sector is also comprised of 18 investment funds, 50 insurance companies, a stock exchange, a Coupon (privatization) Trading Center, a State social fund, and a small private pension fund. NBKR has also licensed many foreign exchange bureaus. Under World Bank support the Kyrgyz Government established the Kyrgyz Agricultural Finance Corporation (KAFC) on 3 July 1996 (see paras. 33 to 42). The Ministry of Agriculture and Water Resources[1] (MAWR) was authorized to set up credit cooperatives to administer agricultural credits.

B. The Rural Financial Sector

1. Formal Banking Services

19. Rural areas have been particularly hard hit by the transition from a command to a market-oriented economy. Low volumes of credit and savings per client, high loan default risk in agriculture, and costly administration of rural branches have led to a major reduction of bank branches operating in rural areas. Some of the banks operating in rural areas have been forced to cut administration costs and risk exposure by reducing financial services to mainly payment transfers and deposits.

20. Traditionally, 36 out of a total 42 raions equivalent to 94 percent of the total population were serviced by bank branches. The closing of AGPB in 1996 caused a serious drop in the presence of financial services. Now 25 raions do not have full financial services available. This is equivalent to 1.6 million people or 35 percent of the total population.

21. From 1994 to 1996, a substantial share of lending to agriculture was financed by the State budget. In that time annual contributions of about Som200 million ($11.5 million) were provided. Most of this lending is at below market rates of interest between 0 and 30 percent per annum. The weighted average interest rate over this period was 12.7 percent. State budget allocations have funded at about 97 percent of the increase in the agricultural lending of banks during this period, of which 90 percent has been channeled through AGPB and the balance through Government agencies.

22. By December 1995, bank lending to all sectors, at 1992 prices, dropped to 18 percent of the level at December 1992. Respectively, the comparative levels are 43 percent for agriculture, 1 percent for industry and construction, and 16 percent for all

---

1 On 1 January 1997 the Ministry of Water Resources merged with the former Ministry of Agriculture and Food to form the Ministry of Agriculture and Water Resources.

other sectors. The decline has been in lending to enterprises, including State-owned enterprises.

23. In the rural bank branches surveyed in Chui, Osh, and Jalal Abad oblasts under the Project preparatory technical assistance (PPTA),[1] the outreach was very low. No branch was lending to more than 4 percent of households compared with a range of 10 to 20 percent in other Asian countries. There was a significant difference in loan size as outreach expanded.

24. The absence of cash has reinforced the dependence of rural residents (farmers in particular) on Government-supplied goods, services, and agricultural inputs, and stifled the emergence of new commercial enterprises and competitive markets.

25. Reportedly there are substantial savings that are not deposited in banks, but that could be mobilized with proper financial service outlets and products. Distrusting the banks, and reluctant to deposit savings in institutions that charge considerable transaction fees, the rural population prefers to hold savings in nonmonetary forms.

26. Rural finance in the Kyrgyz Republic, therefore, is characterized by the absence of reliable full-banking service outlets providing services for savings deposits, demand deposits, transfer of funds, and credit. Monetizing savings and providing financial intermediation is a prerequisite to developing the rural economy and is important to the rural population.

2. NBFI Services[2]

a. The Rural Credit Cooperatives under MAWR

27. These organizations provide limited financial services. They distribute government-supplied agricultural inputs and other commodities to farmers, both in-kind and on credit terms. Nevertheless, they are a key component of MAWRs plans for the rural sector, and need to be taken into account when considering rural financial service modalities. A Presidential Decree dated 3 November 1995, established new guidelines for the provision of services to agricultural units. Among the provisions of this decree, MAWR was authorized to assist in the creation of rural credit cooperatives. These credit cooperatives have been promoted to act as local channels for distributing State resources. The creation and registration of rural credit cooperatives have been rapid throughout the country.

28. Because these rural credit cooperatives are registered at the raion (district) level, precise numbers are not available. However, they are estimated to number in the thousands. One of the problems of the credit cooperatives is that they are open to anyone holding a "use right" for a parcel of land. In practice, this is limited to male heads-of-households.

29. During the early 1996 crop cycle only in-kind agricultural inputs were channeled through the cooperatives. Mineral fertilizers and diesel fuels are the two main commodities. According to farmers interviewed for the Project, these commodities have

---

1 A survey of 140 farms, 140 enterprises, and 140 households was conducted in the oblasts of Naryn, Djalal-Abad, Osh ,and Chui.

2 Only existing services. The Credit Union System to be developed under this project is described in Appendix 2.

been limited in quantity, and not always suited to the requirements of the individual farmers or the crops they were producing.

30. There is considerable discussion among farmers about whether the commodities that have been supplied are credits, or the distribution of State investments and "uncompensated means" as in the old times. None of the supposed loans have fallen due, but there is widespread skepticism over the eventual repayment rates for this system.

b. The Settlement and Savings Company

31. The coverage of SSC is enhanced by its ability to make payments to beneficiaries through the network of about 1,000 post office branches that opened accounts with SSC. With technical assistance from the United Kingdom Know-how Fund, SSC started operations on 28 July 1996.

32. SSC is licensed as a special financial institution and as such is exempt from some prudential regulations such as capital adequacy. NBKR provided a paid-up capital of Som1 million. Branch staffing of SSC is primarily from previous AGPB staff. At the head office in Bishkek, including the Bishkek branch, there are 25 staff and a further 350 staff in the outlying branches. It is likely that SSC will rationalize its branching network by closing some of the less productive branches and the six regional offices.

c. The Kyrgyz Agricultural Finance Corporation

33. KAFC was established by Government Decree No. 303 of 3 July 1996, and was formally registered as a joint stock company in December 1996. KAFC will be licensed and supervised by NBKR as an NBFI. KAFC will observe the rules and regulations applicable to banks with regard to capital adequacy, credit risk exposure limits, classification of loan portfolio, and provisioning and other prudential rules and instructions prescribed by NBKR. KAFC's charter governs the role of the Board of Directors. The Board consists of seven members: three from the Government (currently the sole shareholder); three from the private sector; and executive director of KAFC. When the Government ceases to be the majority shareholder in the corporation, the Board would be elected at the annual shareholders' general meeting.

34. KAFC will initially have three departments: credit, finance, and personnel and training. The credit department will be responsible for lending and loan portfolio management. All field offices and staff will operate under the responsibility of the credit department. KAFC will establish field offices or branches in all six oblasts to be treated as separate profit centers. The finance department will be responsible for treasury, accounting, and management information activities. The personnel and training department will be responsible for staff recruitment, and training and public relations.

35. KAFC's initial lending operations will be haunted by the legacy of the credit nonpayment culture nurtured by Agroprombank and Government agricultural credit programs. Against this background, KAFC needs to establish a reputation for financial integrity and excellent financial performance. For this purpose, KAFC aims to adhere to the following financial requirements: (i) a capital adequacy ratio at not less than 10 percent; (ii) the maximum exposure to a single borrower will be limited to 10 percent of the paid-in capital, or $250,000, whichever is smaller; and (iii) the minimum debt-service ratio will be 1:1.5.

36. The initial paid-in capital is $10.0 million equivalent. Government will be granted shares equivalent to the first $2.0 million equivalent of the World Bank International Development Association Credit withdrawn by KAFC. The total amount of share contributions by the Government from the proceeds of the World Bank International Development Association Credit will not exceed $4.5 million equivalent. In addition, the Government has agreed to transfer to KAFC the proceeds of loan recoveries made by the Debt Resolution Agency in the course of liquidating Agroprombank.

37. The initial interest rate to be charged on the World Bank Loan to KAFC would be equal to the projected annual inflation rate less 2 percentage points.

38. The KAFC Credit Program will meet financing needs of private farmers and agribusiness enterprises. KAFC will channel Government and aid funds. KAFC will bear the lending risk on its subloans (denominated in local currency), while the Kyrgyz Government will bear the foreign exchange risk on the International Development Association credit. KAFC is expected to start lending operations in the second half of 1997.

39. KAFC will provide working capital and on-farm investment credit to private farmers. Working capital credit will finance the purchase of seasonal inputs and hired labor. On-farm investment lending will include construction and rehabilitation of irrigation and farm buildings, livestock breeding, and farm machinery and equipment. During the first two years, KAFC will concentrate on seasonal lending.

40. Initially, KAFC's lending strategy will focus on credit to existing officially registered farmers' organizations (e.g., farmers' associations (slightly over 5,000 at the end of 1996); restructuring state/collective farms (below 2,500 at the end of 1996); and rural credit schemes being operated by some aid agencies and agribusiness enterprises (5 in 1996). For this purpose, KAFC will create a group-lending facility with softer terms than those pertaining to lending to individuals. Continued participation of the intermediaries in the KAFC lending program will depend on their loan recovery and payment performance. Lending direct to individual farmers will be restricted to large farmers with more than 50 hectares under irrigation and/or a loan requirement not below $1,000 equivalent. The borrower's contribution to the subloan amount would not be less than 20 percent. It is expected that most of the borrower's contribution would be in noncash form (e.g., family labor, retained seed). Farmers or farmers' organizations with outstanding overdue loans from other lenders, including Agroprombank and the Government, will not be eligible for loans. The KAFC field staff will cooperate closely with the local agricultural advisory staff, and with nongovernment organizations that provide advisory services to farmers.

41. KAFC will also provide working capital and investment credit to small- and medium-scale private agribusiness enterprises engaged in processing, trading, or provision of agriculture-related services. Minimum subloan size under this category will be $1,000. Subloans for agro-industries will finance new investments, modernization, rehabilitation, and expansion of existing production facilities. The borrower's contribution to subproject cost would not be less than 30 percent. KAFC's term lending will, however, be postponed to the third year of operation to allow KAFC staff to gain operational experience with short-term lending and to coincide with the phasing out of Government transfers to the agricultural credit program.

