

**UNITED NATIONS DEVELOPMENT PROGRAMME
PROJECT OF THE GOVERNMENT OF KYRGYZ REPUBLIC
PROJECT DOCUMENT**

Country: Kyrgyz Republic
 Project number: KYR/99/007
 Project Title: MicroStart Project
 Starting Date: Third Quarter, 1999
 Duration: 3 years
 Executing Agency: National Bank of Kyrgyzstan
 Implementing Agency: International Technical Service
 Provider (to be selected)
 Project Site: Nationwide
 LPAC Approval Date: August 19, 1999
 Programme Officer: Katariina Nuotio

| Summary of UNDP and Cost-Sharing Inputs: | |
|---|-------------------|
| UNDP: | |
| TRAC 1&2 | \$ 100,000 |
| Cost-Sharing: | |
| Finnish Government | \$ 600,000 |
| Parallel Funding: | |
| UNDP SUM/UNF | \$ 100,000 |
| TOTAL: | \$ 800,000 |

Classification information
ACC sector/subsector: General Development Issues/
 Monetary and Financial Issues and Policies
DCAS sector/subsector: Economic Management/
 Employment/ Livelihood policy and planning
Primary areas of focus/subfocus: Promoting
 Poverty Eradication and Sustainable Livelihoods/
 Enhancement of income-earning potential
Primary type of intervention: Capacity Building
Primary target beneficiaries: Target Organizations/
 Non-Government

GOVERNMENT INPUTS
 (local currency)
 in kind:
 in cash:

Brief Description:

In its efforts to join the Government in reducing poverty, the UNDP MicroStart Project in the Kyrgyz Republic will aim to increase the access of the poor, particularly women, to sustainable financial services in order to expand their economic activities, increase their income and opportunities for self-employment and engage them as viable participants in the new market economy.

MicroStart will achieve its aim by building the capacity of up to three local institutions, including formal financial institutions and non-bank intermediaries, to provide microfinance services – both credit and savings – to economically active poor clients on a sustainable basis. More specifically, the project will strengthen the institutional, organizational, and technical capacity of the financial institutions as well as their financial capacity in order to ensure a mid- to long-term impact. Also, the project will contribute to the development of knowledge, expertise and information on microfinance.

| Signed & approved on behalf of | Signature | Date | Name & Title |
|-----------------------------------|-----------|-------|--|
| Executing Agency | _____ | _____ | Mr. Ulan Sarbanov National Bank of Kyrgyzstan |
| UNDP | _____ | _____ | Ms. Anna Stjärnerklint Resident Representative |

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Acronyms

| | |
|----------------|---|
| ADB | Asian Development Bank |
| AKB Kyrgyzstan | Joint Stock Company Kyrgyzstan |
| CCF | Country Cooperation Framework |
| CDP | Community Development Programme |
| CGAP | Consultative Group to Assist the Poorest |
| FINCA | Foundation for International Community Assistance |
| IFAD | International Fund for Agricultural Development |
| ILO | International Labor Organization |
| ITSP | International Technical Services Provider |
| KAFC | Kyrgyz Agricultural Financial Corporation |
| LTSP | Local Technical Services Provider |
| MFI | Microfinance Institution |
| NBK | National Bank of Kyrgyzstan |
| NGO | Non-Governmental Organization |
| SHG | Self-Help Group |
| SSC | Savings Settlement Corporation |
| SUM | Special Unit for Microfinance (of UNDP) |
| UNDP | United Nations Development Programme (multi-lateral agency) |
| WB | World Bank |

Currency Equivalents

1 USD = 38 som (end of April 1999)

Official Poverty Indicators

GDP Per Capita = \$590

Poverty line income = Upper Income , Lower Income

Percentage of population below line = 63%

1. BACKGROUND

1.1 *Pre-project Situation*

After the dissolution of the Soviet Union, the Kyrgyz Republic - among the poorest in former Soviet Union - has faced a number of challenges. With the breakdown of the economic fundamentals of the country, people were left to struggle with declining living standards, inadequate opportunities to generate income, a weakening social safety net and deteriorating infrastructure, particularly in rural areas. The collapse of traditional markets led to a fall in agricultural and industrial investment and output, which in turn caused unemployment and an excessive pool of redundant labor. The underdeveloped domestic market for goods and services and limited know-how of business development has further bleakened the opportunities of the poor.

Income generation opportunities for poor people are seriously constrained by inadequate non-collateral financing, and the lack of available formal savings services in the rural areas. Although a number of credit lines exist in the country, the majority are targeted at large enterprises, and organized farmers associations. Because of high traditional collateral requirements and a lack of an appropriate lending technology, commercial bank lending to low income and poor people is rare. Lack of collateral combined with risk aversion limits access to credit. Restricted financial services, especially outside the Bishkek region, are largely due to underdeveloped financial intermediaries with limited geographical coverage and weak supporting infrastructure. Providing banking services to small isolated communities translates into high costs as reaching minimum efficient scale even in the medium term is not conceivable in many regions. Commercial entities have sought better profit opportunities elsewhere, such as lending to larger clients and holding government T-Bills, which until recently have delivered a 30% real return. There is a widespread lack of confidence in the banking system, which has further been undermined by the loss in value of deposits and high inflation. Procedures for opening and closing accounts and accessing savings are cumbersome and time-consuming coupled with bad service on the part of bank staff. This has further hampered the emergence of a credit/savings culture among the poor.

In March 1999 Kyrgyzstan plunged into a deep financial crisis. The Som fell from 28 Soms to a US Dollar at the beginning of March to over 38 Soms at the end of April. At the same time, three banks collapsed, namely Insan Bank, Mercury Bank, and the formerly quite stable Maksat Bank. Maksat Bank was put under the special administration of the National Bank and transformed to a new government-controlled bank, Kairat, at the end of April. In addition the T-bill volumes and rates have fallen, which will affect banks' low risk income streams.

The Kyrgyz Government has adopted a number of economic and financial sector reforms and policy initiatives, and economic growth was indeed revived since 1996. However, almost half of the population still lives below the poverty line and the trend towards deepening poverty is continuing¹.

Profile of Poverty in Kyrgyz Republic

According to national surveys conducted between October 1993 and March 1996 both poverty and unemployment rose during this time. 49 % of households were poor and 24 % of households very poor in 1996 compared to 39 % being poor in 1993. Not only are there more poor households but the depth and severity of poverty of households have increased. Poverty is more pronounced in rural areas, with Naryn and Chui Oblasts as exceptions. There are major regional

¹ National Human Development Report of the Kyrgyz Republic, 1997

differences in the prevalence of poverty with 66 % of households poor in Osh and 37 % poor in Chui oblasts (Table 1). Overall unemployment in 1996 was 19.6 % being more severe among the young age groups.

Profile of poverty in Kyrgyz Republic in 1996

Low cost poverty line Som 3,621 (roughly \$213) expenditure per person annually with 20 % on non-food items.

| | Poor households % of total | Urban | Rural |
|-------------------------|-------------------------------|-----------|-----------|
| Total Kyrgyzstan | 49 | 39 | 58 |
| Osh | 66.1 | .. | .. |
| Djalal-Abad | 64.8 | .. | .. |
| Talas | 53.6 | .. | .. |
| Issyk-Kul | 52.9 | .. | .. |
| Naryn | 37.5 | 56 | 39 |
| Chui | 36.6 | 40 | 35 |
| - Bishkek | 27 | .. | .. |

Source: Government of Kyrgyzstan Program Document Concerning Poverty Alleviation through the proposed Kyrgyz People's Initiative Fund, July 1997

1.2 Host Country Strategy

The trend towards deepening poverty calls for appropriate intervention. The Kyrgyz Government, with the help of multilateral and bilateral donors, has given due attention to poverty alleviation with microfinance as one of its key components. The target is to reduce poverty to less than 10 % in 25 years.

The Government has developed a Poverty Alleviation Programme within the Framework of Sustainable Human Development to set out its strategy for poverty alleviation and actions to be taken. The main thrust of the strategy is the need for pro-poor economic growth as the enabling environment in which direct poverty alleviation will be undertaken. Economic growth, although necessary for effective poverty alleviation, is by itself not enough to ensure it. Growth must be explicitly pro-poor, expanding the opportunities and lives of ordinary people. It contributes most to poverty reduction when it expands the employment, productivity and wages of poor people and when resources are spent to promote human development. The Government will achieve poverty alleviation and pro-poor economic growth through:

1. Economic stabilization and continued structural adjustment - Special efforts to strengthen the Agricultural Sector
2. Ensuring access to basic services
3. Strengthening the social safety net
4. Employment promotion and effective labour markets - Special efforts to support private sector development
5. Full participation of the people in the development process - Special efforts to ensure the participation of women
6. Institutional integration of poverty into policy making

The strategy recognizes that severe fiscal constraints will limit direct intervention by Government to alleviate poverty, for example through the social safety net. Government is focusing its strategy on social mobilization and helping the poor to help themselves. Key elements of the social mobilization strategy are: (i) the importance of participatory community action to improve

livelihoods; (ii) the need to strengthen NGOs and other civil society organizations, and; (iii) the need for increased availability of micro-credit and training for the poor.

