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KYRGYZ REPUBLIC: Credit Unions and Sustainable Rural Finance Recommendations for Supervision and Development

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CURRENCY EQUIVALENTS

(as of 01 October 05)

Currency Unit	–	Som
Som1.00	=	\$ 0.02448
\$1.00	=	Som 40.85

ABBREVIATIONS

ADB	Asian Development Bank
CU	Credit Union
DGVR	Deutscher Genossenschafts-und Raiffeisenverband e.V.
EBRD	European Bank for Reconstruction and Development
FCCU	Financial Company for the Support and Development of Credit Unions
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH
IMF	International Monetary Fund
KAFC	Kyrgyz Agricultural Finance Company
MCO	Microfinance Organization
NBKR	National Bank of the Kyrgyz Republic
PEARLS	Protection, Effective financial structure, Asset quality, Rates of return and cost, Liquidity and Signs of growth (PEARLS™)
SSC	Savings and Settlement Company
WOCCU	World Council of Credit Unions

NOTE

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

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EXECUTIVE SUMMARY

Success in creating credit unions and attracting members has exceeded the achievements to date in putting in place the supporting infrastructure for sustainability in the Kyrgyz Republic. An apex organization to support credit unions has not yet emerged and the envisioned supervisory system is not yet fully functional. This complicates the exit from the Asian Development Bank (ADB) rural finance program that has fostered credit union growth. In determining an exit strategy for the loan program, the question is whether any further extension from the end-2005 completion date offers the potential to make substantial progress on the unmet objectives, or would lead to further delay in addressing difficult decisions, or even aggravate the problems.

Rural and poor residents of the Kyrgyz Republic are served by a larger number and wider range of financial services providers than is usually observed, including credit unions, microfinance organizations and commercial banks. There is evident segmentation in the market, with credit unions providing loans that are much smaller on average than banks or the Kyrgyz Agricultural Finance Company (KAFC). Consolidation is inevitable as many of the very small credit unions and microfinance organization will have to merge to achieve more sustainable size, or wither as the financial and technical support that spurred their initial development dwindles.

Reported financial performance of credit unions is impressive. However, there are concerns that some credit unions may be misreporting and that some credit unions were formed only to obtain Financial Company for the Support of Credit Unions (FCCU) financing utilizing phantom member contributions. Estimates vary, but at least one-third of the 310 total credit unions are not viable, and perhaps only 40 to 60 would truly prosper without external support. Over \$12 million in loans and grants have been committed to union development, or about 90 cents for every dollar in credit union total assets at end-June 2005.

FCCU reports improved financial performance and adequate loan quality, but recent rapid growth in the loan portfolio may obscure potential losses, and has allowed it to meet performance targets without addressing underlying concerns regarding efficiency and staffing. FCCU, which was intended to become an apex organization, has suffered from the outset from poor governance and oversight. The National Bank of the Kyrgyz Republic (NBKR) has viewed itself as the owner in form only, since the FCCU in substance exists as an instrument of government policy. There has been no substantive progress towards divestiture to credit unions or any other option for privatization. Some credit union leaders have questioned whether it would be better to create a new entity to provide apex services rather than buy and reform FCCU.

The current status of regulation and supervision of credit unions is unsatisfactory. There is little to show for the extensive technical assistance provided to build supervision capacity. Rather than continuing with the planned "bank-like" model for credit union oversight, the NBKR could better match supervisory resources to risks by applying to credit unions the same tiered approach used in regulation and supervision under the microfinance law.

The key question for the future of FCCU is its valuation. If the quality of FCCU's loan portfolio is as reported, divestiture to credit unions or other investors are viable options. If loan quality is poor, the only option for FCCU is liquidation.

If FCCU's loan quality is as reported, the end of the program will not cause a dramatic withdrawal of funds from credit unions. FCCU has a viable business that could support loan repayment and continued provision of finance to credit unions. Any immediate contraction in the credit union system at the end of the program would be due to the end of the flow of new funds

revealing pre-existing weaknesses in credit unions. If credit unions are only viable with a continued flow of new funds from FCCU, it would be better to trigger a shakeout now rather than continue to promote an unsustainable system.

One key component of an exit strategy for the rural finance program is assistance with the valuation of FCCU. If FCCU is found by an independent valuation to be insolvent, it should be liquidated. If viable, the exit strategy could include development of a divestiture plan for FCCU. All this implies a pragmatic resolution of the end-2005 deadline, provided there are incremental improvements in the framework for regulation and implementation of supervision.

A divestiture plan for FCCU should provide credit unions the first option to purchase an ownership stake, as intended in the original program. If credit unions are unable or unwilling to purchase an ownership stake by end-June 2006, FCCU should be sold by tender. Extension of the deadline for divestiture by NBKR would avoid the need for an interim ownership transfer of FCCU that would not accomplish its ultimate resolution.

The recommendations for resolution of FCCU are especially time-sensitive. These recommendations have been discussed since the ADB Kyrgyz Resident Mission circulated the first draft of this report to stakeholders in mid-September. Failure to reach firm agreement on an action plan has resulted in compression of the time-frame for tasks to be completed by end-2005. Without immediate agreement on an action plan, it will not be possible to meet the dates for the various actions summarized below and outlined in Appendix 2.

Summary of Main Recommendations

- Any further assistance for credit union apex development and supervision and regulation to be provided in the context of the government's strategy for microfinance
- FCCU management should undertake no further work on the development of apex functions pending resolution of FCCU's future direction
- Consideration of extension of project closing date to end-2006 subject to key conditions:
 - No disbursements for credit union loans after the current expiry date (end-2005)
 - Government to endorse by November 18 an action plan for resolution of FCCU, which includes among other measures:
 - An international firm to complete an independent valuation of FCCU by end-January 2006
 - If FCCU is found to be insolvent by independent valuation, liquidate
 - If FCCU has value and credit unions do not exercise option to purchase by end-June 2006, sell FCCU by tender
- Harmonize the approach to credit union regulation and supervision with that applied to microfinance—apply a lighter regime to credit unions that do not take deposits

I. INTRODUCTION

1. Efforts to develop credit unions as key suppliers of rural finance in the Kyrgyz Republic have been very successful in terms of the formation of credit unions and attraction of members (Table 1), but less successful in creating the supporting infrastructure for sustainability. Aside from a pilot project terminated at end-2004, no credit union has yet been licensed to accept deposits. An apex or central credit union has not emerged to provide services and ongoing development support for credit unions. A credit union law and economic norms are in place, but the envisioned system of off-site and on-site supervision and enforcement of economic norms is not functioning effectively.

Table 1. Development of credit unions.

	1997	1998	1999	2000	2001	2002	2003	2004	2005 Q2
Number	3	83	166	191	275	350	303	304	310
Members	76	2,849	7,350	11,085	21,313	24,979	24,688	27,707	28,972
Borrowers	42	n.a.	n.a.	n.a.	16,361	18,700	19,134	21,650	23,124
	(som 000s)								
Total assets	n.a	14,994	54,715	101,905	242,382	265,345	317,232	487,554	587,533
Loans	431	13,875	49,490	95,398	227,418	244,247	283,907	440,244	535,071
Deposits	--	--	--	--	--	--	17	2,554	544
External funding	186	4,903	19,583	35,087	88,136	91,285	122,259	215,396	290,508
Share capital	245	8,509	28,991	49,199	117,596	126,720	138,278	160,720	171,962
Institutional capital	--	--	--	1,154	5,720	12,714	26,313	43,940	93,189
Total capital	245	8,509	28,991	50,353	123,315	139,433	164,510	204,660	265,151

Source: Financial Company for the Support of Credit Unions (FCCU).

2. The driving force behind the development of credit unions has been the Asian Development Bank's Rural Finance Institutions Project, initiated in 1997. The key objectives of the project were:

- Establish 280 credit unions across all regions, supported by a credit line to match member contributions, with FCCU to train and develop credit union staff in management and operation of credit unions;
- Support the further development of FCCU to provide the services of an apex organization through technical assistance and financial support, to promote regulation and supervision of credit unions by FCCU;
- Training NBKR staff in regulation and supervision of the credit union system.¹

3. This project was part of a broader effort to deal with the challenges of land reform, liberalization of commodity prices, privatization and the collapse of some state-owned banks which had been the major providers of financial services in rural areas. Three specific initiatives

¹ RRP: KGZ 28395 *Proposed Loan to the Kyrgyz Republic for the Rural Financial Institutions Project* (July 1997).

were undertaken to address the dearth of credit and absence of savings mobilization in rural areas in addition to the ongoing reform of the financial sector and the introduction of NGO-funded microfinance activities:

- The legal foundation for credit unions was introduced by Presidential Decree in November 1995, with the first three established as a pilot project assisted by the Asian Development Bank.² Upon successful completion of the pilot project, the Rural Finance Project supported introduction of credit unions across the country.
- The NBKR established the Savings and Settlement Company (SSC) to provide transfer and savings services throughout the country. The SSC began operations in July 1996 from a network of branches formerly belonging to collapsed state-owned banks. The SSC has a branch in every district and a regional office in each oblast, and a network of agencies operating in about 1000 post office branches. The World Bank is assisting with planned restructuring of SSC in preparation for privatization. SSC was licensed to engage in microfinance in 2005.
- The Kyrgyz Agricultural Finance Corporation (KAFC) was established in 1996 as a state-owned joint-stock company and began lending operations in 1997. Aided by considerable international technical assistance and funding, KAFC quickly grew into the largest single provider of credit in the country. Total credit extended by KAFC at end-2004 was equivalent to more than one-quarter of the credit extended by the banking system, which was supported by capital equivalent to about 12 percent of total capital in the banking system. There is an expectation that KAFC will be privatized in 2006.

4. These initiatives, combined with the provision of microfinance by five commercial banks through 44 lending outlets supported by the European Bank for Reconstruction and Development (EBRD) Micro and Small Enterprise Finance Facility (MSFF) and an additional lending facility provided by the ADB, and the emergence of over one hundred licensed microfinance entities, have resulted in a larger number and variety of sources of microfinance, and a higher volume of microfinance lending per capita than is found elsewhere in Central Asia.

5. The total of microfinance credit extended in the Kyrgyz Republic is equivalent to two-thirds of the conventional bank credit outstanding (Table 2), in sharp contrast to the usual situation of microfinance amounting to only a small portion of formal credit in the economy. In part this is due to the nascent state of bank development, but it is in part also due to efforts to stimulate rapid growth in microfinance. Many of the credit unions and microfinance organizations are very small, and a shakeout or consolidation is inevitable, as these organizations will have to grow to more sustainable sizes, or wither when financial incentives and technical assistance are reduced.

