



**Paving the Way Forward for Rural Finance
An International Conference on Best Practices**

Case Study

**Agricultural Lending Practices:
Non-Financial Services with Financial Products**

Kyrgyz Agricultural Finance Corporation (KAFC)

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Introductory information

1. How KAFC was created

After the disintegration of the Soviet Union, the Kyrgyz Republic (Kyrgyzstan), one of the poorest of the former Soviet republics, embarked on a program of market-oriented structural reforms with frequently commended commitment and resolution. In 1991, the process of privatization was started, and in July 1992 the Parliament of Kyrgyzstan approved a program of accelerated economic reform, including financial and agrarian reforms.

Until 1994, only one bank (state-owned Agroprombank) financed (subsidized) rural sector of Kyrgyz Republic. The 90 percent of assets of Agroprombank were highly insolvent due to bad debt and in 1994, the Agroprombank was liquidated. Commercial banks had very limited lending activities in the rural sector, mostly because of high risks linked to rural lending, low profitability, substantial lack of experience of loan officers in risk analysis and business plan evaluation and did not have an adequate branch network. In this environmental condition the Government had no choice and channeled in-kind credits to farmers through the Ministry of Agriculture and the regional and district authorities. This approach had very limited results and was unsuccessful. The Agroprombank and government lending programs have developed a non-repayment culture among the borrowers.

So, taking into account these situations, the Government of the Kyrgyz Republic addressed to the World Bank with a request for help in overcoming of the crisis in rural lending. In 1996 the World Bank after thorough researches of financial system agreed to start with rural finance project. So, the Government of the Kyrgyz Republic established a non-bank financial institution – the Kyrgyz Agricultural Finance Corporation. The political, economic and legislative environment at the start-up of the new credit organization was:

Political environment

- Political stability
- Predictability of political processes
- Democratization of society
- Strong political support for KAFC from authorities

Economic environment

- Macroeconomic stability, availability of mid-term programs of the Government with the International Currency Fund.
- Mutual understanding and economic co-operation with international organizations (WB, ADB, EBRD, etc.)
- Reform in all economic fields, including the agrarian reform.
- Growth of GDP (Gross domestic product), including for agriculture
- Business less and less dependent on direct interference from authorities
- Banking sector had some difficulties, in particular, two large systematic banks (Agroprombank and Sberbank) were liquidated
- It turned out that budget lending for agriculture was ineffective, credit recovery was low.

Legislative environment

- There was no legislation for regulating micro-financing activity
- The Corporation was regulated according to the Law of banks and bank activity. There were many disparities and contradictions with other laws, for instance, with Tax Code, Civil Code, etc.
- Legislation for regulating credit activities was also imperfect.

The Government became the sole shareholder, but with the intention to privatize KAFC. Although conditions were not perfect, the Corporation started the first credit operations already in March 1997.

2. Description of institution

KAFC was formally registered as a joint stock company in December 1996. Although licensed as a non-bank financial institution, KAFC is supervised by the National Bank of the Kyrgyz Republic as a bank. The main management board of KAFC is the Board of Directors, which consists of the Minister of Finance of KR (Chairman), the Chairman of the State Property Committee of the KR, Minister of Agriculture and Water Resources of the KR, the Executive Director of the KAFC and three representatives of the private sector of the farms or agri-business enterprises.

The main activity of KAFC is rendering credit services to any profitable business in the rural area. Our target clients are private farmers, enterprises dealing with processing, joint stock companies, cooperatives and any other private enterprises or private entrepreneurs dealing with economic activities in the villages. KAFC lending activities are separated by the following credit lines: the Main credit line and Non-collateral group lending.

The Main credit Line: The loans are given over the KGS 15,000 (US\$ 300) to private form of ownership registered according to the current legislation of the Kyrgyz Republic. The potential Borrower must have legal documents on property, private business form, profitable idea and the necessary conditions for project realization. Average loan size under the main credit line – KGS 70,000 (US\$ 1,500).

The Non-collateral lending: The maximum loan amount per one member is KGS 15,000 (US\$ 300). Member at the moment of foundation of the group (includes maximum 10 members) should have an income not exceeding about 1 400 KGS (USD 30) per person/month. And all group members should be from the same village and have informal registration from the village government. Average loan size under non-collateral group lending – KGS 15,000 (US\$ 300).

By both lines KAFC finances the activities in the following sectors of the economy:

- Agriculture (plant growing, cattle breeding, poultry, bee-keeping, fish-breeding, etc.)
- Processing industry and other fields related to the agribusiness (processing, packaging and storing of products produced in the villages and towns).
- Sector of services (tourism, catering, advisory, marketing, transport and other services assigned for the rural people).
- Trade (trade-supply activity in the villages).
- Other profitable types of activities in the villages, which are warranted by capital flows confirmed by the business-plan.