In this context, also the government's macroeconomic target indicators and policies are important. In 1999 the government wants to keep inflation below 20%, with real GDP growth at no less than 2-3 percent. The current budget deficit target for 1999 is 2.1 percent of GDP. To achieve these goals, the government will create tax incentives for businesses, limit the growth of money supply and keep its liberal foreign trade policies in line with its WTO commitments.

Government policy and reforms have been recently documented by a coordinating mission of the UNDP. A report of this mission is available at the UNDP Country Office. For an overview over the Financial Sector in Kyrgyzstan see Section 1.3.

1.3 Overview of Financial Sector

1.3.1 Commercial Financial Sector

The commercial banking sector consists of the National Bank of Kyrgyzstan (Central Bank) and 16 commercial banks including the Savings and Settlement Corporation, which is limited to savings services. There are also non-bank financial institutions which include 17 investment funds, 30 insurance companies, a Stock Exchange, a Coupon (privatization) Trading Center, and one significant state-owned and two small private pension funds. The banking system had, until recently, been dominated by four former state-owned banks - Agroprombank, Elbank, Promstroibank and AKB Kyrgyzstan, which accounted for about 80 % of market share with highly contaminated portfolio with bad debt.

A Comprehensive Financial Sector Reform Program supported by a Financial Sector Adjustment Credit (FINSAC) from IDA was launched in June 1996. This focused on the liquidation of Agroprombank and Elbank, downsizing and restructuring through private capitalization of the remaining two state-owned banks - Promstroi and AKB Kyrgyzstan and creation of a policy and regulatory environment.

Most financial institutions have very limited representation outside the Chuy oblast and therefore many households do not have any access to financial services. The most widely spread banks include SSC with 48 offices throughout the country, Promstroibank and AKB Kyrgyzstan with 26 and 20 offices respectively.

To fill the void left in agricultural finance several rural credit co-operatives (RCC) were established among farmers in 1995. State budget provided loans at varying interest rates (0 to 30 %/a) but the results were not encouraging as most of the funds were channeled to state and collective farms and loan performance proved poor. The Government has agreed to phase out this operation by year 2000.

Lending to the private sector is still limited, although there is some mainly short term lending for trade taking place. Commercial lending especially to the rural sector or urban poor is extremely limited. Most banks require 120-200 % collateral on loans and charge interest rates of 50-100 %/a.

There are a number of reasons for limited commercial lending. In the Soviet system of directed credits, credit was allocated by directive rather than based on risk analysis and repayment ability. Loan officers therefore require substantial training in risk analysis and business plan evaluation. Another major reason explains lack of commercial lending: the high risk-free return on Government Bonds effectively crowds out commercial lending. The real return on Government T-Bills until recently was around 30 %. It is very difficult for most ventures to match that rate of return and therefore it is understandable that banks are content to minimize their commercial

lending. In addition, as the reserve requirement is very conservative (20 %) and that amount must be kept in Som with any foreign currency balances that the bank wishes to maintain on top of the 20 %, willingness to lend is further reduced.

Individual bank saving is still very limited. When the Soviet banking system collapsed, savings were frozen and repayment of those assets has begun only recently. Lack of confidence in the banking system is widespread. Loss of value in deposits due to inflation and low interest rates (currently around 8 %/a in demand deposits) further discourage savings. Opening accounts is often a costly, cumbersome and time-consuming procedure.

1.3.2 Microfinance in the Kyrgyz Republic

There are nineteen government or donor supported credit programs currently in the Kyrgyz Republic, operated by various agencies. Loan size varies from Som 250 to US\$ 5 million, but most programs have limited client outreach and geographical coverage. Collateral is required by most programs and with a couple of exceptions, there is little focus on the poor. None has been so far able to establish a strong and sustainable savings component² and none have reached a level of sustainability that would lead to permanence.

There remains a gap in the provision of non-collateral, non-agricultural microcredit and access to savings services in rural areas. Programs providing non-collateral credit to the poor, such as FINCA, Helvetas and the World Bank PDP, remain weak in their savings components. The relevant programs are described below more in detail, and the Proceedings of the National MicroCredit Summit held in Bishkek in July, 1998 can be obtained from the UNDP Country Office.

1.3.3 Institutional Profiles

To achieve greater and deep outreach and financial viability, a number of institutional forms for providing microfinance services can be pursued in the Kyrgyz Republic. Each option has advantages and poses challenges to on-going institutional viability. A brief analysis of these options is provided in this section.

This section considers:

- Specialized financial institutions. Specialized financial institutions in the Kyrgyz Republic are the KAFC which is limited to providing agricultural credit and SSC which provides savings, not credit.
- Specialized services within commercial financial institutions. Two commercial institutions are analyzed –Promstroibank and AKB Kyrgyzstan.
- Nongovernmental organizations. FINCA, the largest NGO microcredit organization operating in Kryrgyzstan is briefly described.
- Credit unions or other member-owned financial institutions.

Savings and Settlement Company (SSC)

Savings Settlement Company (SSC) is one of the very few operating financial organizations in Kyrgyzstan with nationwide coverage. It is designed to attract savings from the public and can expedite payments through its network of 48 affiliates. The liquidation of two of the biggest state banks, Agromprombank and Elbank, resulted in inadequate geographical coverage of banking services. Partly to overcome this, SSC was established by the decision of the National Bank of Kyrgyz Republic (NBK) 1996.

² Credit Programs have been documented by, e.g., Raylynn Oliver "Credit and Microcredit in the Kyrgyz Republic. Working Document. May 1997". Only programs relevant to the proposed project are discussed in detail here.

SSC was converted into a Joint Stock Company in the end of 1997. The Central bank (NBK) owns 100 % of shares. The functions of SSC include the following: to provide payment services to the Social Fund and Central Treasury (mainly pensions and unemployment benefits) and to provide bank services with full geographic coverage. The company's license includes all bank services except business and consumer credits, which were excluded by NBK to reduce risk in operations.

SSC has the widest coverage of the country through its 48 branches. Branches are well organized and have a broad client base. The minimum deposit is 500 som, and interest rates on deposits are competitive. SSC is also committed to training staff in new systems –20% of staff time is spent on training. SSC was originally selected by the UNDP as a candidate for a microfinance project, including credit. Shortly before the assessment mission, the NBK determined that SSC would not be issued a lending license and privatization plans would be postponed. In addition, with the current financial crisis, the SSC has more pressing concerns than implementing a microfinance operation. T-Bill rates, and the Inter-bank market, their major sources of income, declined from a 30% real return to a 26% interest rate (with 18% inflation) and the Inter-bank rate declined from 70% in February to 26% in March. SSC is further reducing the deposit rate to prevent attracting deposits from the three banks that were intervened by the Central Bank at the beginning of March. The deposit rate has declined from 54% to 22%.

Without a license to lend, implementing a microfinance operation with the SSC is unlikely. Even in the event the NBK would allow SSC to implement a microcredit component, the lack of more general license to lend will prevent SSC from expanding this operation to any significant scale.

Kyrgyz Agricultural Finance Corporation (KAFC)

The World Bank launched the Rural Finance Project which resulted in the establishment of Kyrgyz Agriculture Finance Corporation (KAFC) in 1997 with a license for agricultural credit business only. KAFC is a joint stock company with the Government as the sole shareholder. It has a commercial credit window (IDA credit of US\$ 13 million) and a Small Farmers Outreach Component (IDA credit of US\$ 3 million), both with collateral requirements. In addition, IFAD has provided a credit Sub-Component of US\$ 1.5 million enabling poor farmer groups to get non-collateral loans of up to US\$ 140 per member. KAFC charges 28% yearly interest rate to farmers and 30% to small businesses. The UNDP and KAFC have agreed that IFAD loan funds will be channeled to the groups of rural poor that UNDP Poverty Alleviation Project II and UN Volunteers organise. The IFAD credit line is the source of credit currently tapped by the UNDP organised Self-Help Groups (SHGs).

In the second phase of the Rural Finance Project the World Bank and KAFC intend to support the development of group lending so that the project would achieve its original goal of reaching out to small-scale farmers and microentrepreneurs and providing financing without traditional collateral.

