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Don't Drown the Seedlings:

Lessons for Savings and Credit Union Development from the Experience in East and Central Asia

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 8 March 2006)

$1.00	=	4,606 Azeri manat (AMT)
$1.00	=	8.049 Chinese renminbi (CNY)
$1.00	=	41.3 Kyrgyz som (KGS)
$1.00	=	1,190 Mongolian tughrik (MNT)

ABBREVIATIONS

ABC	–	Agricultural Bank of China
ADB	–	Asian Development Bank
BOM	–	Bank of Mongolia
CBRC	–	China Banking Regulatory Commission
CUSO	–	Credit Union Service Organization
DGRV	–	Deutscher Genossenschafts-und Raiffeisenverband e.V.
EBRD	–	European Bank for Reconstruction and Development
FCCU	–	Financial Company for the Support and Development of Credit Unions
FINCA	–	Foundation for International Community Assistance
FRC	–	Financial Regulatory Commission
GTZ	–	German Corporation for Technical Cooperation (Gesellschaft für Technische Zusammenarbeit)
IDP	–	Internally Displaced Person
ISDU	–	Interim Supervision and Development Unit
KAFC	–	Kyrgyz Agricultural Finance Company
MBFA	–	Microfinance Bank of Azerbaijan
MOCCU	–	Mongolian Confederation of Credit Unions
MOU	–	Memorandum of Understanding
MSSF	–	Micro and Small Enterprise Finance Facility
NBA	–	National Bank of Azerbaijan
NBFI	–	Non-Bank Financial Institution
NBKR	–	National Bank of the Kyrgyz Republic
NGO	–	Non-Government Organization
NPL	–	Non-Performing Loans
PBOC	–	People’s Bank of China
PRC	–	People’s Republic of China
RARP	–	Regional Agricultural Reforms Project
RCC	–	Rural Credit Cooperative
RCCU	–	Rural Credit Cooperative Union
RIF	–	Rural Investment Foundation
ROSCAs	–	Rotating Savings and Credit Associations
SCU	–	Savings and Credit Union
SDFI	–	Social Fund for Development of Internally Displaced Persons
SDU	–	Supervision and Development Unit
SOCB	–	State-Owned Commercial Bank
SRB	–	Support for Rural Banking
SSC	–	Savings and Settlement Company
TACIS	–	Technical Assistance for the Confederation of Independent States
TVEs	–	Township and Village Enterprises
UCC	–	Urban Credit Cooperative
UMSCC	–	Union of Mongolian Savings and Credit Cooperatives
WOCCU	–	World Council of Credit Unions

NOTE

In this report, "$" refers to US dollars.

Preface

This research paper was completed under the general direction of Noy Siackhachanh, Director, and in cooperation with Jurgen Conrad, Economist, in the Governance, Finance and Trade Division, East and Central Asia Department of the Asian Development Bank. The author gratefully acknowledges the support and assistance provided by many individuals, especially the staff of the ADB resident missions in Azerbaijan, Peoples' Republic of China, the Kyrgyz Republic and Mongolia, and the many people who were so generous with their time during the field research for this project. Mr. Conrad provided valuable contributions and support throughout the project. Helpful comments and suggestions were provided by the participants in an Asian Development Bank seminar held in Manila in April 2006, and by other staff of the Bank. The conclusions, and any errors and omissions, are solely the responsibility of the author.

CONTENTS

I. WHY STUDY SAVINGS AND CREDIT UNIONS IN CENTRAL AND EAST ASIA?

1. The potentially beneficial role of savings and credit unions (SCUs) in enhancing access to financial services, particularly in rural areas, has been recognized around the world.[1] The raison d'être for SCUs is to mobilize savings for local investment, which fits perfectly with the objectives of commercialization of microfinance and the involvement of mainstream financial institutions in rural finance. SCUs are designed to be sustainable through the intermediation of member's funds. As locally owned and managed institutions SCUs are well placed to ensure that creditworthy borrowers have access to funds.

2. Faced with the obvious good that can be achieved by SCUs, governments and external funding agencies have invested heavily in many countries to foster the creation of new SCUs and/or expand the outreach of existing SCUs. Despite this, however, SCUs and the supporting infrastructure for their growth and development—the framework for regulation and supervision, and apex organizations which can provide centralized services—are often not well understood. This lack of understanding has been a factor in the underperformance or outright failure of a number of projects intended to support SCU development.

3. Rather than recognizing that SCU are financial intermediaries distinguished by their cooperative ownership, policy makers and the providers of technical assistance sometimes view SCUs exclusively in the context of rural finance, or, even more narrowly, in the context of agricultural finance. This can result in a focus on subsidizing and/or directing credit to particular regions or purposes, which may come at the expense of developing a sound and sustainable financial sector. Further, for both policy makers and the providers of technical assistance there is often uncertainty whether SCUs should be treated as banks, microfinance institutions, or as a special type of non-bank financial institution.

4. This paper is intended to provide practical insights into the nature of SCUs and their supporting infrastructure, and draw conclusions that will be helpful to policy-makers and development partners. Individual SCUs and their related apex organizations can vary widely in size and structure, just as banks, microfinance institutions and specialized rural finance organization come in many forms and sizes. Despite this divergence, there are common principles that can guide policy-makers and development partners. This paper draws on the experience with SCU development in selected countries and the literature on SCUs, microfinance and financial sector development to suggest key points to be considered if projects to support SCU development are to be successful. Some central themes of this paper are:

(i) Most of the issues and challenges in SCU development are not unique. The approaches to regulation and supervision of SCUs, the sequencing of reforms, and support for development should, therefore, draw from the experience with microfinance and financial sector reform more generally.

(ii) Cooperative ownership of SCUs frequently exists in name only. This raises important questions of governance and also has implications for regulatory and

[1] Savings and Credit Unions (SCU) and credit union are used interchangeably throughout this paper. The World Council of Credit Unions definition of credit union encompasses the mobilization of savings: "Credit unions, or savings and credit cooperatives, are user owned financial institutions that offer both savings and credit services to their members. Members of a credit union are both net savers and net borrowers, and are often from a community, organizational or employer group." However, as detailed in this paper, the focus of many SCUs in the sample countries is much more on credit than on savings.

supervisory approaches that rely on the mutual self-interest inherent in cooperative ownership.

(iii) External financing to spur SCU formation, while well intentioned, seems generally to undermine the cooperative nature of SCUs and detract from successful long-term development.

(iv) Obtaining the benefits of small, locally owned and controlled financial institutions has significant costs, but these can be mitigated through centralized provision of core services, training and standardized systems.

(v) Supervisory oversight of many small institutions is inherently resource intensive. While none of the alternative approaches offers a perfect solution, a risk-focused system incorporating the graduated approach that is widely endorsed for oversight of microfinance helps to reconcile conflicting objectives.

