KfW Entwicklungsbank

Kyrgyzstan: Kyrgyz Investment and Credit Bank

Ex post evaluation report

OECD sector	24020 / Financial sector policy	
BMZ project ID	a) 2000 65 631 (first credit line, 2007 sample) b) 2001 65 498 (second credit line), 2004 297 (training measures)	
Project executing agency	Kyrgyz Investment and Credit Bank	
Consultant	GFA	
Year of ex post evaluation report	**2008**	
	Project appraisal (planned)	**Ex post evaluation (actual)**
Start of implementation	a) 08/2000 b) 01/2004	a) 06/2001 b) 05/2005
Period of implementation	a) 29 months b) 36 months	a) 42 months b) 18 months
Investment costs	a) EUR 2.55 million b) EUR 5.11 million	a) EUR 2.55 million b) EUR 5.11 million EUR 0.30 million (training)
Counterpart contribution	-/-	-/-
Financing, of which FC funds	a) EUR 2.55 million b) EUR 5.11 million	a) EUR 2.55 million b) EUR 5.11 million EUR 0.30 million (training)
Other institutions/donors involved	DEG, IFC, EBRD, AKFED	DEG, IFC, EBRD, AKFED, HBL
Performance rating	2	
• Relevance	2	
• Effectiveness	2	
• Efficiency	2	
• Overarching developmental impact	2	
• Sustainability	2	

Brief description, overall objective and project objectives with indicators

The two credit lines were extended to refinance mostly medium and long-term investment loans that had been provided to small and medium-sized enterprises (SMEs) at market conditions. The overall objective was to contribute to the development of the financial sector and to secure and create jobs. The project objective was to put KICB in a position where it would be able to provide private Kyrgyz companies with efficient and sustainable medium and long-term investment loans and other financial services at market conditions. The target group of the programmes was the Kyrgyz private sector and competitive private-sector SMEs, in particular. KICB was newly founded, with the Aga Khan Fund for Economic Development (AKFED) acting as a strategic investor holding a 21% stake. Other shareholders include Habib Bank Limited (HBL) with an 18% stake, the European Bank for Reconstruction and Development (EBRD) with 17%, the International Finance Corporation (IFC) with 17% and Deutsche Investitions- und Entwicklungsgesellschaft GmbH (DEG) also holding 17%. Part of the FC funds from the first of the two programmes was used to cover the 10% counterpart contribution of the Kyrgyz Government.

<u>Indicators to measure achievement of the overall objective(s):</u>

Credit line 1: Five years after market entry:

- The ratio of the M2 money supply to economic output (as measured by GDP) will reach at least 15%.
- Other commercial banks will also offer medium to long-term investment loans.

Credit line 2:

- The penetration of the finance sector, as measured by the loan/GDP ratio, will increase by 30%, compared to the end of 2002.
- The borrowing companies are expected to generate a positive return on equity.

<u>Indicators to measure achievement of the project objective(s):</u>

Credit line 1:

- KICB's gross loan portfolio will be in excess of USD 22 million.
- KICB's overhead ratio will stay below 50%.
- KICB's return on equity will be above 9%. KICB's non-performing loan portfolio will be smaller than 12%.
- KICB's deposits will amount to more than USD 7 million.

Credit line 2:

- The credit line will have been fully drawn no later than in the fourth year after its extension.
- The proportion of NPL in KICB's loan portfolio will be no higher than 5 to 7%.
- KICB is expected to achieve a positive return on equity in real terms.

The programmes reached all targets set to measure achievement of the overall objectives, even outperforming some of them. The ratio of M2 to economic output (GDP)[1] increased to 29% by 2006, compared to a 15% target value, and the loan/GDP ratio soared by almost 500%, compared to its target of approximately 30%. Similar to KICB, there are several other commercial banks which offer medium to long-term investment loans. There is no specific data available on whether or not the borrowing companies are generating a positive return on equity. However, it is fair to assume that this is the case, as the majority of the companies that received programme funds are servicing their debts. Consequently, KICB's proportion of non-performing loans is very low, running at approximately 2%.

