PD-ABW-961

KAZAKHSTAN COMMUNITY LOAN FUND

FINAL REPORT

Agreement Number: PCE-A-00-96-90028-00

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EXCUTIVE SUMMARY

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> ***As a Lender*** - KCLF was grown from a pilot project in a remote town providing group loans, to a nationally recognized network that serves thousands of mostly female clients with a range of loan products.
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> ***As an Institution*** - KCLF has developed systems and policies that are transparent and sustainable.
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> ***As an Employer*** - It has offered staff an opportunity to apply the latest technologies, manage using democratic principles, and meet career objectives.
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> ***As a Leader*** – KCLF has paved the way for other NGOs to become legally licensed NBFIs and set the standard for micro lending in Kazakhstan.
>
> ***As a Teacher*** – KCLF has trained nearly 100 representatives from NGOs and MFIs across Central Asia who are interested in learning about KCLF's methodology, operating systems, policies, and training programs.

KCLF's design, implementation and refinement offer a wealth of useful experiences for donors and other micro finance institutions. Its lessons prove that focusing on building local institutions, supplemented by sound operating principles and controls, with an eye towards efficiency and profitability -- does lead to sustainability.

At the same time, KCLF has faced various challenges that have required the staff to adapt and change. Historical challenges include slower than anticipated growth due to market saturation and delinquency issues. In the future these challenges will center on the stretching of resources to manage a national-level organization and securing the financing to achieve this end. *KCLF's development has been – and continues to be - a learning process.*

ACDI/VOCA is very proud of its role in helping KCLF achieve financial self-sufficiency. KCLF serves as a role model for other ACDIVOCA programs in terms of empowering staff to take an active role in the management of their institution and serving community needs.

We believe that USAID also recognizes these achievements and stands behind the lessons that are drawn from the KCLF experience. ACDI/VOCA would like to take this opportunity to thank the Micro Finance Office and the IGP grant mechanism for its continued support and belief in making KCLF what it is today.

1. INTRODUCTION: BLANK SLATE TO CONCRETE ACHIEVEMENTS

Going back to project inception in 1996, this section of the KCLF Final Report summarizes organizational accomplishments: from a blank slate to "concrete" achievements. It begins with how KCLF became a legal entity and built a reputation as a credible micro lending institution to receiving an "A" Rating while gaining access to commercial financing.

1.1 Pre-Lending Context

Before KCLF could start its activities, certain steps had to be taken to ensure a well-grounded beginning. This included the promulgation of legislation, articulating a methodology, and training staff.

1.1.1 No Legislation

In 1996, when ACDI/VOCA received the initial IGP grant for $950,000, there was no legislation in Kazakhstan to allow a micro finance organization to legally lend. While other organizations decided to launch their lending operations from their representative offices, ACDI/VOCA made the strategic decision to support the creation of a legal framework to offer micro loans.

In 1996, ACDI/VOCA's team supported an NGO Working Group that was led by USAID representatives. This Working Group drafted a banking regulation that created a new banking form, that of a non-banking financial institution (NBFI). After ten months of negotiations with the government and banking officials, this regulation was approved and ACDI/VOCA was the first organization to register a non-banking financial organization in Kazakhstan.[1]

As the first licensed micro financing organization in Kazakhstan, KCLF – with ACDI/VOCA's technical assistance - has paved the way for other NGOs to become legal entities and register as NBFIs. KCLF staff has also played a key role in collaborating with National Bank officials to create NBFI reporting standards.[2] These achievements will have a long-term impact on how micro finance is viewed by the banking system as well as juridical and government officials.

1.1.2 No Non Collateralized Lending

During 1996, KCLF began its work as a non-profit, non-commercial entity and introduced the concept of non collateralized, micro lending. This was an unknown concept in Kazakhstan and was met with much skepticism.

In Taldykorgan, KCLF's first step was to hire staff and train them about group lending and the importance of micro loans. Much of those initial months were taken to teach staff the basic tenants of solidarity group lending, why serving women is important, and how micro credit serves an key backdrop to gradual economic development.

Once the staff had been convinced about the benefits of group lending, ACDI/VOCA began reaching out to community representatives, local officials, and others to introduce the concept. Over several months, the ACDI/VOCA and KCLF staff made a concerted effort to demonstrate the sound principles of group lending and began forming groups.

The first groups received a great deal of training and encouragement as much emphasis was placed on their success. In November 1997, after KCLF's NBFI license was received, these groups received the first round of loans and were closely monitored. It was through these core initial clients that KCLF made a name for itself throughout Taldykorgan and was able to slowly mobilize and serve the entire region. After

[1] During that time, ACDI/VOCA had registered KCLF as a public, non-commercial fund under the civil code.

[2] Until 2001, KCLF was the only legally registered NBFI in Kazakhstan.

the successful completion of this first round of lending, second and third rounds of loans were disbursed and monitored.

1.2 Initial Project Components

The idea to begin a group lending project in Kazakhstan was based on female entrepreneurs' needs for small-scale loans in remote areas of the country. This basic premise, upon which KCLF was founded, has never changed and remains at the forefront of its mission statement.

1.2.1 Project Site Selection

The project site selection was very important to ACDI/VOCA. As part of the initial planning process, ACDI/VOCA's team conducted a socio-economic review of Kazakhstan to determine potential locations for the new micro lending activity. Taldykorgan was identified during this assessment as the poorest oblast in the entire country, with the lowest GDP figures, infant mortality rates, and unemployment statistics.

Once the Taldykorgan location was identified, the ACDI/VOCA team conducted a market assessment of the city. This included hiring a local research firm and local university students to conduct a survey of Taldykorgan's businesses. This survey questioned entrepreneurs regarding issues such as the following:

- How did they start their business?
- Why did they select to begin this type of business?
- Where did they get the initial capital to start their business?
- What are their business plans for the next year?
- What obstacles do they see to the implementation of their plans?
- Their views on the economy.
- Suggestions for improvements by the government and/or the private sector.

This information offered invaluable guidance to the start-up team when they were developing the original methodology and approach for the Taldykorgan office. For example, it provided a backdrop to determine future loan demand, loan steps, gender-related needs, and training requirements. Over the years, the KCLF/Taldykorgan office has up-dated this survey through subsequent field-level interviews and focus group sessions with clients.

1.2.2 Legal Registration & Legal Status

KCLF was registered in 1996 as a non-profit, non-commercial Fund with the Ministry of Social Affairs. In 1997, KCLF applied to the National Bank of Kazakhstan (NBK) to operate as a non-banking financial institution and received its license in November of that year. This NBFI license allowed KCLF to legally provide micro loans in Taldykorgan and in 1999 a re-registration was done that permitted the formation of branch offices.

As a non-profit fund, KCLF's equity is owned by the foundation itself, and not by individual shareholders. All of its profits are used for its stated Mission. Currently, no legal impediments are encountered by the organization, but KCLF's license with NBK restricts it from mobilizing savings.

1.2.3 Group Lending Methodology

KCLF uses a group lending methodology that provides small, stepped loans that are designed to measure client credit-worthiness over a period of time. No collateral is required for loans, as the group guarantees each member's loans.

Groups are self-formed among trusted businesses and friends. Each group is encouraged to diversify its group-member's businesses to reduce overall risk from economic downturns or changes in local laws. Groups are trained to assess businesses and make decisions regarding loan sizes and loan terms; each group must approve the loan applications of their members before disbursement can occur. While loans are made between KCLF and individual borrowers, loan are disbursed, repaid, and guaranteed by the group.

The group lending methodology and the stepped loan approach appears has been adapted to Kazakhstan context. The maximum initial loan size is $100 and terms start at two to four months and extend to twelve months for the largest loans. Group members analyze each other's loan applications and make their own decisions about loan sizes and loan terms. Once approved by the group, borrowers receive initial loans of up to $100. Each successive loan cycle affords borrowers the chance to increase their line of credit – up to $3,000. The incentive to repay loans is based on continued access to credit and business services and well as peer pressure.

