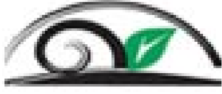

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**Case Study**

Rural Financial Institutions: Start-Ups

# Agrocapital & Bai Tushum: Lessons from 2 Rural Financial Service Foundations

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(ACDI/VOCA)

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All views, interpretations, recommendations, and conclusions expressed in this paper are those of the author (s) and not necessarily those of the supporting or collaborating institutions.

## Introduction

Based on the evolution in the microfinance industry toward commercialization, a governance structure that allows for the continued expansion of funding from depositors and investors has drawn attention to entities such as finance companies and credit unions. By legal definition, Foundations and NGOs lack owners, the ability to attract capital, and, in most countries, the authority to mobilize savings.

However, the challenges of financial services directed to rural families and agricultural production—transaction costs, covariant risk, longer loan terms, larger amounts, and political interference—hardly encourage investors and depositors in new businesses to serve these markets. In countries without examples of the ability to do this on a viable and profitable basis, the term "interested investors" is often an oxymoron. The challenge, as was the case with microfinance institutions, is to demonstrate this viability. Once demonstrated, pursuing investors, owners and depositors becomes a more feasible task. As the movie said, "Build it and they will come."

In two very different countries, Bolivia and Kyrgyzstan, ACDI/VOCA has seen the foundation structure provide this *Field of Dreams* opportunity. Both situations involved donors with available funds, and a strong desire to see credit reach farmers and to be repaid at rates of interest that allowed the programs to cover costs. In neither case was the foundation framework required.

## The Foundations

### 1. Bolivia's *Agrocapital*

**a. Establishment and Structure.** In the case of Bolivia, the foundation was viewed as the most efficient type of legal entity to launch under a USAID-funded project designed to extend loans to farmers who were substituting licit crops for coca. Project objectives revolved around the extension of loans, not the institutionalization of the lender. The donor was interested in a project structure that could, if necessary, be shut down with limited cost in time and money. Neither large numbers of small investors nor small numbers of large investors were desired. At the same time, enforceable loan contracts between a legal entity and the farmers were required.

Analysis of the Bolivian civil code identified the Foundation as the optimal legal entity given these requirements. The Agrocapital Foundation was chartered as a not-for-profit foundation on January 23, 1992, to promote and finance economic activities in rural Bolivia. USAID/Bolivia provided a grant, through ACDI/VOCA, to assist Agrocapital in extending loans to agricultural producers and businesses in the coca producing zone of the Departments of Cochabamba and Santa Cruz, and in the mostly indigenous communities of the high valleys of Cochabamba. Demand for loans for other purposes prompted changes in the charter to provide financial services for all economic activities, including microenterprise. Likewise, demand from other parts of rural Bolivia led to Agrocapital's geographic expansion. Headquartered in Cochabamba,



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Agrocapital now operates 8 agencies in the departments of Cochabamba, Santa Cruz and La Paz.

As required by the laws governing not-for-profit institutions in Bolivia, Agrocapital's equity is owned by the foundation itself, rather than held by individuals in the form of shares. Similarly, any profits it earns must be used for its stated mission. A five-member Board of Directors sets policy, approves strategic and operating plans and hires the General Manager and Internal Auditor. Members elected as President, Vice President and Secretary serve two-year, staggered terms. The board meets quarterly. The General Manager oversees day-to-day management of Agrocapital's three divisions: Credit, Operations and Finance. The Managers of these divisions, along with the General Manager, form an Executive Committee. Branch managers report to the General Manager.

**b. Mission.** Agrocapital staff participated in strategic planning process in 2002, which crafted a Vision and Mission Statement. Agrocapital will be "a *Fondo Financiero Privado* (FFP) committed to the economic agents of Bolivia's rural sector, promoting access to competitive and integrated financial services, and relying on highly qualified personnel and technology in order to serve our customers throughout Bolivia." In carrying out this mission, Agrocapital's main objective is to "constitute a national financial institution distinguished by its identification with those excluded from the national economy, while at the same time pursuing the solvency and profitability expected by its investors." In pursuing this objective, Agrocapital will apply its core values—transparency, honesty, efficiency, commitment, loyalty, discipline, respect, and equity.

**c. Donor Support.** Under a cooperative agreement with USAID-Bolivia, ACDI/VOCA provided technical assistance to Agrocapital from its inception through August 1997. In 1991, ACDI/VOCA and the Bolivian PL-480 Executive Secretariat, which was managing a poorly performing rural loan portfolio at the time, designed the private foundation to manage a loan program in and around the coca-producing areas of Bolivia. In the wake of the bankrupt Agricultural Development Bank, the intention was to remove the government, and the accompanying political pressures, from rural lending in the area. Created to manage one component of USAID's Cochabamba Rural Development Project, Agrocapital is now a profitable institution.[1]

Until June 1997, ACDI/VOCA's long-term advisor served as Manager. Since then, Agrocapital has had a Bolivian General Manager. Through the combined efforts of the