KAFC loans are given for the following terms:

- Short term – term of usage of which does not exceed of 1 year;

- Medium term – term of usage of which is from 1 till 3 years;
- Long – term of usage of which is over 3 years and do not exceed the term of “useful life” of the financed investment or no more than 7 years.

Related to the lending operations the KAFC provides to its clients cash and settlements services

KAFC is the financial organization aimed for the financial services providing to the rural sector of Kyrgyz Republic with strategy to be a bank (micro-finance bank). In this connection the Corporation doesn't make any technical assistance, but is quite open to provide the information services. KAFC provides our clients with all information concerning the conditions of lending through the publication of brochures, periodically makes meetings, workshops so that to explain the mission, programs and future plans of KAFC activities .

As mentioned above, KAFC withdraws the funds from the Government of the Kyrgyz Republic on the interest basis just for the lending. Respectively, the Government of the Kyrgyz Republic provides the funds for KAFC from the state budget and mostly from the funds of the World Bank and Asian Development Bank. Thus, we have no own funding base and strongly depend on the credit lines from the international institutions. It is one of our weaknesses. We need to look for the new possibilities for KAFC to start with own funding, for example, deposits.

At this moment, under the technical assistance of the TACIS Project, KAFC team and the Rabo International Advisory Services (RIAS) are working out the strategy and privatization plan for the Kyrgyz Agricultural Finance Corporation. Based on the recommendations in this strategy and privatization plan the following steps are foreseen in order to further work out and implement the strategy:

- Develop a comprehensive plan will be made with steps and milestones to be taken for obtaining the banking license and with regards to implementation. For the time being KAFC will limit itself to few deposit and saving products, payment clearing, simple treasury products and retail credit products.
- Develop a business plan for the coming three years, this includes among others:
Accurate estimates about costs, returns, financial ratios, etc.
Targets with respect to business volumes for the different products, pricing mechanisms for banking products, etc.
Detailed description about the organizational and operational structure.
Human resources development plan, including required training.
Detailed description of the banking products.
Upgrading of all procedures and manuals

3. Statement of purpose -mission

Currently the mission of the KAFC is to increase in effectiveness and profitability of the agricultural sector and improvement of the standard of living of the rural population by developing a sustainable system through which financial services are provided.

But taking into account the purpose to be a bank, KAFC is going to amend slightly the own mission. KAFC's primary objective will be to provide access to a full range of financial services to the rural and peri-urban population in Kyrgyz Republic in a sustainable and viable way. KAFC will in principle finance all viable economic activities and households. It will do this in a client-orientated manor, that is to say that it will tailor its products to the client needs. KAFC will maintain and/or expand its network of branches in accordance with sound economic principles, while ensuring that a sufficient level of proximity to its clients is

retained. KAFC will open its capital to become over time a client owned financial institution. KAFC will become a co-operative/client owned bank based on Kyrgyz characteristics and market conditions.

KAFC will not be driven by profit maximisation but optimum client satisfaction and sufficient profit to allow for autonomous growth in order to remain well capitalised. It will not cross-subsidise services towards particular client groups and it will use economic criteria for product pricing, evaluation of clients, etc.

In order to be sustainable it will need to generate profit, which will be used to expand its services and to maintain adequate financial ratios to ensure a proper rating in the market. This in turn will provide the needed access to the capital market.

KAFC will implement a human resources development policy based on staff motivation and adequate empowerment at all levels of the organisation. The remuneration policy will be based on staff performance and client satisfaction.

The strategic objective is to maintain the leading position, measured by market share of not less than 30% of the credit volume required by our target groups, by meeting our customers diverse need for financial services more effectively than our competitors.

4. Donors

First Rural Finance Project

Support for KAFC's development was provided through the funds of the International Development Association (June, 1997) with the purpose of providing loans on commercial terms to support the ongoing process of farm restructuring, agribusiness enterprise privatization, and private sector development in the rural sector. The project, named as First Rural Finance Project (RFP I, 4-year program), provided a credit line of SDR 11,9 million (US\$ 16,0 million equivalent) to support KAFC's lending operations. The RFP I was designed at a time when limited institutional and human resources were available to support the transition from a centrally-directed command economy to a market economy and the newly emerging capital markets were insufficient to meet the needs of a market system rapidly developing in response to enterprise privatization.

Farmers Development Fund Project

KAFC's lending operations is dealing also in the program of the Farmers Development Fund (FDF) in order to provide financing to the low income population, who joined in self-help groups (SHGs) through group credit based on social collateral guarantees under the National Program on Poverty Alleviation. This FDF program was funded by International Fund for Agriculture Development (IFAD) as part of the World Bank supported "Agricultural Support Service Program". Group formation and training are supported by technical assistance of United Nations Development Program (UNDP). The program helps to the poor to establish informal financial services as a means to improve their livelihoods, to build their capacity and therefore prepare them for access to and effective use of formal financial services. The group approach will promote solidarity, particularly among women, for fighting poverty and addressing community problems.