5. These common themes are evident in Azerbaijan, the Kyrgyz Republic, Mongolia, and the Peoples Republic of China (PRC) despite the significant differences in the history of SCUs in these four countries. In the PCR, the history of rural and urban credit cooperatives stretches over 50 years, while in the other three countries cooperative savings and credit organizations have emerged only over the last 10 years as part of the transition to market economies. Notwithstanding the divergent history, there are many similarities in the experience with cooperative savings and credit institutions in the four countries examined in this paper, and indeed, in developing and transition countries around the world.[2]

6. The balance of this paper is organized as follows. The next section provides a brief overview of the differences and similarities between SCUs and other providers of financial services, focusing on the nuances of cooperative ownership, the tiered institutional structure commonly found in the cooperative sector, and approaches to regulations and supervision. The third section summarizes experience with SCUs in four selected countries: Azerbaijan; the PRC; the Kyrgyz Republic; and Mongolia. The fourth section draws lessons from the experience in the selected countries and the literature on SCUs, microfinance and financial development more generally, and the final section provides some concluding observations. For each country a more detailed overview of the context for SCU development including its positioning in the formal financial sector, the history of SCUs, current status, and ongoing reforms is provided in Appendix 1.

II. UNDERSTANDING SAVINGS AND CREDIT UNIONS

7. What makes SCUs different? Many other financial organizations provide similar products and services, so the distinguishing feature of SCUs is not the function performed, but rather cooperative ownership. The cooperative principle of “one member—one vote” differs from joint-stock companies in that a single owner cannot accumulate more than one voting share in a cooperative regardless of the level of financial contribution, while a single person or small group could own all the voting shares in a joint stock company. Generally, members can redeem their shares when withdrawing from an SCU, so unlike shares in a joint-stock company, shares in a cooperative are not true equity. Thus, in applying bank-like prudential standards to cooperatives

[2] For discussion of SCUs in a wider range of countries, see Lamberte, Vogel, Mayes and Fernando (forthcoming), Westley and Branch (2000), and Morris (1997).

it is necessary to recognize that SCUs' only true equity may be retained earnings, also known as "institutional capital."

8. The expected benefit of a cooperative structure is that the ownership stake will give the members an interest in the success of the SCUs that extends beyond a customer relationship. Ownership gives the right to share in the profits and to elect the directors. Active participation and oversight by members, at least in theory, can mitigate some of the agency problems common in the management of financial institutions, thus reducing the risks from insider transactions and self-dealing. Membership can contribute to the same group-lending phenomenon that can reduce loan losses in micro-lending. As institutions that can be started anywhere on a small scale, SCUs are well suited to rural finance and to serving areas that may not be attractive to larger financial institutions.

9. Cooperative savings and credit organizations exist in varying forms in many countries. Considered on a scale of development, at one extreme there are the cooperatively owned banks of Europe such as Rabobank and Raifeissen, which have grown from roots in small community-based institutions to rank among the largest banks in Europe, offering a full range of financial services. This development has taken place over a period of 100 years. It is useful to recall that these large institutions were started in an environment when the consumer protection and prudential standards now commonly applied in the financial sector were still unknown. These cooperatives initially were essentially unregulated, relying on the mutual self-interest of the owners to ensure prudent lending and management, often with wholly or largely volunteer staff. It is only comparatively recently that the cooperative banks in Europe have been subject to the same prudential regime as other banks.

10. At the other extreme on the development scale are the start-up organizations of ten or a dozen members. In function, these start-ups are more akin to informal rotating savings and credit associations (ROSCAs) than they are to formal financial institutions. These small SCUs typically mobilize saving through member shares and possibly simple deposit products, and offer small loans to members.

11. The primary motivation for policy makers and development partners to introduce SCUs into the transition economies of Central Asia was to address identified shortages in the supply of agricultural finance. One consequence of banking crises, restructuring and privatization in the early period of financial sector reform in the transition countries was retrenchment or disappearance of the state-owned agricultural bank. A network of SCUs, which can be founded anywhere on a small scale, was viewed as an attractive means of filling the gap in the supply of rural credit.

12. Viewing SCUs through the prism of rural or agricultural finance emphasized their role in meeting the demand for credit but minimized the important dimension of mobilizing savings to achieve sustainable funding. Regardless of their positioning on the development scale, SCUs exist as financial intermediaries, so they may be best considered as specialized types of micro-finance organizations, or in their most developed state, as banks distinguished by their cooperative ownership. This significance of this view of SCUs is that the foremost consideration in the policy framework and approach to regulation and supervision of SCUs should be the same safety, soundness and consumer protection objectives that guide financial sector development. Unsound SCUs may meet short term objectives of channeling credit to specific regions or the agricultural sector, but only well-founded SCUs have the potential for long-term sustainability.

A. Tiers and Apexes

13. Cooperative financial institutions are typically part of a "tiered" structure in countries where SCUs or cooperative banks play a significant role in the financial sector. While the specifics vary, in general there is a first tier consisting of the individual SCUs (or locally owned cooperative banks). The second tier is typically an entity owned by the first tier SCUs which provides a range of centralized services. In some countries, the second tier may be regional in nature, with a third tier bringing together the regional entities under a national umbrella.

14. Tiered systems have evolved over time to meet distinct needs of the SCU sector, often reflecting attempts to realize the types of economies of scale available to larger institutions while still preserving the benefits of community ownership. The second (or sometimes third) tier, often known as an apex or central credit union, may provide some or all of the following to individual SCUs:

(i) Centralized liquidity management

(ii) Computer systems and management support

(iii) Industry association—government relations

(iv) "In-system" regulation and supervision

(v) Mutual support, cross guarantees

(vi) Loans and other products which individual SCUs cannot, for reasons of size or scale, provide to their members

15. There is no universal approach to the ownership arrangements among the tiers and the manner of providing centralized products and services. This reflects not only historical differences in the evolution of SCUs in different countries, but also tensions among the different roles played by the second tier (and third tier, where relevant), and the relationships among the tiers.

16. One of the principal conflicts can arise when an apex or second tier organization exercises supervisory authority. In almost all jurisdictions, regulatory authority (the establishment of the legal framework) lies outside the SCU system, but it is not uncommon for there to be an element of "in-system" supervision performed by the apex, or by a related entity. In the long run, all parts of the SCU system have a vested interest in safe and sound institutions, and thus should support strong regulation and effective supervision as a means of protecting their common "brand name." However, there may be conflicting objectives when making immediate decisions. An apex with the objective of promoting the development of SCUs and increasing, or at least maintaining, the number of individual SCUs using its services, may be reluctant to take supervisory action that could lead to the closure of weak institutions.