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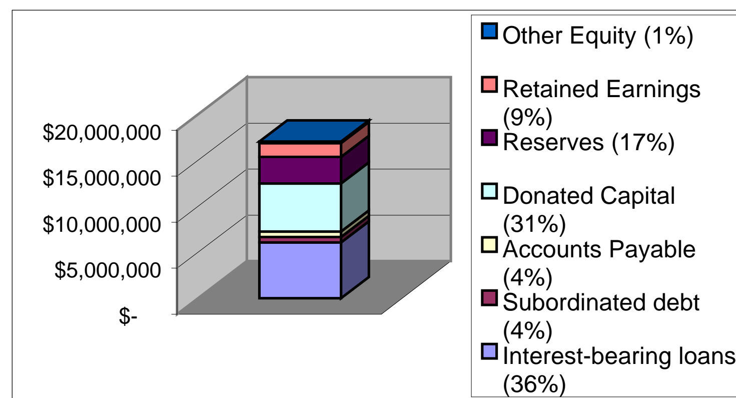
[1] However, political pressures, while absent from the lending process, have not been fully removed. Given that a significant portion of its capital has come from donations of cash and loan portfolio from the PL-480 Executive Secretariat—a Government of Bolivia agency that manages proceeds from food donated by the United States—Agrocapital has faced a protracted application process in its attempt to obtain an FFP license from the Superintendency of Banks. Although a series of audits have documented the validity of donations made to Agrocapital and confirmed Agrocapital's stated equity position, scrutiny and intervention by ministry and legislative officials have challenged Agrocapital's FFP application, as well as a recent bid to invest with FFPs in a company seeking to provide credit bureau services.

management and staff of Agrocapital, and a series of short-term interventions, the foundation's microloan and rural finance products were developed, tested and implemented; its manuals, controls and information system put in place; and the foundation received a start-up operating subsidy that declined over time.

In addition to this technical assistance and operating subsidy, Agrocapital received donations from Bolivian government agencies to expand its loan capital. In its early years, donations accounted for all of Agrocapital's funding. Over time, Agrocapital has expanded its equity with earnings, and leveraged its earnings with borrowed from government funds, multilateral banks including the IDB and CAF, and commercial banks. As of December 31, 2002 Agrocapital's total assets stood at $16,793,653. As the following figure illustrates, 40% of these assets were funded with debt, 31% with donated equity, and 26% with reserves and retained earnings.

**Structure of Agrocapital's Liabilities and Equity** – *Dec. 2002*




**d. Customers and Products.** Agrocapital lends to micro, small, and medium scale businesses in rural and outlying urban areas of Bolivia. These businesses are involved in a range of economic activities: retail sales, transportation, agricultural production, trades and other services. At the end of 2003, 72% or 2,374 of Agrocapital's current borrowers had microloans, with an average balance of $1,379. Most of these borrowers run microenterprises on their own, or with the help of family members. Of the total microloan portfolio:

- 57% went to vendors with market stalls or small shops in rural towns, who sell agricultural products, clothing and household goods;
- 24% to service providers—small restaurant owners, haircutters, or drivers;
- 7% to producers, either craftspeople—artisans, seamstresses, carpenters, cobblers, and those with metalwork or repair shops—or small farmers who borrowed short-term working capital for basic processing, animal husbandry, or inputs purchased late in the production cycle;
- 7% went for housing; and
- 5% for consumer loans.

Agrocapital's microloan portfolio has significantly over the last five years when there were 3,300 microloan borrowers, with an average loan size of $545, and the 70% of the portfolio went to vendors, 23% to production and only seven percent to services. These shifts responded to market realities. An economic crisis in Bolivia from late 1999 to 2001—recession, drought, declining commodity prices, a banking crisis, a staggering arrears rates, and political movements pressing for debt forgiveness—resulted in a contraction of the loan portfolio, for Agrocapital as well as for most FFPs and commercial banks. More established borrowers, who had passed through successive microloan steps, proved more likely to remain as customers, while demand for loans from new borrowers dropped off. These factors led to a higher average microloan size. Short-term microloans to small farmers proved risky in this climate, and the service sector increased its share over producers and vendors.

Although the majority of Agrocapital's customers are microentrepreneurs, microloans account for a smaller share of the total portfolio. This is due to the larger size of loans made to small and medium-size businesses and farmers, which average $9,120 (down from over $10,000 five years ago). The average outstanding balance of all borrowers is $3,299. In dollar terms, microloans currently account for 28% of the portfolio, while 45% is financing agricultural production and agribusiness, 24% for sales and services, and 3% for real estate and consumer loans. This product mix also reflects a significant shift. In its early years, the vast majority of Agrocapital's portfolio financed agriculture and agribusiness. Five years ago, this agricultural production and agribusiness still accounted for 64% of its portfolio, while microenterprise accounted for 17%, and sales and services 19%. This diversification of Agrocapital's portfolio reflects strategic decisions as well as external factors. The strategic plan in 1997 targeted an expansion of microloans to more than 20% of the portfolio, and agricultural production to below 40%.