Second Rural Finance Project

After finishing RFP I, the Government of the Kyrgyz Republic (GOK) agreed with the Second Rural Finance Project (RFP II) in order to expand a sustainable rural financial system that will serve a broad range of beneficiaries, including small-scale farms and rural entrepreneurs, and to expand and diversify the agricultural lending base and clientele deliberately limited in order to fully test the concept, to contribute to the reduction of poverty in rural areas by supporting the development of viable economic activities (on-and off farm) to general income; and to expand access to credit for those with limited collateral. The RFP II was approved for SDR 11,1 million (US\$ 15 million equivalent) in June 1999 by International Development Association (IDA).

Agriculture Area Development Project (ADB)

KAFC is the agency to implement credit part of the Asian Development Bank's Project. The Project has adopted a new area-focused approach to project investment in the agriculture sector in the Kyrgyz Republic. Chui oblast (one of the regions of Kyrgyzstan) was selected for its potential for agricultural growth and development and its importance to the economy. The Project is focused on private farms and agribusiness and attempts to build a partnership between public and private investment that is essential to achieve agricultural growth. KAFC is responsible for the lending component of this Regional project in an amount of USD 10 mln.

SLLPC/DFID Project

KAFC is a partner of the Sustainable Livelihoods for Livestock Producing Communities (SLLPC) Project on credit part with amount of USD 180 000, which is an initiative funded by the United Kingdom Government's Department for International Development (DFID).

The project has a four-year duration, starting January 2002, and a budget of £2 million (equivalent to approximately \$3 million).

The project will provide packages combining credit, training, inputs and technical assistance in order to:

- Develop mechanisms for income generation from business, crops and livestock production;
- Improve and promote communities access to support services; and
- Develop self help-capacities at community level and strengthen local administrations and agencies.

II. Results and Impact

1. Some results

For seven years of work KAFC reached the following financial parameters:

1. Since 1997 till January 1, 2000 KAFC financed 9,173 projects in the amount of KGS 413.7 million. The following table shows approved and disbursed amounts from 2000 till 2002:

Table 1

Unit: KGS thousand

	2000	2001	2002

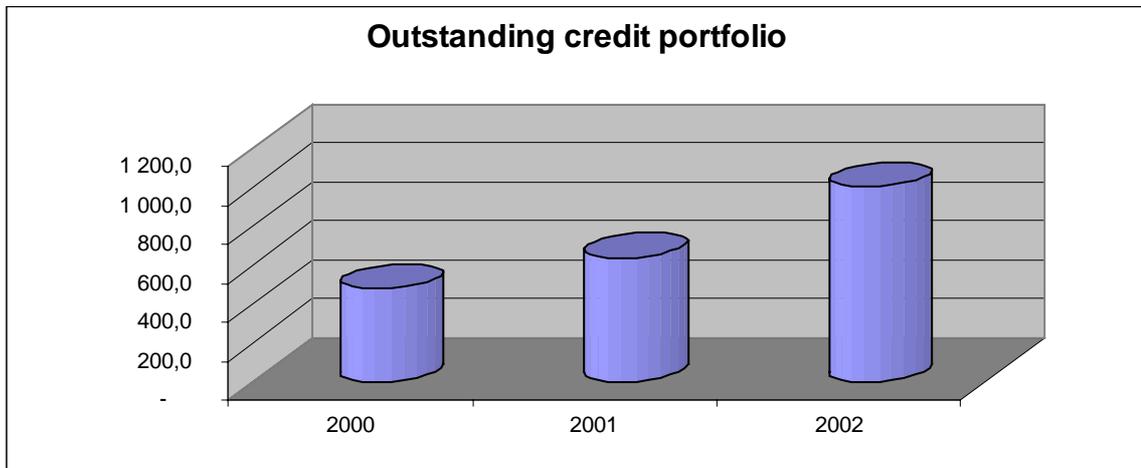
Number of loans disbursed for the year	8 494	9 053	12 685
Amount of loans approved	462,5	586,9	778,2
Amount of loans disbursed	440,9	561,4	785,4
Outstanding credit portfolio	475,6	637,9	1 000,4

Average rate - 2000 USD 1 = 47.10KGS
2001 USD 1 = 48.40 KGS
2002 USD 1 = 46.47 KGS

So, the outstanding credit portfolio on December 31, 2002 amounted KGS 1 billion.