Loan level	*Amount*	*Interest rate*	*Term*
1st loan	$1-$100	50%	2-4 months
2nd loan	$100-$250	55%	4-6 months
3rd loan	$250-$500	60%	4-8 months
4th loan	$500-$750	65%	6-10 months
5th loan	$750-$3,000 (max)	65%	6-12 months

This system allows each member in the group to select loan sizes and terms that meet their individual business needs. Based on its flexible design, this loan schedule has been consistently applied across KCLF branches as clients have found it convenient and responsive to their business needs.

1.2.4 Clientele

KCLF was originally designed as a program to serve the needs of female entrepreneurs. It has never lent exclusively to women, but has geared its loan products and customer service to this client group. This was deemed necessary due to the extremely high rate of unemployment among women after the break-up of the Soviet Union and the significant number of female-headed households.

KCLF's product of small, group-based loans has been attractive to female entrepreneurs in Kazakhstan and over eighty percent of KCLF's clients are females in businesses with equity of $1,500 or less. The majority of female clients are heads of households and support two or more dependents. Monthly net profits of KCLF's clients range between $50 and $500.

Box 1
Client Case Study

Kutpinisa Anarkulova is a bread maker in the Kazakhstan city of Shymkent. She has been a KCLF client since March 2000. Kutpinica used to buy her flour and materials on credit but now saves around 15-20 percent by buying her products in cash. This profit margin allows her to be competitive in the Shymkent break market.

Kutpinica is a widow and supports her son and three grandchildren with her business profits. She is a hardworking and honest micro entrepreneur and sets a good example for other KCLF clients.

Kutpinica has told the KCLF staff that she would like to continue to take working capital loans to help her business grow and expand over the coming years.

KCLF's client base has limited experience dealing with banks or financial institutions. Over 90 percent of KCLF's new clients have never received any previous business training or financial assistance. As these small businesses begin working with KCLF they gradually build basic business and financial skills as well as a credit history.

As KCLF has diversified its products, it has also begun serving new types of clients. This includes small manufacturers and service businesses as well as the very poor (through its consumer lending program). By reaching out to a wider clientele, KCLF has an opportunity to have a greater economic impact throughout the country.

1.3 2001 – 2002

1.3.1 Name Recognition

After KCLF's first year of lending, it had gained a substantial reputation in Taldykorgan. Through word of mouth, loan officer outreach, and advertising, KCLF became well known throughout the city as a client-friendly organization that served the needs of the poor, micro entrepreneurs.

During its second year of lending, KCLF's brand recognition began to spread out to the rural areas outside of Taldykorgan. Staff began regularly receiving requests from neighboring towns and villages for KCLF loans and assistance.

During its second year of operation, KCLF decided to begin serving the areas outside of Taldykorgan. It hired several new loan officers and trained them in the KCLF methodology and began rural lending through these new staff. This expansion was well received throughout the neighboring region as KCLF began to serve a poorer, more rural clientele.

By mid-1999 KCLF realized that it had a product that could be replicated outside the Taldykorgan region and applied to the IGP Office for additional grant to fund an expansion to Southern Kazakhstan.

1.3.2 Replication

KCLF conducted a market survey in the Southern city of Shymkent in early 1999 to assess its needs. Based on its low socio-economic indicators and viable entrepreneurial community, Shymkent was identified as the next most viable expansion option for KCLF.

In the fall of 1999, ACDI/VOCA received an amendment to its Cooperative Agreement with the Micro Enterprise Office and began concrete expansion plans. In September, a Shymkent office was identified, staff were hired and trained, and the first loans were disbursed in February 2000.

By the end of its first year, the KCLF/Shymkent branch excelled with a solid staff and growing client base. Break-even occurred after eight months of lending with a total of 712 active clients and a $115,116 outstanding portfolio. To date, the Shymkent branch is KCLF's largest and most profitable branch, surpassing the original Taldykorgan office in client numbers (1,736) and portfolio size ($528,361).

KCLF's successful replication in Shymkent provided management with a solid backdrop to begin its Almaty office expansion in mid 2001. Building a profitable new office also brought KCLF prestige within the donor and local banking communities.

1.3.3 Product Diversification

By mid 2000, the Taldykorgan branch reached an active client base of 2,700 and management began to foresee a saturation point for group loans.[3] KCLF conducted a market assessment in late 2000 to gain a better understanding of its market penetration and changing business needs.

The assessment revealed that there was strong demand for larger, individual loans in and around the Taldykorgan area. In the winter of 2000/2001 the KCLF staff began a product design process to develop a

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[3] As will be discussed below, product diversification also came at a time when the branch was faced with a growing portfolio at risk from its group borrowers.

new loan product to meet small business needs. The outcome of this process was KCLF's individual loan product offering loans of $750 - $5,000 with flexible collateral conditions.

Taldykorgan launched this individual product in 2001. This new product has provided this branch with a diversified portfolio that includes not only traders (group loans) but also smaller, manufacturing businesses (individual loans). Individual loans currently make up 18 percent of Taldykorgan's portfolio ($83,000). As of June 2002, KCLF has introduced individual loans at the KCLF Shymkent branch, which has a $5,000 active portfolio and 5 individual, active clients as of October 1, 2002.

In late 2001, KCLF undertook another market survey to further refine its marketing and product delivery in Taldykorgan. This survey provided KCLF with new insight to develop another loan product not linked to business development. Design and refinement of a consumer loan product began in late 2001 and early 2002; in the summer of 2002 KCLF launched its first consumer loans in Taldykorgan.

The consumer loan product is based on the principles of group lending. Groups of 4 – 10 individuals come together to take loans of $50 - $500 to purchase consumer goods or provide for family needs. As of October 2002, the majority of consumer loans have been for educational purposes and there has been no delinquency to date. Consumer loans are marketed mostly through organizations and firms. The current consumer loan portfolio is $40,000. After an evaluation is done on its viability, KCLF will determine whether to offer this product in other branches.

1.3.4 Outreach and Break-Even

The financial self-sufficiency of each branch office has been paramount to KCLF's success. Each branch office is structured as a cost center and key portfolio indicators are tracked on a monthly basis (See Example of Monthly Trends Analysis below). An analysis of these indicators is done at the end of each month to identify potential problems and issues that should be addressed.

Example of Monthly Trends Analysis

INDICATOR	JANUARY	FEBUARY…..	BENCHMARK
Portfolio Indicators			
Active Portfolio			
Growth in Active Portfolio			
Number of Active Clients			
Growth in Number of Clients			
Growth in monthly Disbursements (Repeat and New)			
Average Loan Size			
Active Portfolio by Loan Officer			
Portfolio at Risk (> 1 day)			
Repayment Rate			
Client Retention			
Profitability Indicators			
Operational Sustainability			
Operational Efficiency			
Administrative Efficiency			
% of Expenses for Staff			
Number of Clients Per Loan Officer			
Number of Clients Per Employee			
Organization			
Number of Client Dropouts			
Number of Internal Trainings			
Number of Resignations			

In Taldykorgan, break-even occurred during the second full year of operation after significant levels of outreach had been achieved (1,400 active clients and $263,000 portfolio). The lessons learned from this experience allowed the KCLF staff to develop a cohesive model that it took to Shymkent and later to Almaty.

While there are many underlying goals of each branch office, break-even and continued outreach is central to achieving KCLF's Mission Statement. Through continued branch expansion and outreach KCLF is assured a key role in Kazakhstan's formal financial system.