17. Another tension arises in SCU structures from the need to balance the costs of multiple tiers with benefits of centralized provision of services. Individual SCUs can benefit from economies of scale, for instance by using a single centrally provided information technology system. However, they often chafe at the concomitant requirement that product innovation and tailoring services to meet local needs be confined by the limitations of the centralized system.

B. Regulation and Supervision

18. Conflicting policy objectives influence the regulatory and supervisory regime applied to SCUs, and it is often unclear what constitutes best practices (Box 1). There are many different approaches to regulation and supervision, but in developed countries there is a strong tendency for SCUs (or cooperative banks) to be subject to a regulatory regime that has similar prudential requirements to those for banks. While the distinct nature of cooperative ownership is recognized, the requirements for governance, risk management, internal controls, capital adequacy and limits on lending generally parallel the requirements for banks.

Box 1. The Credit Union PEARLS™ System

The PEARLS system (Protection, Effective financial structure, Asset quality, Rates of return and cost, Liquidity and Signs of growth), developed and distributed by the World Council of Credit Unions (WOCCU), is frequently cited in discussions of best practices in the management and supervision of credit unions.

PEARLS is essentially a management tool for credit unions, establishing target ranges for financial ratios that are indicative of key areas of performance. The targets reflect the WOCCU model of a member-owned self sustaining institution, for instance by establishing a target level of zero for external financing. PEARLS is also used in the supervision of SCUs in a number of countries, with performance against the established targets being interpreted as measures of the soundness and operating efficiency of the SCU.

Although useful as a means of focusing on financial performance, and in particular by highlighting financial issues that arise from a cooperative ownership structure, PEARLS alone cannot provide the basis for a sound regulatory and supervisory regime. Requirements for governance, internal controls and risk management extend beyond ratio analysis, and qualitative assessment of managerial capacity and board of directors' oversight is an essential part of effective supervision. In developed countries, the prudential requirements for SCUs generally parallel those for banks. This is appropriate for SCUs that are effectively cooperative banks. However, for SCUs at earlier stages of development, an approach similar to that used in the regulation of microfinance may provide more suitable standards within a "lighter" regulatory regime that is more development friendly.

19. There is a much wider divergence in supervisory approaches, although the differences in institutional arrangements are greater than the differences in supervisory objectives. Supervision of SCUs can be the responsibility of a system-controlled auditing association or stabilization fund, or a government agency or department dedicated to SCU oversight (which may or may not also have responsibility for non-financial cooperatives), or the Ministry of Finance, or Central Bank, or an independent supervisory agency.

1. Why Regulate and Supervise?

20. In attempting to resolve the debate over how SCUs should be regulated and supervised, it is useful to first recall the policy rationale for prudential regulation and supervision, and then to consider how this is applied to other types of institution that perform the same functions as SCUs. Prudential regulation and supervision, which is predicated on limiting and managing risks assumed by financial institutions, is intended first and foremost to protect the stability of the financial system, and secondly to protect the interests of unsophisticated depositors who cannot be expected to assess the soundness of the deposit taking institutions. Thus, the acceptance of deposits is key to determining the regulatory and supervisory approach.

21. This differentiation on the basis of an institution's funding sources has been broadly accepted in the financial sector development literature.[3] At one end of the continuum, institutions that take deposits from the public are clearly "bank-like" even if they are not called banks. Thus organizations that take deposits should be subject to "bank-like" regulation and supervision, including a range of prudential standards which will be similar to those for banks.

22. The rationale for the "bank-like" approach is that even entities which may lack the scale to be systemically important[4] have been given the legal ability to raise deposits from the public. Unsophisticated consumers are not expected to be able to assess the risk that a deposit-taking institution might be unable to honor its commitments, so minimum prudential standards are used to place limits on the risks that can be taken with depositors' funds.

23. The policy objective of protecting unsophisticated depositors becomes blurred when dealing with SCUs. There is at least a theoretical argument that cooperative ownership mitigates the need to protect depositors. Members of an SCU have ownership rights and can not only vote with their feet like the customers of a bank, they can vote to remove directors and, thus directly influence the operations of the SCU. The cooperative ownership structure in theory means that the owners take an active interest in the management of the SCU. In practice, however, the majority of SCU members often behave like customers, concerned only with the products used and services received. This phenomenon is not unique to the four countries included in this study—in developed countries only a small proportion of members typically attend annual general meetings and vote for the election of officers and directors. This reflects the fact that the bonds of cooperative ownership generally weaken as SCUs grow larger.

24. In light of this tendency, it seems appropriate to differentiate the regulatory regime based on a proxy for the level of the risk-mitigating effects of members' mutual self-interest. Thus, by using different regulatory approaches depending on the nature of the SCU, it may it is possible to minimize the danger that burdensome regulation and intrusive supervision will inhibit development, but at the same time provide a measure of protection for members and depositors.

25. Smaller SCUs, say with fewer than 50 members and below a specified asset size, might be considered as early stage institutions where it could be appropriate to have minimal regulation and oversight. The regime could rely on licensing and periodic reporting, building on the expectation that in a small and simple organization, the member-owners can act to protect their own interests by ensuring prudent management of their savings. In case of smaller credit unions which are not primarily funded by member shares and/or member deposits but by external finance, including donor funded credit lines or government funded credit programs, prudent management through cooperative governance alone cannot be relied upon as the provision of outside funds dilutes members' common interest in safeguarding their savings. However, this alone does not provide a strong case for close oversight by a state supervisory body. Instead, the external funding agency has to take appropriate measures, including due diligence, to ensure good governance and prevent the misuse of financial resources.

26. Transparency and disclosure are cornerstones of a supervisory regime for small SCUs. Standardized reporting and accounting, supported by the availability of a simple management information system facilitates disclosure to members and off-site review by the supervisory authority. Member oversight is the primary means of ensuring appropriate management of small

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[3] See Janson, Rosales and Westley (2004), and van Greuning, Gallarda and Randhawa (1998).

[4] A systemically important institution is one whose failure has the potential to trigger failure of other financial institutions, thus threatening the stability of the financial system.

SCUs. Off-site review by the supervisory authority should use minimal resources with the expectation that on-site follow-up would only be required for cases on non-reporting or serious irregularities identified from the SUs periodic reports.

27. SCUs that have a larger number of members and/or exceed a specified asset size are on their way to becoming larger and more professional financial institutions distinguished from others solely by their cooperative ownership. Increasing size and complexity leads to the need for professional management and puts increased responsibility on directors. It also becomes necessary to have prudential standards to protect depositors, who although they may be members, are less likely to understand the entire business of the SCU and to be able to effectively monitor performance and participate in cooperative decision making as SCUs start to resemble small banks. Differentiating on the basis of size and, to a degree, funding sources also helps to address one of the fundamental problems with the supervision of SCUs—the disproportionate amount of resources required relative to the risks.