² TA No. 2453-KGZ; *Agricultural Credit Pilot Project*.

6. There is evident segmentation in the microfinance market, with credit unions and microfinance organizations having an average loan size of about half that of KAFC. This reflects KAFC support for relatively larger farmers, with credit unions and microfinance organization targeting smaller agricultural enterprises as well as activity outside the agricultural sector. Commercial bank microfinance loans are slightly larger again, with the average loan size of \$1,300 moving towards small business lending rather than microfinance. It is worth noting that the average loan size for commercial banks (excluding the EBRD MSSF) is equivalent to about \$6,600, so large loans in the Kyrgyz Republic tend to be quite small by international standards, which is quite consistent with an average bank size of about \$20 million total assets and \$3 million capital.

Table 2. Formal Providers of Financial Services, end-2004.

	Credit Unions	MCO	KAFC	SSC	Banks (MSSF) ¹	Banks ²
Number	305	104	1	1	5	19
Service locations	305	120 ³	54	48 ⁴	44	112
Borrowers	21,650	41,900	36,300	0	8,707	17,542
Loans (som millions)	440	785	1,528	0	470	4,813
Average loan size (som 000s)	20	19	42	--	54	274
Deposits (som millions)	3	0	0	414	0	7,569

¹EBRD Micro and Small Enterprise Finance Facility

² Commercial banks excluding Savings and Settlement Company (SSC), exclusive of MSSF program.

³ Estimate: Most microfinance organizations have only one location. The four largest (FINCA, Bai-Tushm, Kompanion and Leasing-Mortgage Company) account for 85 percent of loan volume.

⁴ Excludes agency offices in 1,000 post offices, which accounts for about 3 percent of SSC deposits.

Sources: NBKR, SSC.

7. The Government is currently preparing its medium term strategy for microfinance development. Credit unions have a central position in the current draft, in part because the segmentation in the microfinance market noted above suggests that credit unions serve a market differentiated from that served by other microfinance providers. In addition, some of the stakeholders providing input to are strong supporters of credit unions, both because credit unions collectively provide the largest number of delivery points of any type of microfinance organization in the Kyrgyz Republic, and because the World Council of Credit Unions (WOCCU) model of savings mobilization is widely endorsed by micro-finance practitioners. A serious concern with the approach to preparation of the microfinance strategy is that it has been largely driven by external consultants, and there is limited evidence, at least through the preparation of the August draft, of significant government leadership and commitment.

8. One particular concern that must be addressed in the microfinance strategy is mobilizing savings for sustainable provision of credit. Total loans extended by the formal financial sector at end-2004 were over som 8 billion, which were funded by less than som 8 billion total deposits (Table 2). This indicates a heavy reliance on donor funds and wholesale financing, which is evident in light of almost som 2.5 billion credit provided by non-bank institutions with virtually no deposit base (Table 2). While useful to stimulate development, the amount of growth this financing structure can support is limited. The credit union model of mobilizing savings is viewed by microfinance practitioners as particularly well suited to address this concern, although practical implementation in the Kyrgyz Republic remains an open question.

9. The challenge for credit union development in the Kyrgyz Republic is to address the outstanding questions regarding long-term sustainability. For the Government and ADB, exit from the Rural Finance Program at end-2005 is complicated because of the significant gaps that

remain in the supporting infrastructure for credit unions. The issue is whether some extension of the existing program or some transition provisions would help to meet the challenges of establishing an apex organization for credit unions, achieving sustainable self-financing, and implementation of an appropriate supervisory regime. The alternative would be to end the program as scheduled based on a determination that the outstanding issues would be better addressed in the context of the government's medium term strategy for microfinance.

10. The balance of this report addresses this question in the context of the Government's emerging strategy for microfinance. The next section of the report summarizes and analyzes the current situation. Section III identifies issues and section IV outlines possible options and their implications. The concluding section provides recommendations and an overview of the steps required to implement the recommendations.

II. CURRENT SITUATION

11. There have been varying degrees of success with the three main components of the rural finance project. In assessing progress, it is important to consider the challenges inherent in building a credit union system from scratch in a country with no history of market-oriented financial institutions. However, the cost effectiveness of the efforts to develop credit unions as a sustainable means of providing rural finance is called into question when considering the financial support provided. Despite over \$4 million in grants committed to date (Table 3), capacity within the credit union system and the framework for supervision has not met expectations. The grants provided are equivalent to about \$13,000 per credit union, or about \$175 per borrower. Although the loans provided are repayable and not all of the grant money has yet been advanced, credit union development has been supported by both grants and loans totaling over \$12 million to date, equivalent to about 90 percent of total credit union assets.

Table 3. Financial support for credit union development (\$)

	Total
ADB Rural finance program loan	9,949,000
ADB Capacity building in savings and credit unions grant	555,000
GTZ/DGRV	3,500,000
Soros Foundation; credit union manual and training	n.a.
Total	14,004,000

Source: ADB.

A. Credit Union Development

12. The most successful aspect of the project has been the introduction of credit unions in all regions of the country. The end-2004 out-turn of 305 with almost 28,000 members exceeds the original target of 280 credit unions, and matches the original objective of 28,000 members (Table 4). Gross formation of credit unions was much higher, with 175 licenses having been revoked to date. Comparing the out-turn for 2004 with the original projections for other success indicators shows that credit unions collectively are much smaller than had been originally forecast. In part, this reflects slower progress with mobilizing member contributions and slower drawdown of the ADB matching funds. In turn, this combined with some early problems with asset quality in credit unions to result in slower growth in institutional capital.

13. Reported financial results for credit unions are particularly impressive, with the return on average total assets far in excess of the original projections. This has been largely driven by the

need for credit unions to build institutional capital, and hence earn large spreads on their lending to members. There are concerns, however, that reported results may not be accurate, as credit unions may be misreporting the quality of their assets, and hence earnings, in order to continue to attract FCCU loans. There are further concerns that some credit unions were formed only to obtain FCCU financing, with phantom member share contributions. Estimates vary, but it seems likely that at least 100 credit unions (about 30 percent of the total) are not viable due to either fraud or incompetence. Persons active in microfinance estimate the potential number of truly successful credit unions to range between 40 and 60 (12 to 20 percent of the current total).

Table 4. Success indicators for rural finance program.

	Projected 2004 (Year 7)	Actual 2004
Number of credit unions	280	304
Total credit union members	28,000	27,707
Shares and institutional capital (\$ millions)	11	5.0
Credit union loans to members (\$ millions)	19	10.6
FCCU loans to credit unions (\$ millions)	8.75	5.0
Net worth/total average assets (percent)	67	42.3
Performing loans/total loans (percent)	90	97.5
Net income/total average assets (percent)	3.8	14.7

Note: End-2004 exchange rate \$1 = som 41.6

Source: Projections, RRP KGZ 28395, July 1997; 2004 actual, FCCU.

14. FCCU management maintains that earlier problems with credit underwriting and administration have been addressed. While there is a problem loan portfolio of just over som 30 million, these loss loans are fully provided for, and management is of the view that the balance of the loan portfolio is of much higher quality, evidenced by the reported 2.5 percent delinquency in the portfolio (exclusive of loans which are fully provided).

15. Despite the confidence of FCCU management, the reported delinquency may not fully reflect the potential for losses. First, loan volumes have been increasing rapidly, and it usually takes some time after the initial advance for delinquency to emerge with a problem loan. As the loan portfolio ages, problems may develop. Second, credit union repayment behaviour may be influenced by the continued availability of credit from FCCU. Credit unions may be less diligent about repaying existing loans to the FCCU without the carrot of potentially accessing large loans in future.

16. Despite some uncertainty about the underlying financial performance of the credit union system and the quality of the FCCU loan portfolio, there is a clear indicator that some credit unions are viewed as sustainable microfinance institutions—their ability to attract external funding on commercial terms from lenders other than the FCCU. Amounts owed by credit unions to institutions other than FCCU totaled at end-June som 20 million, seven percent of total credit union liabilities, reflecting that some credit unions are now viewed as reasonable commercial risks by institutions prepared to invest in microfinance.

17. Eleven credit unions account for 19 percent of the Kyrgyz investment portfolio of Frontiers, a for-profit provider of wholesale finance to microfinance organizations. The \$410,000 advanced by Frontiers to credit unions is equivalent to about 7 percent of the amount advanced by FCCU to credit unions at end-June 2005. Thus, despite unanswered questions about the number of credit unions that are truly sustainable, concerns over the framework for regulation and supervision and the lack of an apex organization, it is clear that the rural finance project has fostered the development of a small number of credit unions that have a strong future as microfinance organizations, even in the absence of the ability to mobilize deposits.

18. Credit union regional and national associations have met several times to develop their own vision or strategy for the future of the system, but as yet few specifics have emerged. The round table held September 21, 2005, resolved to create a single credit union alliance, which could result in a vehicle for the divergent credit union associations to present a unified position on important issues. At this same meeting, credit unions endorsed the concept of acquiring FCCU, and appointed a committee to coordinate the necessary work. However, it is clear that the key issues of valuation of FCCU and the mechanism for acquisition of shares by credit unions have yet to be addressed. Until there is a concrete proposal for credit unions to consider, it will not be possible to have a definitive view on credit union interest in and ability to acquire shares in FCCU.

B. FCCU Evolution Into an Apex and Divestiture

19. The need for an apex organization is widely acknowledged by credit unions. However, there is no consensus that FCCU offers a good vehicle for the provision of apex services. The credit union associations have discussed possible acquisition of shares in FCCU, but there is a degree of hesitance on two counts. First, in the absence of clarity about the process of divestiture by the NBKR, there is understandable reluctance to make firm commitments. Second, some credit union leaders have questioned whether it would be better to create a new entity to provide apex services, as opposed to trying to reform FCCU. There is no consensus on these questions.