42. Subloan repayment periods for farming and agribusiness activities would be based on the projected cashflow and borrower's repayment capacity. Repayment of seasonal loans for farming operations and working capital loans would be matched to the production/service cycle and, as a rule, the repayment period would not exceed 12 months. Subloan repayment periods for on-farm investments, farm machinery and equipment, transportation equipment, and agro-processing investments will not exceed the useful life of the investment financed, and, as a rule, should not exceed ten years, including a grace period of no more than three years.

d. Other NBFIs

43. In the absence of formal financial services in rural areas, some NBFIs, all assisted by foreign aid funds, have begun to provide limited financial services. Of the nongovernment organizations, the larger financial programs are run by the Foundation for International Community Assistance (FINCA) ($6.2 million program grants); and Mercy Corps ($2 million in monetized commodities). Two other programs that aim at extensive outreach are the Peoples Based Development Fund (World Bank) and the Poverty Alleviation Program (United Nations Development Programme). The larger direct aid-assisted programs are: the US-Kyrgyz Joint Commission on Agriculture, Agribusiness and Rural Development ($7 million); and the Central Asia-American Enterprise Fund. The German Government under Kreditanstalt fur Wiederaufbau and German Agency for Technical Cooperation provides loans to small businesses using AKBK as the financial intermediary (DM60 million [$35 million] of which DM2 million is in Technical Assistance).

44. Only the Mercy Corps and the Joint Kyrgyz-American Agricultural Commission are providing working capital loans to agricultural enterprises. The latter's program performance is reportedly poor due to insufficient repayment rates. The funds of both programs are depleted and are not expected to be replenished. Of the still active programs only FINCA and the People's Based Development program are providing loans to relatively small borrowers. FINCA's program, provides short-term (16-week) credit, which is generally not well suited to agricultural lending. The People's Based Development program is a marginal program that has yet to demonstrate a capacity for self-sustainability, a prerequisite for significant developmental impact. Except for FINCA, the financial viability of the above mentioned programs are reportedly poor, so that sustainable operations and a significant development impact of these programs cannot be expected.

45. The PPTA survey concludes that the amount of finance obtained from informal sources such as money lenders, family, and friends is very small. Only 5 percent of households and 2 percent of nonfarm enterprises indicated loans from informal sources. None of the households had loans from money lenders. Informal loan sizes averaged Som4,000 ($285) for households and Som5,670 ($405) for enterprises equivalent to 5 and 10 percent of respective average assets. There is almost no informal financing of trade as two thirds of farmers sell their produce directly to the local market or to the consumer.

PROJECT FRAMEWORK

Design Summary	Project Targets and Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
Goal			
To rebuild a sustainable rural financial system	More than 90 percent of established credit unions (CUs) maintain operations and remain viable beyond the end of the Project	Project completion report	
	CUs become major financial intermediaries in rural areas	National Bank of the Kyrgyz Republic (NBKR) reports on financial sector	
Objective/Purpose			
To increase the level and sources of savings mobilization and lending services in the rural community	Som190 million ($11 million) of members contributions mobilized	Monthly, quarterly, and annual reports to the Financial Company for the Support and Development of Credit Unions (FCSCU) and NBKR	Macroeconomic situation remains conducive to the development of financial institutions Competing financial institutions charge market rates of interest
	Som330 million ($19 million) loans outstanding to members by CUs	Project management reports	Bankruptcy and Pledge Laws are implemented effectively NBK regulatory requirements are complied with
Components/Outputs			
1. Established and self-sustaining national network of credit unions	280 CUs operational by year 7	Project management reports	There are no significant tax disincentives to capital and savings mobilization Mature CUs permitted to provide savings deposits for members
1.1 Accredited and operational individual credit unions	28,000 members of CUs by year 7		

Design Summary	Project Targets and Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
1.2 Sustainable FCSCU	Full cost recovery by the end of Project	Monthly, quarterly ,and annual reports to FCSCU and NBKR	Accredited CUs have high (90 percent) success rate
	Functioning systems, procedures, and controls to international accounting standards	Monthly, quarterly, and annual reports to FCSCU and NBKR	CUs are willing to pay for services provided by FCSCU
		Annual audit	Government agrees to allow FCSCU to use interest rate spread on borrowed funds to finance costs
1.3 Legal and regulatory framework operational	Credit Union Decree/Law in operation	Decree/Law approved	FCSCU effectively supervises CUs under guidance of NBKR
	NBKR regulatory requirements for CUs enforced	Regulations issued	
1.4 Trained staff in credit union supervision	8 FCSCU and 2 NBKR staff trained in supervision and regulation of CUs	Annual reports by FCSCU and NBKR	Training is effective
	4 staff completed study tour	Project management reports	
1.5 Trained CU staff	Members of board of directors, supervisory committee, and credit committee are trained in management and financial and administrative operations for CUs	Annual reports by FCSCU and NBKR Project management reports	
2. Project management			
2.1 Effective project management system	Monitoring and avaluation system is used effectively Funds are disbursed by Directorate of Investment and Technical Assistance Coordination (DITAC) without delay	Project management reports Review missions	Management system is appropriate to situation.

Design Summary	Project Targets and Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
Activities			
1.1.1 Constitute CU organs	Credit line $8.4 million, CUs contribution $8.4 million	Project progress reports and review missions	FCSCU operates as an independent viable financial institution
1.1.2 Apply for NBKR license	Consulting services $2.3 million		FCSCU can efficiently and effectively promote, train, and supervise CUs
1.1.3 FCSCU accreditation	30 p-m management adviser 6 p-m accounting/financial specialist		
1.1.4 Match loan funds	4 p-m product development specialist		Establishment of CUs proceeds according to projections
1.1.5 Recover loans and maintain internal control	24 p-m training specialist 6 p-m unspecified short term inputs		Consultants recruited and perform satisfactorily
1.2.1 Establish company	Total Cost: $22.1 million (incl. contingencies and service charge)		
1.2.2 Prepare and revise annual plans and budgets			
1.2.3 Establish prudential rules and regulations			
1.2.4 Establish management information system			
1.2.5 Promote and establish CUs			
1.2.6 Train CUs staff			
1.2.7 Supervise CUs			
1.3.1 Finalize law on CUs			
1.3.2 Law on CUs approved			

Design Summary	Project Targets & Measurable Indicators	Monitoring Mechanisms	Risks & Assumptions
Activities continued.. 1.4.1 Identify and train staff 1.4.2 Organize and undertake study tour 1.5.1 Undertake CU staff training 2.1.1 Establish monitoring and evaluation system 2.1.2 Disburse funds to FCSCU 2.1.3 Maintain .Project accounts 2.1.4 Report on Project performance			

COST ESTIMATES AND FINANCING PLAN

Table 1: Components Project Cost Summary

Item	Local Currency (Som '000)	Foreign Cost (Som '000)	Total Cost (Som '000)	Local Currency (US$ '000)	Foreign Cost (US$ '000)	Total Cost (US$ '000)	% Foreign Exchange	% Total Base Costs
A. Establishment of CU System								
Establishment of CUs								
Subloan Activities	190,008	102,312	292,320	10,920	5,880	16,800	35	80.1
Institutional Strengthening								
FCSCU	35,235	23,020	58,255	2,025	1,323	3,348	39	16.0
NBKR	2,021	206	2,227	116	12	128	9	0.6
	376	1,503	1,879	22	86	108	80	0.5
CU								
Subtotal Institutional Strengthening	37,632	24,729	62,361	2,163	1,421	3,584	40	17.1
Subtotal (A)	**227,640**	**127,041**	**354,681**	**13,083**	**7,301**	**20,384**	**36**	**97.2**
B. Project Management	2,523	7,621	10,144	145	438	583	75	2.8
Total (A & B)	**230,163**	**134,663**	**364,826**	**13,228**	**7,739**	**20,967**	**37**	**100.0**
Physical Contingencies	4,037	3,219	7,256	232	185	417	44	2.0
Price Contingencies	4,089	2,714	6,803	235	156	391	40	1.9
Total	**238,289**	**140,596**	**378,885**	**13,695**	**8,080**	**21,775**	**37**	**103.9**
Service Charge	-	6,090	6,090		350	350	100	1.7
Total Costs to be Financed	**238,289**	**146,686**	**384,975**	**13,695**	**8,430**	**22,125**	**38**	**105.5**

CU - Credit Union
FCSCU - Financial Company for the Support and Development of Credit Unions
NBKR - National Bank of the Kyrgyz Republic

Table 2: Components by Financiers
(US$ '000)

	Government of Kyrgyzstan		Asian Development Bank		Credit Unions		Total		For. Exch.	Local (Excl. Taxes)
	Amount	%	Amount	%	Amount	%	Amount	%		
A. Establishment of CU System										
Establishment of CUs										
Subloan Activities	-	-	8,400	50.0	8,400	50.0	16,800	75.9	5,880	10,920
Institutional Strengthening										
FCSCU	1,033	25.8	2,975	74.2	-	-	4,008	18.1	1,568	2,440
NBKR	142	92.4	12	7.6	-	-	154	0.7	14	140
CU	-	-	134	100.0	-	-	134	0.6	107	27
	1,175	27.4	3,121	72.6	-	-	4,295	19.4	1,689	2,607
Subtotal (A)	**1,175**	**5.6**	**11,521**	**54.6**	**8,400**	**39.8**	**21,095**	**95.3**	**7,569**	**13,527**
B. Project Management	50	7.4	630	92.6	-	-	680	3.1	511	168
Total Disbursement	**1,225**	**5.6**	**12,150**	**55.8**	**8,400**	**38.6**	**21,775**	**98.4**	**8,080**	**13,695**
Service Charge			350	100.0			350	1.6	350	-
Subtotal (B)	**50**	**4.9**	**980**	**95.1**	-	-	**1,030**	**4.7**	**861**	**168**
Total Cost to be Financed	**1,225**	**5.5**	**12,500**	**56.5**	**8,400**	**38.0**	**22,125**	**100.0**	**8,430**	**13,695**

CU - Credit Union
FCSCU - Financial Company for the Support and Development of Credit Unions
NBKR - National Bank of the Kyrgyz Republic

Table 3: Expenditure Accounts by Components - Totals Including Contingencies

(US$ '000)