2. Institutional Structure for SCU Oversight

28. There is no universal “best” institutional structure for the supervision of SCUs. There are various arguments advanced in favor of particular approaches, such as expected cost efficiencies for self-regulation, enhanced expertise if the SCU supervisory authority is a specialist agency, and advantages from exposure to broader financial sector issues if the authority is also responsible for other deposit-taking institutions. Experience around the world shows that divergent approaches can work.

29. “In system” oversight by an auditing association or stabilization fund controlled by the cooperative sector has historically worked well in Germany and Austria and many other countries. However, provision of services and development support by an apex organization and the requirement for a supervisory authority to enforce requirements that may curb growth can create conflicts. In case of conflicts, development objectives, and particularly the objective to provide credit to (poor) rural areas, may take precedence over supervisory objectives. Particularly in the context of developing and transition economies with broader governance issues and a long tradition of centrally provided finance not based on market principles, it may be better to more clearly separate the development and supervisory function by having a government agency responsible for supervision.

30. There are multiple institutional options for supervision of SCUs by government agencies, which include a specialist agency or department, a non-bank supervisory authority, a unified financial sector supervisor, or the central bank. The most commonly seen variation of government oversight is to entrust SCUs to the banking supervisory authority. The main criticism of assigning SCU supervision to the banking supervisor is the potential over-intensity of regulation and supervision relative to the risks posed by SCUs. Particularly for small SCUs, bank-like regulation may be an unnecessary burden which discourages development, and can result in a disproportionate commitment of supervisory resources to credit unions. The principal argument in favor of a bank-like approach is that SCUs, particularly as they become larger and more sophisticated, are deposit-taking institutions distinguished only by their cooperative ownership structure, and thus there are significant parallels between the supervision of SCUs and other deposit-taking institutions.

III. COUNTRY CASES

A. Azerbaijan

31. SCUs exist in Azerbaijan solely because of development projects which provided external stimulus for their formation. Few members of SCUs understand the concept of an SCU, but are attracted by the possibility of obtaining financing for agricultural or trading activities. In practice, almost all SCUs are controlled by one or a few individuals. The establishment of SCUs preceded the development of a regulatory framework, which, together with problems in the design and delivery of financing programs, contributed to very large initial losses in the credit union system. This history creates challenges in establishing confidence among potential depositors and the supervisory authority, raising considerable questions about the ability of credit unions to develop into self-sustaining financing organizations in the near to medium term.

32. In common with many other countries, banks dominate the formal financial sector in Azerbaijan. Capital markets are in their infancy, and insurance is also at a very early stage of development. Virtually all savings mobilization is undertaken by banks, which together with some non-bank financial institutions provide the majority of credit (Table 1).

33. The history of credit unions in Azerbaijan is very much the history of external funding projects. The three principal drivers to date for the creation and growth of credit unions have been the European Union's Technical Assistance to the Commonwealth of Independent States (EU TACIS) programs to support agricultural finance, the Social Fund for Development of Internally Displaced Persons (SFDI), and the World Bank's Agricultural Development Credit Project. Large numbers of credit unions were created from 1997 through the early part of 2000 solely to access external funding.

Table 1: Azerbaijan Formal Providers of Financial Services, end-2004

	Credit Unions	**Micro-finance**[\1]	**Agrar-credit**	**MFBA**	**Banks**[a]
Number	55	14	1	1	44
Service locations	80[\2]	27	12	6	344
Borrowers	5,000[\2]	45,489	n.a.	2,813	n.a.
Loans (manat billions)	18.8[\2]	128.9	44.0	31.9	4915.4
Average loan size (manat millions)	3.8[\2]	2.8	n.a.	11.3	n.a.
Deposits (manta billions)	0	0	0	0	5147.1

[a] Excludes MBFA.
[b] Estimated from Azerbaijan Credit Unions Association and National Bank of Azerbaijan data. About 80 percent of licensed credit unions are members of the association.
Sources: National Bank of Azerbaijan, Azerbaijan Micro-finance Association, Azerbaijan Credit Unions Association.

34. When credit union legislation was introduced in 2000, followed by prudential regulations in 2001, only a small portion of the provisionally licensed credit unions obtained licenses. Some credit unions made no attempt to obtain a license, while others were unable to meet the new standards. Recent expansion in the number of credit unions is on a sounder footing. However there are still significant concerns that the credit unions may not be sustainable in the long-term as the ability to access external funding is still the driving force for their formation.

35. Credit unions are not permitted to take deposits, and thus are entirely dependent on member shares and external financing. The supervisory authority, the National Bank of

Azerbaijan (NBA) is not receptive to requests that SCUs be authorized to raise deposits, in part because of the track record of large losses incurred by SCUs.

B. People's Republic of China

36. Within East and Central Asia, the PCR is unique because rural credit cooperatives (RCCs) have a history of over 50 years, while in the other three countries SCUs are newly created. RCCs also play a comparatively much larger role in deposit mobilization, accounting for about 10 percent of total banking deposits in China, and a much larger share in rural areas. As with the other countries included in this study, the cooperative nature of RCCs largely exists in name only. Any notion of RCCs being truly member owned and controlled has been undermined though intervention by local government, several rounds of top-down reform, utilization of the RCCs as vehicles for delivery of policy loans and subsidized (agricultural) credit, and many years of operation essentially as branches of the Agricultural Bank of China (ABC).

37. Since cooperative ownership of RCCs is notional rather than factual, there are clearly questions raised about governance of the RCCs and the potential for abuse by the individuals or local governments that control RCCs in practice. These appear to have been recognized in the latest reform program. However, it remains to be seen if the transformation of some RCCs into rural and cooperative banks and making the other RCCs branches of newly established unions of RCCs will be effective in dealing with these issues.

38. Banks account for about 90 percent of the total assets of all financial institutions in China. The four state-owned commercial banks (SOCBs) collectively have more than half of all banking assets (Table 2). It is significant that both urban credit cooperatives (UCCs) and RCCs are included in the official banking statistics. This reflects the fact that cooperative ownership of these institutions has long been only notional, that the reform program for UCCs and RCCs has significant parallels with the reform of the SOCBs, and that the same prudential regime that applies to other banks applies to the RCCs (and their successor rural cooperative and rural commercial banks).