1.3.5 Consolidating and Administrative Headquarters

Until 2001, all of KCLF's operations were supervised through the Taldykorgan office. As the original branch, it also served as its administrative headquarters. This became an inefficient arrangement for two reasons. First, the administration of KCLF's activities from Taldykorgan resulted in a subsidization of these overhead expenses by the local branch. Second, the logistics of managing the Shymkent office from Taldykorgan was extremely cumbersome.

In 2001, ACDI/VOCA applied for a second extension to its IGP grant to provide KCLF with one additional year of technical assistance to restructure its administrative headquarters in Almaty. In the fall of 2001, KCLF moved several key senior staff from Taldykorgan to establish its new headquarters in Almaty.

As KCLF and ACDI/VOCA assessed the necessary steps in this consolidation process, they recognized the effectiveness of also establishing a KCLF/Almaty branch office. As such, funding was sought (in conjunction with the USAID funds) to support the KCLF/Almaty branch operations.

In June 2001, KCLF set up its new Almaty branch based on the direct support of the Eurasia Foundation. In September, the branch began dispersing loans and currently has an active portfolio of $144,000 and a 700 active client base.

The headquarters staff consists of 5 senior staff, including the General Director, a Director of Finance, Director of Operations, Director of Communications, and a Computer Specialist. A financial restructuring of expenses was established whereas each branch office provides funding to the headquarters based on the size of its portfolio (in relation to the entire KCLF portfolio). As such, the headquarters office is truly and overhead expense for the entire institution and provides technical assistance and guidance to all branch offices.

The consolidation of KCLF's office to Almaty is central to KCLF's strategic goals of outreach and expansion. Now, as KCLF prepares to launch its fourth branch in Taraz, it has an administrative structure that can effectively supervise and guide the growth of its branch network across the country.

1.4 Multiple Investors

While USAID has been the primary donor supporting the development of KCLF, ACDI/VOCA – together with KCLF staff - have been very effective in mobilizing other donor resources (as well as commercial capital) to finance its operations in Kazakhstan. As depicted in Table 1, most of these funds have been for lending capital to support portfolio growth. The notable exception has been Eurasia Foundation's recent direct support to the KCLF/Almaty branch office until it achieves operational self sufficiency.

Table 1
KCLF Donors & Funding

DONOR	AMOUNT	USE
USAID	$2.75 million	Technical Assistance through ACDI/VOCA, operational funds, and lending capital
Eurasia Foundation 1999 2001	 $150,000 $150,000	 Lending Capital Operational Funds (Almaty)
USDA Food Monetization Proceeds	$250,000	Lending Capital
HIVOS 1998 2002	 $10,000 100,000 Euro	 MIS Support Unrestricted
Soros Foundation	$100,000	Lending Capital
New Hampshire Episcopal Diocese	$10,000	Lending Capital

The Eurasia Foundation has signed a grant agreement directly with KCLF for the complete funding of the Almaty branch during its first year of operation. During this period, KCLF was responsible for identifying a co-sponsor for the branch. If they were able to identify a co-donor, Eurasia agreed to fund a second year of Almaty branch expenses (for salaries only). KCLF's co-sponsor in 2002 was the HIVOS fund in the Netherlands, providing KCLF with an unrestricted 100,000 Euro grant for operational funding and/or lending capital.

1.5. Moving Towards Commercialization

By 2001, it became apparent to KCLF management that it needed to explore commercial avenues of financing. The challenge for staff was the identification of banks or other parties interested in KCLF and willing to fund its activities. To facilitate the walk towards commercialization, KCLF took a local mortgage to buy a building, went through a rating process, and began negotiations with a financial intermediary.

1.5.1 Commercial Bank Loan

During its annual strategic planning process in 2001, KCLF recognized several important trends. First, a great deal of funds were going to be spent in Almaty due to the high cost of rental space and a higher level of salaries in the commercial capital. Second, financial projections in MICROFIN showed a medium-term need for additional lending capital to support the KCLF network.

Based on these two strategic issues, KCLF decided to approach local commercial banks for a mortgage. By securing a mortgage for an Almaty office space, KCLF hoped to lower its on-going administrative expenses (over the long-term) and secure a building that would serve as collateral for future loans.

Independently of any donor, KCLF senior staff began a thorough assessment of the lending market for mortgage loans. The local bank, Turen Alem, was selected as the most user-friendly and potential long-term ally for KCLF. In the summer of 2001, KCLF secured its first commercial bank loan for $140,000 to purchase a 5-story newly remodeled building in downtown Almaty. This building now serves as both the Almaty branch office and KCLF administrative headquarters.

1.5.2 MCRIL Rating

In late 2001 KCLF decided to undertake an international standard rating. A tendering exercise took place to identify the best organization to complete this rating. KCLF received three proposals from: PlanetFinance, MCRIL, and Microfinanza. KCLF also approached CGAP to co-fund this rating and received a grant to off-set the expense.

In January, 2002 MCRIL was selected as the rating agency and sent a team of two experts to conduct the rating. The MCRIL team was well versed in micro finance, accounting, and general institutional development issues. They approached the rating in a structure similar to that of CGAP's standard methodology of institutional assessments.

KCLF received a grade of "A" from MCRIL which was a major achievement for KCLF. This Rating has been provided to various donors (such as CGAP) as an indicator of KCLF's credit worthiness. The final report was sent to CGAP electronically and placed it on their website as public information.

1.5.3 Dexia Loan

The MCRIL Rating served as an important stepping stone for KCLF to approach the international fund managers, Blue Orchard. Blue Orchard is a financial intermediary for the Dexia Bank in Luxembourg and seeks qualified micro finance institutions as long-term investment partners.

Box 2
Why Commercial Financing?

KCLF was faced with a dilemma in 2001 as donor funding was coming to an end and there were pressing financial needs to meet expansion plans. KCLF initiated a series of staff meetings to garner ideas about how to meet its financial challenges in the coming years. This process generated a host of ideas including approaching international sources of financing.

In the winter of 2001/2002, KCLF opened a dialogue with Blue Orchard to investigate the possibilities of receiving a commercial loan through their banking partner, Dexia Bank. The first steps consisted of an exchange of information including four years of external audits, current financial statements, a concise description of KCLF's activities, Board membership, and annual reports. One of the outstanding elements KCLF did not have was an external rating – which it underwent in January 2002.

In the summer of 2002, a representative from Blue Orchard visited KCLF to become more familiar with its operations. Loan requirements were finalized in these meetings and in August 2002 KCLF received its first $100,000 non-collateralized loan from Dexia Bank. These funds are now playing a critical role in KCLF's expansion strategy and a parallel loan is being negotiated to begin in early 2003.

One of the important lessons KCLF took from its commercial lending experience was the need for financial transparency from *day one* of its lending operations. This includes having not only external audits, but sounds systems that can meet international standards, and a legal operating position that will allow for commercial debt. In addition, KCLF found that a skilled lawyer is highly beneficial to facilitate the negotiation and final loan approval process.

In 2001, ACDI/VOCA and KCLF approached the Blue Orchard representative to begin their consideration of KCLF as a future investment prospect. Over the following year, ACDI/VOCA guided KCLF through the process of meeting the Blue Orchard requirements, including completing an on-line database of quarterly financial statements and portfolio information.

In August 2002, KCLF received its first loan from Dexia Bank in the amount of $100,000. This is an uncollateralized loan at a 6 percent APR. KCLF has already disbursed the entire amount and has begun verbal negotiations with Blue Orchard to secure a parallel loan in early 2003.

1.6 KCLF at a Glance: September 2002

KCLF has achieved a great deal in its five years of lending. It can mark achievements as a lender, an institution, a leader, and a teacher. Together, these tell an interesting picture of a local MFI that has become recognized as a democratic decision-making institution that serves the micro entrepreneurs of Kazakhstan.