1. Governance of FCCU

20. From the outset the ownership and oversight of FCCU and the incentives inherent in the loan program have not been conducive to achieving the objectives of establishing an apex organization. Management of FCCU has operated without strong direction and oversight. The NBKR has not exercised the stewardship expected of the owner of a specialized financial institution, viewing itself as the owner in form only, since FCCU in substance exists as an instrument of government policy. Government has looked to the NBKR to provide direction to the FCCU, notwithstanding that support for the development of credit unions lies outside the core functions of the central bank—pursuit of price stability and maintaining the soundness of the financial system. The oversight function of the supervisory board was supplemented by the steering committee for the Rural Financial Institutions project, but this external support and NBKR regulation and supervision is not a substitute for strong governance. These factors have combined to result in only partial attainment of the original Rural Finance Program objectives for FCCU.

21. Mid-course changes in program direction, while understandable in response to developments, have also contributed to uncertainty regarding the future role of FCCU. The turnaround plan identified the need to proceed with the development of apex functions, but it also identified that in line with a decision made in third meeting of the Steering Committee these apex functions should be limited to financial services such as liquidity management and payment system access. The development function was envisioned by the steering committee decisions as passing to a national association of credit unions.

2. Apex Functions

22. Despite the original intent of the program, and the re-dedication to apex development expressed as part of the mid-program turnaround plan for FCCU, the company to date has existed principally to administer the loan program, on-lending the ADB credit line. Training and

development activities have been implemented through GTZ/DGRV and FCCU does not currently have the capacity to offer ongoing training and consulting support to credit unions, nor is it able to offer products and services other than loans and leasing to credit unions.

23. The original intent of the program was that FCCU would fulfill the self-regulatory role played by system-controlled audit companies or stabilization funds in some countries. However, given the shortcomings in FCCU's supervision identified in mid-program reviews, the decision was made to pass the supervision function to the NBKR. This inevitably led to some duplication and loss of momentum, as FCCU attempted to strengthen its own capacity in the interim period before responsibility was formally transferred to the NBKR with effect from July 1, 2005.

3. Financial Performance

24. Concern over the lending practices and financial performance of FCCU led to changes in the loan agreement in 2003 to introduce, among other things, changes to the restrictions on external borrowings, which were incorporated into the norms for credit unions (see Appendix 1). These same concerns had also led to several efforts to improve the performance of FCCU (Box 1). There has been some success in improving the financial performance of FCCU after the mid-program "crisis" and turnaround plan. However, failure to develop apex functions and continued high operating expenses overshadow reported progress in improving CU loan performance, which in any case is attributable to growth in the loan portfolio rather than to a reduction in the volume of adversely classified loans.

4. Divestiture

25. Credit unions have discussed in general terms the possibility of acquiring an ownership share in FCCU, and FCCU management has initially explored other divestiture options, but no substantive progress has been made towards divestiture. An action plan leading to the divestiture of the NBKR ownership of FCCU to credit unions was included in the turnaround plan developed in the second half of 2004 with ADB assistance. However, many of the measures included in the turnaround plan to prepare for privatization were not within the power of FCCU management or the supervisory board, for example, the conversion of FCCU into an open joint stock company. Even if the supervisory board had formally considered the turnaround plan on a timelier basis, there was no single body or group with a clear mandate or legal capacity to carry forward the necessary work. Thus, it is unsurprising that there has been little progress on this issue. After the passage of a year, it is clear that divestiture of an ownership share in FCCU to credit unions is not possible by end-2005.

C. Regulation and Supervision

26. The current status of regulation and supervision of credit unions is unsatisfactory. The mid-program decision to transfer the supervision function from the FCCU to the NBKR was predicated by the need to address the lack of effective supervision, and the concern that conflicts with FCCU's development objectives would preclude effective supervision. On-site examinations by FCCU began only in 2004. Transferring the supervision function from FCCU to the NBKR emerged from discussions of the 2004 Turnaround Plan, however the NBKR assumed responsibility for supervision only from the first of July 2005. Despite this formal transfer of responsibility, the NBKR is still not able to conduct the planned on-site examinations of credit unions, and the off-site reporting system is still in development.

27. In retrospect, it is clear that in addition to the loss of momentum arising from the delay in implementing the decision to transfer supervision from FCCU to the NBKR, there had been insufficient attention given to the implications of this decision. The value of technical assistance provided to train inspectors in FCCU has largely been lost. FCCU has retained the bulk of its former examination staff in new roles. The NBKR indicates that only two former FCCU staff had applied for positions, with one of these deemed a suitable candidate and offered a position. While the presumption underlying the transfer of supervision from FCCU to the NBKR may have been that staff would be transferred en bloc, this was never specified, and perhaps was unrealistic from the outset as it involved individuals who would have to elect to leave one employer and join another, and the new employer deeming them suitable. Enforcement of headcount limits on FCCU may have encouraged more trained examination staff to apply to join the supervision function of the NBKR, as the prospect of losing employment with the FCCU may have prompted these staff to seek positions elsewhere.

Box 1. FCCU Governance, Management and the Turnaround Plan

Prior to 2004 FCCU was not subject to specific operational performance targets. A number of financial targets were jointly developed and approved by the NBKR, FCCU and ADB in December 2003 for implementation in 2004. At least three of the four performance targets for the first half of 2004 were met, however the ADB and FCCU have different perspectives on this evaluation. Imprecise target definition and questions over data have resulted in FCCU management viewing the targets as fully met despite the lack of clarity. Regardless of whether the targets were met, it is clear that improvements in asset quality and operating efficiency were due to rapid growth rather than reductions in non-performing assets or expenses.

The Turnaround Plan developed in October 2004 included a wider range of performance targets, however, many of the performance indicators of the turnaround plan were vague and difficult to measure (e.g. increasing professional skill of employees, healthy moral in staff); or inconsistent with stated objectives (e.g. 10 percent increase in personnel expenses in 2005 despite planned transfer of supervision to NBKR and intended headcount reduction) or beyond the scope of FCCU management alone (e.g. re-registration into a joint stock company, issuance of shares to credit unions and retention of a controlling position by NBKR for 2-3 years).

The indicator of reducing staff has not been met. Despite the transfer of supervision to the NBKR with effect from July 1, staff of the FCCU has not decreased. Rapid growth in loans and total assets has enabled the FCCU to meet most ratios established as indicators of financial performance without having to address the underlying concerns of overstaffing and high operating expenses, as illustrated by comparing actual results to the Turnaround Plan forecast balance sheet and income statement for the FCCU (table below). Improvements in financial performance are attributable to increasing net interest income and growth in the loan portfolio. Non-interest expenses in absolute terms continue to increase, as does the quantity of adversely classified loans (substandard, doubtful and loss totalled som 34,378 at end-June 2005, versus 30,694 at end-2004).

FCCU Performance Indicators (som 000s)

	end-2003	end-2004		June 2005	
	actual	forecast	actual	forecast	actual
Total assets	218,712	296,159	294,890	341,914	327,758
Net interest income	18,286	24,193	24,502	13,229	14,074
Personnel expenses	7,379	6,276	8,809	3,457	4,964
Total operating expenses	13,722	10,927	13,996	6,202	8,154
Loan loss expenses	2,357	5,540	6,286	2,339	2,454
Net income	7,469	8,240	7446	5,659	5,832

Sources: Forecast—Turnaround Plan Basic Financial Indices of FCCU Performance; Actual—FCCU audited financial statements.

28. Two NBKR staff positions are dedicated to credit union off-site supervision, supplemented by a portion of one staff position in each NBKR oblast office. Reporting requirements have just been changed for credit unions with a view to making them compatible with in-house designed software for credit union monitoring, although the regulation implementing the new reporting requirements has not yet been promulgated. Thus, NBKR's off-site monitoring system is not yet operational despite the provision of technical assistance. In line with technical assistance provided by the ADB (Larry Hendricks) there are plans to establish a non-bank inspection division of nine staff, which would conduct on-site examinations beginning in November 2005.

29. When the non-bank supervision department is fully staffed, the combination of on-site and off-site resources will be 16 positions in head office, plus the oblast office shared positions. This group will be responsible for microfinance organizations as well as credit unions. Over 100 on-site examinations of credit unions are planned for completion each year. This would consume more than two thirds of the resources of the non-bank financial institutions department, and be equivalent to about one-third of the resources devoted to bank supervision. This commitment of resources is inconsistent with the risks posed by credit unions. Credit unions that do not take deposits function essentially as microfinance organizations, and adopting a similar regulatory and supervisory approach to that applied to microfinance operations could result in better matching supervisory resources to the risks posed.

III. ISSUES

30. The issues and options for credit union development, the future of FCCU, and the regulation and supervision of credit unions are not new and have been widely discussed, although not resolved, over the last several years. In deciding on the best course of action as the end of the project approaches, it is important that the need to divest FCCU should not become a substitute for a strategy for credit union development, consistent with the government's broader strategy for microfinance. The course of action adopted should take into account three specific considerations:

- A vision of the future role of credit unions, which in turn, which in turn should drive recommendations for FCCU, and proposals to enhance regulation and supervision
- Consideration of the broader aspects of microfinance development
- Avoiding a repetition of the design and implementation issues experienced with the program to date

A. Future Role of Credit Unions

31. Credit unions are a central part of government's emergent strategy for microfinance. On the basis of reported data, they account for about one-sixth of the total aggregate loan portfolio of non-bank financial institutions and have by far the largest number of lending offices. Over 40 percent of credit union loans are extended outside the agricultural sector, indicating that credit unions are an especially important credit source for small traders in rural areas. For this reason credit unions are seen to fill an important niche despite the wide variety of existing microfinance providers. However, as noted previously, the number of truly sustainable credit unions is likely far lower. Thus, despite conceptual view of credit unions as being well positioned to meet the need for village level finance because they are locally owned and thus able direct credit where

needed, the ability of credit unions to fill this role in practice in the Kyrgyz Republic is far from certain.

32. The present state of development of credit unions calls into question its long term sustainability. Without deposit mobilization, credit unions are effectively limited to operating as microfinance entities. Some credit unions have been able to attract financing on commercial terms, but most remain dependent on member shares and the financing provided by FCCU.

33. Mobilization of deposits permits credit unions to reduce their funding costs, but perhaps more importantly, permits credit unions to develop into institutions providing a limited range of essential financial services instead of only credit. Currently, net savers leave the money under their mattresses or go elsewhere for savings products, therefore limiting the credit union to a type of self-help rotating credit activity, supplemented by externally borrowed funds. Offering deposits has the potential to greatly expand credit union participation. Similarly, the ability to offer transfer and payment services could attract additional business to the credit union. However, the market niche for credit unions to provide savings and transfer services may be limited by the outreach of SSC, which already has the necessary infrastructure in place. Provision of cost-efficient payment services may prove very challenging for credit unions in competition with SSC.