Agrocapital offers two basic types of loans: *microloans*, which were launched in July 1994, and *collateral-backed investment loans* to small and medium scale businesses and producers, which have been made since Agrocapital's inception in 1992. Both types of loans are made to individuals, rather than groups. However, the requirements and methodologies differ between the two types.

Agrocapital has introduced changes in the two loan types, in response to market demand. Microloans are now denominated in dollars as well as *bolivianos*, and larger, more established microentrepreneurs can qualify for a new collateral-backed microloan. Introduced late in 2002, 11 borrowers, with an average loan balance of $5,075, were piloting this new product.

Interest is calculated with each payment, on a declining balance. No prepaid interest is required, however a fixed fee) is charged on each loan. As the table below indicates, interest rates vary over the same product, based on a number of cost and risk factors: whether the loan is denominated in *bolivianos* or dollars; the size of the loan, with larger loans having lower rates; the level of risk of the economic activity involved, with production being riskier than sales; and whether or not there are factors that increase the cost of administering the loan, such as borrowers who live or work a significant distance

from the branch office. Pricing loans against these factors has allowed Agrocapital to cover transaction and administrative costs, while offering competitive rates to its most reliable customers.

**Agrocapital's Loan Products**

| Loan Type | Microloans | Collateral-backed Loans |
|---|---|---|
| **Borrower Requirements** | • Resident: >3 year;<br>• 1 year experience in business preferred;<br>• Cash flow analysis shows available cash is > two times the loan payment amount<br>• Business has assets = to 3 times loan amount; 1.5 times for larger microloans.<br>• For current borrowers, a total of no more than 10 days delinquency in prior loans | • Clean credit record<br>• Ability to put up at least 20% of investment<br>• Collateral that includes real estate, a warrant, or fixed term deposit, complemented by personal or movable guarantee<br>• Loan documents demonstrating feasibility & positive cash flow of project investment |
| **Methodology** | • Step approach. Start small and increase with subsequent loans. Flexibility allows 2 skipped steps, smaller increments, and periods with no debt.<br>• Interest rate declines as loan size increases.<br>• Streamlined analysis—simple cash flow and a visit to the business—allows officers to process loans in 5 days or less and carry, on average, more than 235 loans. | • Feasibility and cash flow analysis for each loan<br>• Collateral appraisal |
| **Guarantee** | • One or two co-signors<br>• For largest loans (over $4,000) and first-time agricultural borrowers: Title documents are deposited, not registered. | Collateral, primarily real estate, with a liquidated value = to loan amount. |
| **Amounts and Terms** | • Maximum initial loan: $1,000;<br>• Maximum loan: $7,000<br>• Avg. balance: $1,379<br>• Monthly payments; maximum term is 2 for initial loans; 3 years for largest loans | • Max. loan: $70,000.<br>• Avg. balance: $9,120<br>• Terms: up to 2 years for working capital loans, and 5 years for investment loans.<br>• Payment periods set up to reflect cash flow |
| **Interest Rates** | • 38-42% per year on Boliviano loans<br>• 26-30% per year on dollar loans<br>• Higher rates on loans with higher risk or costs<br>• $10 Fee at origination; $1 transaction fee/mo | • 13% to 18% for regular loans<br>• Higher rates for loans that are: smaller, in riskier sectors, or more expensive to administer<br>• $15 Origination Fee; $5 transaction fee for monthly and bi-monthly payments; $10 fee for less frequent payments |
| **Currency** | • Boliviano and US Dollar | • US dollar |

**e. Impact and challenges.** In 1992, Agrocapital entered a financial market in which, historically, loans were scarce, subsidized, politicized, and rarely repaid. It saw itself offering a new type of loan, one that responded to market realities. To understand its market, it placed its offices and knowledgeable loan officers in the rural areas. It priced its loans according to risk and cost, and diversified its products in response to market demands. This approach paid off. Its loan portfolio grew continuously from less than $1 million in 1992 to more than $13 million in 1999. At that time, with loans to microentrepreneurs, farmers, agribusinesses, and rural services, it currently served 4,500 customers, more than three-fourths of them microentrepreneurs.

With sound practices and a solid, diversified portfolio, Agrocapital had demonstrated that a significant demand exists for rural financial services; rural customers repay their debts as well as urban ones do; and a rural finance company dedicated to customers long ignored by banks can be profitable and self-sustaining. From 1995 to 1998, Agrocapital returned profits. Operating costs were less than 15% of the total loan portfolio. The portfolio was healthy, with PAR>30 days remaining below 5 percent. Interested in continuing its growth and introducing savings into its mix of financial services, Agrocapital lined up four additional founding investors—ACDI/VOCA, a US energy firm with investments in Bolivia, and two Bolivian businesses—and prepared an application for an FFP license.