	Establishment of CU System					
	Establishment of CUs Subloan Activities	Institutional Strengthening FCSCU	Institutional Strengthening NBKR	CU	Project Management	Total
A. Investment Costs						
Vehicles	-	17	-	-	33	50
Training	-	104	-	-	-	104
Equipment	-	34	7	134	7	181
Furniture	-	12	2	-	3	17
Foreign Technical Assistance	-	1,575	-	-	587	2,162
Local Technical Assistance	-	200	-	-	-	200
Subloan Investments	16,800	-	-	-	-	16,800
Subtotal (A)	**16,800**	**1,942**	**8**	**134**	**630**	**19,514**
B. Recurrent Costs						
Administration Cost (excl. Training and Travel)	-	191	-	-	-	191
Office Supplies	-	-	8	-	-	8
Refresher Training	-	-	3	-	-	3
Travel	-	852	14	-	-	866
Salaries	-	1,024	120	-	50	1,194
Subtotal (B)	-	**2,066**	**145**	**-**	**50**	**2,261**
Total	**16,800**	**4,008**	**154**	**134**	**680**	**21,775**
C. Service Charge					350	350
Total Cost to be Financed	**16,800**	**4,008**	**154**	**134**	**1,030**	**22,125**
Foreign Exchange	5,880	1,568	14	107	861	8,430

CU - Credit Union
FCSCU - Financial Company for the Support and Development of Credit Unions
NBKR - National Bank of the Kyrgyz Republic

Table 4: Expenditure Accounts by Financiers
(US$ '000)

Item	Government of Kyrgyzstan Amount	Government of Kyrgyzstan %	Asian Development Bank Amount	Asian Development Bank %	Credit Unions Amount	Credit Unions %	Total Amount	Total %	For. Exch.	Local (Excl. Taxes)
A. Investment Costs										
Vehicles	-	-	50	100.0	-	-	50	0.2	50	0
Training	-	-	104	100.0	-	-	104	0.5	83	20
Equipment	-	-	181	100.0	-	-	181	0.8	145	36
Furniture	-	-	17	100.0	-	-	17	0.1	7	10
Foreign Technical Assistance	-	-	2,162	100.0	-	-	2,162	9.8	1,737	425
Local Technical Assistance	-	-	200	100.0	-	-	200	0.9	-	200
Subloan Investments	-	-	8,400	50.0	8,400	50.0	16,800	75.9	5,880	10,920
Subtotal (A)	**-**	**-**	**11,114**	**57.0**	**8,400**	**43.0**	**19,514**	**88.2**	**7,902**	**11,612**
B. Recurrent Costs										
Administration Cost (excl. Training and Travel)	95	50.0	95	50.0	-	-	191	0.9	-	191
Office Supplies	8	100.0	-	-	-	-	8	0.0	5	3
Refresher Training	-	-	3	100.0	-	-	3	0.0	0	3
Travel	440	50.8	426	49.2	-	-	866	3.9	173	693
Salaries	682	57.1	512	42.9	-	-	1,194	5.4	-	1,194
Subtotal (B)	**1,225**	**54.2**	**1,036**	**45.8**	**-**	**-**	**2,261**	**10.2**	**178**	**2,083**
Total Disbursement	1,225	5.6	12,150	55.8	8,400	38.6	21,775	98.4	8,080	13,695
C. Service Charge			350	100			350	1.6	350	-
Total Costs to be Financed	**1,225**	**5.5**	**12,500**	**56.5**	**8,400**	**38.0**	**22,125**	**100.0**	**8,430**	**13,695**

CU - Credit Union
FCSCU - Financial Company for the Support and Development of Credit Unions
NBKR - National Bank of the Kyrgyz Republic

THE SAVINGS AND CREDIT UNION SYSTEM

A. Major Design Elements

1. Structure

1. This Project will introduce a credit union (CU) system in the Kyrgyz Republic. The CUs are community and village-level financial institutions that provide savings and credit services to individual members. They are organized and operated on cooperative principles, usually have no external shareholders, the members are the owners of the institution with one vote per member, and leaders are elected by and drawn from the members. The CUs are usually constituted under national cooperative legislation. Individual CUs are the first step in the establishment of such a system. At the next step, the individual CUs usually create an umbrella organization to provide: (i) a forum for its members, (ii) internal regulation and self supervision; and (iii) financial services to the CUs and larger individual member clients.

2. In developed systems, this process started in the last century and has taken several decades to develop. This long period was necessary to build-up resources and gain sufficient operational experience. This experience has identified the following design to the successful establishment and operation of a CU system:

(i) A CU law provides the legal framework under which all CUs operate. Only those organizations that enact bylaws consistent with the law are allowed to bear that title.

(ii) An internal umbrella organization provides the basic rules of cooperation, not stipulated in the law, applicable to all its members. These include rules to ensure that the title CU has a reputation as a reliable financial institution in the country. It also supervises the compliance of its members with the existing legislation and other applicable rules and regulations.

(iii) The Central Bank supervises the whole system including the umbrella organization, affiliated institutions, and all CUs. It provides prudential rules and regulations, and reporting requirements for all institutions covered under the system.

3. The functions of the Central Bank and the umbrella organization are somewhat overlapping. However the purpose is also different. An umbrella organization acts primarily in the interest of its members. The focus is therefore to ensure that the title CU has an excellent reputation. The Central Bank's concern is the stability of the financial system of which the CU system is a part. It follows a particular concern to protect the deposits of third party depositors. As long as the CUs restrict access to their services to its members, there are no third party depositors. This is a major difference to commercial banks, where owners, decision makers, and depositors are different individuals.

4. The National Bank of the Kyrgyz Republic (NBKR), has adopted the following design, using the assistance and recommendations of the Project preparatory technical assistance (PPTA):

(i) NBKR has prepared (a) a draft Law on Credit Unions; (b) a draft decree for the CUs as an interim measure; and (iii) a draft model charter for the CUs.

(ii) NBKR established on 7 April 1997 the Financial Company for the Support and Development of Credit Unions (FCSCU) as the umbrella organization for the promotion, development, and supervision of the CUs. A Charter for FCSCU has been prepared. This strategy is not in accordance with the traditional developments of CU systems, where the individual CUs usually establish their own association. However, given the conditions prevailing in the financial sector and the rural areas it seems to be the most reasonable approach to meet the needs of the country. Ownership of FCSCU will initially be with NBKR and will be gradually transferred to the CUs.

(iii) NBKR ownership of FCSCU is limited to three full years of operation. If the capital mobilized by the CUs is not sufficient to buy the initial capital of Som3 million ($172,000), FCSCU will seek other external funds for capitalization. Preference will be given to specialized financial institutions and other funding bodies. External capital will be gradually reduced through a CU buy-out.

(iv) NBKR intends to convert FCSCU from a nonbank financial institution (NBFI) into a bank, if this is financially justified. This option will be evaluated during the midterm review of the Project.

2. Legislation

a. Law and draft Decree on the CUs

5. Following the initial assistance provided under the PPTA for the trial CUs and the subsequent recommendations, NBKR's Legal Department has prepared a draft Law on Credit Unions that includes the (i) goals of the CUs; (ii) creation, registration, and licensing of the CUs and their associations; (iii) membership of the CUs and their associations; (iv) organs of representation, management, and internal control of CUs; (v) external audit, NBKR regulation, and supervision; (vi) mobilization of resources by membership shares and other sources; (vii) payment of dividends and withdrawal of funds; and (viii) investment activities.

6. As it may take a considerable time to enact the proposed law, NBKR has prepared a draft decree on the CUs to be issued by the President. Issuance of the decree is a condition for loan effectiveness, unless the Law is in force at that time.

b. Charter for the FCSCU

7. The Board of NBKR has approved the Charter of the FCSCU. This Charter stipulates FCSCU's: (i) character as an NBFI; (ii) purpose to promote, develop, and supervise the CUs, as authorized by NBKR; (iii) paid-in capital, transitional ownership (NBKR); and future ownership; (iv) operations in providing advisory services and credit lines to the CUs; (v) supervision function over the CUs, as delegated by NBKR; (vi) financial operations to generate liquidity and cash incomes through the placement of excess liquidity; and (vii) management structure, and internal and external control.

8. A draft Strategic Plan for FCSCU has also been prepared and is summarized in section B1 below.

c. Model Charter for the CUs

9. Based on the assistance and recommendations of the PPTA, NBKR has prepared a model charter for the CUs. Each CU will determine its own charter that sets out the organizational and management structure of the CU, and the administrative and operational procedures to be followed. The charter will be approved by NBKR as a prerequisite for the licensing of a CU by NBKR.

10. The services of a CU will be limited to its members. Membership must be both voluntary and subject to the approval of other members of the CU. Each CU will elect a board of directors, a supervisory committee, and a credit committee. No individual will be represented in more than one organ. Loan applicants do not participate in an organ's decision on their own loan application and subsequent loan supervision.

11. The board of directors represented by a chairperson, treasurer, and secretary, holds regular meetings and is responsible for the control of the overall management of CU operations. The supervisory committee, of usually three members, ensures the accuracy of financial reports and exercises internal controls. The credit committee, comprising three members, reviews loan applications, approves loans, and supervises collection. All committees are responsible and report to membership at each annual general meeting. NBKR approval of the board of directors and the chairperson will be needed prior to issuing a license to the CU. All elected officers serve on a voluntary basis and are subject to election by all members at the annual general meeting. The liability of CU members is limited to the amount of paid-in share capital.

B. Operations

1. The FCSCU Draft Strategic Plan for the 1997– 2000 Period

12. The draft Strategic Plan outlines the operations of FCSCU during Project implementation. Following is a summary of the key elements.

a. Goal of the Project and Principal Strategy

13. The overall goal of the Project is to provide the rural population of the Kyrgyz Republic with durable access to financial services tailored to their needs. This goal will be achieved through the establishment of economically independent and financially viable institutions providing these services in the vicinity of the customers. The CUs and other cooperative banking institutions based on the mobilization of funds from its members have proven to be a successful model for providing financial services to rural areas. Within this context the Financial Company for the Support and Development of Credit Unions (the Company) will play the key role in promoting the development of an CU system in the country. The Company may eventually be transformed into a regional cooperative bank.

b. Objectives and Functions of the Company

14. The objective of the Company is to promote the creation and sound operation of the CUs in the country. It will provide services for the CUs and it's members as an umbrella institution. The Company will provide substantial training for the CUs at the Board and operational level. It will also provide services of financial product development, accounting, and monitoring of the CUs.

15. To protect the name "Credit Union" as one standing for viable community-based financial institutions, the Company will set up and implement adequate supervision mechanisms under the authorization of NBKR.