34. The rather unique approach taken in the Kyrgyz Republic to credit union development, attempting to establish credit unions without savings mobilization, has its origins with decision to proceed with the Rural Finance Program despite the reluctance of the NBKR in 1997 to have credit unions accept deposits. While concerns over the activities of some credit unions established under the program have helped to sustain the NBKR's view, the fact that it had been opposed to credit unions accepting deposits prior to their creation means that this could not have been the original cause.

35. Under the WOCCU model, savings mobilization is essential for credit union viability. However, the presence of ADB external financing has meant that Kyrgyz credit unions have been viable without the need to raise deposits, and except for the now concluded pilot program of ten credit unions, credit unions have not been licensed to mobilize deposits.

36. External finance through FCCU has provided a useful stimulant to credit union growth, but as clearly indicated in the original program design, credit unions will ultimately have to mobilize savings in order to bring down costs of credit and finance growth of their loan portfolios. Individual credit unions are generally too small to make direct lending by international financial institutions or donors attractive, but the use of an intermediary like FCCU adds another layer of cost. This explains the interest rate differential between KAFC loans and credit union loans, as FCCU has to earn a sufficient spread to cover its costs.

37. It is clear that if credit unions are to play a major role in microfinance, they will need to mobilize deposits. This would be best accomplished by realizing the benefits that can come from operating as a true credit union system rather than a collection of individual credit unions. This would require a common information technology platform and shared product development, among other things.

38. An alternative to continuing with efforts to develop credit unions is to conclude that building the infrastructure would take too long or be too costly relative to alternative approaches to microfinance. The logical corollary would be to focus on the development of alternative models of microfinance. Existing credit unions would convert to or affiliate with microfinance

organizations. Purchase by credit unions and development of apex functions would not figure in the future of FCCU, so the focus would be solely on a divestiture process that would maximize the return to government.

39. A decision to require credit unions to convert to microfinance organizations should be taken in the full recognition, however, that any concerns that exist on the part of the NBKR with respect to the potential for fraud or pyramid schemes exist with any entity, whether licensed as a credit union, microfinance organization, or whether it is an unlicensed entity. No system of licensing and supervision can prevent illegal activities, and the spuriousness of the suggestion that this should be an objective of prudential supervision is evident if the logical extension of the argument is considered. If such measures were truly effective in preventing illegal activities, then all businesses and individuals should be subject to periodic inspections to ensure that they do not violate the law.

B. Future of FCCU

40. The impending deadline for divestiture by the NBKR is not a substitute for a strategic view of the future of FCCU. Divestiture by year-end will not resolve ultimate future of FCCU, as the only options that might be completed in the short time available are divestiture to some other government entity. Thus, there would still be a need for a privatization strategy which would require decisions to be made on the future role of FCCU, and there is a risk that a near term effort focus wholly on meeting the legal requirement of divestiture by the NBKR would divert attention from the resolution of the future role of FCCU.

1. Viability

41. A critical question for in deciding the future of FCCU is its valuation, which is principally determined by the quality of its loan portfolio. If the quality is as reported, then the value of FCCU will approximate its book value (reported assets less reported liabilities). Should the audit of the loan portfolio that will be required as a prelude to privatization indicate that further provisions are required, the value of FCCU could be substantially less. At end-June 2005, downward revisions in the value of loan portfolio of eight percent would have reduced the book value of FCCU to zero. Stated another way, FCCU's book value would be zero if loss loans are 17 percent of the portfolio rather than the reported 10 percent.

2. NBKR Ownership

42. Ownership of either a credit union apex or a vehicle to administer a development loan program is not compatible with the objectives of a central bank—price stability and the soundness of the financial system. However, acknowledging the incompatibility of ownership of FCCU with the NBKR's mandate should not necessarily preclude pragmatic solutions to the impending year-end deadline. Would it be better for NBKR ownership to continue for a further defined period while the divestiture options are further explored, thus avoiding a two step process of divestiture by NBKR followed by implementation of the substantive privatization plan?

43. One option suggested by the NBKR is that ownership be transferred to the State Property Fund. This would meet the legal requirement for NBKR divestiture, and might preserve other options as the business of State Property Fund is to sell government assets. The privatization process orchestrated by the State Property Fund should not preclude credit unions acquiring FCCU, or any of the other possible divestment options that have been discussed.

44. Another option for divestiture would be transfer of ownership to an implementation unit or microfinance strategy unity within the Ministry of Finance or elsewhere in government. This option might be well aligned with the government focus on microfinance, as it would place responsibility for the future of FCCU with a body responsible for implementation of the microfinance strategy. The State Fund for Entrepreneurship under the Ministry of Finance already has a mandate to support the development of small and medium sized enterprises through the provision of microcredit, and is also liquidating the portfolio of the former State Fund for the Development of the Economy.

45. Regardless of the divestiture option and timing, there will be a need to value FCCU for disposition purposes. The Chairman and board of the NBKR have a fiduciary responsibility with respect to the investment in FCCU, meaning that any transfer of the shares or assets of FCCU would have to have some substantiation of the transfer value. Audited book value could be a reasonable basis for transfer, but this might be problematic. For example if there was a desire to transfer FCCU ownership to another state entity, as the implication is that an entity such as the State Fund for Entrepreneurship would have to pay the NBKR in excess of som 20 million to effect the transfer. It is possible that credit unions may be prepared to invest in FCCU based on audited financial reports alone, but this seems to lack appropriate due diligence. FCCU management suggests that the valuation of the company could actually be in excess of book value, based on future cash flow expectations. It seems unlikely that any purchasing party would agree to a price without external substantiation of the value.

3. Credit Union Interest in FCCU

46. It is not clear if credit unions would actually pursue ownership of FCCU. Despite the stated commitment of credit unions participating in their strategic planning process to purchase FCCU at book value, leaders of the credit union associations have made conflicting statements. Even if those making the most positive expressions of interest represent a prevalent view, it would take time to prepare and implement this option. The original project plan had been that credit unions would over time invest five percent of their capital in FCCU. Even if credit unions decided through the process of finalizing their strategic view in December to purchase FCCU, and other were put in place, implementation could not take place before mid-2006 because credit unions would have to approve the investment at their annual general meetings.

47. Credit unions appear to have the financial capacity to purchase FCCU (Table 5), however commitment of 15 percent of capital to an investment in FCCU would have a detrimental effect on the efficiency of the financial structure of credit unions. This would result in a large reduction in earning assets, as the resources would have to be diverted from loans to members. Also, it is unlikely that all credit unions would choose to exercise the option to purchase. A scenario of credit unions accounting for half of aggregate total capital opting to invest five percent of their capital in FCCU shares would result in a minority investment in FCCU, assuming that FCCU’s asset quality and hence its book value is as reported.

Table 5. Capacity of credit unions to purchase FCCU (som 000s)

FCCU book value end-June 2005	22,167
Credit union aggregate total capital (shares and institutional capital)	257,070
Maximum investment (15 percent of total capital, Norm N3)	38,560

Source: FCCU.

48. Credit unions have been discussing various minority shareholding options. One possibility would be for the NBKR (or preferably other government shareholder) to continue to hold a majority share for several years, with credit unions gradually purchasing the rest of the ownership stake. A variation on this alternative is to seek a strategic investor to hold the stake not purchased by credit unions.

49. Credit unions have two possible motivations to purchase FCCU. One is to gain control of the entity providing external finance, as even with the termination of the ADB loan, FCCU may have a viable ongoing refinancing business. As owners of FCCU, credit unions would be better placed to ensure it caucused on low cost provision of services, thus reducing the lending rates to credit unions. A second motivation could come from the conclusion that FCCU provides a reasonable basis to provide the services of a credit union central.

4. Does Ownership Affect Repayment?

50. An important consideration for the Government is whether repayment of outstanding loans by credit unions is influenced by who owns FCCU. Government will honour the debt to the ADB, and it can only do so without adverse fiscal implications if credit unions in turn repay the on-lent funds. Some stakeholders have suggested that repayment by credit unions is only possible with a new or extended rural finance program.

51. If repayment of the current debt is only possible through providing additional loans, then the objectives of sustainability are not being met. It would be better to end the program as scheduled rather than provide further lending that would only support ever-greening of funds already advanced.

52. In theory, credit unions should make the same efforts to honour debts regardless of the ownership of the creditor. In practice, credit union ownership might enhance the longer term repayment prospects as credit unions would have an interest in protecting their investment in FCCU and seeing it offer products and services on a cost effective basis.

53. Some stakeholders have suggested that government ownership of FCCU would worsen repayment prospects, as credit unions would feel less obligation to repay government than another owner. It is not clear that there should be a distinction between NBKR and another arm of government in this regard. If government ownership (either directly or through NBKR) truly undermines repayment prospects, then it has only been the prospect of obtaining additional loans from FCCU that has prompted credit unions to repay to date. Since FCCU is likely to be able to continue to provide financing to credit unions even after the end of the rural finance program, this incentive should continue to be in place.

5. Apex Options

54. It is important to consider that a vision of a central role for credit unions in microfinance does not mean a single option for FCCU. The needed apex to support credit unions does not have to be FCCU. Credit union leaders have already indicated that they will need to weigh costs of restructuring/reforming FCCU to provide the services they need against the costs of alternatives.

55. FCCU has a high cost base and would require significant additional assistance to be able to provide the services credit unions want and need:

- centralized treasury and liquidity management
- standardized IT platform
- payment services
- consulting services to support standardized product development
- management training and development

56. Credit unions have already discussed the option of establishing a separate services company for information technology, and the use of the emerging Alliance of Credit Union Associations as the platform for consulting services, training and development has been discussed. There also may be options for a commercial bank or other financial institution (for example, SSC) to provide some or all of the needed services, potentially at lesser cost.

57. Credit union ownership of FCCU could be beneficial in developing the credit union system. As owners, credit unions would be expected to pressure FCCU for efficient and low cost provision of services. However, there are risks. One is that the direction of FCCU is dominated by a few strong credit unions or an association, leading to preferential or sub-optimal allocation of resources. There are also risks from the lack of professional capacity in the credit union movement to oversee development of centralized provision of services. This has been recognized by some credit unions leaders, which is why they have proposed continued significant shareholding by NBKR or the participation of a strategic investor, who would provide then needed stewardship for FCCU.