Challenges were raised concerning Agrocapital's equity. A series of audits—commisioned by Agrocapital, USAID, and the Finance Ministry—ultimately and consistently documented the Foundation's clear title to the funds, but delayed the review of its application. This political challenge was compounded by the beginning of Bolivia's economic crisis. As the table below illustrates, the crisis contributed to a contracted portfolio, increased delinquency, and three years of losses. 2002 saw a reversal in this trend. Portfolio at Risk remains high, although this understates the improvement in loan quality since it reflects legal hurdles involved in writing off bad loans that have been provisioned. 98.8% of the PAR>30 are loans disbursed prior to 2002. Conversely, the operational self-sufficiency indicator overstates improvements in operating income as much of the year's profits resulted from an easing in provisioning requirements by the Superintendency of Banks at the end of 2002. In 2003, Agrocapital adopted a stricter provisioning policy.

***Agrocapital Indicators – 1998 to 2002***

| | ***1999*** | ***2000*** | ***2001*** | ***2002*** |
|---|---|---|---|---|
| Number of loans disbursed | 4,091 | 2,545 | 1,652 | 2,086 |
| Number of loans outstanding | 4,524 | 3,596 | 2,808 | 3,281 |
| Loans outstanding | $13,191,000 | $11,957,000 | $9,109,000 | $10,706,000 |
| PAR>30 days | 6.6% | 14.3% | 14.9% | 13.9% |
| Operational Self Sufficiency | 100% | 90% | 93% | 106% |
| Operating efficiency | 19% | 23% | 21% | 18% |

Bolivia's economic crisis clearly disrupted Agrocapital's momentum, as it did with most of the commercial banks, FFPs and NGOs involved with financial services in Bolivia. Growth and improved loan quality in 2002 seem to indicate Agrocapital's ability to weather economic downturns, and its potential for a return to the more positive performance Agrocapital enjoyed prior to the crisis. Agrocapital's response to the crisis contributed to changes in the structure of its loan portfolio, some planned—like the reduction in the percentage dedicated to agricultural production, and some unplanned—like the significant increase in the average loan size of the microloan. Decline in the number and value of loans has decreased the operating efficiency of Agrocapital slightly, however it remains competitive with most of the FFPs in this indicator, and plans to increase loan disbursements should increase loan officer caseload and efficiency. With



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more than $3.7 million in investments, the Foundation has the resources needed to pursue its current plans for increasing its lending operations.

Significant growth over the longer term will require expanded funds. To compete with the FFPs in returns on equity, Agrocapital will need to leverage its equity. This can be pursued to some degree as a Foundation with increased debt. However, it requires an FFP license in order to capture deposits. Given the need to reverse the impact of the recent economic crisis, and the current political climate in Bolivia, Agrocapital may very well continue to operate as a Foundation for the near term.

While the optimal choice at Agrocapital's inception, was the choice to establish Agrocapital as a foundation a constructive one or a limiting one in the long term? This status allowed Agrocapital to quickly expand lending to farmers, businesses and microenterprises in rural Bolivia. Its performance and growth allowed it to be a player with the licensed FFPs in ASOFIN and its capital structure proved able to weather two years of economic crisis. At the same time, Agrocapital's structure and funding as a Foundation diminished the perception by a number of political actors of Agrocapital's status as a private entity. This frustrated Agrocapital's attempts to obtain an FFP license, a license needed for the institution to further diversify its private sources of funds.

**2. Kyrgyzstan's *Bai Tushum Financial Foundation***

**a. Establishment and Structure.** In the case of Kyrgyzstan, an initial attempt at farmer-owned credit associations failed due to a legal environment in which associations, like foundations, could not be legally owned, but rather funded by donors. Unlike foundations, donors to associations "enjoyed" unlimited liability. This challenge to true ownership resulted in limited contributions beyond the funds generated by the monetization of grain under a USDA-funded activity.

Initial success with lending in three parts of the country prompted a consolidation of the associations into 3 branches of a single entity. ACDI/VOCA and Swiss Caritas, who were providing technical assistance to the associations, weighed the benefits and constraints of three types of legal entity: joint stock company, credit union, and foundation. The table on the following page lays out these relative strengths and constraints, in terms of ease of conversion, desired governance, and operational issues.

The Foundation had the most consistent advantages, and its disadvantages—concerning the ability to capture deposits—would be faced in the medium term, and could be resolved by having the foundation invest in a finance company at that time. As a result of this analysis and their commitment to building on the achievements of the pre-existing associations, Swiss Caritas joined ACDI/VOCA in September 2002 as co-founders of the Bai Tushum Financial Foundation, a non-commercial public foundation, as defined by the Kyrgyz civil code. It was registered with the Ministry of Justice. In August 2002, a law for microfinance organizations was passed which requires microfinance companies, microcredit companies and microcredit agencies to obtain a license from the National Bank. Bai Tushum has obtained its National Bank license as a microfinance agency.



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This new status will allow the foundation to expense loan loss provisions, which will result in significant reductions in the taxes it is required to pay, and to lend borrowed funds.