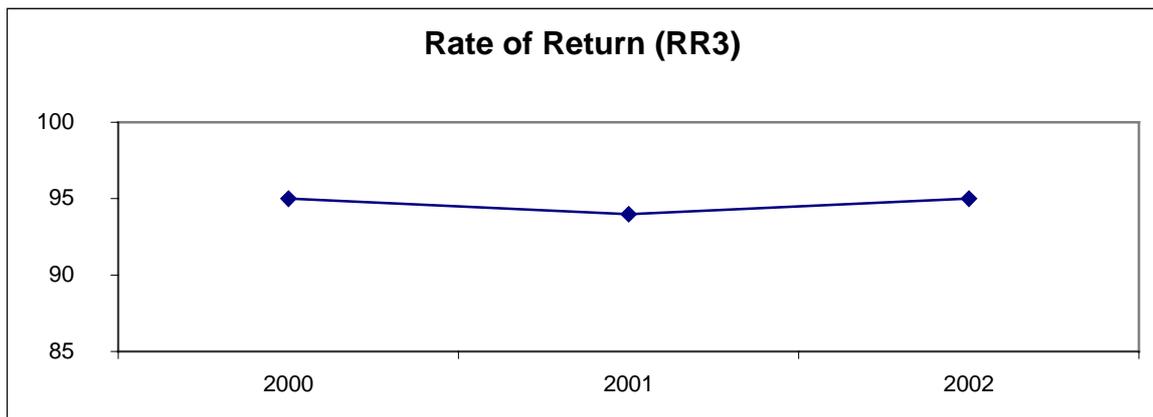
Table 2
thousand

Unit: KGS



2. All these years Return rates were stable:

Table 3



As crediting is the main KAFC's activity Loans to total assets ratio is high enough

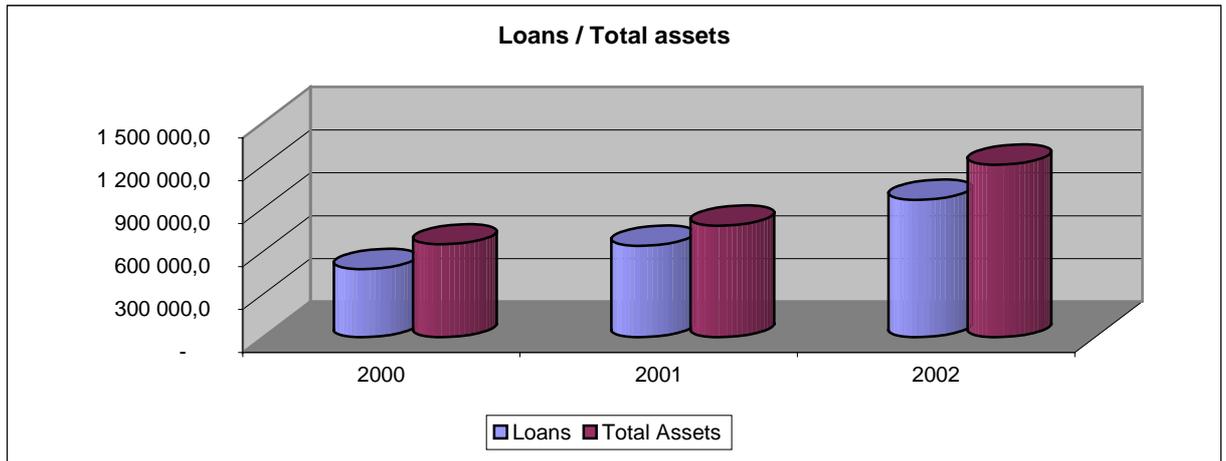
Table 4

Unit: KGS thousand

		2000	2001	2002
Loans		475 780,0	638 095,0	959 179,0
Total Assets		648 168,0	779 351,0	1 205 614,0
Loans/Total Assets		73%	82%	80%