Table 2: People's Republic of China: Banking sector end-2005

<table>
<tr><th></th><th>Number</th><th>Assets (RMB billions)</th></tr>
<tr><td>Policy banks</td><td>3</td><td>5,512</td></tr>
<tr><td>State-owned commercial banks</td><td>4</td><td>19,658</td></tr>
<tr><td>Joint-stock commercial banks</td><td>13</td><td>5,813</td></tr>
<tr><td>City commercial banks</td><td>115</td><td rowspan="2">2,110</td></tr>
<tr><td>Urban credit cooperatives</td><td>626</td></tr>
<tr><td>Rural credit cooperatives</td><td>30,438</td><td rowspan="3">3,626</td></tr>
<tr><td>Rural cooperative/commercial banks</td><td>57</td></tr>
<tr><td>Rural credit cooperative unions</td><td>325</td></tr>
<tr><td>Establishments of foreign banks</td><td>238</td><td>749</td></tr>
<tr><td>Total</td><td>31,494</td><td>37,468</td></tr>
</table>

Sources: People's Bank of China, China Banking Regulatory Commission.

39. The situation in rural areas is significantly different than the country-wide overview of the financial services sector would suggest. While the RCCs and their successor rural cooperative and commercial banks account for about 10 percent of total banking assets, they held about 85

percent of all agricultural loans outstanding at end-2004. In many rural areas the RCCs are the only institution offering credit products, although there is more competition in the provision of deposit services, particularly from China Post Bank, which was established in 1989 and now has over 32,000 service locations.

40. The current RCC reform program began as a pilot in seven provinces and one municipality in 2003. The objectives were to clarify the ownership structure and strengthen governance of the RCCs, transfer administrative responsibilities for the RCCs to local governments, and to deal with the accumulated financial problems reflected in a high share of non-performing loans (NPLs). In concept, the approach is similar to that already employed for the reform of the SOCBs and UCCs, involving measures to deal with both the existing stock of NPLs and reforms intended to check the flow of new NPLs. However, it is an open question whether the intended measures are adequate in practice.

41. The scale of the problem is huge, with some 30,000 RCCs to be addressed. There is an enormous demand for the commercial banking skills required to successfully manage reformed RCCs, and it is far from clear that the necessary management expertise is available. The reform program reduces complexity by substantially reducing the total number of financial institutions under supervision and by giving a clearer perspective on the ultimate regulatory and supervisory regime, which will be the same as for other banks. However, merging RCCs into larger units rather than resolving the weakest RCCs before the consolidation may have undesirable long-term effects as it will create a number of weak banks, at least some of which will ultimately prove unviable.

42. Although progress is being made with the legal reorganization and consolidation, implementing fundamental change in the management of the RCCs is proving a daunting task, as "the fundamental problems of inadequate risk controls, poor corporate governance and a shortage of qualified staff have yet to be solved."[5] The reported profitability and improvement in asset quality of the various rural financial institutions has clearly been over-stated given the public statements by the China Banking Regulatory Commission (CBRC) regarding the need to correct the fraudulent inflation of reported capital adequacy by RCCs.[6]

C. The Kyrgyz Republic

43. A distinguishing feature of the Kyrgyz Republic is the wide array of formal providers of financial services, many with extensive penetration in rural areas. In addition to the government-owned Savings and Settlement Company (SSC), two of the 20 banks and a large non-bank financial institution, Kyrgyz Agricultural Finance Corporation (KAFC) have a country-wide branch network. KAFC is the largest provider of microfinance, and plans to introduce deposit services. The state-owned Kyrgyz Post provides payment services through its 900 offices country-wide, and in 2005 embarked into lending operations as an agent for KAFC. SSC is one of the largest providers of payment and deposit services in the country, but has only recently started to embark into credit business. Microfinance is also provided by more than 100 specialized organizations and by SCUs. The total of microfinance credit extended is equivalent to two-thirds of the conventional bank credit outstanding. This is—at least partly—due to multiple efforts of external funding agencies to stimulate rapid growth in microfinance.

[5] Tang Shuangning, Vice-Chairman of the China Banking Regulatory Commission (CBRC), quoted in "Rural credit co-ops give China a headache", Reuters, March 1, 2006.

[6] Statement by CBRC Vice Chairman Tang Shuangning, available at http://www.cbrc.gov.cn/mod_en00/jsp/en004002.jsp?infoID=2337&type=1

44. The driving force behind the development of SCUs in the Kyrgyz Republic was the Rural Finance Institutions Project of the ADB, which was initiated in 1997. The key objectives of this project were to establish 280 credit unions across all regions and their apex organization, the Financial Company for the Support and Development of Credit Unions (FCCU). It was expected that FCCU would perform supervisory functions on behalf of the National Bank of the Kyrgyz Republic (NBKR) in addition to financially supporting the development of credit unions and providing central services to them, including payment and treasury services. A credit line was provided to FCCU for on-lending to SCUs. The credit line was complemented by loan- and grant-financed technical assistance to build FCCU's capacity and also capacity of the National Bank of the Kyrgyz Republic (NBKR) as the ultimate regulatory and supervisory body for the SCU sector and owner of FCCU. The German Corporation for Technical Cooperation (Gesellschaft fuer Technische Zusammenarbeit; GTZ) and Soros foundation also provided complementary technical assistance.

Table 3. Kyrgyz Republic: Formal Providers of Financial Services, end-2004

	SCUs	Micro-finance organizations	KAFC	SSC	Banks (MSSF)[a]	Banks[b]
Number	305	104	1	1	5	19
Service locations	305	120[c]	54	48[d]	44	112
Borrowers	21,650	41,900	36,300	0	8,707	17,542
Loans (som millions)	440	785	1,528	0	470	4,813
Average loan size (som 000s)	20	19	42	—	54	274
Deposits (som millions)	3	0	0	414	0	7,569

[a] Micro and Small Enterprise Finance Facility (MSSF) provided by the European Bank for Reconstruction and Development.
[b] Commercial banks excluding Savings and Settlement Company (SSC), exclusive of MSSF.
[c] Estimate: Most microfinance organizations have only one location. The four largest (Foundation for International Community Assistance [FINCA] Kyrgyzstan, Bai-Tushm, Kompanion and Leasing-Mortgage Company) account for 85 percent of the loan volume.
[d] Excludes agency offices in 1,000 post offices, which accounts for about 3 percent of SSC deposits.
Sources: National Bank of the Kyrgyz Republic, Financial Company for the Support and Development of Credit Unions.

45. The efforts to develop SCUs have been very successful in terms of the formation of credit unions and attraction of members (table 4), but less successful in creating the supporting infrastructure and ensuring sustainability. The gross number of credit unions established since 1997 is over 400, with in excess of 100 having been closed by the NBKR or voluntarily wound-up. The motivation for the formation of many of these credit unions was the ability to access external funding through the FCCU administered credit line. Since credit unions are not licensed to accept deposits and attract comparatively few funds from their members, most SCUs remain dependent on external financing.[7] Many of the credit unions (and microfinance organizations) are very small, and a consolidation of the sector is inevitable when external assistance is reduced.