**Advantages and Disadvantages of Three Legal Structures in Krygyzstan:**
Joint Stock Companies, Credit Unions and Foundations

| *Strength* | *JSC* | *Credit Union* | *Foundation* |
|---|---|---|---|
| **Conversion from current status** Clearly defined registration/licensing process | Not yet | Yes, with Min. of Justice and NB | Yes, with Min. of Justice |
| Speed with which operations begin | Longest | Medium | Shortest |
| Cost-effectiveness of banking TA based on scale of operations of beneficiary | Medium | Low | Highest, with ACDI/VOCA and Caritas collaboration |
| **Governance** ACDI/VOCA and Caritas can participate in governance structure in early years | Yes | No | Yes |
| Nationals can participate in governance structure in early years | No | Yes | No |
| Strong governance structure from start | Yes | No | Yes |
| **Operational Issues** Continuity in staff, products, and market image | Yes | More difficult | Yes |
| Tax exemption | If amendm't passes | If amendment passes | With amendm't & SCI license |
| Build on current loan portfolio without period of contraction | Yes | No | Yes |
| Can leverage equity with liability | Yes | Yes | Not until it invests in JSC |
| Can accept deposits | No | Yes | Not unless it is "converted" to bank |
| Can attract broad base of willing investors | After demonstrating viability | With greater economy of scale | After demonstrating viability & forming JSC |
| Can project market image with limited impact of other entities | Yes, would be one of the first JSC SCIs | No, reputation rides with broader credit union movements | Yes, limited number of financial service foundations |

At the head of the Foundation's structure are the Founders' Assembly, formed by representatives of ACDI/VOCA and Caritas. They defined the Foundation's mission and objectives, registered it, and appoint the Board of Directors, or Supervisory Committee, which can contain up to seven members. Currently five positions are filled. The Supervisory Committee is chaired by an ACDI/VOCA representative with extensive microfinance experience in the region. It also includes a second representative of ACDI/VOCA who serves as long-term technical advisor to Bai Tushum; a representative of Swiss Caritas, from the Swiss Cooperation office in Kyrgyzstan; a representative of the Kyrgyz NGO sector; and a commercial lawyer representing the private sector. Board member terms last two years. The board meets quarterly to set policy and approve strategic and business plans and the introduction of new products.

The Board hires and supervises the Executive Director, the Chief Accountant, and an Internal Auditor. The Executive Director heads an Executive Board responsible for day-to-day management. The Executive Board also includes a Chief Accountant, Operations Coordinator, Legal Advisor, and a Senior Branch Officer. The Foundation's headquarters is in Bishkek, where it shares offices with the Chui Branch. The two other branches are located in Osh and Djalal Abad.

**b. Mission.** As stated in its charter, Bai Tushum is "dedicated to the social and economic development of both the rural and urban sectors of the Kyrgyz Republic through the:

- lending, with interest, of its funds to individuals and institutions,
- provision of technical and other services related thereto, and
- investment of funds in organizations that advance its goals and objectives."

As in the case of Agrocapital, the foundation hopes to develop effective systems, a solid track record and reputation, and a degree of profitability sufficient to invest, with others, in a finance company. This path is implicit in the objectives stated in its charter:

- Achieve profitability reflected by financial and operational self sufficiency
- Achieve client satisfaction by providing good quality financial services to farmers and SMEs
- Create new employment opportunities by supporting SMEs
- Grow the organization in a sustainable manner by attracting new and quality clients and investors

**c. Donor Support.** USAID began funding technical assistance for Bai Tushum in its opening years with a cooperative agreement signed in 2001. Additional funding for technical assistance was made available by the Swiss Development and Cooperation Agency (SDC). Bai Tushum is currently receiving long and short-term technical assistance in the areas of institutional development and management from ACDI/VOCA. TA is slated to continue last until 30 September 2004. ACDI/VOCA's microfinance and banking consultant provides day-to-day guidance to the management team of Bai Tushum. He also has co-signing authority, with the Executive Director, on use of Founders' contributions to expand Bai Tushum's loan portfolio. In this way, he can slow expansion of lending activities should the foundation or one of its branches encounter a situation in which the quality of its portfolio is rapidly deteriorating. There has been no need to exercise this authority.

**Other donors** and lenders include EU TACIS, which has provided funds for the development of a mortgage lending product; and CGAP, which funded both a rating exercise conducted by Microfinanza Ltd., and a product costing exercise conducted by a local accounting firm. Bai Tushum is in discussions with International Finance Corporation (IFC) to receive a commercial loan and implementation of a pilot leasing program, Blue Orchard for a commercial loan, and the Soros Foundation for potential



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guarantee support. To date, however, Bai Tushum has not leveraged its equity with loans, but has added to its earning with profits. Its $2.2 million in equity as of December 2002 was comprised of 60% donated capital and 40% retained earnings.

**d. Customers and Products.** Currently Bai Tushum offers four different loan products, while it plans to introduce two new products during the year 2003. Crop and Livestock loan products are available to farmers, individual entrepreneurs and legal entities that are involved in relevant business activities. **Crop Production** loans finance the production of seed, grains, industrial crops and vegetables. Livestock loans finance mild and dairy production; cattle, pig and sheep breeding and fattening; poultry farming, bee-hiving, animal breeding, fish farming.