16. The Company will provide financial services that are in the interest of the CUs. This includes lending of borrowed funds to the CUs and investing funds for the CUs.

c. Ownership and Control of the Company

17. The Company will be set up under the authority of NBKR with an initial capital of Som3 million. As ownership and control of the umbrella organization by the CUs is fundamental for successful CU systems, the Company will actively promote the acquisition of capital shares by the CUs.

18. To support the cooperative principles and to ensure businesslike operations of the Company, NBKR will limit its participation in the capital and control of the Company to the end of the third full year of operation. During this period, the Company will promote the transition of Company ownership from NBKR exclusively to the newly created CUs. When the CUs acquire ownership in the Company, they will obtain an adequate voting right in the general assembly of the Company. The Company will reserve at least 25 percent of the voting rights for the CUs upon acquisition of member shares. The Company will promote full ownership by the CUs.

19. If this target of full ownership cannot be met by the CUs at the end of this period, the Company will consider inviting foreign minority shareholding of a maximum of 10 percent of the total share capital per investor. Preference will be given to foreign cooperative banks. If the capital requirements for the ownership transfer of the company still cannot be met, the Company will consider equity participation by other foreign funding bodies. If this cannot be met by the above mentioned types of institutions, the equity participation of international commercial banks and other international financial institutions supporting the CU system will be considered.

20. It is the long-term goal of the Company to become a rural cooperative bank fully owned by the Kyrgyz CUs. Foreign ownership in the Company and an eventual rural cooperative bank would be transitory until the respective minimum capital requirements have been met.

d. Organization and Staffing of the Company

21. The Company's general assembly will promote the establishment of a separate Consultative Committee to provide for the regular feed-back between the CUs, NBKR, and the Company's management. This Consultative Committee will eventually be

transferred into the General Assembly, when respective full acquisition of the capital by the CUs has been reached.

22. The Company's management consists of a general director and two deputy general directors. The general director represents the Company in its external relations and legal functions. The general director may delegate part of his/her powers to a designated deputy director.

23. The Company consists of three departments: (i) promotion of CUs and the CU-System; (ii) monitoring, self-regulation, and supervision of CUs; and (iii) finance, accounting, and administration. While the general director maintains the overall responsibility, he/she will also be responsible for the finance, accounting, and administration department. The two deputy directors will be responsible for one of the two remaining departments. The organization structure and the Company's functions are shown in Figure 1.

24. The Company will at its full scale of operation employ about 22 individuals of which 3 are management, 16 are professional, and 3 are support staff level. Five professional staff will permanently work in the regions of the Kyrgyz Republic.

Figure 1: Organization chart and functions of the FCSCU

NBKR

General Director

Promotion and Development of Credit Unions and Association	Monitoring and Supervision of Savings and Credit Unions	Finance, Accounting, and Administration	Consultative Committee of Credit Unions
• Formulation of company strategy and action plan	• Review of charter of savings and credit unions	• Development of lending, borrowing, and investment policies (with NBKR)	• Representation of CUs (minimum 10)
• Plan and implementation of public awareness campaigns	• Standardization of CUs operations and procedures	• Development of financial products for company and CUs	• Annually elected by CUs
• Assistance in establishment of CUs	• Set up and run management information system	• Loan processing	• Operational feedback to CUs
• Training of CU staff	• Set up performance rating and early warning system for CUs	• Financial investments of own funds • Advice for financial investments of CUs	• Regular feedback to FCSCU and NBKR
• Promotion of CU ownership of FCSCU	• Set up procedures for off-site and on-site surveillance and reporting	• Accounting for FCSCU and consolidation of accounts for CUs	• Regular consultation with FCSCU and NBKR
	• Review regularly performance of CUs	• Internal audit • Audit of CUs	• 10 regular board members
	• Provide regular feedback on best practices to CUs and consultative committee	• Develop deposit insurance system • Study cross default liability system for restructuring unviable CUs	• Annually rotating membership (1/3 replaced)
	• Monthly reporting to NBKR and consultative committee	• Clearing (contract) arrangements • Procurement of goods and services • Personnel affairs	

2. Prudential Rules Regulations and Reporting Requirements for the CUs

25. Consistent with its function to supervise banks and nonbank financial institutions (NBFIs), NBKR will establish rules and regulations for CU operations. NBKR will delegate the detailed supervision of CUs to FCSCU. Based on audit reports prepared by FCSCU, NBKR will determine its program for on-site surveillance of individual CUs.

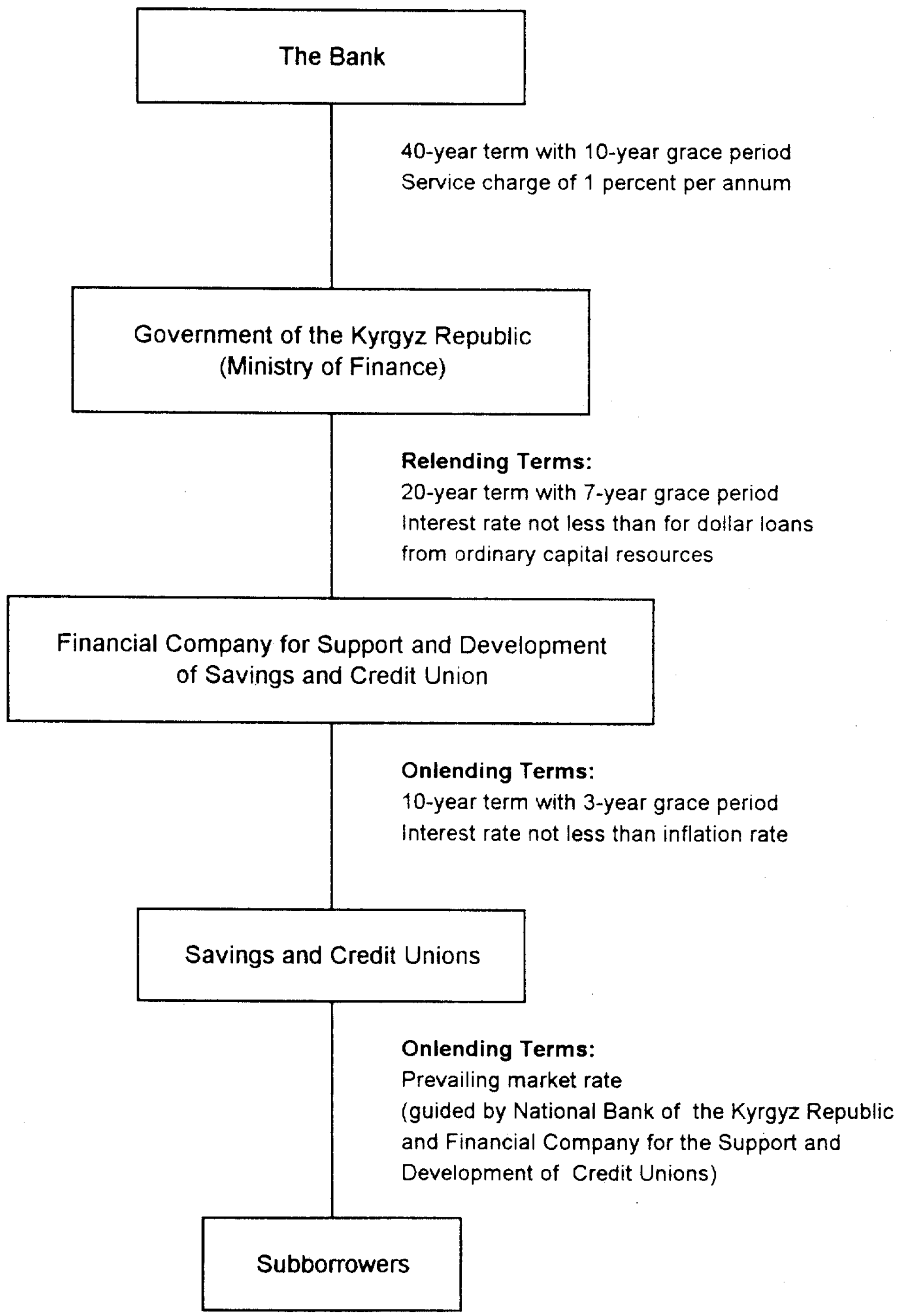
26. Prudential rules and regulations are stipulated in the various draft legal documents mentioned earlier. They explicitly regulate the nature and scope of CU operations, and asset liability ratios restricting CU risk exposure to individual loan and borrower risks, and the CU's capital adequacy. They also regulate certain minimum requirements to qualify for operations. The proposed rules and regulations include:

Capital adequacy	initially 50 percent for mature CUs 20 percent [1]
Minimum CU capital	Som50,000 ($2,875)
Minimum CU membership	10 members
Maximum exposure to single borrower	15 percent of CU net worth loan/borrower share ratio of 3:1
Collateral requirement	optional for loans less than Som7,000 ($410)
Loan term	initially a maximum 4 months longer-term subject to FCSCU authorization
Liquidity: Cash as of total assets	minimum 2 percent
Liquidity: Cash and current bank accounts	minimum 10 percent of total assets
Profitability: return on assets	not less than 1 percent for mature CUs
Savings deposits mobilization	only mature CUs after NBKR approval