Table 5
thousand

Unit: KGS



3. Capital adequacy ratios for the last three years are the following:

Table 6
thousand

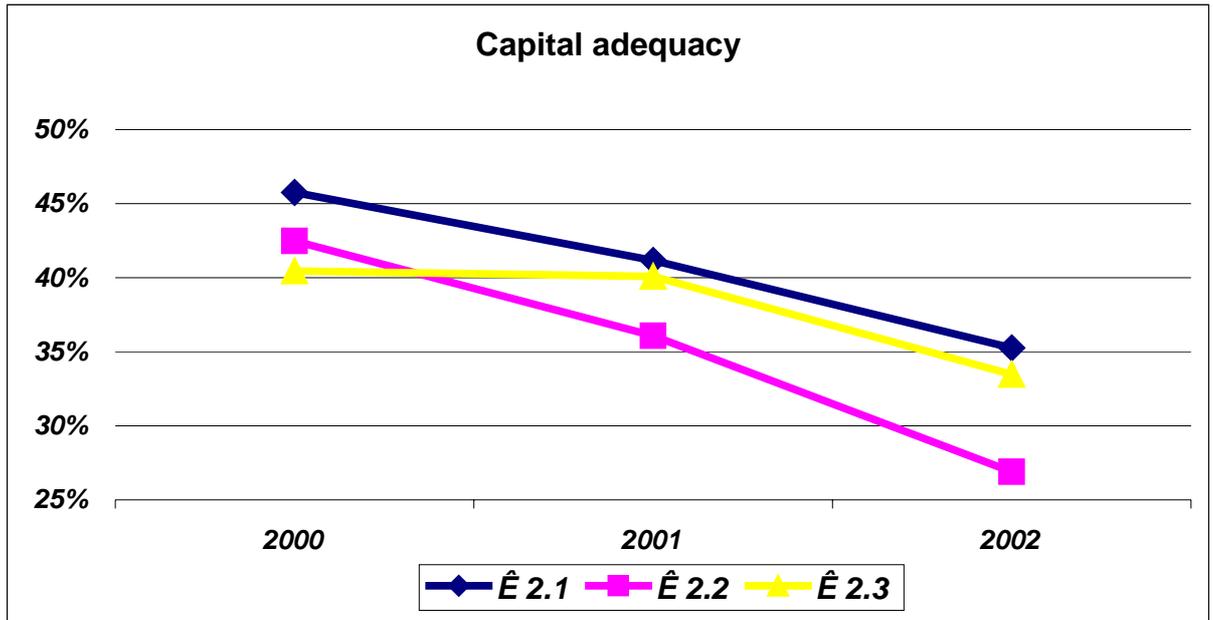
Unit: KGS

		2000	2001	2002
Net total capital		267 593,9	324 003,4	419 393,5
Net risk assets		584 783,2	787 133,4	1 189 337,8
Tier first capital		248 349,3	283 936,5	319 953,5
Total assets		661 599,0	808 083,0	1 252 716,6

Capital adequacy

Net total capital / Net risk assets	K 2.1	46%	41%	35%
Tier first capital / Net risk assets	K 2.2	42%	36%	27%
Net total capital / Total assets	K 2.3	40%	40%	33%

Table 7



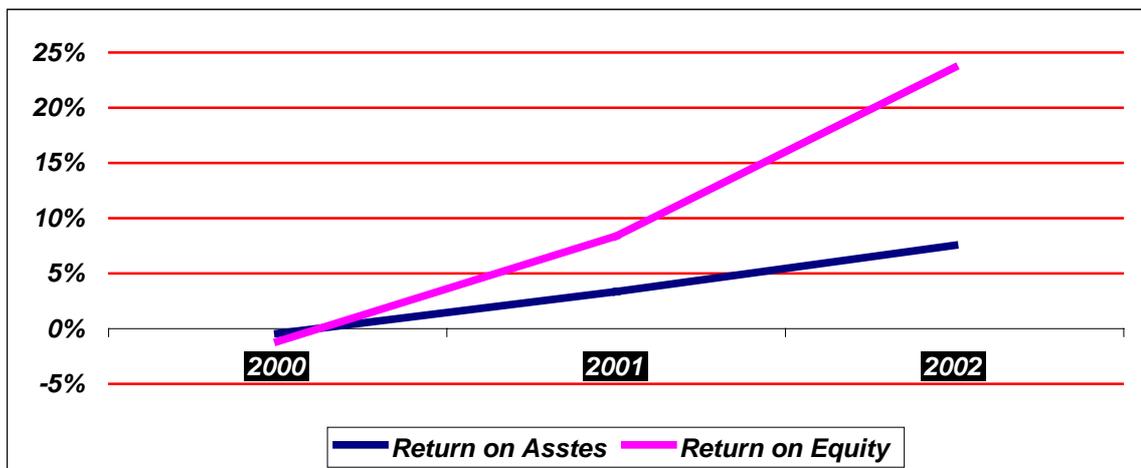
4. Return on Assets and Return on Equity ratios are for the last 3 years are the following:

Table 8
thousand

Unit: KGS

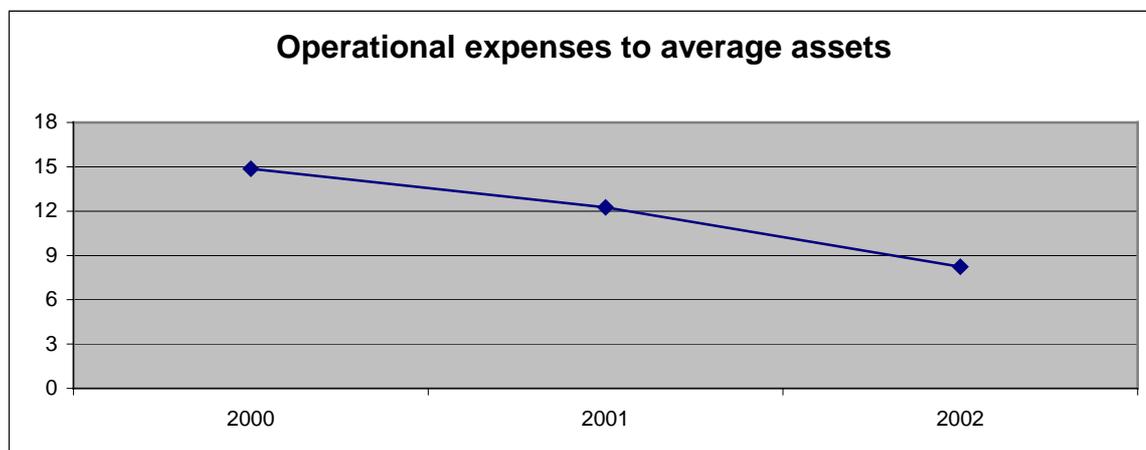
	2000	2001	2002
Average assets	572 983,4	727 816,9	1 039 783,5
Average capital	213 187,0	290 792,8	332 107,4
Net income	11 934,8	29 498,5	84 437,8
Return on Assets	2%	4%	8%
Return on Equity	6%	10%	25%

Table 9



5. Operational expenses to average assets are the following:

Table 10



2. Social impact

KAFC skillfully combines its commercial activity from the one hand and makes social impact from the other hand. The main credit line is commercial banking instrument, but non-collateral group lending completely made by KAFC and we are represent the sole institution who carries out non-collateral lending and covers the poorest in the Kyrgyz Republic.

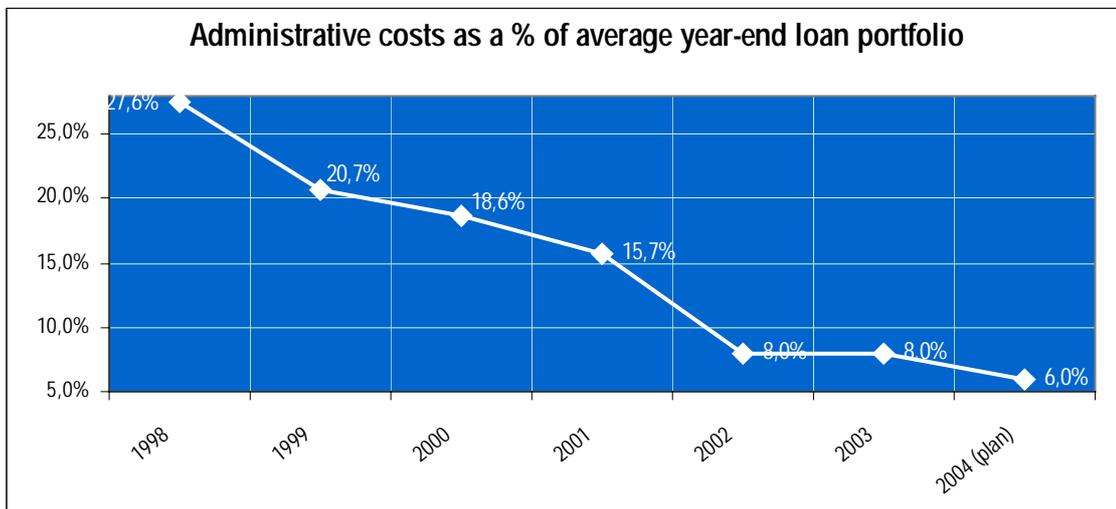
KAFC is the largest organization, which provides constant access of rural population to the financial funds. We have very wide network within whole Kyrgyzstan: 11 branches and 41 regional representatives. Approximately 20% of new farmers have obtained access to loans. In the period of transition economy, KAFC built completely new products, service and delivery methodology applicable to local condition and Kyrgyz mentality in the land-locked country. Moreover, KAFC provides relatively acceptable conditions of lending. Although our interest rates are build on the commercial base they are quite applicable for our clients. Analysis of households' activity has showed the increasing of theirs income. We have many examples of it. On average, income per one person in household, which got three loans from KAFC, has increased from 300 KGS (6.5 USD) till 700 KGS (15.2 USD) per person/month. According our very conservative calculation, nearly six thousand of households could increase theirs income using the KAFC's loans.

KAFC constantly diversifies its loan portfolio, lending not only for agriculture development but other ones as well (for firms, shops, hairdressers opening, etc.) Thus, KAFC creates completely new working places. It was made approximately two thousand working places since KAFC started its activity. Besides that farmers, who have got KAFC's loans, indirectly make new working places, attracting season workers.

3. Sustainability

KAFC is functioning primarily on a commercial basis- extending credit based on rigorous financial appraisal and fully covering its cost of funds, administrative margin, and provisioning with its on-lending rates. Operational expenses to the average credit portfolio (operational efficiency): in 1998 – 27.6%, in 1999- 20.7%, due to implementation of operational efficiency: in 2000- 18.6%, in 2001–15.7%, in 2002 –8%. So, we set the goal to decrease it to 6% by the end of 2004.