46. Although notionally cooperative, in practice many SCUs are controlled by an individual or family or small group of individuals. Some credit unions have misreported in order to remain eligible for FCCU funding, and some were formed only to obtain FCCU financing utilizing phantom member contributions. Estimates vary, but at least one hundred SCUs are not viable

[7] A deposit taking pilot program was started with support from German Corporation for Technical Cooperation (Gesellschaft fuer Technische Zusammenarbeit, GTZ) in 2004 and completed in 2005. However, the resulting draft licensing mechanism has yet to be introduced.

due to either fraud or incompetence, and perhaps only 40 to 60 would truly prosper without external support.

47. Neither FCCU nor the existing credit union associations have yet developed into apex organizations or central credit unions to provide services and ongoing development support for SCUs. A credit union law and economic norms are in place, but the envisioned system of off-site and on-site supervision and enforcement of economic norms is not functioning effectively. When the originally envisioned system of on-site and off-site supervision by FCCU was not implemented some five years into the ADB funded development assistance, a decision was taken to transfer responsibility for day-to-day supervision to the NBKR, which is also in charge of supervising commercial banks. The NBKR approach to supervising SCUs, which has yet to be fully implemented, can be characterized as "bank-like".

Table 4: Kyrgyz Republic: Development of Credit Unions

	1997	1998	1999	2000	2001	2002	2003	2004	2005 Q2
Number	3	83	166	191	275	350	303	304	310
Members	76	2,849	7,350	11,085	21,313	24,979	24,688	27,707	28,972
Borrowers	42	n.a.	n.a.	n.a.	16,361	18,700	19,134	21,650	23,124
	(som 000s)								
Total assets	n.a	14,994	54,715	101,905	242,382	265,345	317,232	487,554	587,533
Loans	431	13,875	49,490	95,398	227,418	244,247	283,907	440,244	535,071
Deposits	--	--	--	--	--	--	17	2,554	544
External funding	186	4,903	19,583	35,087	88,136	91,285	122,259	215,396	290,508
Share capital	245	8,509	28,991	49,199	117,596	126,720	138,278	160,720	171,962
Institutional capital	--	--	--	1,154	5,720	12,714	26,313	43,940	93,189
Total capital	245	8,509	28,991	50,353	123,315	139,433	164,510	204,660	265,151

Source: Financial Company for the Support and Development of Credit Unions.

D. Mongolia

48. Despite the small population and low population density, Mongolia is well served by formal financial institutions compared to other countries at similar stages of economic development. The 17 licensed banks comprise by far the largest portion of the financial sector, although the number of non-bank financial institutions has grown rapidly. Three of the commercial banks have country-wide branch networks.

Table 5:Mongolia: Formal Providers of Financial Services, end-2005

	Credit Unions	NBFIs	Post Bank	Xaan Bank	Xacbank	Other Banks[a]
Number	700 [b]	150	1	1	1	14
Service locations	300 [b]	n.a.	85	404	65[c]	725*
Borrowers	30,000 [b]	51,200	n.a.	177,540	50,000	n.a.
Loans (tughrik billions)	100 [b]	18.8	62.0*	134.4	37.8	625.2
Average loan size (tughrik thousands)	3,300 [b]	367	n.a	757	756	n.a.
Deposits (tughrik billions)	80	0	70.0*	179.6	55.0*	712.4

*estimates, awaiting final 2005 data.

[a] All banks excluding Post Bank, Xacbank and Xaan Bank (formerly Agriculture Bank).

[b] Actual data is not available. Of about 700 registered SCU, observers estimate that only about 300 operate. The reported rapid growth of commercially controlled SCUs suggests that the volume of SCU loans and deposits may have doubled since the only reliable data was gathered at the beginning of 2004 (Box 1). Some observers estimate that SCU deposit and loan volumes could be much higher.

[c] Includes 31 "franchised" SCUs.

Sources: Bank of Mongolia, Financial Regulatory Commission, Xacbank, Postbank, Xaan Bank.

49. SCUs began to be established in Mongolia in 1996 and 1997 through a project funded by the ADB. This intervention was successful in establishing a small number of truly member-owned and focused organizations. Subsequently, ADB's Rural Finance Project was approved in 2001 to (i) support the creation of a credit union service organization (CUSO) to further promote SCU development and (ii) provide training and capacity building to new SCUs. The program also envisioned the creation of a Supervision Development Unit (SDU) for the oversight of SCUs, and the provision of a credit facility to be on-lent to SCUs. However, the project has not been fully implemented.

50. The Rural Finance Project had been in the pipeline for more than two years before approval, and the prospect that there would be an ADB credit line to support credit unions was well known. This encouraged SCU formation, which was viewed as a means of positioning individuals to receive external funding. Many of these newly created credit unions ceased operation when the expected external financing did not quickly materialize. In one sense, the quick disappearance of many registered SCUs was a very positive result of the sequencing of the rural finance project, which foresaw the back-loading of the credit line component. Access to the on-lending credit line was not to be provided until the CUSO and SDU were established. The credit line was not disbursed and the project was ultimately cancelled due to unsatisfactory progress in the first two phases. In the interim, SCUs in Mongolia have attracted substantial deposits, although precise data is not available for even such basic indicators as the number of operating SCUs, reflecting the failure to establish a legal framework for regulation and supervision over the last ten years.

51. Establishment of the SDU was hindered by the lack of consensus on the appropriate approach to regulation and supervision of SCUs. There were differing views on whether a separate SCU statute was required, with some participants, including international consultants and external funding agencies supporting multi-purpose cooperative development, advocating that the most cost-effective approach was to deal with SCUs within the framework of the general cooperative law. Those interested primarily in ensuring that SCUs remained unregulated may have exploited legitimate differences of opinion over the best approach to unnecessarily prolong the discussions and delay action.

52. The proliferation of SCUs controlled by commercial interests and essentially operating as unregulated deposit-taking institutions creates serious risks to financial sector development in Mongolia. Should there be large losses among the depositors of these SCUs, there is the risk that confidence will be lost in the smaller number of SCUs that truly operate on a cooperative basis. Even more concerning, the loss of confidence might spread to commercial banks, undermining the progress made in recent years in reforming the banking sector. A further concern is that SCUs are bidding aggressively for deposits, driving up the funding costs of banks.

IV. LESSONS FOR SAVINGS AND CREDIT UNION DEVELOPMENT

53. At their earliest stage of development, SCUs can be considered as a specialized type of microfinance organization. At their most advanced stage, they are bank-like deposit-taking institutions, distinguished only by their cooperative ownership. Thus, while there are special considerations that apply to SCUs, the approach to their development, and in particular

establishment of a sound system of regulation and supervision, needs to be based on the principles widely used in microfinance and general financial sector development.