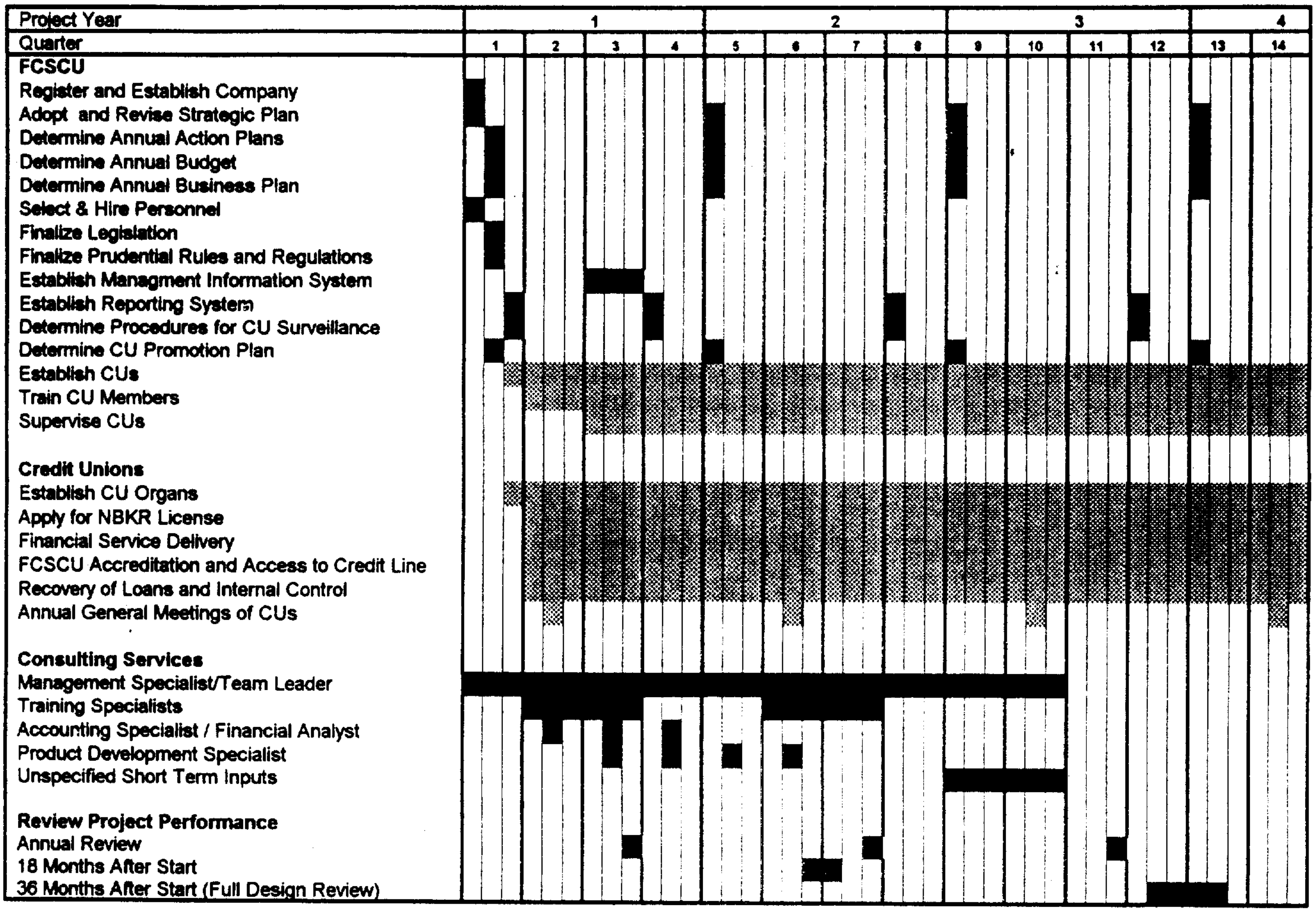
27. The CUs will report monthly and prepare the following reports consistent with the financial accounting requirements in the Kyrgyz Republic: balance sheet, income statement, cash flow statement, loan classification and loan loss provisioning sheet, a list of the largest ten borrowers, and identified prudential ratios.

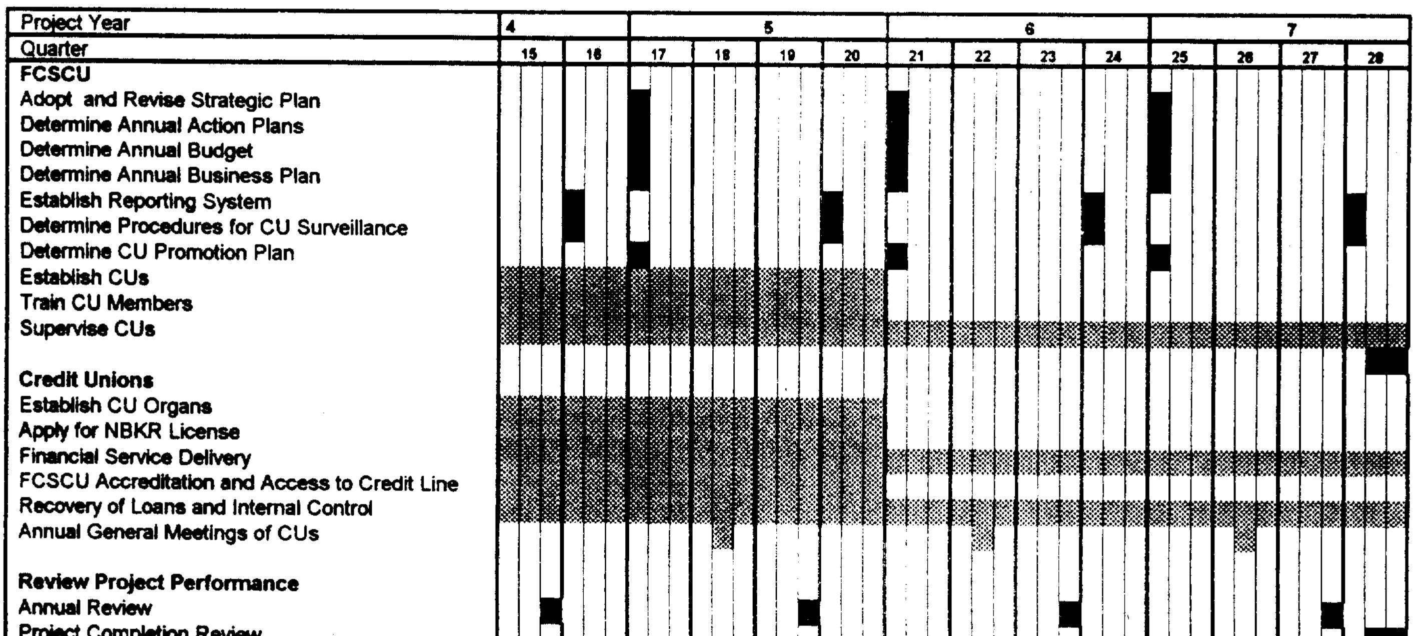
1 Mature CUs have operated for at least three years and are subject to NBKR approval.

FLOW OF FUNDS AND INTEREST RATES FOR MATCHING LOAN FUNDS



PROJECT IMPLEMENTATION SCHEDULE





FCSCU = Financial Company for the Support and Development of Credit Unions; CU = Credit Union; NBKR= National Bank of the Kyrgyz Republic.

TERMS OF REFERENCE FOR CONSULTING SERVICES

1. The consulting services will assist the National Bank of the Kyrgyz Republic (NBKR) and the Financial Company for Support and Development of Credit Unions (FCSCU) to implement a comprehensive system of community-based credit unions (CUs). The consulting services will be provided by a firm with proven experience and substantial backstopping facilities in the establishment and management of CUs or cooperative banks in rural areas. The consultants will be based in FCSCU and will provide services to FCSCU, NBKR, and the CUs.

2. The consultants will carry out the following tasks in close coordination and agreement with the FCSCU, NBKR, the CUs, and other relevant authorities.

A. Activities

1. Start-up

3. Based on FCSCUs strategic plan, the consultants will

(i) prepare a detailed action plan for the implementation of the Project, clearly identifying the respective functions and responsibilities of FCSCU, NBKR, and the consulting team;

(ii) revise the action plan at least annually;

(iii) review the most recent CU legislation with regard to it's compatibility with other relevant legislation, rules, and regulations; this includes NBKR prudential rules and regulations, regulations on bank supervision, the draft Law on Credit Unions, the charters for FCSCU and the CUs, and other relevant legislation; and

(iv) identify issues that have a significant impact on the CU system, and make recommendations for any required modifications.

2. Self-Regulation and Self-Supervision of the System

4. The consultants will assist FCSCU in

(i) further developing prudential rules and regulations, and rules for CU action; and

(ii) drafting and adopting appropriate supervisory procedures for off-site and on-site surveillance of the CU system; these procedures will be reflected in the design and implementation of a management information system (MIS) to be developed by FCSCU.

3. Accounting and Audit

5. Considering NBKR requirements for financial institutions to establish accounting systems according to international standards, the consultants will assist

FCSCU to establish and adopt such a system for FCSCU and the CU system. This will be linked with the establishment of an MIS in this Project. This includes the development of reporting and internal control systems of FCSCU and audit of the CUs.

4. Management Information

6. The consultants will assist FCSCU to design and implement an MIS able to provide the necessary financial and managerial information on a regular and standardized basis. This will include (i) the provision of monthly balance sheets and income statements, (ii) classification of loan portfolio, (iii) a rating system to determine the financial health of individual CUs and the compliance of the CUs with legislation and their rules and regulations; (iv) an early warning system for unviable CUs; (v) information about growth of membership, borrowers, and fund providers, and (vi) status of the Bank credit line. All reporting will be for the individual CUs and consolidated at the national level. This MIS will provide the basis for reporting to FCSCU management and NBKR. The MIS will also be used to meet the needs for benefit monitoring and evaluation in accordance with the Bank's *Handbook on Benefit Monitoring and Evaluation*.

5. Institutional Development and Services

7. The consultants will assist FCSCU:

(i) in preparing its annual action and business plans, which should include the coverage of the CU system, the focus of FCSCU's activities, staffing, annual budgets, and plans for cost recovery of their services;

(ii) in developing it's services to the CUs, including the establishment and review of the organs of the CUs, and FCSCU, and their respective powers and ownership; as well as the drafting and implementation of an exit strategy of NBKR ownership in FCSCU within three years, and the gradual introduction of ownership and control by the CUs;

(iii) by conducting public awareness campaigns through seminars and other media; and preparing promotional material;

(iv) by assessing training needs of the CUs;

(v) by estimating training costs and devising ways to make training cost-effective;

(vi) by selecting training materials for the CUs based on those available from the agencies such as the World Council of Credit Unions, other credit union systems, and cooperative banking institutions;

(vii) preparing training, service, and supervision manuals;

(viii) designing and conducting courses for the trainers of CU representatives and staff; and

(ix) surveying the effectiveness of training of the staff of FCSCU and the CUs, and reviewing and modifying the training material and methods accordingly.

8. The consultants will design and conduct courses for FCSCU staff in financial accounting, financial risk analysis, promotion, CU self-regulation and supervision, and audit.

9. The consultants will assist FCSCU in developing suitable financial products and services for itself and the CUs. This includes the development of loan and savings products, asset liability management, a deposit insurance system, the study of cross default liability systems for restructuring nonviable CUs, and clearing arrangements with suitable channels and institutions.