Two types of SME loans are available to individual entrepreneurs and legal entities engaged in business activities on a patent basis. **SME/Agricultural processing** loans finance agricultural processing; the manufacturing of packages for food and agricultural products and food; and the manufacturing of consumer goods, construction materials, and other eligible businesses involved in production. **SME/ Trade** loans finance all kinds of trade; public catering (cafes, bars, restaurants etc.); and service provision in rural and urban areas (automobile services, barbershops, recreation, tourism and other eligible small and medium businesses).

All of these loans range in size from 30,000 to 1,000,000 soms (600-20,000 dollars). The average loan balance is $1580. Loans are backed by collateral (immovable property), and borrowers must have at least a 25% stake in any financed activity. The maximum, and typical, loan term is 12 months. Interest rates range from 28-36% for crop loans, 29-40% for livestock loans, 32 to 42% for SME/Production loans, and 32 to 46% for SME Trade loans. Higher interest rates apply to borrowers with shorter credit histories. Borrowers pay a 1% loan processing fee. All expenses related to loan disbursement, collection of information, registration, document processing and certification are paid by borrower.

Loans are disbursed and repaid in local currency, in cash or through bank transfer. Interest rates are fixed, but may be revised by mutual agreement of the borrower and lender. Interest is paid monthly or quarterly and penalties are charged in cases of late interest or principal repayment. The Foundation does not provide repeat loans to customers with multiple delinquencies. Loans are not provided for financing existing debts, starting new business, speculative businesses, growing or processing tobacco, the production or sale of liquor, or other businesses or projects with negative environmental or social impacts.

Bai Tushum has made a conscious effort to diversify its loan portfolio, which was heavily concentrated in agriculture and agribusiness, and prone to wide seasonal expansions and contractions. In June of 2001, 75% of its portfolio was in crop production and livestock loans. By the end of 2002, those loans represented 58% of the portfolio. Similarly, the percentage of the portfolio with balloon payments of principal at the end of the loan term dropped from 71% to 48% of the loan portfolio over this same time period. Contrasting with these indicators of diversification, loan terms continue to Bai Tushum's original

crop production loan, with most loans coming due in 12 months, even when the relevant business cycle could allow for a shorter term.

**Planned products.** Bai Tushum plans to introduce leasing and mortgage lending products during 2003. The lack of collateral is a major constraint that limits many SMEs' access to commercial credit. Few financial institutions are willing to finance the replacement of aging machinery and equipment for agro-processing SMEs. In order to overcome this constraint, Bai Tushum is currently working with IFC Leasing Project for Central Asia to introduce a **micro-leasing product** for its customers. An MOU has been signed, under which IFC will provide technical assistance to Bai Tushum in accounting and legal areas.

Through this instrument Bai Tushum can develop longer term financing mechanisms for its clients and increase their borrowing capacity. Leasing allows microenterprise clients to use equipment before paying its full cost; to benefit from ownership without depleting cash or increasing debt; to conserve capital for other business expenditures; to simplify budgets by using a fixed payment plan; and to protect against inflation and obsolescence.

Bai Tushum plans to pilot test the leasing product in the fall of 2003, after amendments to the tax code have been enacted clarifying tax and accounting procedures for leasing. Bai Tushum will start with leases under $10,000, testing them with local Bishkek client that have proven credit histories. As leasing is new to Kyrgyzstan, and to Bai Tushum a conservative approach will be adopted, using the following features:

- **Lease terms:** 18 months to three years, depending on the client and the equipment. Lessees meeting all lease requirements will own the equipment at the end of the term.
- **Advance payments:** Advance payment will be required for all leases, ranging from 20 % to 40%, depending on client history and the cost and nature of the equipment.
- **Insurance:** Leased equipment will be comprehensively insured against all risks for the entire term of the lease, including personal liability insurance for cars and trucks.
- **Lease Payments:** Lessees will pay in equal monthly installments that cover principal and all expenses including interest, taxes, and insurance.
- **Monitoring:** Strict, regular monitoring will be carried out. A credit specialist will visit each new client during the month that the lessee receives the equipment to ensure that the equipment is on site, in place, in good condition, and that the business is proceeding as planned. Clients will be required to report monthly on the status of their equipment and their business. The lessee will be contractually obliged to repair equipment that is not in good condition. Failure to repair the equipment on time will be grounds to repossess it.