Regarding microfinance, KAFC plans to offer a wide network of offices, 46 offices, one in each rayon. However, neither the management at the headquarters nor at the branch level have much knowledge of microfinance technologies. KAFC does not offer savings facilities, and a license for mobilising deposits is not envisioned for the future. The interest rates are subsidised, which will make it difficult for KAFC to cover costs of operation. As a government owned institution concentrating on medium- and large-scale agricultural credit it is not likely to be the strongest candidate for microfinance operations.

Promstroi-bank

Promstroi-bank was privatised in 1996. It used to be the state construction bank during the Soviet era. Promstroi has 26 branches throughout the country. By the number of branches it is second biggest after SSC. By the volume of total assets (336 million som) it belongs to the group of six large banks. On the volume of funds raised in deposits and contributions it belonged to

the first group, that raised more than 200 million som. In 1997 it had the second highest return on equity of all the banks, 65.9%.

From the point of view of microfinance, would Promstroi be likely candidate for sustainable microfinance? It is the biggest and strongest bank that was reviewed by this mission. It had a wide branch network, which would enable services also in the rural areas. According to the Deputy Chairman, they might be willing to try microfinance technologies in a branch that is not busy servicing larger more established clients. Promstroi is a large, conservative bank that concentrates on industry as well as on the better off clients. For example only traditional collateral is accepted, such as property, and in rare cases, new vehicles under three years of age which are warehoused until the loan is repaid. Collateral of 200% of the loan plus interest is the established practice. Microfinance operations would go against the corporate culture of the bank. However, there might be one or two branches in certain economically depressed areas that could be possible candidates to implement a microfinance project.

AKB Kyrgyzstan

AKB was established in 1989 as a state-owned bank and has been gradually privatized. Before privatization it used to be the social bank. AKB has the third largest branch network in the country with 23 branches and 450 employees. By the volume of total assets (300 million som) it belongs to the group of six large banks. Active portfolio of AKB is 145 million som. In terms of the volume of raising funds through deposits and contribution, AKB belongs to the lowest group of banks that raised less than 100 million som (1997). In 1997 it had the highest return on equity of all the banks, 71,2%.

According to the management, the bank has a broad social mission to serve the people, including those who require small savings and loans. AKB has recently gone through a restructuring and decentralisation process with assistance from TACIS experts which analysed work load and number of personnel. As a result, branches have been restructured, staff reduced and other staff trained. AKB's new growth strategy is to increase clients and work more closely with clients to provide better services.

Branches at the oblast level can make decisions on loans up to 500,000 som independent from the head quarters. Smaller branches within the oblast have decision making authority on loans of up to 200,000 som. They also establish their own collateral requirements to secure individual loans. Branches also decide on the interest on deposits.

A large percentage of the bank's clients are already small borrowers, and there is no minimum requirement for loan size, some of which have been as low as 1,000 som in the branches, and some of which have very short terms --the average term for small loans is 6 months. For example, in the 3 branches in Issyk-Kul, the main line of the branch business is microcredit, defined by the bank as loans less than 50,000 som. In March 1999, the AKB oblast branch in Issyk-Kul had an outstanding portfolio of 924,000 som with 30 individuals, for an average loan size of 30,000 som. The branch is seeking to lend loan capital of 276,000 som.

The same lending technology is used for both large and small loans. The interest rate is calculated according to a commercial rate which was currently 70% p.a., calculated on a declining balance. All loans require collateral, at a minimum of 120%. However, non-traditional collateral is accepted, such as equipment, cars, trucks, grain, animals. According to the Vice President at the AKB headquarters, repayment on small loans is much higher.

From the financial institutions visited, AKB was the most interested in participating in a microfinance project. According to the Vice President, AKB is interested in trying a technology to secure future business for the bank. The Bank expressed its willingness to learn and hire new staff for this purpose. Further they were willing to re-start small branches.

To a great degree AKB has a pool of staff, management and clients from the previous Soviet era. There have, however, been recent changes that are gradually being put into place. AKB

would require further assistance in becoming more customer friendly, particularly in the appearance of branch teller services to make them more inviting and in all aspects of microlending technologies, including cost-effective outreach, timeliness and other principles of microfinance described in previous sections of this report. Their greatest assets at this point are the willingness to reach a larger client base and acquire new technologies, a mission consistent with microfinance and a restructuring process that has opened some doors to change.

For the most part, NGO microcredit operations in the Kyrgyz Republic are small, averaging under 400 clients.

FINCA

FINCA (Foundation for International Community Assistance) has a community-based group lending program that started in May 1995. 55 credit officers around the country train groups of approximately 12 individuals to manage 3-4 month loans. Loans start at US\$65 per person and successful repayment makes the individual eligible for increasingly larger loans to US\$300. Five percent monthly interest is charged and interest, principal and savings are paid weekly in supervised meetings. FINCA clients are 99% women that trade in the bazaars in urban areas. No collateral is required but 20 % of the loan value is mandatory (cash) savings. FINCA Kyrgyzstan operates at the moment 800-900 village banks with 11200 active clients. Repayment rate is 99%. The program works in all six oblasts. The operational self-sufficiency is 154%.

FINCA has been successful in reaching operational self-sufficiency by charging an interest rate that reflects the program's local operating costs and inflation, going to scale (by far the largest number of active clients from the programmes serving microenterprise clients) and building an operating structure that is efficient and includes built in incentives for the credit officers.

Currently FINCA is studying the various options available to become a legally registered local organization. FINCA currently operates as a project under USAID auspices.

Credit Unions

The ADB supported "Rural Financial Institutions Project" aims at establishing a Credit Union (CU) system comprising a network of about 280 individual CUs across the country over a seven year period ending May 2005. CUs are community level co-operative financial institutions that provide savings and credit services to individual members, expected at about 100 people per group. The system is expected to mobilize about US\$ 11 million by way of share capital and retained earnings by the end of the project period. The FCSCU (Financial Company for the Support and Development of Credit Unions), established in 1997, will promote, develop, monitor and supervise the CUs and NBK will be responsible for overall supervision and regulation of the system. The project includes a credit line of US\$12.5 million to equally match the total contributions of CU members shares, which is lent to the credit union at a 24% annual rate. The loan portfolio is expected to reach US\$19million by end of period. The minimum capital requirement is Som 30,000 for the CU to be eligible for license and capital should reach Som 50,000 to be eligible for credit. Minimum membership is 10 people. The borrowings cannot exceed capital and a member is eligible for a loan from CU up to three times of his capital (Som 25,000 - US\$10,000 loans at 36 % - 54% interest). Collateral is required for loans above Som 7,000 (US\$400). Up to March 1999, 100 CUs had been established, in average 35 members in each CU. Although a training system is included, the risk of the hangover of the past legacy of failure of state-run co-operatives and erosion of credit culture on the performance of CU system cannot be under-estimated.

Would CUs be interested and capable of operating sustainable microfinance? The CU approach is suitable especially in rural areas, since the overhead costs are much lower than in the case of traditional microfinance institutions (like FINCA) or banks. Also, CUs accept that the

membership share (1000 som) is paid in installments. This would, in principle, enable also the poor to join the CU.

All loans require collateral, and, for the most part, the better off farmers and townspeople have joined CUs. Outreach to poorer clients to date is limited, and currently CUs are not allowed to collect deposits from members. Lastly, the major part of the ADB loan and technical assistance for the support of CU is still unused. CUs have available loan funds and TA more than they can effectively use. The credit union movement in the Kyrgyz Republic is young and growing rapidly. While there are concerns about the rapid growth, particularly several newer credit unions are establishing themselves with capital below the minimum established rate, credit unions are a viable option for relatively isolated, highly educated people residing in agricultural communities. The credit unions have recently established an Association that is set up to attract international donor funding and may operate in competition with the Financial Company for Credit Unions. It is unclear whether the movement is committed to operating as a formal financial intermediary and is structured to accomplish this task.

2. UNDP COUNTRY OFFICE STRATEGY

2.1 *Ongoing programmes and projects*

UNDP is currently implementing various projects within the framework of the National SHD Strategy. Specific projects which will have linkages with the MicroStart Project include:

UNDP Participatory Poverty Alleviation Project, phase 2

Since July 1998 UNDP Kyrgyzstan through its Project Implementation Unit in the Gender In Development (GID) Bureau has been implementing the Participatory Poverty Alleviation Project, phase 2 (PAP2). In addition to the social mobilization of Self-Help Groups (SHGs) in rural Kyrgyzstan by International and National UNVs, PAP2 is playing an important role in linking these SHGs to a formal micro-crediting institution, KAFC (see section 1.6.3 above). The credit capital for the specialized credit line of US\$ 1,5 Mio for collateral-free microcredits is provided by IFAD and administered by KAFC. The credits are intended for agriculture and supporting services. The Rural Agricultural Development Service (RADS) is supporting the project with agricultural extension service.