As for the project objectives of the two FC programmes, we note that the target indicators were reached and, for the most part, exceeded. The gross loan portfolio was well above its target of USD 22 million, amounting to USD 28.9 million in 2006. Non-performing loans were less than

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[1] M2 refers to a measure of money supply that includes demand deposits of institutions other than banks, the currency in circulation (excluding cash held by banks), term deposits with an agreed maturity of up to two years and deposits with a statutory notice period of up to three months.

2% in 2006, compared to target levels of 5% and 12%. KICB's return on equity reached 23.6% in 2006, which was considerably higher than its 9% target. The successful picture at KICB was rounded off by a deposit volume of USD 18.9 million in 2006, compared to a target figure of USD 7 million. The resources provided by the second credit line were drawn from the relevant fund much earlier than expected. We see this as evidence of the positive response to KICB's lending products. Although the annual increase in loan extensions was still below the 70% target in 2006, the rate of subsequent years exceeded that level. While the target overhead ratio of 50%[2] was not reached, the actual value of 53% is still appropriate, as new financial products are under development and the bank is in the process of building a branch network.

Project design / major deviations from the original project planning and their main causes

The FC funds of both programmes (EUR 2.5 million and EUR 5.1 million) were provided under a loan agreement with the Kyrgyz Ministry of Finance on the usual terms and conditions for transfers to Kyrgyzstan (0.75% interest rate, 40-year maturity including 10 interest-free years). Some of the funds provided under the first programme were used to cover the 10% equity contribution of the Kyrgyz Republic to KICB (USD 0.7 million). After this counterpart contribution had been deducted, the remainder of approx. EUR 1.8 million, along with the funds provided under the second credit line, was used to refinance KICB's loan assets.

The pass-through terms and conditions for the first credit line were determined at market conditions, using USD LIBOR plus 2% (later replaced by EURIBOR) with semi-annual adjustments on the interest payment and redemption dates and a 40-year maturity including 10 interest-free years. The second credit line was also extended at market conditions, with an interest rate of EURIBOR + 2% p.a. and a 15-year maturity including 5 interest-free years. In the course of the project, KICB exercised its option of turning the funds provided under the first credit line into a subordinated loan.

The funds provided through the two KfW credit lines were used to make investment loans worth USD 18 million to private-sector companies in the Kyrgyz Republic. To extend the loans, KICB used a mixture of FC project funds, its own funds and a credit line provided by the EBRD. The very low share of non-performing loans in KICB's portfolio bears witness to the commercial success of the borrowing companies. On-site visits to those companies also produced evidence of their entrepreneurial spirit and their economic performance, which helps to secure and create jobs. As 86% of equity of the borrowing companies is held by Kyrgyz shareholders, the programme made a significant contribution to supporting the domestic economy. However, only 61% of the funds were extended to SMEs. This means that the target group benefited to only a limited extent. In sectoral terms, the bulk of finance was provided to industrial companies, accounting for 59%. Geographically speaking, Bishkek received 59% of the funds, followed by the greater Bishkek area and the Issyk Kul region.

Funds provided under basic and advanced training measures were used to pay for consultancy services in order to develop the retail business.

Key results of the impact analysis and performance rating

With regard to the intended effects, the results of our ex post evaluation show that the action chains that were used as underlying assumptions have not changed and are still valid.

[2] The overhead ratio is the amount of current expenses divided by the sum of taxable net interest income and other current income.

Accordingly, it was assumed that loans to support the private sector would boost investment, create jobs and income, and this would lead to further investments. The programme objective was in line with the development policy goals and guidelines of the German Federal Ministry for Economic Cooperation and Development (BMZ), the goals of the other KICB shareholders that were involved and the strategies of the Kyrgyz Government. Due to plausibility considerations, it may also be assumed that, by providing funds to the private sector, the programme also contributed to the Millennium Development Goals no. 1 (halving the proportion of income-poor people) and no. 8 (promoting development partnerships through successful donor coordination).