A. Establishing the Concept of Cooperative Ownership

54. The most fundamental obstacle to the development of SCUs is the promotion of the concept of cooperative ownership. The history of central planning in each of the four countries included in the study meant that the concept of a member-owned self-sustaining financial institution was entirely foreign. Even in China, where SCUs have in name existed for 50 years, the RCCs had factually operated under strong central direction, with savings channeled to the centre and credit directed by plan.

55. Can cooperative ownership be successfully introduced where there is no history of the concept? The weight of evidence in Azerbaijan, the Kyrgyz Republic and Mongolia is not encouraging, where it is clear that the vast majority of SCUs are in effect controlled by one or a few people, who have been attracted to the legal structure of cooperative ownership by the prospect of obtaining external financing, or the desire to avoid the regulation associated with other legal forms. In China, the current reform initiative appears destined to change the legal structure of RCCs while leaving unanswered the question of who will really own and control the institutions. Considering the literature more generally, Poland is cited as an example of successful establishment of credit unions in a formerly planned economy,[8] and it is worth noting that in Poland there had been a history of cooperatives until the Second World War, and that even during the Soviet period there was individual land ownership. This was not the case in most other transition economies, including the four countries covered in this study.

56. There are some success stories in Azerbaijan, the Kyrgyz Republic and Mongolia despite the broad failure to instill true cooperative ownership. In each country there is a small number of SCUs that does appear to operate on a cooperative basis and seems to be financially sustainable. Why have these SCUs developed differently?

57. The small numbers of SCUs operating successfully on cooperative principles generally seem to have been recipients of considerable education and support for the members of the SCU. Often, these SCUs have been parts of pilot projects, and frequently have been intended to be models or sources of trainers for other SCUs. This suggests that education of individuals about their role in the SCU is key to establishing cooperative ownership.

58. There are also some financially successful institutions in Azerbaijan, the Kyrgyz Republic and Mongolia that are SCUs in name only. Those which are able to fund their lending activities through their owners' funds and/or wholesale financing can be a valuable source of microfinance and small business lending. Provided that they are not raising deposits, there is no public policy need for burdensome regulation and supervision of these entities and the legal framework should provide straightforward options for these organizations to operate as something other than SCUs, such as microfinance organizations. Their legal structure should, however, reflect that they are controlled by one or a few individuals rather than purporting to be cooperatives when they are not. A significant number of SCUs in the Kyrgyz Republic seem to belong to this type, for which a re-registration into microfinance organizations should be considered.

[8] Evans and Richardson (1999).

B. Can Savings and Credit Union Development be Fast-Tracked?

59. Is it possible to get more of a good thing by expanding the number of SCUs and increasing the outreach of existing SCUs? The evidence suggests that a lot of money and effort has resulted in the creation of very few true cooperatives. In the case of Azerbaijan and the Kyrgyz Republic, by far the largest commitment of funds was for on-lending programs. It remains to be seen what the repayment record will be in the Kyrgyz Republic, and hence the total cost of the development efforts, but in Azerbaijan the results are known from the earliest on-lending program: default rates by SCUs in excess of 98 percent. Subsequent projects have been better designed and seem likely to incur less substantial losses, however, there are still significant problems arising from the incompatibility of external financing assistance with the concept of a member-owned and controlled self-sustaining financial institution.

1. Problems with External Financing

60. The evidence clearly suggests that programs designed to providing matching funds for SCU member contributions and, more generally, the use of SCUs to deliver (subsidized) credit programs have actually undermined SCU development. While this may seem a strong conclusion, two reasons emerge from the experience to suggest that it is true:

(i) External financing weakens the common bond of the SCU, and sends the wrong signals by implying that the sources and control of financing still lie outside the SCU, which is of particular relevance in countries transitioning from centrally planned economies,

(ii) The potential to obtain external financing introduces moral hazard and invites rent-seeking activities, or more bluntly, creates incentives for fraudulent behavior.

61. In Azerbaijan, the Kyrgyz Republic, and Mongolia, it is clear that many members of newly created SCUs were attracted only by the possibility of obtaining loans financed by external funding. In many cases, membership shares were seen as a fee to be paid to obtain a loan, often deducted from the loan proceeds rather than actually contributed by the borrower. In fact, a large number of SCUs created for the sole purpose of tapping an external credit line disappeared when access to the credit line did not quickly materialize.

62. This motivation for establishing an SCU is understandable and would not be problematic except that the governance of SCUs is dependent on the presumption of members' mutual self-interest. When it became clear in Azerbaijan and the Kyrgyz Republic, and to a degree also in the PRC, that this specific cooperative feature of governance did not exist, the response was frequently to attempt to impose a more restrictive regulatory regime and tighter conditions on on-lending programs. This failed because no amount of regulation and supervision can take the place of sound internal governance.

63. In addition to the SCU specific concerns of undermining the common bond and sending the wrong signals in a transition economy, there are lessons from the microfinance and financial sector development experience that are relevant to SCU financing programs. Sustainable finance is depended on sustainable funding, which in the long term can only come either through the mobilization of savings or attraction of wholesale finance on commercial terms. NGO, donor and government financing can have the perverse effect of discouraging the

mobilization of savings, and when provided at subsidized rates, effectively crowds out commercial financing.[9]

2. Challenges in Capacity Building

64. Supporting SCU development through capacity building usually takes one or more of three forms: support for individual SCUs; support for apex organizations; and, support for regulation and supervision. In the countries examined, there has been some far from universal success with support for individual SCUs, and very little indeed to show for the investments in apexes and in regulation and supervision, both through apex organizations or other regulatory bodies such as central banks.

65. The greatest success appears to have come from education and training in cooperative principles, which may provide the foundation for truly grass-roots SCUs. While only a small portion of the SCUs created in Azerbaijan, the Kyrgyz Republic and Mongolia are truly cooperative, focusing exclusively on training and development without the destabilization influence of available external financing might improve the success rate, at least in the long-term.

66. Apex organizations have been particularly challenging, in part because of the difficulties in reconciling the realities of a start-up situation with the cooperative vision of an apex owned and controlled by the individual SCUs. Start-up SCUs lack the managerial and financial means to own and control an apex. However, in Azerbaijan, the Kyrgyz Republic and Mongolia, as SCUs became more established, associations of SCUs were created outside the organizations intended in the original program designs to function as apexes, in part because SCUs felt the need for an organization to represent their interests. This further complicated efforts to provide apex services, as the associations became rivals in attempts to obtain support from external funding agencies.