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Table 2 and 3 below summarize KCLF's financial position as of September 2002. This financial snapshot reveals a healthy institution that has a growing equity based and improving capital adequacy that will make future commercial financing possible.

Table 2
Balance Sheet and Income Statement

BALANCE SHEET (in US Dollars)

ASSETS	**September 30, 2002**
Cash and Deposits	184,973
Loans Outstanding	1,186,140
Loan Loss Reserve	(2,462)
Net Loans Outstanding	1,183,678
Net Fixed Assets	563,811
Inventories	7,102
Accruals	13,769
Accounts Receivable	27,580
Total Assets	1,980,913
LIABILITIES AND EQUITY	
Current Liabilities	16,521
Non-Current Liabilities	192,984
Deferred Income	1,257
Equity	1,771,408
Donated Equity	210,213
Current Year Profits (loss)	(16,224)
Prior Year Retained Earnings (loss)	1,577,419
Total Liabilities and Equity	1,980,913

Table 2, con't
INCOME STATEMENT (in US Dollars)

	September 30, 2002
Financial Income	410,020
Financial Expenses	14,267
Administrative Expenses	434,317
Total Operating Expenses	448,584
Net Profit/(loss) from Operations	(38,564)
Non-Operating Income and Expenses	244,999
Grants and Donations	210,213
Other Non-Operating Income (expenses)	33,857
Loans Written Off	929
Total Profit/(loss)	204,576
Income Tax	11,516
Net Profit	193,060

The portfolio information presented below reveals a healthy institution with a diversified lending base. With three active products, KCLF has disbursed over 40,000 loans through $12 million, while retaining a portfolio at risk rate (> 30 days) of less than 1 percent.. Table 3 also shows that KCLF has helped almost 4,500 poor start businesses and/or create employment in some of the most difficult areas in Kazakhstan.

Table 3
Portfolio Indicators, September 2002
(in US Dollars)

INDICATOR	GROUP	INDIVIDUAL	CONSUMER	TOTAL
Portfolio Information				
Active Clients	3,847	70	239	4,156
Credit Portfolio	1,021,970	87,658	39,212	1,148,840
Loans Disbursed for the year	10,252	104	284	10,640
Cumulative Loans Disbursed	40,919	121	284	41,324
Delinquency				
Portfolio at Risk (> 30 days)	.36%	0	0	.32%
Amount of Delinquency	3,056	0	0	3,056
Repayment Rate	99.87%	100%	100%	99.88%
Written-Off Loans (year)	40	0	0	40
Amount Written Off (year)	7,941	0	0	7,941
Profitability & Efficiency				
Average Clients Per Loan Officer	148	7	34	97
Average Portfolio per Loan Officer	40,000	8,766	560	26,717
Loan Use				
Average Loan Size	286	1,861	220	290
Loans for Working Capital	97%	80%	0% (mostly education)	
Loans for Fixed Assets	3%	20%	0%	
Impact				
Female Clients	84%	81%	79%	
Number of Start-Ups (cumulative)	1,244	1	0	1,245
Number of Jobs Created and Retained (cumulative)	2,878	343	0	3,221

2. EVOLUTION TIME LINE

The matrix on the following page depicts a two-dimensional picture of KCLF's organizational development. The rows reflect a time series of events, beginning with start-up, expansion, replication, and commercialization. The columns "structure" the time-line into different categories – such as governance, donor-funded interventions, institutional development, products, systems, strategic challenges, and impact.

What is clear from this pictorial diagram of KCLF's history is that progress was achieved only through a multi-faceted approach of working at various levels. For example, the success during start-up was achieved not only through the obtaining of an NBFI license but with the development of a transparent institutional culture, designing a loan product that met micro entrepreneurs' needs, and empowering local staff.

It is also important to note the series of achievements and impact that KCLF has had over the course of its historical development. These fall into the following groupings:

- *Promising Product* – KCLF receives the first NBFI license for micro finance in Kazakhstan and disburses its first loans.
- *Sustainable Model* – KCLF has demonstrated a sustainable model and developed a product that has a clear market niche. Operational break-even is achieved during the second year of operations.
- *Replicable Model* – KCLF retools the model and expands to a new location.
- *Bankable System* – KCLF receives an "A" rating from MCRIL in 2002 and takes its first commercial loan.

KCLF's evolution is noteworthy and shows steady progress over time at multiple levels. As KCLF proceeds into the future, these stepping stones will serve as important points of departure for its continued success.

3. BUILDING AN EFFECTIVE MICRO FINANCE INSTITUTION

3.1 Governance

KCLF's legal status and governance have played a key role in its success. In addition to its charter, KCLF's board and executive committee ensures a well-governed institution.

3.1.1 Charter and Legal Structure

KCLF is registered as a non-commercial, public fund with a license from the National Bank to operate as a non-banking financial institution (NBFI). As a public fund, KCLF's charter serves as the founding legal document that guides all activities.

KCLF's charter outlines the basic structure of the fund in terms of mission, objectives, and clientele. The charter also sets out the framework for the staffing pattern, in terms of a General Director, Director of Finance, and Internal Auditor.

As a public fund, KCLF is required to have a "founder" that maintains control over critical aspects of the fund, such as Board membership, new branch development, and liquidation. ACDI/VOCA is named as KCLF's founder in its charter document, which is registered with the Ministry of Social Affairs.

	Start-Up *October '96 – Dec '97*	*Proving the Model in Taldykorgan* *1998 - Sept '99*	*Replication in Shymkent* *October '99 – Sep '01*	*Going National and commercialization* *Oct '01 - Present*
Governance	• KCLF registered as not-for-profit fund operating in Taldykorgan- 1997. • Receives 1st Non-Bank Financial Institution license - 11/97.	• Active Board of Directors established – 1/99. • Strengthened model & began rapid outreach.	• Amend charter to allow operations throughout Kazakhstan and to establish branches.	• Change in Board of Directors. • Amend charter to limit powers of the founder to approving board members and branch expansion.
Donor-funded interventions	• ACDI/VOCA receives USAID-funded Innovative Grant (IGP), $950,000 to develop group lending model in secondary city	• IGP project adjusted to allow for resident technical assistance. Ms. Stallard arrives in April '98 • Eurasia Fund grant - $150,000 • USDA grant - $250,000	• Phase II of A/V's IGP $1.5 mil to replicate micro enterprise lending in Shymkent	• Phase III of IGP $300,000 to retain ACDI/VOCA technical assistance for additional year
Institutional	• Development of transparent and learning culture.	• Purchase of building in TK • Hiring & training local KCLF Director.	• Shymkent branch opened in November '99. • 1st loans in Shymkent in February 2000.	• Two-tier management structure, Almaty HQ and branches.
Products	• Design of group formation process and loan product • First group loans formed and disbursed.	• Refinement of group formation and lending methodologies.	• Individual loans introduced in Taldykorgan in 2001.	• 1st Consumer loans – 4/02
Systems	• Hiring & training process established. Using leadership and loan training to screen candidates transparently.	• Formal strategic planning process launched in 1998. • Annual external audits begun '98. • Design/implementation of loan tracking software (ISKRA) in '99.	• More structured group and portfolio management procedures	• Consolidated accounting system for all branches.
Strategic Challenges	• Legal standing • Building [illegible] • Developing loan methodology	• Creating corporate and market identities • Developing management systems.	• Delinquency in TK. Distractions of replication, disparate loan sizes within groups, market saturation and loose group oversight all contribute. • Contraction in TK.	• Distinct market characteristics of Almaty branch • Going "national" • Going "commercial"
Impact and significant achievements	***PROMISING PRODUCT*** • First NBFI license • First loans • Borrowers paid back their unsecured loans	***SUSTAINABLE MODEL*** • Demonstrated market niche in TK. • Operationally Self-Sufficient • Learning Model	***REPLICABLE MODEL*** • Tightening of group management procedures. • Introduction of individual loans for faster growing entrepreneurs.	***BANKABLE SYSTEM*** • A rating by MCrill in 2002. • Blue Orchard managed loan from DEXIA Bank – 8/02 in the amount of $100,000.