Housing remains one of the most pressing social problems in the Kyrgyz Republic. Mortgage loans have become unavailable to the public due to high interest rates, low income and the lack of long-term financial resources. Bai Tushum, in collaboration with EU TACIS is implementing a pilot project to introduce **mortgage finance** for micro and small entrepreneurs to acquire fixed assets for housing and business purposes. Salient feature of this product are provided below:



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| | |
|---|---|
| Residential loan amounts | US$ 2,000 up to 5,000 |
| Commercial loan amounts | US$ 2,000 up to 10,000 |
| Terms | Up to 5 years |
| Interest rates:<br>➢ Residential<br>➢ Commercial<br>➢ Interest applied on: | <br>25 up to 30% (in local currency)<br>30 up to 35 % (in local currency)<br>Declining balance |
| Procedure for loan repayment: | Fixed monthly or quarterly payments of interest, with partial repayment of principal. Payments not to exceed 35% of income. |
| Size of mandatory insurance premium | 0.2%-1 % of apartment value |
| Location of the purchased property | Cities of Bishkek, Osh, Jalalabad |
| Penalties: | Double interest rate for defaulting on interest payments and principle repayment |

**e. Impact and Challenges.** During the first decade after independence, banks in Kyrgyzstan were reticent to lend to agriculture and the rural sector. With funds and food proceeds from USDA, USAID and the Swiss Agency for Cooperation and Development, lending programs in the form of associations were launched in 1997 to respond to the urgent demands for loans by these strategic sectors. These portfolio and cash resources developed by these associations formed the start-up capital of Bai Tushum.

As the indicators in the table below demonstrate, Bai Tushum has demonstrated an ability to lend to rural residents and small enterprises in Kyrgyzstan. Loan disbursements nearly doubled between 2001 and 2002. The number of borrowers increased by 69%, and the loan portfolio by 50%. This led to a slight reduction in the average loan balance. The quality of the portfolio has improved dramatically since Bai Tushum received its first donations of cash and loan portfolio. Its portfolio has been diversified, with SME products growing from 25% of its portfolio in mid 2001, to 42% by the end of 2002.

***Bai Tushum Indicators – 2001-2002***

| | **2000** | **2001** | **2002** |
|---|---|---|---|
| Number of loans disbursed | 439 | 690 | 1,203 |
| Number of loans outstanding | 633 | 700 | 1,182 |
| Loans outstanding | $860,969 | $1,179,352 | $1,755,842 |
| PAR>30 days | 14.5% | 7.5% | 4% |
| Operational Self Sufficiency | *only 3 months of operations* | 135% | 185% |
| Operating efficiency (administrative costs/average loan portfolio) | | 21% | 17% |

Operational Self-sufficiency was achieved within its first year of operation, and increased significantly in its second year. Return on assets was 13%, up from 1.5% the previous year. As mentioned, Bai Tushum has not leveraged its equity with debt. However, continuing its growth will require this in the coming year. As of December, cash and short-term investments were equal to $370,000. With its current legal form, the Foundation can borrow from financial institutions. The Foundation entered into discussions and negotiations with international lenders, including multilaterals like the



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IFC and international funds like Blue Orchard. As required, Bai Tushum will also pursue loans with local financial institutions.

To further its plans for increased borrowing, Bai Tushum obtained a positive rating from Microfinanza, Ltd. The rating noted a number of challenges and achievements. Significant among the challenges are increased competition, particularly for small and microenterprise loans, by institutions offering loans at lower interest rates. External and internal factors contribute to this situation. The largest competitor has a history of lending at subsidized rates of interest. At the same time, Bai Tushum's limited scale, lack of operating subsidy, and relatively low case load for loan officers all drive up its costs per loan. However, operating efficiency has improved with increases in portfolio size and quality. The evaluation also encouraged an increased diversification in the loan portfolio, and a related shortening of the average loan term.

Strengths noted in the assessment included comprehensive and formal procedures and internal controls, rapid and efficient loan disbursements, tight management of costs; positive financial results, a solid governance structure, and good training policies.
Like the rest of the country, Bai Tushum's staff has faced dramatic changes in the work place as Kyrgyzstan has moved from a command economy. Bai Tushum recognizes that building the capacity of the staff, and creating a structure, procedures and planning processes that incorporate their participation, are as important to Bai Tushum's success as lending procedures and internal controls. Bai Tushum has developed various incentive systems, including promotion within the organization and cash bonuses. All senior staff members are encouraged to take an active part in solving strategic and operational issues. Branch managers join headquarters staff in annual and strategic planning exercises.

In addition to the training offered by ACDI/VOCA, Bai Tushum has allocated 2% of its annual budget for staff development and training. New loan officers undergo a comprehensive orientation program, with both formal and on-the-job training modules. Once every six months, an in-house refresher training program is conducted by the Foundation's management using a training manual for the loan officers. It has established an on-the-job training system so that if any key staff member leaves there are internal candidates groomed to take on new responsibilities. In addition staff members are also able to access outside technical training from sources like the Microfinance Center in Poland.

## Conclusions: Foundations as Start-Up Retailers of Rural Financial Services

**Foundation as pragmatic approach.** In two very different countries, Bolivia and Kyrgyzstan, ACDI/VOCA has seen the foundation structure provide the opportunity of launching rural financial services. Both situations involved donors with available funds, and a strong desire to see credit reach farmers and to be repaid at rates of interest that allowed the programs to cover costs. In the case of Bolivia, the foundation was viewed as the most efficient type of legal entity to launch, with criteria that focused on launching a lending program more than creating a sustainable organization. In 1992, under a USAID-funded project designed to extend loans to farmers who were substituting licit

crops for, the Agrocapital Foundation was founded. At project end in 1997, its loan portfolio had grown from $1 million to $12 million and portfolio at risk hovered around 5%. Subsequently, the foundation weathered a crisis in the Bolivian financial sector, and began to pursue a strategy of launching a licensed Fondo Financiero Privado with other investors, a legal framework that would allow it to accept deposits and attract investment capital.