Experts Group on Microfinance

Following the UNDP sponsored MicroCredit Summit in July 1998, an Experts Group on Microfinance was established bringing together the national and international organizations involved in this area. It was agreed that a proposal would be developed for joint financing covering the areas of (i) developing a common or coordinated approach for building the capacity of NGOs for microfinance, (ii) a national information and resource network for microcredit, (iii) creating a Credit Rating Network, and (iv) a legislative framework for improving the enabling environment for microcredit development.

Support to Small and Medium Enterprises project

The project has a dual objective of (a) contributing to the creation of an enabling policy and regulatory environment to promote small and medium enterprises (SME); (b) enhancing the national consulting capacity to provide technical support services to SMEs. A network of small business support centers / support providers has been established in oblast centers throughout the country. Among other activities, these will support SME in developing business plans for accessing a variety of credit lines available in each oblast.

2.2 The MicroStart Project within the UNDP country programme

How does the MicroStart Project fit in the UNDP Kyrgyzstan country programme? Within the National SHD Strategy, the UNDP Country Office has developed three frameworks to focus its strategy and manage its activities: Governance, Area-Based Development and SHD Promotion Framework. The MicroStart project will fall under the Area Based Development Framework and cooperate closely with other projects, as described below (see Annex D for MicroStart's place within the Country Office Framework.)

The MicroStart project builds upon important lessons learned by UNDP during the first phase of the Poverty Alleviation Project PAP1 (1995-1998), as well as during PAP2. In PAP1 local NGOs received grants from UNDP to onlend as microcredits. It was seen, though, that NGOs couldn't provide high quality microfinancing. This is the reason why in PAP2 the professional rural finance institution KAFC was selected as a partner. One shortcoming of this selection, which could be addressed with the MicroStart Project, is that KAFC allows no microcrediting in urban areas and does not provide formal savings services. Experience also indicates the need for improved capacity for microfinancing within the institution.

2.3 Project Justification

UNDP has determined that sustainable microfinance services are essential if poor people are to break the poverty cycle. Sustainable microfinance services require institutions that are capable of providing savings services and credit on a permanent basis, and clients who are engaged in economic activities and prepared to assume the responsibilities of credit contracts. Building sustainable microfinance in the Kyrgyz Republic requires considerable effort on both the supply-side, working with institutions and the demand-side, working with the clients. Based on the experience in PAP1, UNDP is interested in working with formal institutions that can provide a savings services to poor people, in addition to beginning and building a sustainable microcredit services.

2.4 Coordination

For the success of the MicroStart Project coordination with other UNDP projects, especially with PAP2 and the Follow-Up to the MicroCredit Summit, is essential.

Coordination between MicroStart and PAP2 may help provide participating organizations of MicroStart with customers for microfinance services. However, it is important not to restrict the operation of the microfinance operation of the project to providing services to the SHGs, as explained in Chapter 1.4. In many cases it will be cost-effective for the MFIs to work with organized SHGs, since prior organization will provide the institution with "ready-made" customers. The PAP2 involvement in organizing and training clients will lower the costs and minimize the risks of the provider. The MicroStart Project has a broader mandate to implement microfinance operations that will eventually be widely available on a sustainable basis to poor people in both rural and urban areas.

The implementing agency of the MicroStart Project will actively participate in the Expert Group on Microfinance ensuring coordination with UNDP and other organizations in the microfinance sector of Kyrgyzstan.

The SME business consultants in oblast centers could support potential borrowers of the MicroStart participating organizations in designing feasible business plans. Also, they could provide their clients with information on microfinance services of the participating organizations.

On the other hand, the SME Support project would benefit from the better microfinancing services enabled by the MicroStart project.

3. PROGRAMME FRAMEWORK

The overall objective of this project is to contribute to poverty alleviation by increasing access of the poor to sustainable credit and savings services for income generating activities.

The premise of MicroStart is that providing small loans--with repeated access to increasingly larger loans--to the economically active poor can help them break out of their cycle of low investment and low returns. The design of the financial products and the methodologies used will play a role in ensuring appropriate self-targeting of clients. The current loan range of 1,000 som -30,000 som practiced by local organizations seems appropriate for MicroStart, given the types of investments made by the desired target group. The loan duration for MicroStart should be 12 months or less, although research may be done during the period on developing longer term financial products, which has been identified as a need in the sector. Repayment will be in regular installments of interest and principal. Alternatives to collateral will continue to be encouraged to ensure that the poor are able to access to loans. The International Technical Service Provider (ITSP) and the Local Technical Service Provider (LTSP) will work with participating organizations to ensure that they have suitable selection criteria, appropriate financial products and delivery technologies. A key to working with formal financial institutions and non-bank financial intermediaries is to assist them to develop microcredit and savings delivery technologies, particularly cost-effective approaches for reaching clients and a system based on non-traditional collateral substitutes. Good systems of monitoring to ensure that they are reaching the intended target clientele with valued and quality services are also critical.

An International Technical Services Provider will be selected and contracted by the UNDP Country Office, with the support and advice of the Special Unit for Microfinance (SUM) in New York. The ITSP will be responsible for managing the MicroStart Project, and will sub-contract a Local Technical Services Provider to act as its local counterpart in the implementation of the project. Prior to sub-contracting, the ITSP will submit its selection of the LTSP to the UNDP Country Office for approval. As it is the ITSP who enters into a contractual arrangement with the LTSP, the ITSP should have complete autonomy in selecting its local counterpart. The ITSP and LTSP will coordinate with the PAP2. An Advisory Board, chaired by UNDP, will set the major programme policies, approve the annual action plan, approve the selection of participating organizations, approve the distribution of tranches to the participating organizations, and other advisory responsibilities. (See section 3.3 below for details.)

3.1 *Expected Outcomes*

The expected outcomes of the programme are as follows.

1. Up to three local organizations (microfinance institutions or banks) will have an increased capacity to provide microfinance services, both credit and savings, to rural and urban poor households, on a financially sustainable basis.
2. The number of microfinance clients served by participating organizations will increase at least 50% per year during the course of the project, with an overall target for growth to be at least 2,000 clients per institution by the end of the project.

3. Effective management systems, procedures and microfinance staff will be in place in participating organizations at the end of the project, including specialized microfinance windows, agencies or cost/profit centers within commercial banks.
4. Appropriate financial products and services for the target clientele, including a cost-effective savings and credit outreach technology will be developed by participating organizations within the first year.
5. Excellent management of the loan portfolio and of client/member savings will be the norm at participating organizations.
6. Microfinance institutions will have effective savings mobilization techniques.
7. Interest rates will be charged that are sufficient to cover all costs of delivering the services. By the end of year three, participating institutions, including commercial banks, will continue to operate the microfinance services.
8. Participating organizations will have a viable financial and institutional strategy for building their microcredit portfolio.
9. Best practice standards of reporting will be incorporated into the microcredit operations.
10. Impact studies of clients of participating organizations will be carried out in collaboration with PAP2, and results disseminated, in coordination with the global MicroStart programme.
11. Study of the participating organizations will be carried out that describes and analyzes the experience in developing new microfinancial services, including savings.

3.2 Target Beneficiaries

Indirect beneficiaries of this project are the poor of Kyrgyzstan, who as clients will benefit through improved microfinancing services. The direct beneficiaries of this project will be the participating organizations, which will gain improved capacity to deliver microfinancing services.

One of the selection criteria for participating organizations is a well-developed branch structure or network throughout the country. While the MicroStart project may be implemented initially in select branches of commercial entities, the choice of those with country-wide representation will ensure a broader impact of the project within the overall operation. Efforts will be made where possible to ensure exposure to the principles and practices of sound microfinance to key individuals to providing for a more supportive environment. An additional selection criteria for participating organizations is a willingness to coordinate with other UNDP projects.

Clients will be economically active poor adults, in both rural and urban areas. They will have existing activities, in any productive sector, which includes agriculture, livestock raising, fishing, petty trade, artisan activities, transformation of products, and a variety of services. Clients include a broad range of the economically active poor who do not have access to financial services, including the SHGs who have started economic activities through the PAP2 project. They may be existing or new clients of microcredit service providing organizations or projects who require formal savings facilities, Self-Help Group members who are organized by projects and NGOs, or new clients with microenterprises and economic activities. Selection of clients/members is the jurisdiction of the individual organizations. In selecting the participating

organizations, however, the ITSP and LTSP will review each institution's selection criteria to ensure that they are compatible with the objectives and target group of MicroStart.

3.3 Implementation Arrangements

The project will be implemented by the selected International Technical Service Provider and executed by the National Bank of Kyrgyzstan.