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Box 3
KCLF Law Suits

Together, the charter and KCLF's license allow the fund to sue its delinquent clients. This has been imperative over the years as KCLF has had to sue businesses that were unwilling to repay their debts.

This was a new concept to many KCLF staff who had never dealt with the judicial system during the Soviet Era. As such, KCLF management had to explore various options to teach staff on the merits of working through the judicial system.

After the first law suits, it became well-known to businesses throughout Taldykorgan that KCLF would take delinquency seriously. Over the years, KCLF's legal status has been central to ensuring its reputation and sound financial status.

Since inception, KCLF has won all of its lawsuits and has developed a sound reputation within the local, judicial system. The Taldykorgan office now has a full-time lawyer that overseas all KCLF lawsuits for that office. To date, the other offices have had no delinquency but may hire lawyers as the need arises.

As noted earlier, KCLF applied to the National Bank of Kazakhstan in 1997 to become the first registered NBFI providing micro loans in the country. This license is critical to KCLF's legal lending and has proved central to its transparent operation.

As a non-profit fund that charges interest and technically makes a "profit" KCLF has been required by the tax authorities to pay a profit tax and VAT. Value-added Tax is charged on a range of products, but most importantly is charged on KCLF's one percent commission. The profit tax is paid to the tax authorities on the revenue earned minus income.[4]

In the long-term, KCLF is considering changing its legal status to a commercial fund – such as a joint-stock company. The benefits of being a commercial fund is that equity investments and international borrowing would be easier. However, KCLF will retain its public fund status for the near-term as this provides a tax free window for future grants.

3.1.2 Historical Development of Board

In the winter of 1998, KCLF held a strategic planning session to determine the structure and composition of its first Board of Directors. Due to its relatively remote location in Taldykorgan, KCLF staff was concerned about bringing representatives from Almaty to participate in Board membership. As a result, different configurations were considered to allow for a strong Board that would actively participate in its strategic vision.

ACDI/VOCA, together with KCLF staff, decided that the best Board structure was to encourage client participation, supplemented by donors and staff representation. As such, the following structure was given to the first Board in 1999:

- 5 representatives from KCLF's client base
- 2 representatives from the international donor community
- 2 representatives from KCLF staff

To launch this process, KCLF undertook a thorough evaluation of its existing client base and interviewed loan officers and staff to identify the most qualified candidates. Based on this assessment, KCLF identified

[4] This is calculated *before* loan loss provisions are calculated. This issue has recently been raised by KCLF to government authorities and is currently under consideration. KCLF would like to have the same benefits as the second tier banks which calculate profits after loan loss provisions are calculated.

10 likely client candidates for Board membership. These candidates were interviewed and screened to ensure that they understood their potential role and would be active participants.

In January 1999, KCLF held its first General Assembly of clients to democratically elect client representatives to the Board. Five members were elected through this process and later, five KCLF staff members were nominated and two were elected to the Board. USAID and the Soros Foundation were invited as the original "donor" Board representatives.

Over the following three years, monthly Board meetings were held to discuss strategic issues. Over time, however, there became less enthusiasm from the clients and donors (traveling from Almaty) to attend Board meetings and KCLF began considering restructuring options.

After KCLF moved its headquarters to Almaty, new opportunities arose for Board membership. In January 2002, KCLF redrafted its charter document and re-registered it with the Ministry of Social Affairs. This new charter placed new importance on the Board's roles and responsibilities and framed membership to include one donor, one micro finance consultant/representative, one lawyer, and two NGO/entrepreneur representatives.

In February 2002, KCLF held its first newly empowered Board consisting of the following membership:

- The Director of the Eurasia Foundation
- The Kazakhstan Country Representative of ACDI/VOCA[5]
- The gender lawyer from the American Bar Association
- The Director of the Business Women's Association (a national level organization representing women's rights issues)
- The Director of the Entrepreneur's Forum (a national level organization that represents small business interest to the Government of Kazakhstan)

The first Board meeting in February included a training session from ACDI/VOCA's Washington, DC office on the duties and responsibilities of a Board of Directors. This session instructed the Board about their strategic leadership role and fiduciary responsibilities. Several sessions were held after this initial meeting to review and finalize changes to the Board's By-Laws (that were then submitted to the Ministry of Social Affairs and the National Bank). The KCLF Board of Directors currently meets on a quarterly basis to discuss strategic issues and key structural issues.

KCLF now has a high profile Board that can provide the fund with leadership to guide its future growth and development. Board representatives are also well-respected members of the business community and will serve as important contacts throughout KCLF's growth and development.

3.1.3 Executive Committee

During the consolidation process of bringing the headquarters to Almaty, KCLF also revised its charter document to provide greater clarity to the division of power between the Board of Director and General Director. ACDI/VOCA and KCLF decided that one formal mechanism to institute this division was the creation of an Executive Committee. It was decided that the composition of the Committee would be the General Director, Director of Finance, Director of Operations, and Director of Communications.

The Executive Committee's role is to establish an intermediate-level decision-making body that serves as a double check on the General Director's authority. The Executive Committee's responsibility is to regularly meet to discuss critical management decisions and take group decisions on key issues. This Committee has become a flexible mechanism to provide the General Director with structured insight and guidance on the day-to-day management of the fund.

[5] This is – and will remain – Janice K. Stallard, who fills the spot of micro finance consultant.

3.2 People

Hiring quality staff is a central KCLF tenant. A great deal of time and resources are spent on recruiting and then training all staff members. KCLF has a 63-person staff of which 75 percent are women.

3.2.1 Management Structure

KCLF's senior management resides at its headquarters in Almaty. The day-to-day management of the fund is done by the General Director. Reporting directly to the General Director are three functional directors including, a Director of Finance, Director of Operations, and a Director of Communications. The duties of these directors are as follows:

- Director of Finance – supervises the financial and accounting units in each branch, conducts the analysis of KCLF's efficiency and profitability, reports to donors, and oversees all tax related issues.
- Director of Operations – supervises all branch-level operational activities, including training new loan officers, market assessments, and client outreach and evaluation.
- Director of Communications – responsible for KCLF's promotional activities, supervising all external and internal training efforts, and managing communications with international and regional partners.

Each branch is structured in a uniform manner, including a Branch Manager that supervises daily activities. Each branch has three departments, including Finance and Accounting, Operations, and Administrative and Computer Support. These departments have the following tasks:

- Finance and Accounting Department – consists of accountants and cashiers that handle daily disbursement and repayment activities. Normally supervised by a chief accountant.
- Operations Department – consists of loan officers who perform outreach and daily client interactions. Normally supervised by a senior loan officer or Coordinator.
- Administrative and Computer Department – consists of one or two database operators, a computer specialist, a lawyer, and secretary.

3.2.2 Transparent Hiring and Promotion

In 1999, KCLF began recruitment and hiring process that was based on democratic and transparent principles. As such, an internal hiring committee was established for 6-months (to be rotated every 6 months) comprised of randomly selected KCLF staff. KCLF's General Director also sat on the committee but was given only one vote.

The internal hiring committee was given complete powers to interview, test, and score candidates for all positions. At the end of the interviewing process, a vote was taken on candidates and the majority position ruled.

This simple, but imperative hiring process became central to KCLF's successful recruitment. By establishing this committee, KCLF involved staff in one of the most important management aspects of its business. This reinforced to staff that management was dedicated to utilizing democratic principles in all aspects of its operations.