The DAC (Development Assistance Committee of the OECD) policy markers that were chosen at the time of project appraisal still seem appropriate from today's point of view. In keeping with the project appraisal report, we would classify both programmes in the poverty reduction category as aiming at "general poverty reduction at the macro and sector levels". By providing finance to the private sector, jobs were also created and secured for the poor strata of the population and in areas outside the capital. The project appraisal report was correct in assuming that the programmes would not offer any gender potential, as there is no discrimination in the selection of final borrowers and in the companies' recruitment processes. In line with the markers selected at the time of project appraisal, the programmes did not pursue any governance-related aims. As any loan extension made by KICB is subject to compliance with the IFC's environmental standards and most of the final borrowers are small and medium-sized businesses which do not operate in sectors associated with high environmental risks, it would not have been appropriate to define any objectives in terms of environmental protection and resource preservation.

In our summary evaluation of the effects and risks described above, we have arrived at the following conclusions regarding the programmes' developmental effectiveness:

Relevance: Limited access for private-sector companies to investment loans which are provided at market conditions continues to be one of the major hindrances to private-sector growth. Against this backdrop, the action chains that were used as assumptions in the project appraisal report have not changed and are still in place. Accordingly, support for the private sector by improving access to loans will boost investment, create jobs and income, and this will increase the volume of investments even more. The programme objective was in line with the development policy goals and guidelines of the German Ministry (BMZ), the goals of the other KICB shareholders and the strategies of the Kyrgyz Government.

As KICB's mission statement does not explicitly mention SMEs as the bank's target group, there is a certain lack of coherence between the approaches of different KICB investors. While the IFC and DEG want to support the private sector without focussing on SMEs in particular, the credit lines of the EBRD and KfW are explicitly provided to assist SMEs. And yet, this minor deviation from the objectives of the investors has not had any negative impact on KICB's lending activities so far. The provision of loans by KICB, and the banking sector in general, continues to be limited to companies from the formal sector of the economy. In view of the significance of the informal economy, a comprehensive approach to supporting the private sector should give informal businesses better access to the banking sector. Examples of how to achieve this include the downscaling programmes introduced by other banks in Kyrgyzstan, and special support measures for such businesses. Overall, the relevance of the programmes is rated as good (**sub-rating 2**).

Effectiveness: The detailed analysis (see annex 4) of the levels of achievement for the various project objectives may be summarised as follows: the programmes reached most targets set to measure achievement of the projective objectives, and some of them were even exceeded. For instance, the gross loan portfolio of USD 28.9 million was considerably larger than the target figure of USD 22 million, and non-performing loans were only approximately 2%, compared to target levels that had been set at 5% and 12%. Even in those cases where the actual figures were markedly higher than the targets, e.g. the gross volume of the loan portfolio, the indicators defined at the time of project appraisal were not based on what would have to be considered conservative assumptions (i.e. high risk aversion), given the market conditions prevailing at the time. Rather, they would be deemed to be ambitious under the given conditions, and the outperformance should be attributed to KICB's efforts. The overhead ratio target of 50% was not reached. Yet the actual value of 53% is still appropriate, as new financial products are under development and the bank is in the process of building a branch network. The annual growth target (above 70%) for the volume of new loan extensions was reached one year later than planned, due to the very tense political situation in 2005. Overall, the effectiveness of the programmes is rated as good (**sub-rating 2**).

Efficiency: The efficiency of KICB's operations is high. There are 9 portfolio managers who are responsible for a loan portfolio which totalled USD 39.1 million in the business customer segment in 2007. The average portfolio size of USD 4.3 million per manager is deemed to be efficient, considering their low level of professional experience, close monitoring procedures, the large number of visits to customers and the constant low rate of non-performing loans. Comprehensive internal policies and regulations, including the bank's internal controlling system, guarantee the quality of lending activities, especially with regard to the collateralisation of loans, while still granting enough flexibility to structure loans according to customer needs. An analysis of KICB's audited annual financial statements for 2007 shows the following very positive figures and ratios:

- Return on equity was 23.6%.
- Net interest income was sufficient to cover all operating expenses.
- The capital adequacy ratio (i.e. the ratio of regulatory capital to risk-weighted assets) was 24% according to the report of the independent auditors, as compared to a minimum of 8% required by the central bank.
- The net interest margin was 7.8%, compared with a national average of 10%.