The main actors within this MicroStart Project are (more detailed information is given below):

- The **International Technical Services Provider** is the actor responsible for the successful implementation of the programme. The ITSP has the responsibility to provide technical assistance services to the participating organizations and is selected by the UNDP Country Office from a shortlist provided by SUM.
- The **Local Technical Services Provider** is subcontracted by the ITSP and will facilitate the adjustment of the project to the local context. The LTSP carries out the activities specified by the ITSP in the terms of reference. The LTSP may be a local NGO, an individual, a consulting firm, or a field office of the ITSP.
- The **Participating Organizations** may be NGOs, public or private banks, specialized banking institutions, credit unions or other institutions already engaged in microfinance. They are the main beneficiaries of the institution and capacity building withing the MicroStart project.
- The **Advisory Board**, co-chaired by UNDP, provides guidance to the MicroStart project through review of the ITSP's annual workplan, confirmation of the participating organizations, and a number of monitoring activities.
- The **UNDP Country Office** selects an ITSP from SUM's shortlist and approves the ITSP's annual work plan. It also establishes the Advisory Board. The UNDP Resident Representative has the overall fiduciary responsibility for the MicroStart Capital Grants facility.
- The UNDP **Special Unit for Microfinance** (SUM) provides support to the ITSP and the UNDP Country Office. It also compiles the reports and studies from each MicroStart project into global reports.

See Annex E for a graphical illustration of the Implementing Structure.

3.3.1 International Technical Services Providers (ITSP)

a. Selection

UNDP has conducted an international competitive bidding process of leading microfinance organizations and consulting firms from around the world to qualify as International Technical Service Providers for the MicroStart Programme. There is a short-list of roughly 30 pre-qualified organizations that are available to provide technical assistance under the programme. SUM will identify 2-3 organizations from this list that it feels have the experience, expertise and capacity to meet the needs of the context and will share this information with the Country Office.

- The UNDP country office may want to include the following criteria in addition to the best practice standards and performance indicators used by SUM in pre-qualifying ITSPs:
- Experience working in the CIS;
- Experience working in countries with similar income distributions, disparities and quality of life indicators;
- Significant experience in institution building and developing technologies for bank and non-bank financial intermediaries;
- Strong understanding of the MIS needs of organizations providing microfinance and possession of the skills to assist in the development and implementation of these systems
- Experience working in the language of the host country.

The country office and the ITSP will negotiate a contract for the fixed rate of \$400,000 for three years payable in tranches, based on the work plan elaborated by the ITSP and agreed to by the country office of UNDP. This contract will contain a budget line and workplan for the LTSP sub-contract.

b. Responsibilities

The International Technical Service Provider has overall technical responsibility for providing technical assistance services to selected participating local organizations and ensuring the quality of any technical assistance provided by the LTSP or other entities contracted by the ITSP. The ITSP is also responsible for ensuring that all reporting requirements under the MicroStart project (which have been developed according to internationally recognized standards for minimal reporting requirements) are incorporated into quarterly reports to the UNDP. The ITSP will prepare a detailed work plan upon arrival in country for review and approval by the Advisory Board.

The ITSP will be responsible for the following:

- Identification and selection of the LTSP (an established NGO, knowledgeable individual, consulting firm, or local representation of the ITSP that has the capacity and established reputation necessary to help implement the project at the local level) in consultation with UNDP;
- Preparation of a workplan with benchmarks and performance criteria with the LTSP;
- Development of criteria for the selection of Micro-Capital Grant recipients;
- Selection of potential grant recipients based on an examination of their capacities and potential, mission and commitment to microfinance--and particularly in developing suitable technologies to providing efficient services to clients in a viable way;
- Presentation of recommendations and justification of selection of grant recipients to the Advisory Board for approval;
- Developing tailored training, exposure, and technical assistance plan for each participating organization in consultation with the LTSP and organization concerned;
- Organizing exchange and exposure visits among participating organizations and to other organizations and organizations active in the sector;

- Providing regular technical assistance and monitoring visits to the programme to help develop appropriate management information systems; improve client selection; enhance distribution and collection mechanisms; and build planning, review, and problem solving skills. It is envisioned that in the Kyrgyz Republic the bulk of this work will be done through the ITSP who will work directly with the participating organizations and also send experts in different disciplines to provide specific training through strategic site visits;
- Ensuring that recipient organizations have appropriate, reliable, and transparent reporting;
- Reviewing quarterly reports and the progress of local organizations;
- Following up on any problems identified through the quarterly reports;
- Requesting subsequent tranches for participating organizations;
- Providing access to best practice and "state of the art" in monitoring, collection and avoiding delinquency and default, accounting, reporting, auditing, management of savings, management systems and tools, resource mobilization, and other areas as appropriate. This will be achieved through making documentation available to all participating organizations and facilitating translation into the local language for key resources. In addition, this will involve hosting or participating in best practice seminars in the region to share experiences and determine how best to apply lessons learned.

The ITSP will report to the MicroStart Advisory Board, via quarterly reports copied to SUM/UNDP New York and the Government of Finland

3.3.2 Local Technical Services Provider (LTSP)

a. Selection

The International Technical Service Provider will identify a Local Technical Service Provider, which can be an established NGO, consulting firm, individual or the field office of the ITSP that has the capacity and established reputation necessary to help implement the MicroStart at the local level. The ITSP will consult with UNDP in its final selection of the appropriate LTSP.

The criteria for selection will be determined by the ITSP, based on their perception of the needs of the sector and participating organizations. However, the basic criteria for selection should include:

- Knowledge and understanding of the local languages, economy and culture and diversity between regions
- Established and good working relationship with the local community
- Respect for local knowledge and experience
- Ability to work in both of the priority areas identified (urban and rural)
- Local staff with a high level of energy and commitment to the objectives of microfinance and openness and ability to work closely with people
- Experience in finance and banking, and particularly to microfinance
- Commitment to increasing outreach to female clients
- Understanding of the financial requirements and preferences of poor households, particularly women, and the constraints they face in accessing microcredit
- Willingness to provide full administrative support to the MicroStart project.

The ITSP will select local organizations and provide the direct technical assistance to organizations for whom microfinance is a new or young activity. These organizations are identified by the ITSP and approved by the Advisory Board. The selected LTSP organization would be sub-contracted by the ITSP for the life of the project and in addition to the financial remuneration that it would receive would benefit from working closely with the ITSP and participating in global MicroStart activities.

b. Responsibilities

The LTSP will be responsible for carrying out the activities specified by the ITSP in the terms of reference for the LTSP. These activities will also be included in the three-year and annual work plan. Performance will be reviewed on an annual or semi-annual basis with the ITSP. The LTSP will report to the ITSP. Payment for services will be made by the ITSP.

Among the responsibilities that the ITSP may assign to the LTSP are:

- Maintain regular contact with participating organizations through phone, fax, e-mail, and mail;
- Provide ongoing technical assistance according to work plan (these should be combined with monitoring visits, and should have clear technical assistance objectives, as well as responding to any other needs or problems observed during the visit);
- Carry out regular monitoring visits for each participating organization;
- Organize training and workshops for participating organizations, and other practitioners as feasible
- Ensure that all quarterly reports from participating organizations are submitted to the ITSP on a timely basis;
- Submit a quarterly activity report to the ITSP;
- Other responsibilities as determined on the basis of the needs of participating organizations, the capacity of the LTSP, and the judgment of the ITSP;
- Benefit from additional training as needed and as feasible to increased capacity of the LTSP to provide ongoing assistance in microfinance.

3.3.3 Participating Organizations

a. Selection

Suggested selection criteria for participating organizations are detailed below. These will be reviewed by the ITSP and LTSP. Modified criteria will be presented to the Advisory Board for approval.