6. Strategic Investors

58. A strategic investor could help to ensure that FCCU does focus on the development of centralized services, and provide professional capacity to support this work and ensure a properly functioning supervisory board. However, the small size of FCCU (current book value is about \$530,000) makes it an unattractive investment for an international financial institution such as the ADB.

59. An investment in a quarter or even 49 percent of FCCU would also likely be too small to be attractive to organizations like Raiffeisen or Rabobank who might be motivated by mix of philosophic support for cooperatives and commercial interest. Likely strategic investors, or potential purchasers of a controlling interest, would therefore probably be limited to local and regional financial institutions or commercial entities. It is not clear that these investors would provide the desired focus on development of centralized services, or provide the needed professional capacity and strong governance.

7. Governance and Oversight of FCCU

60. One of the major challenges in any interim arrangement is to ensure appropriate incentives and oversight of FCCU pending final resolution. Continued majority holding by the NBKR or another government agency runs the risk of a continuation of the weak stewardship that has been in evidence throughout the life of FCCU. Once the rural finance program ends, ADB no longer has a direct voice in the disposition of FCCU.

C. Regulation and Supervision

61. Despite extensive technical assistance, the envisioned supervisory regime for credit unions still has very significant shortcomings. The original project called for FCCU to exercise most supervisory authority, under the overall direction and responsibility of the NBKR. This was

intended to replicate the role played in many countries by a system-owned auditing association or stabilization fund. The original design of credit union regulation and supervision was predicated on the WOCCU model of savings mobilization, which requires prudential oversight to protect unsophisticated depositors. From the outset, however, the reluctance of the NBKR to have credit unions accept deposits meant that in practice, prudential oversight existed as a measure to safeguard on-lent funds.

62. When the anticipated system of on-site and off-site supervision by FCCU was not implemented some five years into the program, a decision was taken to transfer responsibility for supervision to the NBKR, in effect revoking the delegation of powers that had initially been established. While it has been suggested that there is an inherent conflict between the development mandate of FCCU and supervision of credit unions, this conflict is not as sharp as it may initially appear. The expectation that FCCU will prudently administer a loan portfolio is not wholly divorced from the concept of supervision, and in fact, it might be reasonably expected that FCCU would exercise effective supervision through loan terms conditions and monitoring of those credit unions that access loans. Thus, the failure to establish the intended supervisory regime is attributable to poor execution on the part of FCCU management as well as the chosen institutional structure.

63. Building supervision capacity, whether in FCCU, the NBKR, or elsewhere was and remains a significant challenge. As noted earlier, transfer of responsibility for supervision from FCCU to the NBKR without also transferring staff who had benefited from technical assistance in supervision has compounded the more general problems of attracting and retaining skilled staff. Despite the acknowledged difficulties, some CU leaders advocate a further change to introduce a measure of for self-regulation. Changing the institutional arrangements for supervision again would only lead to a further loss of momentum, so the near term objective should be to establish an effective regime within the NBKR.

64. In establishing an effective regime in the near term, the NBKR would be helped by revisiting the approach to regulation and supervision of credit unions (Box 2). Rather than purporting to apply a “bank-like” model of extensive off-site reporting and on-site examinations, while not effectively implementing the regime in practice, the NBKR and the public would be better served by a regime using tiers of regulation and supervision, depending on the credit union’s source of funding. This approach is reflected in the current Kyrgyz microfinance law and could be applied to credit union regulation and supervision.

65. Use of a tiered regime does not imply that regulations should not be strictly enforced. Failure by credit unions to meet ongoing licensing and reporting requirements should lead to sanctions and ultimately forced liquidation. This will help to spur the inevitable consolidation in the sector.

66. Even with consolidation in the credit union system, use of a tiered approach to regulation and supervision would go a considerable way towards addressing the practical problem of how to supervise a relatively large number of mostly small credit unions. The rationale for this approach is evident when considering the rationale for regulation and supervisions of entities, and has already been applied in developing the tiered approach to microfinance supervision.

67. The main reason for prudential regulation is to preserve the safety and soundness of the financial system. This rationale for prudential regulation would only apply as credit unions become significant in size and gain access to the payment system—if and when they grow into bank-like institutions, distinguished only by their cooperative ownership. Should the reach this

point, they should be subject to bank-like regulation. However, while they remain systemically unthreatening, a lighter supervisory touch would foster development.

68. Protection of unsophisticated depositors is a second rationale for prudential regulation and supervision. For credit unions, concerns in this regard can be somewhat mitigated relative to banks or microfinance companies when credit union depositors are also owners, and thus able to directly influence the election of directors. However, there are parallels between the need to protect unsophisticated depositors in credit unions and other deposit-taking institutions as many credit union members lack financial acumen, especially if credit unions are permitted to raise deposits from non-members.

Box 2. Regulation and Supervision of Credit Unions

Determining international best practices for the regulation and supervision of credit unions is complicated because there are three standards that might apply, depending on the national definition of credit union.

In development work, the most widely cited international best practices for credit union oversight is the WOCCU PEARLS system. The WOCCU model is predicated on credit unions mobilizing savings. Adherence to the PEARLS recommended standard of zero external borrowings (Appendix 1) would actually have precluded the financing provided to credit unions under the Rural Finance Program, so it is clear that the WOCCU model requires some adjustment if it is to be applied to credit unions not mobilizing deposits.

An alternative best practice applicable to credit unions which do not actually mobilize savings and thus rely on external financing, as is the case for credit unions in the Kyrgyz Republic, derives from the now accepted commercial approach to microfinance. A tiered structure for regulating microfinance has become widely endorsed (for a summary see Inter-American Development Bank, 2004, *Principles and Practices for Regulating and Supervision Microfinance*), recognizing that the two rationales for prudential oversight, protection of systemic stability and of unsophisticated depositors, do not apply to small entities that do not take deposits.

Credit unions or cooperatively-owned banks in many countries have become sophisticated deposit-taking institutions, distinguished primarily by their ownership structure. In these cases, the Basel Core Principles for Effective Banking Supervision is the relevant international standard, recognizing both the potential systemic implications of institutions participating in the payment system, and the need to provide some protection to unsophisticated depositors, even if the depositors may also be owners.

In many countries some responsibility for supervision is entrusted to a credit union system-owned entity such as an auditing association or a stabilization fund. These arrangements have generally been developed over many years, and benefit from the member credit unions' collective self-interest in protecting the credit union brand and minimizing their own exposure to loss through claims on the stabilization fund to resolve weak credit unions. These approaches are applicable in either the WOCCU or bank-supervision model, but do not apply in the micro-finance model due to the lack of collective self-interest among microfinance organizations.

69. It is sometimes suggested that prudential supervision is required to prevent credit unions from undertaking illegal activities such as pyramid schemes or defrauding customers or creditors. These suggestions are based on the ill-founded premise that it is somehow possible through on-site inspections to prevent illegal activities. It is widely accepted that prudential

regulation cannot and should not prevent all manner of undesirable activity.³ Prudential regulation and supervision is required to protect the soundness of the financial system and the interests of depositors. Protection from other undesirable activities should be provided by the more general framework of civil and criminal law.

70. In order to strike the balance between fostering growth and protecting unsophisticated depositors, credit unions should be subject to a continuum of regulation similar to that applied to microfinance:

- Credit unions using only member shares should be subject to a light regime consisting primarily of licensing and periodic reporting. Only about 20 currently active credit unions fall in this category.
- Credit unions using external finance such as donor funding or bank financing should also have a light regulatory regime, with the sophisticated donors or financial institutions being expected to exercise due diligence in the protection of their investment. In the case of credit unions borrowing from FCCU, loan terms, conditions and monitoring would comprise the primary means of oversight. Almost all credit unions currently would fall in this category.
- Credit unions mobilizing deposits should be subject to a similar regulatory and supervisory regime as that applied to microfinance organizations accepting deposits

71. Following the approach of the microfinance law, the NBKR's scarce supervisory resources should be focused on any credit unions taking deposits. Credit unions not taking deposits should be subject to a regime consisting primarily of licensing and periodic reporting. Credit unions taking deposits should be subject to prudential norms, more frequent reporting, and a program of on-site examinations.

IV. OPTIONS

72. Broadly speaking there are two options to exit from the rural financial program: ending the program as scheduled without an extension or transition provisions; or provision of a limited additional time period and/or transition provisions. There is unlikely to be further substantive progress on the outstanding objectives of developing an apex or establishing effective supervision and regulation during an extension. It is also important to consider that the end of the program will not cause any immediate contraction in credit unions. A shakeout may well occur, but any credit unions that are currently viable will not suddenly lose viability at the end of the program.

³ See, for example, Government of Australia (1997), *Financial System Inquiry Final Report* ("the Wallis Commission"), especially Chapter 5; Government of Canada (1998), *Improving the Regulatory Framework*, Background Paper #5 (MacKay Task Force on the Future of the Financial Services Industry), especially pages 7-8.

A. Rural Finance Program Ends as Scheduled end-2005

73. Ending the program leaves open the question of the future of FCCU and the development of an apex institution. The end-December deadline for divestiture of FCCU by NBKR would have to be addressed, either by extension of the time period for NBKR divestiture, or by transferring the ownership to another government entity. Privatization or liquidation of FCCU would have to follow in due course, and the option of credit unions acquiring an ownership stake, or any other privatization option, would remain open.

74. The principal concern in many quarters is that the end of the program will lead to an immediate contraction of credit unions. Should this occur, however, it will not be as a direct result of the end of the program, as many stakeholders mistakenly equate the end of the program to an abrupt withdrawal of funds from the credit union system. The planned repayment by FCCU over the remaining 13 years of the 20 year term of sub-lending agreement provides the foundation for a viable business for FCCU, which could continue to providing financing for credit unions as long as asset quality remains adequate (Box 3).

75. If a major contraction in credit unions occurs it will be because the increasing flow of matching lending funds from FCCU has obscured inherent weaknesses in the credit union system. Stakeholders widely acknowledge that some credit unions are already dormant and that others are not viable. It is not clear how large a credit union system is sustainable solely on the basis of member shares and external financing. Ability to mobilize deposits would enhance sustainability, but even with this there will be an inevitable shakeout. It would be better for this shakeout to occur now rather than to keep credit unions without prospects for long term viability alive through a continued flow of FCCU financing.