Table 11



KAFC's sustainability can be concluded from the following tables:

Table 12

Unit: KGS million

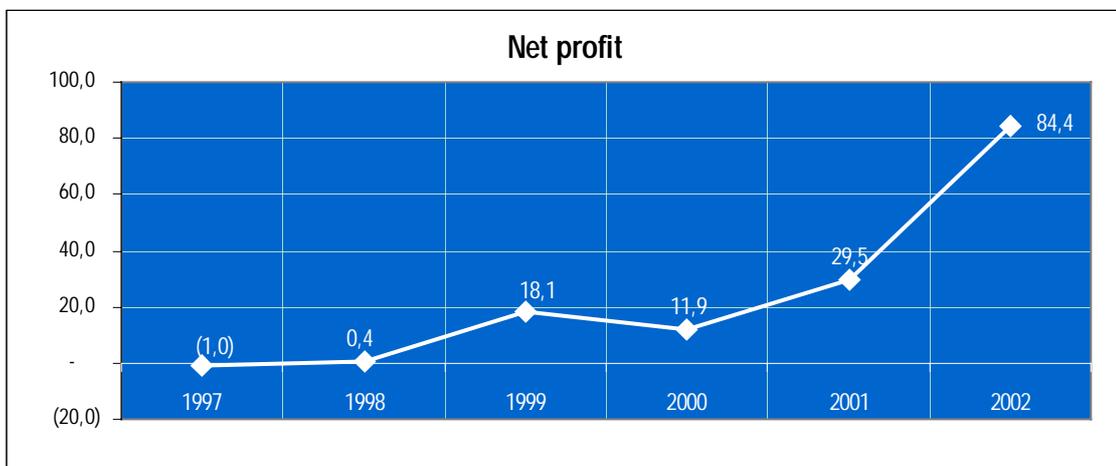


Table 13 Profitability and efficiency indicators.

№	Ratio	Formula	2000	2001	2002
1	Net Interest Income	Net Interest Income / Average Earning Assets	20.0%	22.2%	18.0%
2	Interest Expense	Interest Expense / Average Assets	6.9%	4.4%	2.1%
3	Net Interest Spread	(Interest Income / Average Earning Assets) minus (Interest Expense / Average Funding)	13.4%	18.0%	16.5%
4	Operating Costs	Operating Costs / Average Assets	8.3%	6.8%	5.2%
5	Efficiency Ratio	Non Interest Expense / (Net Interest Income + Non Interest Income)	54.3%	39.6%	37.5%
6	Operational Efficiency	Total Expenses / Total Income	67.5%	50.7%	44.5%
7	Assets Efficiency	Average Earning Assets / Average Assets	74.0%	79.9%	84.4%

To be sustainable in the future KAFC, as mentioned earlier, is developing strategy for obtaining the banking license.

III. Challenges with project implementation

During our activities KAFC came across with many challenges, which were divided accordingly as external and internal aspects.

External challenges:

1. Special aspects of the transition economy
2. Rapid agrarian reforms
3. National currency implementation
4. Lack of investment capital
5. Macroeconomic environment risks
6. Lack of credit culture
7. Lack of client's credit history
8. Weakness of legislative base
9. Political interference into credit management
10. Corruption of the previous credit system

Internal challenges

1. Lack of managers working experience
2. Lack of loan officers working experience
3. Non-prepared staff
4. Lack of MIS system
5. Lack of understanding of KAFC future
6. Lack of technical equipment

7. Lack of internal regulation procedures
8. Lack of risk management and internal control
9. Lack of regional network

Gradually, KAFC was getting over these challenges with assistance of authorities and donors.

In order to overcome external challenges we made negotiations with the Government of KR, cooperated with the Ministry of Justice, Banks Association, had regional meetings with local authorities and rural people. KAFC used the cautious strategy on activity expanding and elaboration of the further steps with respect to the macroeconomic environment.

Due to Swiss and Japan grants, KAFC has designed the first organizational structure, human resource management procedures, internal credit procedures, etc. In 1998, with technical assistance of TACIS project, acted within the framework of European Union grant, the mission of KAFC was formulated, training for KAFC's officers and making the regional network were started. There was created, by own efforts, the internal information program, quite corresponded to KAFC purposes in the beginning of its work. Creation of KAFC Operational Manual was finished.

At the same time KAFC was strongly supported by the World Bank. The World Bank provided us with advise, consultants, helped in selecting of Management Information System, which is based on the newest technology "Data Base Management System"(Oracle). MIS system will allow conducting accounting in compliance with the international standards, and connecting KAFC branches with Head Office into the united information space. At the moment MIS system is in stage of implementation.