The organizations eligible for participation in MicroStart the Kyrgyz Republic will be those that are already engaged in microfinance activities in a limited way, or show a commitment to expand their current banking services to include microfinance. They can represent a range of institutional types (NGOs, private and/or public banks, specialized banking institutions, such as the SSC or KAFC, credit unions or other institutional forms). They can also represent different client foci, such as urban and rural clients, services and products, such as savings or credit, and delivery methodologies, such as individual loans, solidarity groups or large village banks and credit associations. The suggested criteria for selection of organizations or bank credit windows are as follows:

- Willingness to include people without access to financial resources as clients for services
- Have a need for technical and/or financial assistance
- Capacity to absorb and utilize the assistance, including the willingness to recruit new staff and have them assigned for training
- Have a legal status, preferably as a formal financial intermediary or non-bank institution
- Anticipate regular growth in number of clients, with the intention and potential to reach a significant volume
- Potential for significant national outreach.
- Intention and potential to attain self-sufficiency through the setting of sustainable interest rates
- Commitment to coordinate activities with the Poverty Alleviation Project phase 2 and other projects that support social mobilization efforts and business development/

training.

b. Responsibilities

Participating organizations will be responsible for the following:

- Expanding the outreach of financial services to significant numbers of poor households and low income micro-entrepreneurs, with preference given to women;
- Providing appropriate financial services in an efficient and sustainable way--participating organizations will charge rates of interest for their services sufficient to cover all costs of delivering the services.
- If implemented in a branch of a formal financial institution, the participating organization will be responsible for disseminating the results and performance of the project to the broader organization and provide technical assistance in start-up of microfinance in other branches
- Promoting microfinance activities supported through MicroStart within the agreed upon geographic area and with the target population, with a focus on people on or below the nation's poverty line
- Identifying the conditions of client participation in programme (e.g., loan terms, savings products), with assistance of ITSP. Loan conditions must be consistent with broad guidelines of MicroStart programme;
- Identifying potential clients, providing them with microfinance information, orienting them to delivery mechanisms, responsibilities and conditions and providing any additional pre-loan training;
- Applying loan appraisal process (feasibility study or peer review), disbursing loans, collecting principal and interest, and resolving any repayment problems;
- Establishing or improving record keeping and management information to ensure good loan tracking and provide information on a timely basis;
- Setting realistic targets and performance objectives at the beginning of MicroStart for each of the three years, with the assistance of the ITSP;
- Establishing or maintaining separate accounting for capital funds that are used for on-lending under the project. In working with banks or non-bank financial intermediaries any Micro Capital Grant that is used for on-lending is expected to leverage additional capital from the participating organization. The project activity within a branch of a financial institution should be tracked as a separate profit center to establish performance indicators that can be used to expand the project to other branches.
- Developing and implementing annual plans;
- Preparing and submitting quarterly reports to the TSP;
- Participating actively in training seminars, workshops, exchange visits, and other activities that are part of the MicroStart initiative;
- Identifying and articulating needs so that technical assistance can be tailored to be responsive to these needs;
- Providing the LTSP and ITSP with access to people and information to enable them to provide better support and technical assistance;
- Making all records and information available for programme audit;
- Participating in institutional impact assessment to be coordinated by UNDP/SUM;
- Participating in client impact assessment to be coordinated by the ITSP, LTSP and UNDP;
- Working in collaboration with other participating organizations as well as other providers of microfinance services.

3.3.4 Advisory Board

a. Composition

The Resident Representative of UNDP will name an Advisory Board of 3-5 people³, representing a variety of relevant structures and organizations. The Advisory Board will provide guidance to the MicroStart project in the Kyrgyz Republic, and as such will play a vital role in the success and sustainability of the MicroStart initiative. The Advisory Board should be co-chaired by UNDP and the relevant government representative. Other Board members could include: a donor that is involved heavily in microfinance; a banker from a private or public bank that is interested in microfinance; a representative from any existing structure which supports the microfinance sector (for example, an organization which provides training, institution building, or a member of the Expert Working Group on Microfinance. The ITSP and the LTSP should be observers to the Advisory Board.

b. Responsibilities

It is desirable that Advisory Board members can commit to three years to ensure continuity. The Advisory Board should meet at least on a quarterly basis, with additional meetings at the beginning during the selection of participating organizations, establishment of a work plan or whenever grant proposals require timely approval. The specific responsibilities of the Advisory Board will include:

- Review proposed work plan of ITSP on annual basis;
- Confirm the participating organizations based on the recommendations of the ITSP;
- Ensure that participating organizations are chosen on the basis of their potential for sustainable growth.
- Review contracts between the ITSP and the participating organizations stating outputs to be achieved within specified time frames;
- Monitor achievements of participating organizations, and approve disbursement of second and third tranches based on achievements and future work plans;
- Ensure reporting requirements are being met;
- Instruct the contracting of annual audits of selected participating organizations; review completed audits; and ensure compliance with audit findings;
- Review evaluation to be carried out at the end of the second year of programme implementation and guide ITSP in implementing recommendations;
- Develop a plan in consultation with the ITSP and LTSP to ensure that participating organizations have access to technical support and/or financing mechanisms upon the completion of the programme.

3.3.5 UNDP Country Office

a. Responsibilities

The UNDP Resident Representative has overall fiduciary responsibility for the MicroStart Capital Grants facility. In addition, the Country Office has the following responsibilities in the MicroStart programme:

- Select an ITSP from among the qualified organization identified by SUM, taking into consideration the ITSP's proposed budget and staff allocation;
- Approve proposed three year outputs and annual work plan;
- Review annual achievements and outputs and disburse additional funds based on performance and authorization from Advisory Board;
- Consult on selection of LTSP;

³ The Special Unit for Microfinance will provide orientation and training for the members of the Advisory Board, and support the development of working norms.

- Establish an Advisory Board and serve as Co-Chair (Resident Representative);
- Ensure that ITSP has the autonomy to propose and work with local organizations with the best potential for sustainable growth;
- Review quarterly reports and follow up as necessary with the TSP;
- Conduct monitoring visits as deemed appropriate, roughly annually;
- Contract annual external programme audits with instructions from the Advisory Board;
- Disburse initial and subsequent tranches of funds to participating organizations upon instructions from the Advisory Board, based on requests of ITSP. Conditions for subsequent disbursement include satisfactory progress towards targets and performance standards, submission of work plan for the next period, and annual audits;
- Ensure that copies of all progress and audit reports are sent to SUM/UNDP;
- Contract forward-looking evaluation after two years to help identify follow up to project.
- Encourage the participation CO staff involved in the management of UNDP the Kyrgyz Republic's microfinance activities in relevant training opportunities made available through the MicroStart Programme or other internationally recognized training institutes.

3.3.6 UNDP Special Unit for Microfinance (SUM)

a. Responsibilities

UNDP's Special Unit for Microfinance (SUM) is responsible for the following:

- Providing guidance to UNDP on the contracting of the ITSP. This includes a technical review of the ITSP proposals and recommendations concerning the most appropriate TSP, based on the merits of the workplan, schedule of activities and outputs, and budgets proposed;
- Assistance with the selection and formation of the Advisory Board, if needed;
- Orientation and training of the Advisory Board;
- Continual backstopping of the MicroStart project, including follow up and liaison with the ITSP as requested;
- Assistance with institutional impact studies;
- Compiling results of institutional impact studies and ensuring broad dissemination;
- Assistance with client Impact Studies through the dissemination of guidelines for sub-contracting low cost impact studies and the development of protocols to ensure that impact studies undertaken are following similar or at least comparable methodologies. SUM is also exploring options to carry out new low cost impact studies currently being developed by the AIMS project (under the auspices of USAID and CGAP) in a number of MicroStart countries;
- Compiling results of client impact studies and ensuring broad dissemination;
- Carrying out programme audits on a random sample of programmes;
- Facilitating international workshops with participating UNDP Country Offices to develop further competencies in microfinance best practice and to provide a forum for country offices to share experiences and learn from each other;
- Compiling quarterly country progress reports prepared by each ITSP into global reports and disseminating to UNDP Country Offices, ITSP locally and headquarters and international donors.

3.4 Timing

The MicroStart project in the Kyrgyz Republic will be implemented over three years, starting in the third quarter of 1999.

4. DEVELOPMENT OBJECTIVE

The development objective of this project is to contribute to poverty alleviation by increasing access of the poor to sustainable credit and savings services for income generating activities.

5. IMMEDIATE OBJECTIVES, OUTPUTS, AND ACTIVITIES

Specific activities to be undertaken and outputs expected will be clearly articulated in the TSP's detailed workplan, to be completed as one of the TSPs first activities after contracting has been finalized. The outputs and activities listed below are meant to provide a range of activities that will be undertaken by the TSPs.

5.1 *Immediate Objective One, Outputs, and Activities*

Immediate Objective 1: Strengthen the *institutional, organizational, and technical* capacity of up to three local organizations to provide microfinance services (both credit and savings) to rural and urban poor households, on a financially sustainable basis.

Output 1.1: Participating organizations will have an increased capacity to provide microfinance services, both credit and savings, to rural and urban poor households, on a financially sustainable basis.

Output 1.2: The number of clients served by participating organizations will increase at least 50% per year during the course of the project, with an expected increase of at least 2,000 per institution by the end of the project.

Output 1.3: Effective management systems, procedures and microfinance staff will be in place in participating organizations at the end of the project, including specialized microfinance windows, agencies or cost/profit centers within commercial banks.

Output 1.4: Appropriate financial products and services for the target clientele, including a cost-effective savings and credit outreach technology will be developed by participating organizations within the first year. Interest rates and fees for service will be charged that are sufficient to cover all costs of delivering the services.

Output 1.5: Excellent management of the loan portfolio and of client/member savings will be the norm at participating organizations.

Activity 1.1.1: Analyze the operating environment including socio-economic, legal, and financial opportunities and constraints for poor households and potential microfinance clients. This exercise should corroborate the feasibility study, in terms of analysis of the environment, potential partnerships and collaborators, and donor activity.