Currently, further expansion of the business activities is hampered by KICB's tight liquidity position, which has been caused by maturity mismatches and squeezes in national and international markets that are used for refinancing purposes. KICB requires adequate external funding sources to maintain its current lending volume.

As regards allocative efficiency, it is important to note that the growth of the loan portfolio bears witness to a high demand for KICB's products. However, this growth is driven by all customer segments and not only by the SME target group which is at the centre of the programmes under review, even though the definition of the target group is somewhat blurred. In summary, the efficiency of the programmes is rated as good (**sub-rating 2**).

Overarching developmental impact: The programme reached all targets set to determine achievement of the overall objectives, even outperforming some of them. There is no specific data available on whether or not the borrowing companies are generating a positive return on equity. However, it is fair to assume that this is the case, as the majority of the companies that received programme funds are servicing their debts. The NPL rate is very low, running at approximately 2%.

Private sector: The funds provided by the two KfW credit lines were used to provide investment loans worth USD 18 million to private-sector companies in the Kyrgyz Republic. The very low share of non-performing loans in KICB's portfolio reflects the commercial success of those companies, which make a substantial contribution to securing and creating jobs. As 86% of their equity is owned by Kyrgyz shareholders, the programme has made a significant contribution to supporting the domestic economy. However, only 61% of the funds were provided to SMEs. The remainder was extended to larger companies. This means that the target group benefited only to a limited extent. In sectoral terms, the bulk of finance was given to industrial companies, accounting for 59%. Geographically speaking, Bishkek received 59% of the funds, followed by the greater Bishkek area and the Issyk Kul region.

Banking sector: When KICB was set up in 2001, a new player with considerable financial clout entered the Kyrgyz banking sector. Since then, competition in the banking sector has increased. This is partly a consequence of the creation of KICB, but it is also due to the fact that several Kazakh banks have entered the market since 2003. The FC involvement did not lead to a crowding-out of commercial banks, as the Kazakh banks came to the market at a later point in time. Since KICB started up its operations, a number of new financial products have been introduced to the market, with KICB often blazing the trail, for instance, for long-term investment loans, mortgage products, leasing arrangements and consumer credits. The latter may be regarded as questionable from a development perspective, but they are not part of KICB's core business. The demonstration effects for the banking sector that are associated with KICB may be attributed to its good corporate governance structure and the new finance products the bank offers. Quite a few borrowers made their first contact with the formal banking system through KICB. Thus the bank has helped broaden the banking sector's customer base. In summary, the overarching developmental impact is rated as good (**sub-rating 2**).

Sustainability: A crucial factor for the financial sustainability of KICB's operations is continued access to funds that are required to refinance its lending business. Access to the commercial financial markets in order to raise funds for refinancing purposes is hampered by the poor sovereign rating of the Kyrgyz Republic. At the moment, KICB's refinancing operations depend on the standing of its shareholders. The ongoing diversification into the retail segment has a positive impact on KICB's financial sustainability. KICB is very aggressive in pursuing the development of new markets, for instance, by implementing intensive internal training measures to enhance the professional skills of its staff. This step is taken in response to the scarce supply of skilled workers in the domestic labour market. A small proportion of the FC funds was used to cover the 10% contribution required from the Government. Despite this commitment and the involvement of other shareholders, there is no ownership on the part of the Kyrgyz Government (with the Ministry of Finance acting as the official borrower) that would interfere with the bank's governance structure in any significant way. The Kyrgyz Ministry of Finance clearly regards the bank as a financial institution in which (private) foreign shareholders hold a majority stake. Consequently, the Ministry expects the foreign shareholders to tackle the bank's problems without soliciting further assistance from the Kyrgyz Government (e.g. additional government guarantees for credit lines). The project design, which proposed only a small government stake of 10% in KICB, was intended to achieve this very goal – to make sure that KICB, once it had established its position in the market, would be able to develop its business and raise the necessary funds by its own efforts without relying on government assistance. In summary, the sustainability of the programmes is rated as good (**sub-rating 2**).