KAFC draws much attention for training of KAFC staff. Our officers were trained in courses and workshops conducted as by the National Bank, Training Centers of Kyrgyz Republic, and by international organizations (APRACA, CGAP, Japanese AFC, RABObank, etc).

Managers of KAFC had earlier worked mainly in the National Bank of the Kyrgyz Republic, the Ministry of Finance and partially in the commercial banks. The work experience and intensive training at the main financial bodies allowed creating a new non-bank financial institution-KAFC. Our managers and officers received Diploma of the Ministry of Agriculture and Water Resources and the Ministry of Finance in 1999, 2001. As a result, in April 2002 KAFC staff was honored with the visit of the Mr.J.Wolfenson, President of the World Bank and Mr. A. Akaev, the President of the Kyrgyz Republic as a successful project.

KAFC has a strong potential to expand operations.

External conditions:

The agrarian reforms completed, legal environment is improved, macroeconomic and politic environments are stable, rapid increase of the farmers' demand;

Internal conditions:

The most important to expand operations: the Management Information System implementation (based on ORACLE and implementing during 2 years) will be completed to the mid 2003 in order to automate the operations and decrease the operational expenses. As a result, it will allow us to increase the operational efficiency. Beside that, KAFC had a well-trained staff and continues the policy of intensive training. In order to determine the strategic plan of expanding operations – we are doing feasibility study and corporate business plan, which will precisely show the future grows of Kyrgyz Agricultural Finance Corporation.

IV. Policy and Donor recommendations based on our experience

1. Ideas for generalizing innovation or technology to new areas or broadening scope

K AFC will continue to generalize new ideas and plan to expand its activity. For that we set the following goals:

1. Corporation will be leader in providing bank services to rural sector, occupying 30% of target market. Within one year it will operate with a banking license.
2. Corporation will be privatized during the next five years
3. Strategic business plan for 3-5 years of K AFC development is being worked out
4. K AFC managers will pay much attention to personnel as essential asset for the bank
5. K AFC will work at its image in order to have strong brand
6. Corporation will be financially stable organization, achieving broader package of banking services and diversification of loan portfolio
7. K AFC's loan portfolio will be diversified over all rural economic activities, maximum 60% in agriculture, while the agriculture portfolio will be well spread over the country and agricultural sub-sectors
8. K AFC will continue to keep good relations with international organizations in order to improve its professional qualifications and also to attract additional financial resources
9. In 4 years time K AFC will be for at least 40% self-funded through savings and deposits
10. Corporation will improve permanently the operational procedures, informational system, functionality and organization structure, risk management etc.
11. All branches of K AFC will be profit-centers

2. Lessons learned from K AFC experience

Lessons learned during years of activity

- Availability of well-developed strategy business plan is necessary for establishment of micro-financing institutions. World Bank and Government of KR have agreed that K AFC is a "temporary institution", which gradually would be absorbed into the banking system. But it was not specified – when, how and under what conditions it would be carried out. Now it is long process to reach agreement between all parties before doing the next step.
- Availability of well regulated legislative environment, which facilitates development of bank and micro-finance operations. K AFC had great difficulties with regulating its activity, for instance, in taxation. It was hard, and we still have obstacles in alienation and sale of pledged property and etc.

- Staff, and especially management personnel, need intensive training before starting their work. Managers and senior employees need to be bankers.
- Special promotion activity is necessary among future loan recipients, especially in countries of transition. Farmers must be educated time and again about their responsibility when receiving loans. Culture of non-repayment of loans is very much ingrained in minds of rural people. As far as possible farmers training satisfies and providing consulting services will be organized
- It is advisable, that micro-finance institution are located close to farmers. Farmers do not have physical possibility to travel far to the institution and thereby loans become inaccessible
- It is very important to have strong support from the side of all governing bodies – Parliament, Government, Central Bank. These organs need to be more like advisors and assistants. New institutions need support.
- As far as possible organize insurance or guarantee system for loan operations
- It is necessary to take into account local features. Even in such a small country like Kyrgyzstan, group lending cannot be applied in all regions or villages
- Group lending has its own features and needs an other approach than for individual lending
- Well functioning of loan or credit bureau is required.
- Detailed control of possible internal or external corruption is required.
- Correct highlighting of key points while working with local governing institutions. Remain at “arms length”, it is necessary to pay attention to their opinion if it is rational and constructive

Final conclusion

The Kyrgyz Republic has 12 years of independent statehood, 9 years of reforms. The process of reform, transition to market economy showed that it is not easy to find the right way of developing. KAFC is one of the successful stories in our country, but before that the country made mistakes with agriculture lending programs. Kyrgyz experience demonstrates to other countries that creation and developing of viable and sustainable financial institution is very possible, if the efforts of local authorities and donors will come together and compliment each other.

Thank you for the attention.