Activity 1.1.2: Select participating organizations by first determining selection criteria with the approval of the Advisory Board, followed by analyzing the capacity and needs of a range of local organizations. The TSP will then propose the local organizations to participate in MicroStart to the Advisory Board, which will make final approval decisions.

Activity 1.1.3: Carry out detailed diagnosis of needs of selected organizations and priorities in the microfinance sector as a whole which MicroStart might address.

Activity 1.1.4: Assess current management and accounting systems and incorporate into workplan activities for future development.

Activity 1.1.5: Elaborate a three year plan of action to address these needs. This should include outputs and budget and be submitted to the Resident Representative and then the Advisory Board for approval.

Activity 1.1.6: Meet with selected organizations to discuss conditions of participation. Work with selected organizations to develop targets as well as parallel funding from their own loan capital.

Activity 1.1.7: Prepare contracts between UNDP and participating organizations, which include conditions of participation and targets as well as an annual action plan, which will be reviewed and approved by Advisory Board. Contracts for micro-capital grants for lending or fixed assets should have standard clause regarding the ownership of assets during implementation and disposition of assets at the end of the project.

Activity 1.1.8: Upon recommendation of the TSP and approval by the Advisory Board, the UNDP Resident Representative will disburse first tranches of funds to the participating organizations. Subsequent tranches will follow the same procedures.

Activity 1.1.9: Implement the plan of action, with ITSP and LTSP providing planned technical assistance in product design, delivery technology, credit officer and management staff training (inside and outside the country), monitoring and standard, transparent reporting. Participating organizations carry out planned activities as well as participate fully in MicroStart events and meet agreed targets.

Activity 1.1.10: Ensure follow up and monitoring of the programme. Submit reports on a timely basis.

5.2 Immediate Objective Two, Outputs, and Activities

Immediate Objective 2: Increase the *financial* capacity on an organization-wide basis to provide microfinance services to the economically active poor households and microentrepreneurs.

Output 2.1: By the end of year three, participating institutions, including commercial banks, will continue to operate the microfinance services.

Output 2.2: Participating organizations will have a viable financial and institutional strategy for building their microcredit portfolio, including expansion of the project to other branches.

Output 2.3: Best practice standards of transparent and performance oriented reporting will be incorporated into the microcredit operations.

Activity 2.1.1: Set up project of a cost/profit center basis to track performance. aspects of the microfinance sector.

Activity 2.1.2: Document project experience, including performance, effective technologies and innovative approaches to cost-effective service delivery, including mobile branches, part-time representations and use of organized groups and associations.

Activity 2.1.3: Establish on-going communications with other branches and headquarters operations regarding the performance and expansion of the project.

Activity 2.1.4: Develop staff training manuals and on-the-job training procedures.

Activity 2.1.5: Elaborate medium term institutional and financial strategy.

Activity 2.1.6: Implement strategy in other branches.

Activity 2.1.7: Ensure follow up and monitoring and make adjustments as necessary.

5.3 Immediate Objective Three, Outputs, and Activities

Immediate Objective 3: Contribute to the development of knowledge, expertise, and information in microfinance.

Output 3.1: Information exchange strategy and mechanism will be established within the country and globally

Output 3.2: A mechanism for contributing to the public advocacy efforts of UNDP through the Advisory Board and participating organizations will be elaborated and implemented.

Output 3.3: Impact studies of clients of participating organizations will be carried out in collaboration with the PIU of the Poverty Alleviation Project phase 2 and other interested institutions, and results disseminated, in coordination with the global MicroStart programme.

Output 3.4: A number of events in collaboration with other institutions will have been carried out and ongoing processes initiated to promote sector wide learning and exchange.

Output 3.5: A study of the participating organizations will be carried out that describes and analyzes the experience in developing new microfinance services, including savings.

Activity 3.1.1: Explore what already exists, and add to it. Provide for learning exchange with key individuals and organizations, such as the Central bank, Expert Working Group on Microfinance, and relevant private sector organizations and government officials.

Activity 3.1.2: Establish a working model for advocating the best practices and lessons learned in microfinance within the country through the Advisory Board, participating organizations and other related organizations and individuals

Activity 3.1.3: Establish working relationships with organizations with expertise in impact assessment.

Activity 3.1.4: Undertake or facilitate impact studies of clients of the participating organizations by the end of the programme.

Activity 3.1.5: Promote sector wide learning and exchange activities, such as round tables on key issues and training.

6. PROGRAMME INPUTS

6.1 Source of Funds

Funding has not been confirmed by any of the following sources. In addition to the leveraged funds from local institutions (see below), the draft budget will require resources in the amount of US\$800,000. The budget costs are expected to be co-financed in the following way:

- a. \$600,000 from the Government of Finland
- b. \$100,000 from the Country Office in Year 2000/2001
- c. \$100,000 from UNF/SUM (funding is based on a Country Office match, approval of UNF funds and review of microfinance effort against established criteria)

The contribution from the government will include provision of office space and of community services.

6.2 Budget Components

At the country level, MicroStart will consist of the following integrated components:

- **A Micro-Capital Grants Component** of up to \$300,000. This will be granted to participating organizations in amounts up to \$150,000, disbursed in tranches over the three-year programme. These grants will be used as capital for lending, purchase of fixed assets to facilitate the institution's microfinance activities or obtain training services for loan and savings officers, mid and senior management, or to defray operating costs as the institution sets in place mechanisms for cost recovery. The specific utilization of these funds will be determined in conjunction with the TSP on an institution by institution basis, with the approval of the Advisory Board. *All procedures governing the dispersal and monitoring of Micro-Capital Grants are outlined in the MicroStart Operations Handbook (see Section 6: Reporting) and will be reflected in the Memorandum of Understanding between the recipient institution, the TSP and UNDP.*
- **A Technical Services Component** of \$ 400,000, which will be provided to the ITSP over the three-year programme. These funds will be used to cover the costs of the ITSP and the LTSP as well as the technical services they provide to the selected organizations. Specific inputs will be determined by the Country Office and ITSP and specified in the contract and terms of reference. SUM will assist Country Office by developing a standard contract as a guideline and advising as needed.
- **A Project Support Component** of \$100,000 which will include audit and evaluation, monitoring and training for local organization staff outside the country.

In addition to the above components, **Parallel Funding** of up to \$300,000 will be mobilized. Participating organizations, such as banks and non-bank financial intermediaries will be expected to augment capital funds for on-lending, operational costs, training and other start-up costs (for example fixed assets and MIS systems) on at least a 1:1 basis. With the exception of SSC that does not engage in lending to individuals, each institution visited during the mission, has excess loan capital, including the credit unions (a credit line through the ADB), AKB and Promstroj (own loan capital), KAFC (credit lines through the World Bank and IFAD).

7. ASSUMPTIONS AND RISKS

The **assumptions** for the MicroStart programme to be a success in the Kyrgyz Republic include the following. That:

- UNDP continues to support the institutional approach to microfinance and will facilitate the work of the ITSP and LTSP in this direction.
- MicroStart will be able to function according to the principles of best practices in microfinance and that the participating organizations will be able to conduct their activities without conditionalities which may disrupt their activities.
- Participating organizations will recruit young staff and train them in new technologies.
- Local organizations are free from mandates so they will be able to provide services in a cost conscious and effective manner. This includes defining a revenue structure compatible with their activities, developing a cost structure free of a directed credit

line or mandates by outside agencies to serve individual clients, and determining the rate on comparable savings services to provide these services.

- Participating organizations will be able to set appropriate interest rates and fees which will allow for financial sustainability.
- An adequate enabling environment will be provided in terms of a regulatory framework through policy recommendations made by the UNDP Resident Representative, based on the advice of the international best practitioner.
- Inflation projections are accurate and remain below 20%.
- The financial sector does not deteriorate.

The following section indicates some of the **risks** and special considerations that should be taken into account in implementing MicroStart in the Kyrgyz Republic.

Credit Culture/Market Economy. There appears to be a need for social mobilization for clients at the outset to understand basic business principles and banking systems. While an effective credit delivery methodology through a formal institution includes credit orientation, social mobilization and community development activities are generally not a part of a cost-effective service delivery technology. Microfinance banks have engaged in organizing groups for credit and have been effective at this task. However, it is important to distinguish between organizing groups to receive financial services which is part of a credit technology, and organizing groups for broader community development purposes, which may not be a part of the service. Both are extremely valuable in the context of the Kyrgyz Republic, however the activities will require focusing.

High Literacy and Isolated Villages. Even remote villages in the Kyrgyz Republic have a highly literate and educated population. This bodes well for any group organizing for financial services and transparency in the group as people learn rapidly and are able to keep their own accounts and most members of the group will be able to understand them. An initial up-front investment in a group, provided regular monitoring will be able to shoulder most of the time consuming tasks of record keeping.