10. The consultants will organize two foreign study tours of CU systems. The foreign study tour will provide four individuals the opportunity to examine the development, management, and supervision of established CUs and cooperative banking systems abroad. Participants would first visit comparable transition countries that are in the process of establishing, or have already established CU or cooperative banking systems, and visit the respective regulation and supervision agencies. After the start up of the Project, officers from FCSCU and the NBKR Supervision Department will visit a country, where the CU or cooperative banking systems have matured to provide further insights in product development, self-regulation and strategic visions, as well as regulation and supervision by banking authorities.

6. Regulation and Supervision by NBKR

11. The consultants will actively advise the NBKR's Bank Supervision Department on fulfilling its role in supervising the CU system, including FCSCU. For this purpose, selected NBKR staff will participate in FCSCUs activities and training programs.

B. Reporting

12. The consultants, in coordination with the staff of FCSCU, will prepare the following reports:

(i) An inception report to be submitted to the Government and the Bank at the end of the sixth week after mobilization of the consultants. The report will (a) present an action plan for the consultancy; (b) present a preliminary situation analysis of issues to be addressed by the Project; (c) report on the status of the development of FCSCU and the Law on Credit Unions; (d) present a detailed itinerary and budget for the proposed study tour; and (f) update the status of the trial CUs.

(ii) Quarterly reports will be submitted within one month of the end of each quarter. These reports will (a) present revised workplans for the consulting services and review outputs; (b) review progress of the Project and consulting services, and propose modifications where necessary; and (c) provide an analysis of achievement of Project targets, including numbers of CU members reached and the financial and organizational strength of the CUs.

(iii) The consultants will submit a final report at the completion of their services. All individual consultants will prepare final reports upon completion of their respective assignments. These reports will summarize

their activities and include recommendations for improvements in the implementation of the Project. In all reports the consultants will use and update the Project framework format.

C. Expertise to be Provided by the Firm

1. CU Management Specialist/Team Leader

13. The consultant will have a strong background in CUs or rural and cooperative banking systems management, including it's self-regulation and supervision. He/she will have tertiary qualifications in finance and at least ten years of relevant international experience in CUs or rural cooperative banking. The consultant should have excellent management skills.

14. As consulting team leader he/she will oversee and coordinate the activities of the individual team members to achieve Project objectives and advise on and assist NBKR and FCSCU in the preparation of Project reports.

2. Accounting Specialist/Financial Analyst

15. The specialist will be familiar with internationally applied accounting systems for financial institutions, preferably CUs or cooperative banks. Familiarity with the Soviet accounting system and the new accounting system for financial institutions to be established in the Kyrgyz Republic is highly desirable. The specialist will also have experience in financial risk analysis of financial institutions. He/she will have tertiary qualifications in finance and a strong background and international experience in accounting and supervision of financial institutions, preferably in Eastern Europe or Central Asia.

3. Product Development and Specialist

16. The specialist will have tertiary background in economics or finance. He/she will have experience in development of financial products combining the clients needs and lenders risk. He/she will have substantial experience in asset and liability management, and product pricing of financial institutions.

4. CU Training Specialist

17. The training specialist will have an overall knowledge of CU systems organizational structure and functions. The specialist will have substantial experience in the identification of training needs, cost effective design, and implementation of training programs for CUs or cooperative banks. Tertiary qualification in economics or finance with at least eight years of experience in management and training of CUs is required.

5. Unspecified

18. Provision is made for six person-months of unspecified short-term inputs to accommodate unforeseen requirements for specialist expertise during the course of Project implementation. This is considered necessary in view of the Project's focus on savings mobilization as well as lending services, the transitional nature of the economy, and the ongoing reform in the financial sector.

D. General Responsibilities of the Firm

19. The consulting firm will take the final responsibility for the adequacy of the proposed consulting team. If justified, the firm is free to bundle certain specializations under one individual. The firms will have substantial backstopping facilities available that will allow them to provide systems support, training, and alternative personnel, if necessary at short notice.

20. All individuals offered/employed by the firms in this Project will be proficient in oral and written English. They will also be familiar with personal computer software: MS Word for Windows and spreadsheet programs such as Lotus 123 or MS Excel. The firm will make adequate provisions for the translation of all reports and documents from English into Russian. They will always keep a full set of such documents available in FCSCU and NBKR and provide respective updated copies to the Bank.

E. Proposed Duration of Assignments

21. The proposed duration of assignments is as follows:

Function	Duration (months) international expertise	Duration (months) local expertise	Total Duration (months)
Management Adviser/Team Leader	30	-	30
Accounting Specialist / Financial Analyst	3	3	6
Product Development and Marketing Specialist	4	-	4
CU Training Specialist	12	12	24
Unspecified	6	-	6
Total	**55**	**15**	**70**

FINANCIAL PROJECTIONS, 1997–2003

A. Key Assumptions for Credit unions

1. Uptake of the SCU System

1. The Financial Company for the Support and Development of Credit Unions (FCSCU) is responsible for the promotion, development, monitoring, and supervision of credit unions (CUs). It is expected that an individual CU will take three years to obtain its full size. FCSCU will promote the creation of 280 CUs: 40 during the first year of operation and an additional 60 per year during the second through the fifth year of the Project. It is expected that the consolidated maturity is reached after seven years of operation, covering about 5 percent of the 570,000 rural households. Table 1 summarizes the expected uptake.

Table 1: Projected Uptake of CUs and Membership

Year	1	2	3	4	5	6	7
Additional number of CUs	40	60	60	60	60		
Number of CUs at end of year	40	100	160	220	280	280	280
Percent of total CUs	14	36	57	79	100	100	100
Total CU members	1,200	4,600	10,000	16,000	22,000	26,200	28,000

2. Compared with microfinance institutions in other countries such as Indonesia (average size 500 members) and Viet Nam (average size 350 members), the projected average number of 100 members per CU might appear small. However, taking into account the most recent experience of the three trial CUs under the Project preparatory technical assistance and discussions with the National Bank of the Kyrgyz Republic (NBKR), this size of CU appears realistic. This reflects also the members' preference to constitute CUs within the same village or family group. NBKR has set a minimum size of ten members for licensing.

2. Sources and Applications of Funds of the CUs

3. The CUs will obtain their funds from member share capital, retained earnings, and matching loan funds from the Bank through FCSCU. Member savings deposits will be allowed when the CUs have gained sufficient experience in operations. This is expected after about three years of full operation. Matching loan funds will be provided to the CUs through FCSCU, and will equal the total contribution (capital, savings mobilized, and retained earnings) by the CU. This mechanism provides an important incentive to mobilize domestic resources. These loans will equal $250 per member up to a membership of 50. To provide an incentive for larger CUs, matching loans will increase to $350 for each additional member. Total matching loan funds will be limited to $35,000 per CU.

4. The three trial CUs have an average minimum capitalization of Som3,415 ($196) and a range of Som1,300 ($65) to Som6,330 ($360) per member for

all CUs. Therefore, an average initial capital of Som2,000 ($115) per member appears realistic. Besides, the initial capitalization, individual members are expected to make annual capital contributions in cash of Som900. It is further expected that the individual CUs will invest the equivalent of 5 percent of their equity to purchase shares of FCSCU. About 10 percent of the total mobilized funds (including retained earnings, net of investments in FCSCU) would be held as cash reserves, leaving the remainder as loanable funds. Due to the short-term nature of the CUs' lending cycle, loanable funds would equal loans outstanding. During the implementation of the Project, loans are expected to be on very short terms (less than one year), and will fall due during the same year.

3. Operating Revenue

5. Interest on loans and on cash reserves would be the only sources of income for the CUs. This income would be adjusted by interest on loan losses during the same year (10 percent on outstanding interest payments). The loan risk is limited through the short-term nature of loans, and the timely collection of due amounts.

6. Dividends from the investment in FCSCU are not expected during the Project lifetime as relatively high start-up costs for FCSCU are expected, and the major objective is to provide cost-effective services to member CUs. Interest rates on subloans to CU members are expected to be positive in real terms covering the full cost of CU operations (45 percent per annum at present). Interest rates on cash reserves are expected to be at 10 percent per annum, in line with deposit rates for current accounts (from 8 to 20 percent per annum at present). Due to the high volatility of interest rates on loans and deposits the indicated lending and deposit rates should not be interpreted separately. It is necessary that the CUs maintain a sufficient interest spread of at least 13 percent to cover loan losses, administration cost, and a small profit, by adjusting interest rates with current market trends.

4. Operating Costs

7. The interest rates on savings for mature CUs are expected to at least equal the inflation rate (31 percent per annum at present; savings interest rate 32 percent per annum, respectively). To encourage savings, the interest rate on borrowings by members would not be priced less than that on savings. With the current restrictions for newly created CUs, savings deposit mobilization will only be allowed for mature institutions. Thus, new small CUs will not have access to these funds to expand their business more quickly. Cost recovery will be reached only after the second year of full operation.

8. FCSCU will charge real positive interest rates (32 percent per annum at present) on the outstanding loan funds to the CUs. In addition, it will charge a membership fee of $10 equivalent per annum per member to reflect adequate sharing of the high FCSCU promotional and institution-building costs. Staff costs would equal $5 per member, reflecting the high degree of voluntary staff in the start-up phase of a CU and limited overhead costs. This will allow the CU to limit risks of high overhead costs at low rates of uptake. Fixed costs are projected at an annual constant $300 per CU. Ten percent of administration costs has been added as miscellaneous cost.

9. Net operating costs would be adjusted by loan loss provisions of 10 percent on the principal of loans outstanding. Taking into account loan loss rates of

microcredit institutions in Viet Nam and Indonesia at about 2 percent of loans outstanding, 10 percent appears conservative. However, the recent change from a State-administered command credit system to a commercial credit system, coupled with the fragility of the transition process, calls for a significantly higher rate of loan loss provisions. According to NBKR, losses of the banking sector can reach up to 20 percent of the commercial banks' portfolio. For reasons of simplicity, loan losses have been projected to occur during the same year.

10. The CUs are expected to be treated as nonprofit organizations. Therefore it is assumed that income tax on net profits will not be applicable. Municipal taxes are 5 percent of revenues. It is assumed that 50 percent of net profit after tax will be retained in the CUs. This figure appears plausible as the CUs' retained earnings would increase access to the matching funds credit line.