76. The NBKR would continue the implementation of credit union supervision with the currently committed resources. This would probably not result in a recasting of the approach to supervision to have a light regime for credit unions not taking deposits, but the practical problem of how to supervise over 300 credit unions would begin to fix itself as the number of credit unions declines. Without the incentive of FCCU loans, few new credit unions will be founded, and the pace of voluntary wind-up and license revocation will increase.

77. The likely outcome of such a scenario is a smaller credit union system which would in future be overshadowed by more rapid growth of other providers of microfinance. The more successful credit unions, if unsuccessful in obtaining a deposit license, would likely seek to convert to microfinance organizations. This would free them from the credit union restrictions on external borrowing, enabling them to grow as microfinance entities. The fact that some credit unions are already attracting external finance from sources other than FCCU, most notably Frontiers, indicates that this will be a viable option for part of the credit unions system.

Box 3. FCCU's Ability to Repay

The crucial factor determining FCCU's ability to repay the loan to the Kyrgyz Government is the quality of the portfolio of loans outstanding to credit unions. If asset quality is as reported, then FCCU should be able to sustain an ongoing refinancing business while repaying the rural finance program loan, even without new financing sources. The volume of credit union loans outstanding would decline slowly, leading to a gradual reduction in credit union dependence on FCCU financing.

Worse than reported asset quality will not initially impair FCCU's ability to repay the loan, since loan loss provisions are a non-cash expense. However, reductions in earning assets and cash earnings would cause FCCU's resources to be consumed to cover expenses, and FCCU would have to reduce its refinancing activity. This could lead to a sharp withdrawal of funding from credit unions, as FCCU would have to focus solely on loan collection rather than being able to continue to provide refinancing.

FCCU anticipates having cash and term deposits available to meet credit union demand for new loans in 2006 and begin repayment of the loan to government, with these cash resources supplemented by repayment of existing loans. If the remaining balance of the ADB loan is fully drawn by end-2005 (a rate of drawdown consistent with performance since end-2003), FCCU's other assets remain constant at end-June 2005 levels, and there is no increase in adversely classified loans, in 2006 FCCU will have net loans outstanding to credit unions of som 331 million, total assets of som 385 million and debt to the Kyrgyz government of som 362 million.

Even without reducing non-interest expenses below the 5.4 percent of average assets achieved in 2004, given its current cash resources and expected credit union loan repayments, FCCU would be able to make loan payments (Scenario 1). At the same time, FCCU could continue to provide some refinancing for credit unions, financed by the recycling of funds from loans being repaid and existing cash resources, as the total of these sources exceeds the shortfall of earnings over the required loan repayment.

The ability of FCCU to make loan payments and continue supporting credit unions increases if non-interest expenses are held constant at the som 14 million level incurred in 2004 (Scenario 2), and even more so by achieving the level of 3 percent of average assets originally projected under rural finance program (Scenario 3). Each scenario assumes that the spread between the rate of interest earned on the loan portfolio and paid on the outstanding loan from the Kyrgyz republic remains constant at current levels and loan loss provision expenses are equal to two percent of the portfolio. Non-interest income will be negligible once FCCU is no longer receiving the grant portion of the rural finance program.

FCCU projected income and expenses, 2006 (som 000s)	Scenario 1	Scenario 2	Scenario 3
Net interest income	33,122	33,122	33,122
Loan loss provision expense	6,620	6,620	6,620
Non-interest expense	20,814	13,978	11,564
Net income	5,688	12,524	14,939
Loan repayment due (13 year straight line amortization)	27,828	27,828	27,828
(Shortfall)/surplus of earnings over loan repayment	(22,140)	(15,304)	(12,890)
Memo items: FCCU cash resources at end-June 2005	47,833		
Credit union loans repaid, January-June 2005	23,046		

Source: Estimated based on FCCU audited financial statements.

B. Possible Extension of Program or Transition Provisions

78. If an extension or transition provisions are contemplated as part of the exit from the rural finance program, the key question is how to keep good money from following bad? Despite the success in establishing credit unions, there is little progress to show for time and money invested in the framework for regulation and supervision and the attempts to build an apex. Are

there measures than might lead to progress on the unmet objectives of the program, and are conditions that might lead to more successful outcomes?

79. Some stakeholders would like to see additional financial support for loans to credit unions. This should not be considered until the shortcomings with the infrastructure for sustainability—apex functions and effective supervision—are addressed. The objectives of starting credit unions and attracting members have been met, so the near-term focus of any additional support has to be on sustainability. Even if there is a shakeout that results in a substantial reduction in the number of credit unions and members, creation of a smaller sustainable system is a better achievement than a larger system surviving only due to an ever-increasing flow of external financing.

80. Decisions on the future of FCCU are dependent on an assessment of its value. If an independent review were to determine that the loan portfolio was significantly weaker than currently reported, neither credit unions nor any other investor would be willing to purchase FCCU. Thus, the decision process is to first determine the value of FCCU, then have credit unions determine if they would purchase all or part of the company. If credit unions will not purchase FCCU, but it does have positive value, then it would be divested by tender. If FCCU is ultimately determined to be insolvent on the basis of an independent assessment of its value, then its assets would be passed to an appropriate agency such as DEBRA for liquidation. In order to proceed quickly a number of the steps required to move towards divestiture can be undertaken concurrently.

81. A major issue to be addressed in any extension or transition period is the oversight of FCCU. Extension of NBKR ownership or an interim transfer of ownership to another government entity is likely to result in a continuation of lack of stewardship and strong direction for FCCU. One way to address this might be to make any extension conditional on a meaningful business plan for FCCU that would include a true focus on improving efficiency. This direction would be helpful regardless of the final decision on privatization as it would position FCCU for other divestiture options such as sale to a financial institution, as well as making it more attractive for credit union purchase. Targets for FCCU performance have to be proxies for true stewardship by the owner during the transition or extension period, as history to date illustrates that lack of oversight of FCCU has been a problem.

82. The question of providing apex services to credit unions remains open. It would be better to defer any further efforts to develop these in FCCU until there is a firm decision on its future ownership. If credit unions do acquire ownership, then additional support might be provided for apex development in FCCU. If credit unions opt not to acquire an ownership interest in FCCU, then it would be better to pursue alternative means of providing apex services. Further investment in attempting to develop apex services in FCCU may well be wasted at this time.

83. Extensive work has been done already on regulatory proposals, so in theory these could be moved ahead quickly with NBKR commitment. However, the NBKR remains at best lukewarm about deposit taking by credit unions, being more concerned about the potential for political blame in the event of pyramid schemes or the collapse of a credit union leading to loss by depositors. While the concerns are understandable, the NBKR must strike a balance that permits the mobilization of deposits in rural areas if microfinance is to become sustainable.

V. RECOMMENDATIONS

84. Government, as outlined in its emerging microfinance strategy, will want to further support the development of credit unions. This implies that providing apex services and an appropriate regime for regulation and supervision will be government priorities. Some incremental progress on regulation and supervision can be achieved before the end of the rural finance program, but further substantive progress towards the unmet objective of establishing an apex organization cannot be expected. This is because the issue of apex services is intertwined with the unresolved question of the future of FCCU.

85. This suggests that in exiting from the rural finance program, measures should be taken to resolve the future of FCCU, and work currently in progress on strengthening supervision should be continued with already committed resources. Further work on apex services should be held in abeyance pending a determination of the future of FCCU. Thus, the objectives of any transitional provisions or extension of the rural finance program would be to assist in the development and implementation of a resolution plan for FCCU and incremental improvements in supervision through the provision of already planned technical assistance.

86. Further technical assistance will be required to support the development of apex services, and likely also for further refinement of the approach to regulation and implementation of supervision. This would have to be addressed as part of the government's broader microfinance strategy, as there would appear to be limited appetite among donors currently engaged with the credit union system. One of the lessons from the current program is the need to ensure strong government ownership and leadership. A government steering group or implementation unit charged with executing the microfinance would logically include credit union development within its mandate. This could help to provide the necessary leadership and direction.

87. There are three main components of the recommended exit strategy from the rural finance program. These are: assistance with the resolution of FCCU; pragmatic resolution of the end-2005 deadline for NBKR divestiture; and incremental improvements in the framework for regulation and implementation of supervision. Highlights of each component are provided below, with more detail provided in Appendix 2.

A. Resolution of FCCU

88. The key first question about the future of FCCU is whether anyone would buy it. The answer to this question depends on valuation, so the first step towards final resolution should be the immediate retention by the NBKR as owner of FCCU of an international firm to complete an independent review and valuation. If the quality of the FCCU portfolio is found to be largely as reported, then sale to credit unions or other investors would be feasible. If FCCU is found to be insolvent, then the divestiture options are limited to passing the company and/or its assets to a state body such as DEBRA or the Entrepreneurship Development Foundation for collection and liquidation.

89. If FCCU is found to have value, then near term improvements in its financial performance would better position it for sale to credit unions or sale by tender. Thus, FCCU should develop by end-November 2005 a business plan for 2006 focusing on efficiency and predicated on continued operation as financing source for credit unions using the existing stock of ADB funds. FCCU should defer decisions on pursuit of new business lines (i.e. payment

services, provision of IT platform for credit unions) so that these can be determined by the new owners.

90. Consistent with the original intent of the program, credit unions should be given first option to purchase FCCU. The offering of FCCU would be on an “as is” basis, that is, without any change in the current limited product offering of FCCU, in order to ensure a timely determination of its future. Some improvement in financial performance can be expected under a new business plan, but apex services would have to be built after credit unions acquire ownership.

91. Options for credit unions to acquire an increasing ownership share over several years, the involvement of strategic investor, and other options proposed by credit unions could be considered. However, to ensure timely resolution, credit unions should be required to make an initial purchase of shares (or put cash in trust for shares if there are procedural delays) by end-June 2006. Should credit unions not make the cash commitment, or if issues relating to phased purchase or involvement of a strategic investor are not agreed by end-June 2006, then there should be a default decision to proceed with divestiture by tender.