Savings. There is an immediate concern on the part of the PIU of the Poverty Alleviation Project phase 2 that SHGs they are currently working will have access to formal savings services. Within a six month time period, the groups will have accumulated enough savings to make it risky for the groups to continue to keep savings in the village. With the current inflation, devaluation of the som and banks decreasing their deposit interest rates to prevent attracting deposits, the groups may be better advised to keep savings circulating among the members for a higher return. For example, In one group a member was loaned 100som and returned the 100 som principal and 60 some interest within the week. If the group will not need immediate access to member's savings, and with the current uncertain economic situation, savings could also be kept in foreign currency fixed deposit accounts. Over the course of the MicroStart project, savings mobilization technologies will require due attention by the technical service provider and participating organizations

Project Focus. Development organizations as well as many financial institutions operate based on a project focus. This is most apparent with directed credit lines within financial institutions that are for specific purposes and targeted clients, such as small farmers. Many NGOs also operate on a project rather than an institutional basis where they are set-up exclusively to manage a particular fund or contractual service. Although their numbers are growing, NGOs remain small, often one person run operations.

Absence of Commercial Providers Image of banks, High Tax and Reserve Requirements, Capital to Absorb External Shocks. Microcredit technologies will be new to all banks and financial institutions, including the K AFC. While loan amounts may be small, the technologies in use are scaled-down versions of standard commercial loans with high collateral requirements and elaborate business plans and evaluations. Loans are based on pre-determined cash flows that may no longer be relevant once the loan is approved and disbursed. Further the image of banks, particularly those in the public sector is often tied to pension checks that do not regularly come, and savings accounts that have been devalued. Reserve requirements are high and the capital base of banks is generally low which weakens their ability to withstand external shocks.

Vulnerability of the Financial Sector. The financial sector as a whole is vulnerable to external influences, particularly the Russian financial crisis, and internal shocks such as recent flooding and a recent cyanide spill that decreased tourism. The Central Bank has put in place a regulatory framework, and with the assistance of the World Bank is identifying how to tighten the system.

Need to focus on women. Many of the most successful microfinance programmes in the world work primarily or exclusively with women, who make up the majority of the world's poor and face the greatest barriers in accessing formal financial services. One of the most successful methodologies for reaching women has been through group lending or solidarity groups. There is a need to examine appropriate mechanisms for increasing outreach to women clients and ensuring that they have equal access to the benefits provided through this project. The ITSP and the LTSP should help participating organizations to identify and implement innovative and effective ways of reaching women.

8. PROGRAMME MONITORING, REVIEW, REPORTING, AND EVALUATION

MicroStart Requirements

As MicroStart is a programme being initiated on a global basis, programme monitoring, review, reporting, and evaluation are particularly important--not only to the success of the programme in any given country, but also to the success of the initiative world wide. It is essential that each level contribute to appropriate and timely monitoring, review, reporting, and evaluation. These should be viewed not simply as programme requirements, but as management tools to be used to identify problems in a timely manner so as to take remedial action and to recognize and build on achievements.

All of the reporting requirements and formats under this programme can be found in the MicroStart Operations Handbook (for an overview see Annex G). This handbook is a presentation of the various administrative and procedural stages of a MicroStart Country Programme and should be used as a reference guide by the Technical Service Providers (TSPs), Country Offices, and local organizations. The handbook is divided into six basic sections, which cover the processes involved in a MicroStart project, and provides guidelines for the completion and presentation of required information. A last section (7) of the handbook is still being designed, and will provide additional resources for Organizations interested in impact assessments at the client level. This section will be forwarded at a later date.

All Quarterly reports provided by the ITSP should include portfolio indicators for participating organizations, progress made and problems encountered by participating organizations, activities carried out during the period by the ITSP and LTSP, analysis of any problems encountered and description of solutions adopted, and an action plan for the next reporting period. SUM will consider ways to share the most relevant information from these reports on an annual basis from country programmes with all 25 participating MicroStart programmes.

The UNDP Country Office will define appropriate evaluation mechanisms on the country level to enable it to determine an appropriate follow up to the initiative, if desired.⁴ As part of the project effort, the ITSP is expected to undertake a forward looking evaluation of the project with each of the local organizations involved. In addition, SUM will coordinate evaluation of the global MicroStart project after three years of implementation. A representative of the Government of Finland will participate in these forward looking evaluations.

In order to assess not only the performance of the initiative, but also the impact the initiative has had on participating organizations, clients, local technical services providers, and the microfinance environment, an impact assessment system is required. All participating UNDP Country Offices, ITSPs, LTSPs, and participating organizations agree to ensure that an appropriate system is developed and necessary baseline and impact assessment data is collected and analyzed. This information should be utilized on a national and global level to draw lessons from the experience, demonstrate the level of results of such initiatives, advocate for enabling policies and resource flows to the sector, and determine what might be appropriate follow up to this project.

Strategic Results Framework

In line with the UNDP Results-Based management philosophy, a Strategic Results Framework – illustrating the project objectives, outcomes, outputs and respective indicators – has been developed for this project. The Framework is the major strategic management tool for monitoring and evaluation of the project performance. The progress of the project and its contribution to the overall Framework on Poverty and Sustainable Livelihoods will be measured based on the set of indicators provided in The Strategic Results Framework in Annex C.

9. LEGAL CONTEXT

This project document shall be the instrument referred to as such in Article I of the Standard Basic Assistance Agreement between the Government of the Kyrgyz Republic and the United Nations Development Programme, signed by the parties 13 February, 1992. The host country implementing agency shall, for the purpose of the Standard Basic Assistance Agreement, refer to the government co-operating agency described in that Agreement.

The following types of revisions may be made to this project document with the signature of the UNDP Resident Representative:

- Revisions in, or addition of, any of the annexes to the project document;
- Revisions which do not involve significant changes in the immediate objectives, outputs or activities of a project but are caused by the rearrangement of in already agreed to or by cost increases due to inflation;
- Mandatory annual revisions which rephrase the delivery of agreed project outputs of increased expert or other cost due to inflation or take into account agency expenditure flexibility.

The government agrees to the recruitment of national consultants required for the implementation of this project in accordance with UNDP policies and procedures established within the United Nations system for this purpose. These services constitute an addition to the

⁴ As country level evaluations were not included in the original design of the MicroStart programme, the ITSP is not obliged to carry out any evaluation nor were funds originally allocated for that purpose. The design team recommends, however, that an external forward looking evaluation be carried out, primarily with a view towards identifying appropriate follow up initiatives of the project, within the participating organizations. Provisions for such an evaluation have been included in the budget.

regular personnel resources to be provided by the Government and will be available for the duration of UNDP participation in the project. The remuneration of national consultants will be determined on a case-by-case basis in accordance with the policies and procedures of UNDP but should not exceed either the prevailing compensation for comparable functions in the host country or remuneration levels applicable within the United Nations system.

10. UNDP Country Office Support

The UNDP country office may provide support services at the request of the Government through its Executing Agent designated in the project document as described below.

The UNDP country office may provide support services for execution activities such as assistance with reporting requirements and direct payment. In providing such support services, the UNDP country office shall ensure that the capacity of the Executing Agent is strengthened to enable it to carry out such activities directly. The costs incurred by the UNDP country office in providing such support services shall be recovered from the administrative budget of the office.

In addition, the UNDP country office may provide at the request of the Executing Agent, the following support services for implementation activities:

- Identification and assistance with and/or recruitment of project and programme personnel;
- Identification and facilitation of training activities, including fellowships, short-term training and study tours;
- Procurement of goods and services; and
- Access to UNDP-managed global information systems, the network of UNDP country offices and specialised systems containing operations information, including rosters of consultants and providers of development services.

The procurement of goods and services and the recruitment of project and programme personnel of the UNDP country office shall be in accordance with UNDP regulations, rules, politics and procedures.

The relevant provisions of the Standard Basic Assistance Agreement between the Government of Kyrgyzstan and the United Nations Development Programme, signed by the parties on 13 February, 1992 including the provision of liability and privileges and immunities shall apply to the provision of such support services. The Government shall retain the overall responsibility for the nationally executed programme or project through its designated Executing Agent. The responsibility of the UNDP country office for the provision of the support services described herein shall be limited to the provision of such support services detailed in the annex to the project document (where relevant).

Any claim or dispute arising under or in connection with the provision of support services by the UNDP country office in accordance with this letter shall be handled pursuant to the relevant provisions of the Standard Basic Assistance Agreement.

The UNDP country office shall submit progress reports on the support services provided and shall report on the costs reimbursed in providing such services as may be required. Any modification of the present arrangement shall be effected by mutual written agreement of the parties hereto.