After weighing the individual evaluation criteria discussed above, the overall performance of the project is rated as good (**overall rating 2**).

General conclusions and recommendations

It is fair to conclude that the credit lines that were provided to KICB are a successful example of how to support the creation of a new bank, while avoiding the high risks associated with financing existing banks with institutional and operational weaknesses that could jeopardise the success of the project. The following recommendations are based on an analysis of our ex post evaluation:

When selecting indicators for the overall objective level, it is important to make sure that target achievement corresponds well with the activities of the project executing agency. For instance, a target like M2/BIP can be reached irrespective of the contribution of the project executing agency. Also, the selection of project objective indicators should take account of the local circumstances and practices. For instance, the indicator "return on equity of final borrowers" was not in line with the criteria that are used in the local loan approval process. In order to guarantee that the programmes are successful in reaching out to SMEs as their target group, the project executing agency, the donors and the shareholders need to have a common understanding of the definition of SMEs and the significance of classifying companies as SMEs. This recommendation is particularly important for countries where the term "SME" lacks a clear definition.

Whenever financial sector programmes are implemented in countries where a large proportion of the private sector is made up by informal businesses, measures to bring them closer to the formal sector of the economy are of particular importance, e.g. through downscaling efforts by the banking sector and through capacity building in the businesses concerned. In such cases, access to loans that are only available for companies from the formal sector is just one of the hindrances that need to be overcome in providing the entire private sector with funds.

In countries with a low sovereign rating such as Kyrgyzstan, even a successful executing agency will, over a longer period, need to access refinancing facilities from institutions that do not have to fully pass on high country risks by charging the borrowing project agency high interest rates. The programme design ought to take this into account to avoid putting the sustainability of the sponsored institutions at risk.

Abbreviations

AKFED	Aga Khan Fund for Economic Development
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
EBRD	European Bank for Reconstruction and Development
IFC	International Finance Corporation
KICB	Kyrgyz Investment and Credit Bank

Notes on the methods used to evaluate project success (project rating)

Projects are evaluated on a six-point scale, the criteria being relevance, effectiveness (outcome), "overarching developmental impact" and efficiency. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

1	Very good outcome that clearly exceeds expectations
2	Good outcome fully in line with expectations and without any significant shortcomings
3	Satisfactory outcome – project falls short of expectations but the positive results dominate
4	Unsatisfactory outcome – significantly below expectations, with negative results dominating despite discernible positive results
5	Clearly inadequate outcome – despite some positive partial results the negative results clearly dominate
6	The project has no positive results or the situation has actually deteriorated

A rating of 1 to 3 is a positive assessment and indicates a successful project, while a rating of 4 to 6 is a negative assessment and indicates a project which has no sufficiently positive results.

Sustainability is evaluated according to the following four-point scale.

Sustainability level 1 (very good sustainability): The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability): The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected.)

Sustainability level 3 (satisfactory sustainability): The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability): The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and an improvement is very unlikely. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meets the level 3 criteria.

The overall evaluation on the six-point scale is derived from a weighting of the five individual criteria which is appropriate for the specific project in question. A rating of 1 to 3 in the overall evaluation indicates a "successful project", while a rating of 4 to 6 indicates an "unsuccessful" project. Account also needs to be taken of the fact that, as a rule, a project is only given a developmentally "successful" rating if the achievement of the project objective (effectiveness) and the impact at the level of the overall objective ("overarching developmental impact") as well as sustainability are assessed at least as "satisfactory" (subrating 3).