In addition to staff involvement, the hiring committee provides a more well-rounded approach to making staff decisions. It gives staff an opportunity to voice their opinions and empowers them to take ownership in KCLF's activities.

KCLF management also made a policy that staff would have the first opportunity to apply for any internal vacancies. This internal promotion policy has allowed secretaries to be promoted to chief accountants – as was the case in Taldykorgan. The KCLF staff takes pride in these policies that gives them both job satisfaction and professional opportunities.

3.2.3 Training

To compliment the transparent hiring process, KCLF also instituted its own series of internal training programs. Many of these programs were developed due to a lack of existing training on the local market, although KCLF does make use of specialized micro finance training – such as that offered by the Micro Finance Center in Poland.

A complete list of the internal trainings is listed under the lessons learned section, but it is noteworthy to emphasize the resources KCLF devotes to loan officer training. In 1999, it became apparent that KCLF standard loan officer training was not efficient to give new staff the skills they needed to effectively operate as loan officers. This existing training was a three-day screening process that introduced KCLF's methodology to candidates and scored them based on three elements: (1) communication skills; (2) understanding of the methodology; and (3) ability to work with others/conflict resolution skills.

In early 2000, KCLF added a new one-month probation period for all loan officers that included intensive hands-on training regarding KCLF's documentation process, systems, and automated MIS.[6] Two specialized trainings were developed on how to assess a business that included basic communications training and a second training on financial analysis. At the end of this first month of training, loan officer candidates are evaluated and a final determination is made on their placement.

After loan officers pass their first month on probation, they are assigned to work with a more experienced loan officer for one month. At the end of this month, if they are considered ready, new loan officers are allowed to start serving clients.

This more rigorous approach to training loan officers has ensured a solid platform from which to reach new clients and serve existing clients. KCLF's internal training programs recognize the importance of the loan officer in all aspects of its business and works to help them improve their activities – and, in turn – improve KCLF's overall performance.

KCLF currently devotes 5 percent of its annual budget on internal training for all staff. This includes the organization and implementation of internal training for all staff as well as attending specialized micro finance training abroad.

3.3 Strategic

Building an effective institution requires developing sound strategic plans and policies. KCLF's strategic outlook also includes a constant assessment of its market position and potential for outreach.

3.3.1 Strategic Planning and Setting Benchmarks

In the winter of 1998, KCLF began its first strategic planning session. This included all staff in a process to develop a three-year strategic operational plan as well as establish benchmarks for the future.

A one-day workshop was held with all staff to gain their insight regarding the first year of operations, what had been learned, and where KCLF should be going. This strategic planning process proved very fruitful and gave management a clear vision for future operations. Time was also devoted during this first meeting to formally recognize KCLF's Mission Statement (which stands to this day).

[6] KCLF provides loan officers with access to all client information through its internal network, on a "view" only basis.

The initial three-year strategic plan provided KCLF with a path for its forward growth and development. It outlined key objectives, major activities to achieve those objectives, the necessary resources (financial, human, and institutional) for implementation, and operational benchmarks.

KCLF now conducts an annual, branch-level strategic planning process. This process always begins with a review of that year's strategic plan and benchmarks. Assessments are made regarding achievements and failures. This branch-level work provides staff an opportunity to structure its localized activities in addition to providing suggestions for KCLF's overall efforts.

Branch Managers and headquarters staff meet annually to synthesize these strategic plans and develop a consolidated plan for the institution. The consolidated strategic plan then serves as KCLF's guiding document for the following year.

3.3.2 Market Analysis

KCLF is constantly reviewing its market position and assessing the potential for growth. Most branches include in their strategic plan an outline for its expansion plans. According to the scope of the expansion, the market assessment is conducted at the branch or headquarters level.

Normally, when a branch decides to expand to a neighboring market or village it conducts its own market analysis through existing loan officers. However, as KCLF has begun to strategically launch new sub-offices, these market assessments will be coordinated from the headquarters.

The two key elements to KCLF's market analysis are: understanding potential demand and the competition. KCLF normally hires an external research firm to conduct a thorough market analysis of potential demand for group and small-scale individual lending. This includes surveys of entrepreneurs working in bazaars and on the streets as well as selective focus group sessions. A systematic review of the competition is completed in-house to gain an understanding of their products and services.

Once KCLF completes its analysis of a new market, a staff-level meeting is held to discuss the findings and make a decision. These brainstorming sessions usually lead to key decisions being taken regarding the new market opportunity.

In general, KCLF has conducted its market analysis on an as needed basis. However, as it begins to grow in size and scope, KCLF has included an annual market review as part of its operational plan.

3.4 Systems

Developing sound operating systems is basic for a sustainable micro finance institution. KCLF's systems include a sophisticated management information system, internal controls, and staff incentive systems.

3.4.1 Information Systems

KCLF began lending using a US-based management information system (MIS) called General Management Systems (GMS). GMS served KCLF well in the early years although it soon became apparent that the English-based system had significant weaknesses that would not allow KCLF to meet its outreach goals.

Therefore, in 1999 KCLF applied for and received a small grant from HIVOS/Netherlands to develop its own MIS. KCLF hired a local programmer and began the implementation of its own licensed software called, ISKRA (which means entrepreneur in Kazak).

ISKRA serves as KCLF's portfolio management system and is a highly flexible management tool. ISKRA houses all client and loan information as well as providing some financial information – such as an aging of the portfolio, portfolio at risk, and repayment rates.

All information is entered daily and is available on a network which allows KCLF managers, loan officers, and accountants to have "real time" portfolio information. ISRKRA has a sophisticated security system that allows only certain employees to enter information. However, all portfolio information is available to staff to "view" through an internal network, providing loan officers daily up-dates on their client's activities.

ISKRA is an extremely flexible tool that has grown with KCLF over the years. Through continuous up-grades and changes, ISKRA now automatically consolidates all branch information on a daily, weekly, and monthly basis.

3.4.2 Internal Controls

Every micro finance institution needs a system of internal control. KCLF learned, however, that this can be initially done in a simplified manner through internal cross-checks. The key was teaching the staff about how to manage cash and financial transactions in a clear manner that could be easily checked and reconciled.

KCLF developed a standardized matrix of procedures and cross-checks during its first three-years of operation to ensure that cash deviations were rectified and fraudulent actions were identified. Now, with three branch operations and soon a fourth, KCLF has hired an internal auditor that will undertake formal responsibility to ensure internal control compliance.

The internal auditor reports directly to the Board of Directors. The auditor's responsibility is to undertake regular financial and portfolio reviews of KCLF's operations. While the auditor must note and take action on financial and client activities that do not conform to policies and procedures, an emphasis is placed on highlighting innovation. This emphasis on the positive, or creative solutions, ensures that staff work openly with the auditor and view her activities as non threatening.

3.4.3 Incentive Systems

In 1997 KCLF instituted a fairly simple loan officer incentive system that was based on building good groups. While this incentive system worked well, KCLF has gradually adapted it based on changing conditions. To ensure its effectiveness, KCLF reviews its incentive system annually and makes up-dates based on staff suggestions.

For the past two years, KCLF has implemented a loan officer incentive system largely based on active client portfolio.[7] This incentive system has worked very well and has remained in-place until 2002. This year, KCLF introduced several supplemental indicators that place greater emphasis on new client outreach.

KCLF's incentive system has always recognized good performance and has provided financial bonuses for achievements. Supplementing this system has also been a semi-annual review that entails assessing each loan officer's performance according to his/her own plans. This semi-annual review allows managers to work with their staff and provide them with feed-back and guidance on their day-to-day performance

3.4.4 Exiting Client System

In 2001, KCLF recognized that exiting clients had a lot of useful information about how its program worked – and did not work. To glean these insights from exiting clients, KCLF developed an exit interview form and associated database to track this information.