In the case of Kyrgyzstan, an initial attempt at farmer-owned credit associations failed due to a legal environment in which associations, like foundations, could not be legally owned, but rather funded by donors. Unlike foundations, donors to associations "enjoyed" unlimited liability. Analysis of legal options focused much more significantly on institutional sustainability than had been the case in Bolivia, and the foundation option allowed for an expansion of current lending activities without shutting the door to savings mobilization and investment in the future. This expansion has been realized, along with profitability, and Bai Tushum approaches the point where leveraging its equity is crucial.

**Intensive Technical Assistance.** In addition to donor assistance with capital, both foundations have benefited from intensive technical assistance. ACDI/VOCA's resident advisor served as the initial manager of Agrocapital. Similarly, our resident advisor in Kyrgyzstan serves as a member of the board of Bai Tushum. Technical assistance to both institutions has emphasized the effective design of loan products, procedures and internal controls; the development of MIS that are reliable for loan tracking, accounting, and financial reporting and analysis; and strategic planning.

**Governance.** In both instances, the governance structure was strengthened through technical assistance and international cooperation. Donors and technical assistance providers took an active role in the development and capacity building of the institution's people and processes, while local board members and staff increasingly took ownership in and management of the foundations. This insulated the institutions from political pressures and skepticism earlier in their evolution. Two elements of the governance structure diminished this insulation for Agrocapital over time:

- the fact that Agrocapital, consistent with Bolivian law, was founded by individuals—representatives of ACDI/VOCA and the PL-480 Executive Secretariat at the time, rather than by legal entities; and
- the capitalization of Agrocapital with donations from the Bolivian government.

These two facts have increased the scrutiny Agrocapital has received in its attempts to be licensed by the Superintendency of Banks. Bai Tushum, consistent with Kyrgyz law, was founded by legal entities—ACDI/VOCA and Swiss Caritas, and capitalized by donations from foreign government programs.

**Product design and diversification.** In product design, both foundations emphasize convenience and flexibility over price. This fact has particular relevance in Kyrgyzstan, where the main competitor has been an institution offering subsidized interest rates. Borrowers determine the amount and purpose of the loans for which they apply. Loan

officers visit prospective clients and prepare cash flow projections. Pricing is pre-established based on loan size and purpose, and loans that are risky or require increased time to administer are charged additional percentage points. Borrowers are provided a repayment schedule, and are responsible for making the payments at the branch office. Loan officers are continually informed of imminent and late payments, and visit their customers accordingly. At the same time, loan repayment has consistently been better than in the commercial banking sector, even for Agrocapital during Bolivia's banking crisis.

Both foundations, launched with a donor priority on lending for agriculture, have pursued product diversification while maintaining a significant commitment to—and share of their portfolio in—agricultural production. Diversification responded to market demands and the need to more effectively manage risk and cash flow. Agrocapital developed a significant portfolio in lending to mills and other agribusinesses, service providers, and microentrepreneurs. Bai Tushum, in its third year of operation, has a $2 million portfolio, with loans primarily to farmers that average $1700. During 2003 it plans to introduce an equipment lease product for agricultural machinery, likely to be funded by IFC on commercial terms. In addition, Bai Tushum is implementing a pilot project to introduce mortgage lending for housing and business purposes. EU TACIS is cooperating in this effort.

**Financial performance and potential for commercialization.** The jury remains out on the ability of each of these foundations to establish a place in the market, and to convert themselves into entities with a governance structure more attractive to commercial funding sources. However, the foundation framework has allowed each to enter into legally enforceable contracts with borrowers; develop products and market recognition for reliable services; maintain portfolios at risk comfortably below 10% (at least prior to the banking crisis in Bolivia beginning in 2000); and operate at levels of operational self-sufficiency (in Bolivia from 1996 through 1999, and again in 2002). In Kyrgyzstan, Bai Tushum reached financial self-sufficiency during its first year of operation and received an A rating in a recent evaluation by Microfinanza, an international rating firm.

Agrocapital, having weathered a significant crisis in the financial sector and succeeded in funding nearly half its portfolio with borrowed funds, seeks to invest in an FFP. Bai Tushum has obtained a license from the Kyrgyz central bank, which will enable it to borrow from financial institutions for its lending operations. Continued success for Bai Tushum could ultimately attract investors in a finance company. In both cases, the foundation structure has allowed donors, local players, and technical assistance providers to develop a new financial service, one not ready to attract investors seeking to maximize return on their investment, but one that enjoys a significant market demand. Tracking their continued progress will reveal whether they have been built so that commercial capital will come.



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