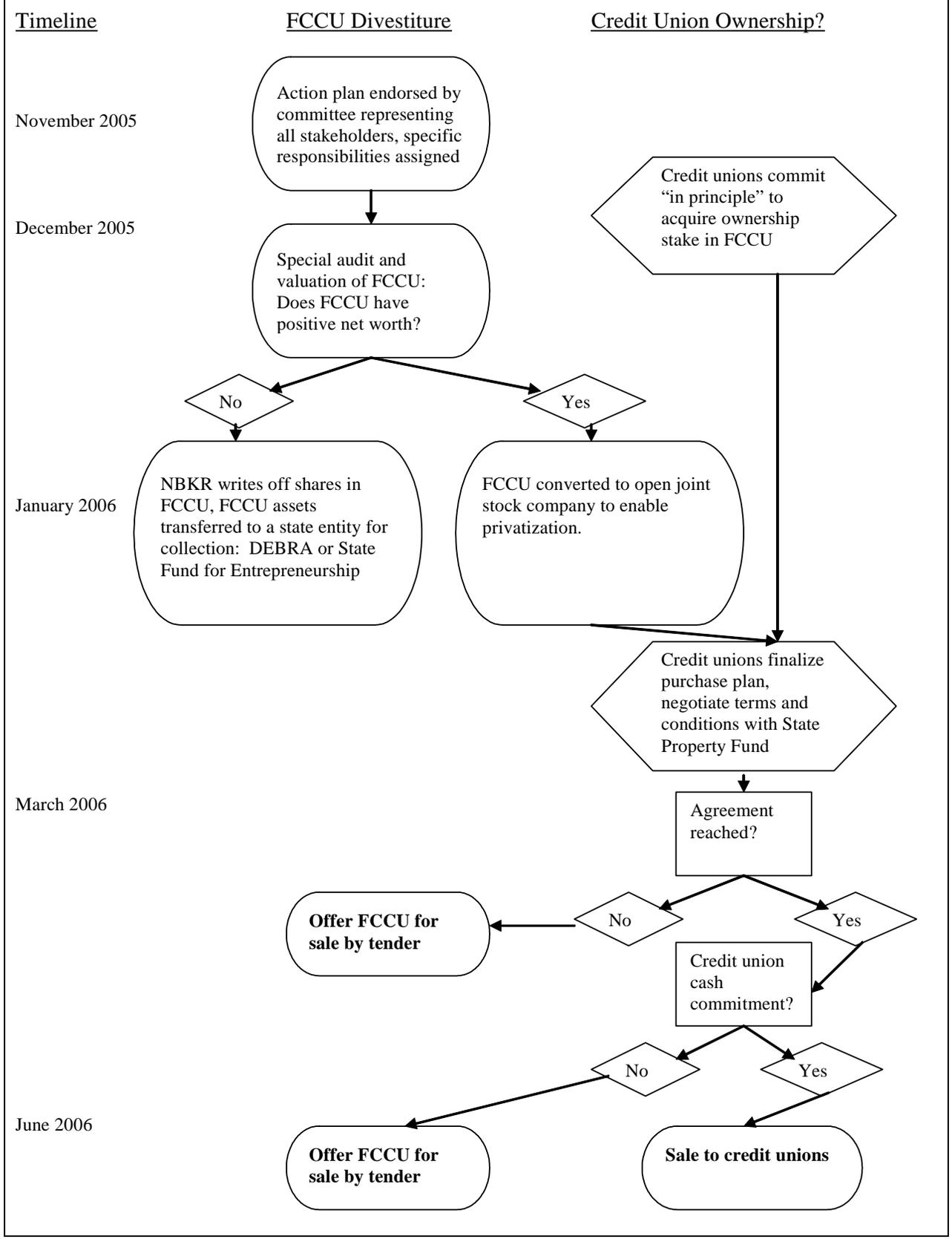
92. There are legal and procedural issues to be resolved in order to divest FCCU. As shareholder, the NBKR may be able to offer to credit unions the sale of all or a portion of its shareholding in the current closed joint stock legal structure. Obtaining an independent valuation is vital to determine the fair price to be paid in this transaction, ensuring appropriate transparency and accountability despite offering the sale, at least initially, to a single bidder. Privatization through a tender process would require conversion of FCCU into an open joint stock company, and would be conducted using the prevailing rules for privatization of any state property.

93. Most of the procedural work to prepare FCCU for divestiture is required regardless of whether it is sold in all or in part to credit unions, or by tender to other purchasers. The decision process for credit unions can proceed in parallel with other steps needed for privatization (Figure 1). This means that offering FCCU to credit unions as an “acid test” of their interest need not lead to long delays in divestiture if credit unions ultimately are not interested.

B. Pragmatic Solution to the December 2005 Deadline

94. Agreement between the government and the ADB to extend the deadline for divestiture of FCCU by the NBKR would be the most pragmatic option. Completion of an independent valuation of FCCU could render the need for divestiture moot. If the value of the FCCU loan portfolio is found to be substantially less than reported, FCCU would be insolvent. The NBKR would write off its investment and the company would be placed in liquidation, with assets placed with a state agency for collection.

Figure 1. Concurrent Processes for FCCU Divestiture.



95. The future of FCCU will not be resolved by year-end, and the only divestiture option feasible within the time frame is to another government entity, and even this may be difficult as there is the potentially contentious issue of valuation. The NBKR can hardly write-off an investment in an entity with an audited book value in excess of som 20 million, but a government agency may be reluctant to pay the NBKR a price reflecting its book value. Even if the question of valuation for transfer purposed can be resolved, transfer to a government agency would only be a temporary measure, as the future of FCCU will still have to be determined. The effort required to complete a temporary measure will divert resources from other priorities, and will result in an inevitable loss of momentum towards the ultimate divestiture of FCCU. Thus, despite the acknowledged incompatibility of FCCU ownership with the NBKR's mandate, continuation of ownership for a further one-year period would facilitate a final determination of the future role and ownership of FCCU.

C. Regulation and Supervision

96. Incremental progress can be made with regulation and supervision before the end of the program. The ADB should consent to amendments to the norms for credit unions. Specifically, the ADB should consent to a removal of the limit or four times capital on external borrowings, although it would be appropriate to retain this limit in the loan agreement only for on-lent ADB funds. This change would preserve the intent of the rural finance program of gradually reducing credit union dependence on FCCU funding, while at the same time providing an equivalent treatment for credit unions as that afforded to microfinance entities.

97. The ADB should also consent to the amendments proposed by the NBKR to the capital adequacy norm, which would reduce the pace at which credit unions are required to accumulate institutional capital. Considerations should be given to further revising the capital adequacy requirement. One option would be to require credit unions taking deposits to have the PEARLS recommended minimum 10 percent institutional capital, and provide a phase in period of two years to reach 12 percent. The capital adequacy requirement might be reassessed for credit unions not taking deposits, as they do not need capital as a cushion to ensure deposits are not at risk and 12 percent institutional capital may exceed their actual requirements.

98. In the longer term, the NBKR should harmonize its approach to credit unions with its approach to microfinance organizations. This work has been extensively discussed and reviewed over the last several years, and the NBKR should be able to implement this without further technical assistance. Similarly, the off-site reporting and monitoring system for credit unions is ready for implementation and should require little additional support. Continued turnover and staff shortages at the NBKR have meant that further investment in training and development of supervision staff will be required.

D. Conditions for an Extension

99. Agreement between the ADB and government to extend the loan program until end-2006 should be conditional on the following:

- No disbursements for credit union loans after the current expiry date (end-2005), as the objectives of stimulating credit union growth have been met, and the focus is now on the infrastructure for sustainability.
- Government, represented by the Ministry of Finance, President's Administration and NBKR to endorse by November 18 an action plan for resolution of FCCU
- NBKR as owner of FCCU to retain by end-November an international firm to complete an independent valuation of FCCU, with the valuation to be complete by end-January 2006
- If FCCU is independently valued at less than zero, the company and/or its assets will be passed to a state entity for liquidation (DEBRA, or the Fund for Entrepreneurship, or such other entity as may be agreed)
- If FCCU is independently determined to have value, credit unions have the option to negotiate sale terms and conditions for all or a portion of the equity of FCCU, at a price determined by the independent valuation.
- If FCCU is independently found to have value and a transaction with credit unions is not consummated by end-June 2006, FCCU will be offered for sale by tender, with the sale to be completed not later than end-December 2006.
- The divestiture of FCCU is to be overseen by a working committee including the Ministry of Finance, President's Administration and NBKR, which will report monthly to the ADB on progress with FCCU divestiture.

APPENDIX 1. PRUDENTIAL NORMS FOR CREDIT UNIONS

	Original loan agreement	2003 amendments to loan agreement	Current economic norms for credit unions	Changes proposed	Prudential or other rationale	Comment/ recommendation
External borrowings	No limits	External borrowing limited to the greater of 4 times institutional capital or the total of share capital plus institutional capital; reducing to multiple of 3.5 times institutional capital in April 2005, multiple of 3 in April 2006, 2.5 in April 2007 and 2.0 in April 2008.	N1: In year 1 external borrowing limited to total share capital; in years 2 through 5 the greater of total capital (shares plus institutional capital) or 4 times institutional capital; year 6 or from April 2006 3.5 times institutional capital; year 7 or from April 2007 3 times institutional capital	Remove the restriction on external borrowing	Intended to limit credit union reliance on ADB loan program financing and by ensuring gradual reduction of external borrowing, spur the mobilization of member savings. PEARLS establishes a target of zero for external borrowings, as deposits are generally cheaper and more stable than external financing.	Limits and planned reduction over time was predicated on credit unions mobilizing deposits. Without deposits, credit unions effectively operate as microcredit companies. Microcredit companies do not have restrictions on the amount of external finance. Lenders providing finance to credit unions (e.g. Frontiers, or banks) can be expected to impose practical limits on CU borrowing. Recommendation: ADB should consent to the requested removal. If the current loan program is extended or a new program developed, ADB should consider restrictions in the loan agreement that would apply only to ADB funds.
Single borrower limit	Three times the borrower's capital in the CU; maximum loan not to exceed 15 percent of total paid in share capital	Three times the borrower's capital in the CU in first year of CU operations; subsequently maximum loan not to exceed 15 percent of total capital (shares and institutional capital)	N2: Year 1—3 times member share; Subsequently maximum loan not to exceed 15 percent of total capital (member shares and institutional capital)	None	Ensure adequate diversification of loan portfolio	Not addressed in PEARLS monitoring system, but a sound prudential requirement that should be maintained.