B. Key Assumptions for FCSCU

1. Uptake, Sources, and Applications of Funds

11. FCSCU will provide the following services: (i) active promotion of the establishment of the CUs; (ii) channeling of matching loan funds to the CUs; (iii) supervision of their financial performance and accuracy of accounts through off-site data collection and analysis, and on-site inspection; and (iv) assistance for contracting clearing services using the NBKR payment system.

12. Due to the key service functions provided for the CU system, the financial viability of FCSCU is directly linked with the uptake of the CUs described in paras. 1 and 2. FCSCU will obtain its financial sources from initial share capital from NBKR, additional share capital from the CUs, retained earnings, Bank loans for matching funds, and initial start-up costs channeled through the Government. Profits after taxes will be fully retained during the implementation period.

13. Deposits by member CUs are subject to NBKR regulations, but not allowed in the early years of the Project. Therefore, it has been assumed that no deposits from member CUs will be available for FCSCU as a resource. FCSCU will obtain the Bank's matching loan funds of $8.4 million, channeled through the Government at a variable interest rate for a period of 20 years including a grace period of 7 years. The onlending to CUs will be for a period of 10 years including a 3-year grace period. Loan funds for institutional building will be used to finance furniture and small equipment up to 100 percent, and the recurring cost for operations of up to 50 percent over the Project implementation period. These loan funds will reach 89 percent of operational costs in year two and be gradually phased out over five years.

2. Operating Revenues

14. At current market trends, FCSCU will earn interest on loans to the CUs at 32 percent per annum. As already indicated under para. 6, interest rates on sources and applications of funds should not be interpreted separately. Given the limited fee income from the CUs in the first years of operation, the high provisions for loan losses of 10 percent of the portfolio, and the relatively high cost of institution building, FCSCU will need an interest spread of at least 25 percent to become profitable in the third year of operations and to absorb the accumulated start-up losses by year six. By year seven it may be expected that this margin will fall significantly.

3. Operating Costs

15. FCSCU will incur depreciation cost for its investments in office equipment, furniture, and vehicles projected at $107,000 over the Project period. The staff costs are estimated at $130,400 per annum following the second year of operation. Other administrative costs include office rental, utilities and office expenses, travel and training costs, as well as maintenance costs. Table 2 illustrates the relatively high level of travel and training costs necessary for the promotion, development, monitoring, and supervision of CUs.

Table 2: Projected Annual FCSCU Administration Cost
$ ('000)

Year	1	2	3	4	5	6	7
Staff	80.5	109.2	130.4	130.4	130.4	130.4	130.4
Office and utilities	23.7	23.7	23.7	23.7	23.7	23.7	23.7
Travel	62.1	101.3	115.2	124.9	137.7	91.2	71.2
Training	8.4	12.0	12.0	12.0	12.0	12.0	12.0
Maintenance	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Miscellaneous	15.0	21.4	23.5	25.0	26.9	19.9	16.9
Total	**195.6**	**273.5**	**310.6**	**321.8**	**336.6**	**283.1**	**260.1**

16. Net operating costs would be adjusted by loan loss provisions of 10 percent on the principal of loans outstanding. For reasons of simplicity, loan losses have been projected to occur during the same year. Income tax on net profits is 30 percent, whereas municipal taxes are 5 percent of revenues (see para. 10). FCSCU's income tax burden will be lowered as losses of previous years may be written off in the five following years. As indicated, FCSCU's main function is to provide cost-effective services to its members. With the high initial start-up costs, any profits will be fully retained.

C. Results

1. An Individual CU

17. The key financial indicators for the sustainability of an CU are (i) capital adequacy defined as the ratio of net worth to total average assets; (ii) asset quality defined as the ratio of the fully performing loans to total loans; (iii) return on assets defined as net income after tax to average total assets; (iv) return on capital defined as net income after tax to average net worth; and (v) annual growth of the loan portfolio, equity, and net profit.

18. Due to the restrictions on external savings deposit mobilization, capital adequacy is expected to remain at very high levels of at least 50 percent. For small financial intermediaries, capital adequacy ratios of 20 percent are usually considered satisfactory. As already indicated under para. 9, loan loss reserves of 10 percent of total loans outstanding are considered very high, but adequate for the Kyrgyz Republic.

19. The return on assets will be negative during the first two years of a CU's operation, rising to an acceptable 0.6 percent in year three, and reaching a very satisfactory 2.1 percent in year 4. The net spread shows an acceptable level of 7.3 percent.

20. Annual growth rates for loans and equity are usually very high during the start-up phase of new financial intermediaries. However, the fact that annual growth rates for equity will exceed growth rates of the loan portfolio beginning in year five confirms the financial soundness of the CUs, as well as the system as a whole. These figures also show that there is scope for deposit mobilization as capital adequacy of over 50 percent appears unnecessarily high. Table 3 provides a summary of the key financial indicators. The income statements and balance sheets for the CUs are in Tables 7 and 8, respectively.

Table 3: Key Financial Performance Ratios for Individual CUs
(%)

Year	1	2	3	4	5	6	7
Net worth/total av. assets	50	50	50	50	56	62	67
Performing loans/total loans	90	90	90	90	90	90	90
Net income after tax/av. total assets			0.6	2.1	2.8	3.5	3.8
Net income after tax/av. net worth			1.1	4.1	5.2	5.9	6.0
Administrative cost/total recurrent cost	51.1	36.2	33.6	19.5	17.3	17.1	22.6
Administrative cost/av. loans outstanding	5.3	3.0	2.7	1.4	1.2	1.2	1.6
Annual growth rates							
Loans		238	88	33	16	15	15
Equity		238	88	33	30	27	24
Profit					65	45	27

Source: Staff estimates

3. FCSCU

21. FCSCU reflects capital adequacy below a desired level for a financial institution. Due to the relatively high start-up costs for promoting, developing, monitoring, and supervising the CU system, the FCSCU's activities are more those of a service company than a financial company. This will gradually change with the uptake of the CU system. Assuming that FCSCU is exclusively capitalized by the CUs, it will reach satisfactory levels of capital adequacy toward the end of year six.

22. Start-up costs for the promotion, development, monitoring, and supervision of CUs are high, coupled with initially low fees and interest revenues during the initial low uptake of the CUs. Return on assets is negative during the first three years of operation, but are projected to improve to acceptable levels of about 2.0 percent by year six. If necessary, FCSCU will have the flexibility to improve its profitability through measures such as raising fee levels above $10 per member and strictly controlling the development budget.

23. Due to the weak situation of the Kyrgyz Republic's financial sector and negative experiences with pyramid investment schemes in eastern European and Central Asian economies, NBKR will not allow deposit mobilization in the initial stage of

the CU development. This will significantly slow the leverage and uptake of the CU system. Developed systems in Europe have shown that savings mobilization from the public is a key element for low-cost resource mobilization. Through strict supervision as well as the establishment of deposit insurance schemes, the interests of depositors were adequately maintained. NBKR will allow deposit mobilization to experienced and successful CUs at a later stage.

24. As mentioned above, profitability is somewhat weak, but growth rates on profit after tax are expected to improve considerably after the fourth year of operation. The key financial indicators for FCSCU are summarized in Table 4.

Table 4: Key Financial Performance Ratios for FCSCU
(%)

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Net worth/total av. assets	-16	-38	-24	-12	-2	7	14
Performing loans/total loans	90	90	90	90	90	90	90
Net income after tax/av. total assets				0.1	1.3	2.0	2.0
Net income after tax/av. net worth						59.9	17.7
Service cost/av. loans outstanding	83.5	20.1	7.5	3.7	2.3	0.9	1.1
Service cost/total recurrent cost	96.4	89.2	77.6	64.0	53.3	31.3	34.8
Total revenue/total recurrent cost	12.0	40.8	94.6	157.9	207.5	307.5	292.6
Recovery of service costs:							
Service fees/total administration cost	2.9	6.0	15.4	29.6	44.7	09.2	90.9
Service fees/training cost	8.5	15.4	40.1	74.2	106.9	208.9	307.8
Fee revenue/total revenue	23.2	13.0	12.6	12.0	11.5	11.1	10.8
Annual growth rates							
Loans		388	165	90	53	31	16
Equity							144
Net Profit after tax					1811	139	25

D. Risk Analysis

25. One considerable risk might be a slower than expected uptake of the CU system. If the average size of an CU is halved to 50 members, the system would be affected as follows. The results are shown for an CU and FCSCU in Tables 5 and 6, respectively.

1. CUs

26. Individual CUs would maintain their financial soundness, if not improve capital adequacy and profitability. The main reason is that costs of the CUs are almost entirely variable, allowing for a very flexible risk-minimizing expansion of the CUs.

Table 5: Key Financial Performance Ratios for CUs
at a 50 percent Lower Uptake

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Net worth / total av. asset (%)	50	50	50	54	60	66	70
Net income after tax/av. total assets (%)	-3.1	0.0	0.4	2.2	3.0	3.7	3.8

2. FCSCU

27. With institution-building costs unchanged, the lower uptake would have a negative impact on the financial situation of FCSCU. Profitability, defined as return on assets, would be positive in year five instead of year four, but reaching acceptable levels of about 2 percent in year six. The sensitivity analysis confirms that a lower uptake will have a transitory negative impact on FCSCU. The viability could be further improved by adjusting the institutional development budget to a lower uptake and thus lower revenues. Furthermore, FCSCU will have enough flexibility to mitigate the financial risk through effective cuts in the operating budget, for example through delaying staff recruitment.