After a year of utilizing this system, KCLF has warehoused great volumes of information about client needs, why they are leaving the program, what they do not like about KCLF's products and services, and what would have to change if they were to come back as a client. Clients who leave due to delinquency are not interviewed.

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[7] Active portfolio minus portfolio-at-risk.

KCLF has learned that most clients leave due to reasons beyond their control such as business default, moving from the area, or lack of need for working capital loans. However, important information has been gathered regarding negative aspects of its product line – including high interest rates, short loan terms, and no grace period. At the same time, KCLF has understood that its quality of service is well-respected and that loan officers and staff offer a friendly, client-oriented product.

As will be discussed below, KCLF's systematic exit interview process has provided management with critical information that has fed into product adaptation and development.

3.4.5 Accounting Systems

KCLF uses off-the-shelf accounting software that has been tailored to its specific needs. This is the 1-C Russian-language accounting software. Through adaptation and sophisticated programming, it now uses this software in a uniform manner throughout its branch network and can automatically consolidate branch reports at the end of every month.

3.4.6 Reporting System

KCLF's reporting system is streamlined to avoid duplication. To this end, KCLF has developed several internal report generators that allow staff to easily meet local reporting requirements. This includes quarterly reports to the National Bank of Kazakhstan and several donors.

The key here is that good reporting builds transparency into operating systems but should not become overwhelming to the institution. As KCLF continues to expand its operations to the national level, it continues to look for reporting system efficiencies.

3.5 Product Diversification: Meeting Market Demand

Meeting client demand is central for KCLF to continue retaining clients and reaching a greater market share. KCLF strives to continuously meet client demand through market surveys, exit interviews, and the piloting of new products.

3.5.1 Group

KCLF uses a group lending methodology that provides small, stepped loans that are designed to measure client credit-worthiness over a period of time. No collateral is required for loans as the group guarantees each member's loans.

Groups are self-formed among trusted businesses and friends. Each group is encouraged to diversify its group-member's businesses to reduce overall risk from economic downturns or changes in local laws. Groups are trained to assess businesses and make decisions regarding loan sizes and loan terms; each group must approve the loan applications of their members before disbursement can occur. While loans are made between KCLF and individual borrowers, loan are disbursed, repaid, and guaranteed by the group.

The group lending methodology and the stepped loan approach appears has been adapted to Kazakhstan context. The maximum initial loan size is $100 and terms start at two to four months and extend to twelve months for the largest loans. Group members analyze each other's loan applications and make their own decisions about loan sizes and loan terms. Once approved by the group, borrowers receive initial loans of up to $100. Each successive loan cycle affords borrowers the chance to increase their line of credit – up to $3,000. The incentive to repay loans is based on continued access to credit and business services and well as peer pressure.

3.5.2 Individual

In mid-2000, KCLF began a process of launching a new product to better meet small business needs. This included a market assessment of small businesses, as well as clients, to ascertain the demand for an individual loan product.

Based on demand, KCLF management outlined a pilot individual product and solicited feed-back from its loan officers regarding its structure. In tandem, KCLF reviewed its human resource and financial limitations to providing a new individual product. A new training line was developed for individual loan officers and new sources of credit were identified. Then, after careful calculations and projections were made, KCLF launched its first individual product in 2001.

This new, individual loan product was first offered to existing group clients that had outgrown the stepped lending approach. Loans were offered in the range of $750 - $5,000 with flexible collateral conditions. Over time, new clients have been welcomed into the program through the individual product line. This individual product has provided KCLF with a more diversified portfolio that now includes an increasing number of manufacturing and service businesses.

3.5.3 Consumer

In late 2001, KCLF undertook another market survey to further refine its marketing and product delivery in Taldykorgan. This survey provided KCLF with new insight to develop another loan product not linked to business development. Design and refinement of a consumer loan product began in late 2001 and early 2002; in the summer of 2002 KCLF launched its first consumer loans in Taldykorgan.

The consumer loan product is based on the principles of group lending. Groups of 4 – 10 individuals come together to take loans of $50 - $500 to purchase consumer goods or provide for family needs. As of October 2002, the majority of consumer loans have been for educational purposes and there has been no delinquency to date.

4. STRATEGIC CHALLENGES AND RESPONSE

KCLF has faced various challenges over the last five years. These challenges have required KCLF staff to adapt and change: it has been a learning process. This section summarizes three strategic challenges: scale and outreach, going national, and financial management.

4.1 Scale and Outreach

KCLF has historically been unable to meet its scale and outreach objectives. This is partially a result of overly optimistic forecasts as well as an emphasis on quality lending. As of September 2002, KCLF has an active client base of almost 4,200 and an active portfolio of $1.2 significantly below targets stipulated in the IGP grant applications.

During each reporting period these discrepancies have been discussed and addressed, however, at the close of the project it is paramount to evaluate these weaknesses and the reasons behind them. Due to significant market variances at each branch, a short description of each branch's scale and outreach challenges are given below.

<u>Taldykorgan</u>

As the original branch, Taldykorgan was the also the place of experimentation, piloting, and learning by doing. As such, there were mistakes made in the early incentive systems (designed in early 1997) that emphasized only growth and not quality. Growth was quite rapid in the early years, leading KCLF to believe that there would be continued strong demand for its product. However, a more critical analysis would have indicated services being extended to weak businesses, part-time businesses, and loan sizes that did not match business needs.

As KCLF's Taldykorgan office approached the 3,000 client mark in 2000 problems began to appear. Delinquency started slowly and eventually reached a crisis point in 2001 with a 5 percent portfolio at risk. At that time, KCLF was beginning its consolidation efforts in Almaty and had to re-shift its attentions back to Taldykorgan.

The delinquency problem in the Taldykorgan office was critical for KCLF in two very important ways. First, it lost income from hundreds of loans, incurred costs related to lawsuits, and had to write off thousands of dollars in loan arrears ($57,000 cumulative was written of as of December 2001).

Even more overwhelming for KCLF was client dissertation due to associated bad debt, i.e., a client could be a good borrower but in a group that defaulted and therefore be unable to take repeat loans. During the delinquency crisis and shortly thereafter, KCLF lost over 1,000 clients and its portfolio shrank.

The Taldykorgan's shrinking client base and portfolio placed an even greater burden on the Shymkent branch to perform. It was only from this branch's growth that 2000/01 year-end numbers were not negative.

This type of delinquency problem pushes an institution to re-evaluate its product and tighten its methodology to ensure these situations do not arise again. As noted earlier, KCLF went through a retooling of its approach and now has a tighter and more streamlined approach to group lending. They key to this approach has been a more rigorous assessment of loans over $500 and regular, random spot-checks of clients. This approach is implemented throughout the KCLF network and has led to excellent portfolio quality indicators albeit more limited growth.

This delinquency lesson has been important for KCLF and will continue to influence policies and decision-making by senior management for many years to come. Going through a major delinquency crisis makes an institution more conservative and lend less aggressively. The challenge for the future is to take these important lessons and continue to implement them cautiously.

Shymkent

Shymkent has been a vibrant market for KCLF's loan product. Even with a great deal of competition from the EBRD-funded banks, it has continued to meet its growth and efficiency benchmarks. After eight months of lending, the Shymkent branch also broke-even and was able to cover all of its operating expenses through interest income.

Shymkent currently surpasses both branches in number and volume (1,731 active clients and $528,360 portfolio). However, based on Taldykorgan's delinquency crisis, the Shymkent Branch Manager now takes a more conservative approach to the branch's outreach. Shymkent's 2003 strategic plan includes the establishment of a sub-office in Turkistan.

Almaty

The Almaty market has been significantly more difficult to penetrate than originally anticipated. This market is well served by informal money lenders and, to some extent, the EBRD-funded banks. The availability of cash in Almaty has made its loan products less attractive to micro entrepreneurs. In addition, those that request loans have demands higher than an initial $100-200 loan.