	Original loan agreement	2003 amendments to loan agreement	Current economic norms for credit unions	Changes proposed	Prudential or other rationale	Comment/ recommendation
Limits on Investments in financial institutions	No specific requirement	Not addressed	N3: Total investment in financial institutions limited to 15 percent of the total of institutional capital and share capital	None	Provide flexibility to invest in apex organizations or other financial institutions providing services to credit unions, while ensuring the majority of assets are devoted to directly meeting member needs.	PEARLS establishes a 10 percent target for financial investments. Lower limits encourage a more effective financial structure, but 15 would facilitate early acquisition of a majority share in FCCU.
Limit on investment in fixed assets	No specific requirement	Not addressed	N4: Total investment in fixed assets limited to 10 percent of the total of institutional capital and share capital.	None	Limit the amount invested in non-earning assets to help ensure and effective financial structure.	Not specifically addressed in PEARLS, but low limit on fixed assets implicit in PEARLS target of 5 percent for non-earning assets. A sound prudential requirement that should be maintained.
Liquidity	No specific requirement	Not addressed	N5: For credit unions not accepting deposits, liquid assets must equal at least 5 percent of total liabilities. For credit unions accepting deposits, liquid assets less short term liabilities of the credit unions must equal at least 15 percent of deposits plus shares repayable within 30 days.	None.	Credit unions should have sufficient liquid assets to meet unexpected withdrawals. Credit unions not accepting deposits have much less need for liquidity.	Consistent with PEARLS target of 15 percent liquidity.

	Original loan agreement	2003 amendments to loan agreement	Current economic norms for credit unions	Changes proposed	Prudential or other rationale	Comment/ recommendation
Capital Adequacy	A capital adequacy ratio (CAR) larger than for banks or a debt equity ratio of 5:1.	CAR minimum 20 percent, comprised of minimum 12 percent institutional capital and maximum 8 percent share capital, phased in from April 1, 2004, 13 percent CAR, institutional capital at least 3 percent; April 2005, 14 percent CAR, institutional capital at least 6 percent; April 2006 17 percent CAR, institutional capital at least 9 percent; April 2007 20 percent CAR, institutional capital 12 percent.	N6: No requirements in first year of operation; year 2 CAR 13 percent, minimum institutional capital 1 percent; year 3 or April 2004, CAR 13 percent, 3 percent institutional capital; year 4 or April 2005, CAR 14 percent capital, 6 percent institutional capital (12 percent for credit unions taking deposits); year 5 or April 2006, CAR 17 percent , institutional capital 9 percent.	NBKR has proposed modest reductions in the pace of increase in the minimum ratio of institutional capital. Credit unions have proposed an alternative CAR of institutional capital plus one half of member shares of at least 20 percent of total assets.	Institutional capital represents the only true capital of credit unions, as member shares are subject to withdrawal. Thus, requiring credit unions to have the majority of the CAR in institutional capital is sound. PEARLS establishes a minimum target of institutional capital to total assets of 10 percent. The requirement to reach 12 percent provides an additional measure of soundness to support deposit taking.	Despite the acknowledge desirability of building institutional capital, the pace of accumulation required in the current norm is unreasonable. Even without growth, credit unions would require a return on assets of 3 percent to finance the accumulation of institutional capital. PEARLS target ROA is 1 percent. Recommendation: The ADB should agree to a reduced pace of accumulation of institutional capital. Credit unions taking deposits should have the PEARLS recommended minimum 10 percent institutional capital, and two years to reach 12 percent. The capital adequacy requirement might be reassessed for credit unions not taking deposits, as they do not need capital as a cushion to ensure deposits are not at risk.

	Original loan agreement	2003 amendments to loan agreement	Current economic norms for credit unions	Changes proposed	Prudential or other rationale	Comment/ recommendation
Restrictions on maximum deposits	No restrictions	Not addressed	N7: Credit unions in 3 rd year of activity, or from April 2005 deposits limited to 12 percent of total assets; year 4 or April 2006, 18 percent of assets; year 5 or April 2007 24 percent of assets; year 6 April 2007, 30 percent of assets.	CUs proposed relaxation of restriction, but NBKR has not made this request to ADB. CUs propose complete removal for highly rated CUs.	Intended to ensure credit unions do not grow too rapidly and develop adequate experience with deposit-taking.	While caution is understandable, this approach is contrary to the objective of reducing reliance on external financing, and the PEARLS target of deposits to total assets of 70 to 80 percent. Recommendation: Credit unions licensed to take deposits should not be restricted except by other prudential standards, such as the capital adequacy requirement.
Provisioning requirements	Not addressed.	Not addressed.	N8: Satisfactory (up to 30 days delinquency), no provision required. Doubtful (30-180 days in arrears) 50 percent provision; Loss (above 180 days in arrears), 100 percent provision.	Satisfactory (current) 2 percent provision , Watch (less than 30 days arrears) 5 percent provision; Substandard (31-60 days arrears) 25 percent; Doubtful (61 to 90 days arrears) 50 percent; Loss (over 90 days arrears) 100 percent provision.	The new standards are more conservative, and consistent with the regulation on classification by micro-finance organizations.	The new standard is sound and appropriate.

APPENDIX 2. ACTION PLAN TO DIVEST FCCU

Action	Responsibility	Date
2005		
Endorse action plan for FCCU divestiture and approve time-line in principal.	President's Administration; Ministry of Finance, NBKR	November 18
FCCU management instructed to prepare 2006 business plan to prepare for privatization: <ul style="list-style-type: none"> • Hold in abeyance further work on developing apex functions • Operate with existing funding resources • Focus on improving efficiency consistent with a wholesale lending operation • Meet by end-June 2006 the original program targets for efficiency and asset quality • Personnel expenses 1.4 percent of average total assets (2004 outturn 3.4 percent) • Total non-interest expenses 3.0 percent of average total assets (2004 outturn 5.4 percent) • Classified loans (substandard or worse) no more than 10 percent of loan portfolio (2004 outturn 12.8 percent) 	FCCU Supervisory Board (NBKR as owner has ultimate responsibility)	November 18
TOR prepared for independent review and valuation of FCCU	NBKR, coordinated with MOF, President's Administration and State Property Fund	November 21
Credit unions confirm interest in principal in acquiring FCCU; alternatively indicate lack of interest and FCCU proceeds to sale by tender or liquidation, depending on results of valuation	Credit union associations, as part of their strategic planning exercise (technical assistance from GTZ)	December 14
Proposals due from international firms to complete independent valuation	NBKR, coordinated with MOF, President's Administration and State Property Fund	December 5
Selection of valuation firm and award contract	NBKR, coordinated with MOF, President's Administration and State Property Fund	December 12
2006		
Completion of valuation of FCCU	International auditing firm	January 31
Decision to proceed with privatization or liquidation of FCCU	NBKR, President's Administration; Ministry of Finance	February 10
If privatization, NBKR shareholding in FCCU offered to CUs at valuation price. If CUS propose less than majority purchase, concurrent development of plan for another state entity to acquire the balance of the NBKR ownership stake.	NBKR, coordinated with MOF, President's Administration and State Property Fund	February 13
If liquidation, pass FCCU and/or assets to state agency for collection	NBKR, President's Administration; Ministry of Finance	February 28

Action	Responsibility	Date
If privatization, negotiate terms and conditions of sale to credit unions. Consider partial privatization, with government through State Property Fund or other suitable entity retaining ownership, with credit unions purchasing balance over time.	State Property Fund, working group including NBKR, President's Administration; Ministry of Finance	February 28
Credit union alliance provides individual credit unions with detailed proposal for consideration at credit union annual general meetings.	Credit union alliance, following completion of negotiations.	February 28
If agreement not reached with credit unions, proceed to convert FCCU to open joint stock company and offer for sale by tender.	State Property Fund, working group including NBKR, President's Administration; Ministry of Finance	April 4
If agreement reached with credit unions, individual credit unions seek approval for investment in FCCU at their annual general meetings	Credit unions	1st quarter
If credit unions make cash commitment, proceed with divestiture	Credit unions, State Property Fund	June 30
If credit unions do not make cash commitment, proceed with sale by tender	State Property Fund	June 30

APPENDIX 3. LIST OF PERSONS MET

Ministry of Finance

Mr. Emirlan Toromyrzaev State Secretary
Mr. Mirlan Baigonchokov Investment Policy Department

Administration of the President

Mr. Kubat Kanimetov Head of Economic Policy Department
Mr. Jyrgalbek Kasymov Expert, Economic Policy Department

Office of the Prime Minister

Mr. Tsoi Man-Su Head of Economic, Industrial and Trade Department
Ms. Zina Asankojoeva Head of Division on Finance

National Bank of Kyrgyz Republic

Mr. Ulan Sarbanov Chairman
Ms. Saadat Janybekova Deputy Chairman
Ms. Saltanat Alybaeva Head of Department on Supervision Methodology and Licensing

Ms. Anjelika Li Head of Banking Supervision Department
Mr. Kayip Kulenbekov Head of Non-Bank Supervision Department
Ms. Natalia Danshina Acting Head of Non-Bank Supervision Department
Ms. Miriam Usupova Department on Supervision Methodology and Licensing

Entrepreneurship Development Foundation

Mr. Ruslan R. Sultanov Vice General Director

Financial Company for the Support of Credit Unions

Mrs. Kanysh Sharshekeeva Director General
Mr. Samat Jumashev Deputy Director General

Foundation for the Development of Cooperatives (Raiffeisen)

Mr. Tilek Ashimov Chairman

DGRV-GTZ

Mr. Klaus Lehrke Team Leader, Rural Financial System Project

Kompanion Financial Group

Mr. Erkinbek Jumabaev Chief of Internal Audit Department

W. Jacobs Audit

Ms. Ludmila Goffin Director

Frontiers Micro Lending Company

Patricia Gates General Manager, and Regional Advisor to the Central Asia Micro Finance Alliance

Soros Foundation

Elmira Kaibogarova Program Assistant, Economic Reform and Public Administration

Credit Unions

Mr. Meiman Kasymov Chairman, Paritel Kredit, and Chairman, Chui Oblast Credit Union Association

Mr. Kubanychbek Zununov Chairman, Tokmok Credit Union, and Chairman, National Alliance of Credit Union Associations

Ms. Elena Sehetuibova Chairman, Credit Union "777"

Mr. Bolot Kojomuratov Chairman of "ABN" Credit Union

International Monetary Fund

Mr. Michael Mered Resident Representative

World Bank

Mr. Abdybaly tegin Suerkul Consultant, Private Sector Development

USAID

Ms. Irina Krapivina Enterprise and Finance Specialist

Asian Development Bank - Kyrgyz Resident Mission

Mr. Ashraf Malik Country Director

Ms. Asel Chyngysheva Project Officer