Table 6: Key Financial Performance Ratios for FCSCU at a 50 percent Lower Uptake (at unchanged institutional buildup cost)

Year	1	2	3	4	5	6	7
Net Worth / total av. assets (%)	-16	-47	-40	-34	-19	-5	4
Net income after tax / av. total assets (%)	-53.3	-16.0	-5.6	-1.5	0.5	2.2	2.0

Table 7: Projected Income Statements for an Individual CU (Constant $, March 1997)

Item Year	1	2	3	4	5	6	7
Income							
Interest on loans	1,395	6,116	13,595	20,693	25,507	29,389	33,687
Interest on loan losses	(136)	(597)	(1,327)	(2,019)	(2,489)	(2,868)	(3,288)
Gross income	**1,259**	**5,519**	**12,268**	**18,673**	**23,018**	**26,521**	**30,400**
Operating costs							
Interest on member savings	0	0	0	0	0	0	0
Interest on borrowings	552	2,418	5,376	8,183	9,473	9,600	9,600
Total interest costs	**552**	**2,418**	**5,376**	**8,183**	**9,473**	**9,600**	**9,600**
FCSCU service fee	300	700	1,000	1,000	1,000	1,000	1,000
Personnel	75	250	425	500	500	500	500
Office and utilities	150	300	1,050	300	300	300	1,050
Other admin. costs	53	125	248	180	180	180	255
Total admin. costs	**578**	**1,375**	**2,723**	**1,980**	**1,980**	**1,980**	**2,805**
Total operating costs	**1,129**	**3,793**	**8,098**	**10,163**	**11,453**	**11,580**	**12,405**
Net operating income	**130**	**1,726**	**4,170**	**8,511**	**11,564**	**14,941**	**17,995**
Loan loss (principal)	(605)	(2,048)	(3,849)	(5,126)	(5,937)	(6,810)	(7,801)
Interest income on cash	61	265	650	1,163	1,756	2,437	3,218
Net income before taxes	**(415)**	**(57)**	**971**	**4,548**	**7,384**	**10,568**	**13,411**
Taxes	16	87	210	339	427	493	565
Net income after tax	**(431)**	**(143)**	**760**	**4,209**	**6,957**	**10,076**	**12,846**

Table 8: Projected Balance Sheets for an Individual CU (Constant $, March 1997)

Item Year	1	2	3	4	5	6	7
Assets							
Cash	1,278	4,928	10,779	17,324	24,162	31,942	40,844
Loans outstanding	6,052	20,475	38,491	51,262	59,370	68,100	78,014
Loan loss provisions	(605)	(2,653)	(6,502)	(11,628)	(17,565)	(24,375)	(32,176)
Shares in FCSCU	172	583	1,097	1,460	1,893	2,403	2,983
Total Assets	**6,897**	**23,333**	**43,864**	**58,418**	**67,860**	**78,070**	**89,665**
Liabilities							
Savings & current liabilities	0	0	0	0	0	0	0
Long term debt	3,448	11,667	21,932	29,209	30,000	30,000	30,000
Equity							
Share Capital	3,448	11,667	21,839	27,011	32,184	37,356	42,529
Retained earnings	0	0	93	2,197	5,676	10,713	17,136
Total Equity	**3,448**	**11,667**	**21,932**	**29,209**	**37,860**	**48,070**	**59,665**
Total Liabilities and Equity	**6,897**	**23,333**	**43,864**	**58,418**	**67,860**	**78,070**	**89,665**

Table 9: Projected Income Statements for FCSCU (Constant $, March 1997)

Item Year	1	2	3	4	5	6	7
Income							
Interest on loans	22,069	129,839	393,239	828,057	1,370,645	1,911,010	2,341,907
Interest on Loan Losses	(2,207)	(12,984)	(39,324)	(82,806)	(137,065)	(191,101)	(234,191)
Net interest income	19,862	116,855	353,915	745,251	1,233,581	1,719,909	2,107,716
FCSCU service fees revenue	6,000	17,500	51,000	101,500	160,000	215,500	256,000
Interest & fee income	**25,862**	**134,355**	**404,915**	**846,751**	**1,393,581**	**1,935,409**	**2,363,716**
Expenses							
Interest on borrowings	7,710	35,654	96,013	193,149	313,421	432,166	526,424
Depreciation	11,840	20,240	21,440	21,440	21,440	(85,760)	21,440
Personnel	80,472	109,200	130,368	130,368	130,368	130,368	130,368
Administration	115,122	164,326	180,275	191,440	206,249	152,706	129,724
Total Expenses	**215,144**	**329,421**	**428,096**	**536,397**	**671,478**	**629,480**	**807,956**
Loan loss (principal)	(13,793)	(67,356)	(178,418)	(339,118)	(517,536)	(676,846)	(786,846)
Interest income on cash	1,797	8,222	27,644	67,064	138,036	222,111	321,902
Profit before tax	**(201,278)**	**(254,200)**	**(173,955)**	**38,301**	**342,603**	**851,195**	**1,090,817**
Taxes	603	3,350	11,325	25,382	95,676	261,642	356,746
Net profit after tax	**(201,882)**	**(257,550)**	**(185,280)**	**12,919**	**246,926**	**589,553**	**734,071**
Dividends	0	0	0	0	0	0	0
Retained Earnings	(201,882)	(257,550)	(185,280)	12,919	246,926	589,553	734,071

Table 10: Projected Balance Sheets for FCSCU (Constant $, March 1997)

Item Year	1	2	3	4	5	6	7
Assets							
Cash and Current Accounts	17,965	82,218	276,440	670,644	1,380,356	2,221,114	3,219,025
Loans outstanding	137,931	673,563	1,784,179	3,391,177	5,175,355	6,768,459	7,868,459
Loan loss provisions	(13,793)	(67,356)	(178,418)	(339,118)	(517,536)	(676,846)	(786,846)
Net loans Outstanding	124,138	606,207	1,605,761	3,052,059	4,657,820	6,091,613	7,081,613
Fixed Assets	59,200	101,200	107,200	107,200	107,200	107,200	107,200
Depreciation	(11,840)	(32,080)	(53,520)	(74,960)	(96,400)	(10,640)	(32,080)
Total Assets	**189,463**	**757,545**	**1,935,881**	**3,754,943**	**6,048,976**	**8,409,287**	**10,375,758**
Liabilities							
Savings/current liabilities	0	0	0	0	0	0	0
Long Term Debt	218,931	1,044,563	2,408,179	4,217,177	6,159,355	7,806,459	8,906,459
Total Liabilities	**218,931**	**1,044,563**	**2,408,179**	**4,217,177**	**6,159,355**	**7,806,459**	8,906,459
Equity							
Share Capital	172,414	172,414	172,414	169,559	274,487	398,141	530,542
Retained Earnings	(201,882)	(459,432)	(644,712)	(631,793)	(384,866)	204,687	938,757
Total Equity	(29,468)	(287,018)	(472,298)	(462,234)	(110,379)	602,828	1,469,299
Total Liabilities and Equity	**189,463**	**757,545**	**1,935,881**	**3,754,943**	**6,048,976**	**8,409,287**	10,375,758

FINANCIAL ANALYSIS OF INDICATIVE SUBLOAN ACTIVITIES

A. Introduction

1. The three trial credit unions (CUs), have a total of 76 members, 39 are farmers. Others are involved in agro-processing, trading, commerce, or professional activities (e.g., teachers, doctors, and nurses). The CUs have extended subloans to 64 members over two loan cycles up to a maximum term of four months. A small number of members have received two loans.

2. The trial CUs have given priority to farmer members providing subloans for the purchase of inputs such as seed, fuel, fertilizer, and pesticide; the rental of tractors, combines, and vehicles; and the purchase of livestock for resale. Subloans for nonfarming purposes have included the purchase of inputs such as grain and flour for bakeries; small garment enterprises; and trading and commerce activities, e.g., shop owners and cafeteria. The subloans have ranged in size from Som3,000 ($172) to Som51,000 ($2,930) and an average loan size of Som12,317 ($707).

3. Given the diversity of membership, the wide potential of rural activities for which subloans can be extended, and the authority of the credit committee of each CU to determine its own loan portfolio, it is difficult to present a representative set of subloan activities likely to be financed under the Project. Nevertheless, the Project preparatory technical assistance identified seven typical subloan activities based on a survey undertaken in the Osh, Djalal Abad, Chui, and Naryn oblasts to illustrate the scope of activities that could be financed by the CUs.

B. Major Assumptions

4. The typical enterprises include crop production, dairy, and services. The models prepared include short-term activities to be completed within 3 to 12 months during the start-up phase of an CU. At a later stage, medium-term loans might be introduced. The household survey underscored the high demand for financing term activities. However, the available limited number of members, the initially limited amount of savings per member, and the economic situation of the country limits loans to short-term periods. Many rural households carry on multiple economic activities that they will finance with credit, and will use income from multiple sources to make the loan repayments.

5. Loans for the farm enterprises will initially be limited to seasonal finance for farm inputs. Term loans for farmers will be available only when they have demonstrated their ability and willingness to repay seasonal loans. Loans to rural enterprise will be provided for working capital, and business expansion and diversification.

6. The major assumptions used in the analysis of subloan activities are (i) borrowers will first utilize the labor within their household, and additionally utilize labor from neighboring households, usually from the same family, to limit cash expenditures for labor; (ii) cash flow needs are further reduced as borrowers contribute in-kind to the subloan activities; and (iii) the CUs will evaluate the commercial viability of the subloan activities with special emphasis on the individual member's sources of cash.

C. Results

7. Table 1 presents the estimated investment requirements of each subloan activity, the net incremental cash flow, net return per day, and the debt-service cover. As the subloan activities are of a short-term nature no internal rates of return have been computed. In general, all the subrojects are shown to be viable activities. It is expected that subloan activities with loan sizes beyond the equivalent of Som16,000 will be financed by the beginning of the third year of a CU's operation.

Table 1: Summary of Financial Analysis of Indicative Subloan Activities

Subproject	Loan Amount Som	Net Incremental Cash Flow Som	Net Return per Day[a] Som	Net Return per Day[a] $	Debt Service Cover (times)
Mixed crop farm (5 ha)	2,300	11,800	131	7	22.3
Mixed crop farm (13.5 ha)	20,000	16,400	60	3	2.1
Mixed crop farm (23 ha)	18,000	66,100	301	17	16.9
Wheat seed farm	19,000	27,000	758	43	3.0
Dairy herd (100 head)	7,700	143,400	200	11	18.2
Tomato ketchup production	18,900	15,000	29	2	0.9
Teashop	2,500	9,000	52	3	13.3

a Net return per day is estimated as net revenue/profit divided by the number of days worked on the farm or enterprise.

Source: Project preparatory technical assistance. See Feasibility Study Report of TA No. 2435-KGZ: Agriculture Credit Pilot Project, for $910,000, approved on 27 November 1995.