The result of this situation has been much slower lending in Almaty. In fact, this office has not reached 1,000 active clients after a year of lending (something that had been achieved in both Taldykorgan and Shymkent).

This slow pace is acceptable to KCLF at the moment, given its grant funding available from the Eurasia Foundation.[8] This funding has provided KCLF with a longer than normal window to reach break-even. Break-even is projected to occur in the summer of 2003.

Given this situation, the Almaty branch office has not helped KCLF meet its scale and outreach targets (700 active clients and $144,000 portfolio). In fact, Almaty's performance is directly linked to KCLF's inability to achieve its IGP benchmarks.

4.2 Going National

KCLF's long-term strategic objective is to have a branch in every major city Kazakhstan. Going national is KCLF's next big challenge.

The key obstacles to becoming a national-scale institution are funding and competition. Funding issues are incrementally being addressed through access to Dexia Bank funds, although this is usually earmarked for lending capital. To meet operational expenses, KCLF initiated negotiations with the IFC a year ago to explore their interest in supporting micro finance development in Kazakhstan. The IFC has expressed interest in working with KCLF to fund new branch openings and progress continues towards a concrete deal.

KCLF's must also carefully assess its competition over the coming years before moving into new cities. The EBRD-funded small business program is already active in every city and has started outlets in several secondary cities. As such, KCLF will have to make a name for itself against a backdrop of known competing services. KCLF has found, however, that its product typically serves a lower-end clientele than EBRD's program. In Shymkent, and gradually in Almaty, KCLF has successfully marketed its program to the micro entrepreneurs that do not have the necessary collateral to take an EBRD loan but still have significant financial needs.[9]

[8] This grant funding is provided directly to KCLF by the Eurasia Foundation for Almaty branch salaries.

[9] The EBRD began its first lending in Taldykorgan in 2002.

KCLF is prepared to meet its challenges to "go national" and will continue to implement strategic solutions that allow for a national presence. As it takes on a more systematic approach to marketing and identifying large-scale financing, KCLF is crafting a strategy for sustainable expansion that will meet micro entrepreneurs' needs across the country.

4.3 Funding and Financial Management

To meet its funding challenges, KCLF will have to continue its promotional efforts with donors, international funding sources, and local banks. To date, KCLF's financing consists of three donor grants, one local bank mortgage, and an international commercial loan.

These donor funds and commercial loans are serving the needs of the entire KCLF network. However, negotiating and finalizing these deals are time consuming and often open ended. As a result, access to funding has not always met KCLF's planning needs and interim steps have been necessary.

As KCLF gears up for more aggressive outreach and expansion, more resources will have to be devoted to networking and promoting the program to donors and interested lenders. This responsibility will clearly rest at KCLF's headquarters and put added pressure on this staff to provide continuous funding resources that will ensure uninterrupted lending.

5. LESSONS LEARNED

There have been many lessons learned in the start-up and implementation of KCLF. These range from the importance of building a local institution, to the basic principles of strengthening local human resources and developing sound operating systems. These lessons are captured below in following text.

5.1 Building a Local Institution

One of the basic tenants of the KCLF program has been to build a locally registered, independent institution. This has meant registering as a local non-profit as well as applying to the National Bank for a license to lend. To legally operate also meant that KCLF had to apply to the proper tax authorities and initiate a bureaucratic process to ensure they met local tax obligations.

The result of these legal and administrative steps has been a sustainable and transparent micro finance organization. Its recognition by the National Bank has helped KCLF integrate itself into the formal financial system and become associated with several national banking associations. Step by step, KCLF has grown from a small organization operating in one small town to a nationally recognized institution that is sought after for its advice and stature.

5.2 Strengthening Local Human Resources

ACDI/VOCA's work with KCLF has placed a premium on strengthening local staff capacities. This began with the hiring of a local Director in 1998 that would run KCLF's day-to-day operations. The local Director, Shalkar Zhusupav, was central to the capacity building in the early years and a great deal of time and resources were devoted to enabling him to manage the Fund. This included hands-on training and technical assistance as well as attending several Micro Finance Center/Poland trainings and study tours.

In addition to strengthening the KCLF Director, a strong system of internal and external training was put in place during the second year of operation. This training system was geared to "fill in the gaps" of existing KCLF staff knowledge – such as computer training, accounting training, micro finance best practices, financial management, strategic and business planning, and internal control. In 2002, KCLF now runs an extensive internal training program that is managed by the Almaty Headquarters, including:

- Annual Loan Officer Training
- Computer Training (Word, Excel)
- Accounting Training

- Micro Finance Best Practices Training
- Setting Sustainable Interest Rates
- Business Planning
- Communications and Presentations Training
- Business Assessment Training
- Financial Analysis Training
- Leadership Training

KCLF continues to expand its repertoire of internal training through attendance at international conferences, workshops and seminars. KCLF also makes an effort to send key senior staff on study tours, as was recently done by the Director of Operations to visit "Fora" in Russia. These human resource development systems will enable KCLF to meet its future challenges with well-rounded and well-trained staff.

5.3 *Sound Systems*

Transparent and well-functioning systems are at the heart of any micro finance organization. These systems include a management information system, reporting system, accounting system, and internal control system. These have all been addressed, in various stages, throughout KCLF's development.

KCLF uses its own licensed management information system, ISKRA. ISKRA houses all client and loan information as well as providing some financial information – such as an aging of portfolio.

ISKRA is an extremely flexible tool that has grown with KCLF over the years. Through continuous up-grades and changes, ISKRA is now able to automatically consolidate all branch information on a daily, weekly, and monthly basis.

KCLF uses an off-the-shelf accounting software that has been tailored to its specific needs. The lesson for other institutions is to build on existing systems whenever possible. This allows for the local institution to work in the local language and to hire programmers to adapt the software to meet its needs. Through adaptation and sophisticated programming, it now uses this software in a uniform manner throughout its branch network and can automatically consolidate its reports at the end of every month.

Every micro finance institution needs a system of internal control. KCLF learned, however, that this can be initially done in a simplified manner through internal cross-checks. The key was teaching the staff about how to manage cash and financial transactions in a clear manner that could be easily checked and reconciled. KCLF developed a standardized matrix of procedures and cross-checks during its first three-years of operation to ensure that cash deviations were identified and fraudulent actions were rectified. Now, with three branch operations and soon a fourth, KCLF has hired an internal auditor that will undertake formal responsibility to ensure internal control compliance.

5.4 Starting Small

KCLF's lessons learned is to start small, experiment and then grow. Its experience in Taldykorgan taught KCLF that there were significant benefits to launching a small pilot, refining the results, and then expanding with a targeted and effective product.

KCLF's experience in Taldykorgan played a strong role in helping the Shymkent branch office succeed so quickly and break-even after eight months of lending. Together, these two offices formed the basis for forming a branch in the competitive Almaty market and consolidating its headquarters there. This phased progress allowed KCLF to build internal synergies, a strong staff, and a nationally recognized name that will lead it into the future with a sustainable and well-structured organization.

6. CONCLUSION

KCLF's design, implementation and refinement offer a wealth of useful experiences for donors and other micro finance institutions. Its lessons prove that focusing on local institutions and staffing, supplemented by sound operating principles and controls, with an eye towards efficiency and profitability -- does lead to sustainability.

ACDI/VOCA is very proud of its role in helping KCLF achieve financial self sufficiency. It serves as a role model for other ACDIVOCA programs in terms of empowering staff to take an active role in the management of their institution and serving community needs.

We believe that USAID also recognizes these achievements and stands behind the lessons that are drawn from KCLF. ACDI/VOCA would like to take this opportunity to thank the Micro Finance Office and the IGP grant mechanism for its continued support and belief in making KCLF what it is today.