67. In Azerbaijan, the Kyrgyz Republic and Mongolia attempts were made to support SCU development by providing the foundation for an apex organization concurrently with the establishment of SCUs. In each case the expectation was that over time SCUs would assume ownership of the apex organizations established with outside assistance, and that these organizations would be able to provide full support for SCU development. Some possible explanations for the observed lack of success in implementing this strategy include:

(i) divergent or unclear views on the roles to be played by the apex;

(ii) an apex that is not actually owned by member SCUs may be insufficiently focused on meeting the needs of SCUs;

(iii) incentives arising from external financing and grants that may not align with the objectives of SCU development;

(iv) a “chicken and egg” problem, with small new SCUs not being able to pay for apex services, but unable to develop into larger institutions without having access to these services.

[9] See Robinson (2001) for a discussion of the issues in the context of microfinance, and Morris (1997) for a review of some generally unsatisfactory experiences of using credit-unions as on-lending agents for external financing.

68. These issues are further explored in the case studies in Appendix 1, however, it is useful to consider that they are not unique to newly established SCU systems. In many countries there is continuing debate over the role and structure of the tiers, and structures continue to evolve. For example, in Canada, the Desjardins caisse populaire (credit union) system has removed its middle tier of regional federations, devolving to a two tier system in an effort to reduce costs and increase standardization.

69. It is clear from the experience in Azerbaijan and the Kyrgyz Republic that combining the functions of an apex with the disbursement of on-lent funds has not worked well. This is, in part, because the focus on on-lending detracted from the development of capacity to provide other services. Successes in the commercialization of micro-finance generally, and also the apparent attractiveness of a "franchising" program for SCUs offered by Xacbank in Mongolia, suggests a narrow focus on provision of a standardized "start-up" kit and the concomitant training for individual members in cooperative ownership may be the best way to develop SCUs.

70. However, there is no easy way to reconcile this narrow focus with the provision of the broader range of services such as money transfer and centralized liquidity management that larger and more successful SCUs will require. In Azerbaijan and the Kyrgyz Republic various options have been discussed such as the establishment of a bank to serve the SCUs, or purchase of services from unaffiliated banks or non-banks. The needed services could be provided by an apex, but the challenges of developing the capacity within the SCU system, and even more importantly the lack of consensus on the best course of action, have proved insurmountable obstacles in these two countries.

3. Other Start-up Issues

71. Development of SCUs in transition countries is plagued by a number of "chicken and egg" issues, where the problem is how to get from the starting-point of a complete absence of SCUs and supporting infrastructure to something resembling the SCU system in developed countries. The regulatory regime generally contemplates a range of "bank-like" standards for accounting, internal control, audit and governance, but in the start-up phase and often for long afterwards, many individual SCUs are too small to support the necessary investment in management and systems.

72. Use of an apex organization to gain some degree of standardization and economies of scale is the commonly seen approach to make the provision of training, equipment and software cost-effective. However, even this is expensive and perhaps unrealistic for SCUs of 10 or 20 members, and also has its own conundrum. An apex being established at the same time SCUs are being established may not be able to provide systems and support immediately when required. This can lead to the fastest developing SCUs going their own way, and thus the apex may not have the support of the strongest SCUs, which can lead to a vicious cycle of the apex being unable to meet the needs of its member SCUs, which further undermines its scope to help SCUs achieve economies of scale. As an example, stronger SCUs in the Kyrgyz Republic seem to favor the development of SCU associations into true apex organizations or the provision of central services by banking institutions outside the SCU sector rather further effort to develop FCCU into an institution which provides the services they need (apart from access to external finance).

73. A frequent challenge in SCU start-up is that the demand for credit outstrips savings. This can be due to a lack of monetization of savings—in rural Mongolia and the Kyrgyz Republic significant portions of household savings are in the form of livestock. The prevalence of other

providers of financial services can also contribute—the postal savings system raises significant deposits in rural China, and both the Kyrgyz Republic and Mongolia are comparatively well served by country-wide networks of bank branches. The temptation is to attempt to spur SCU development by providing external financing, but this should be resisted due to the detrimental effects noted above. Experience with SCUs around the world, and also with ROSCAs and other informal savings programs, is that over time savings can be mobilized even among the very poor. Short term benefits from external financing provided to fast-track SCU development tend to undermine the longer term goal of establishing sustainable financing mechanisms, i.e. the development of SCUs which intermediate local savings into productive investment.

C. Regulation and Supervision

74. Fatal flaws in the initial approaches to regulation and supervision in Azerbaijan, the Kyrgyz Republic and Mongolia have poisoned the waters for future development of SCUs. In each case, SCUs were established in advance of the introduction of the legal and regulatory framework for them, including capacity for sector supervision. In the case of Mongolia, this deficiency has yet to be remedied, and in the case of Azerbaijan and the Kyrgyz Republic has resulted in confusion and changes regarding SCU business powers and reporting requirements. Initial poor experiences with unauthorized deposit-taking, credit losses and outright fraud have left the supervisory authorities, particularly those also in charge of banking supervision, with a generally unsympathetic view towards SCUs. In China, the history of changing responsibilities and conflicting roles of the PBOC, CBRC and ABC has contributed to the lack of clear lines of oversight and the accumulated losses.

75. The failure to establish effective supervision of the SCUs in the Kyrgyz Republic and Mongolia does not reflect any inherent difficulties with the drafting of laws and regulations, or with the training of staff and development of policies and procedures for the supervisory agency. In fact, these are among the better defined and more achievable objectives in SCU development. However, lack of policy-level commitment to a clear framework for regulation and supervision and poor implementation of such a framework and/or weak enforcement of regulatory requirements resulted in unsatisfactory outcomes.

76. The experience with the regulation and supervision of SCUs parallels the experience with banking in many transition countries, where initial reforms resulted in a weak and unclear licensing regime leading to explosive growth of unsustainable banks, occurring when the supervisory authority was also in a nascent stage of development. Thus, the lessons from banking and financial sector development more generally are also applicable to SCUs. In instances where the development of SCUs has preceded the development of the infrastructure for regulation and supervision, it may require a crisis, or at least considerable distress in the SCU system, to motivate the political will to address the emerging problems, much in the same way that banking crises have provided the impetus for improved regulation and supervision in many countries.

77. Sequencing is important. This was recognized in the program designs in Azerbaijan, the Kyrgyz Republic and Mongolia, where it was originally expected that introduction of a specialized SCU law would precede or be competed very early in the project. In each case, however, the projects proceeded despite delays in the introduction of the expected laws. In retrospect it is clear that programs to support SCU development should not have proceeded, and the incorporation of SCUs should have been delayed until there was an appropriate licensing regime in place.

78. The experience with SCU supervision around the world, and also with financial sector supervision more generally, is that there are many institutional structures that can function effectively. The failure to establish an effective “in-system” supervisory authority in the Kyrgyz Republic, and the subsequent failure to effectively implement supervision in NBKR, is not a function of the chosen institutional structure. Similarly, central bank oversight of SCUs has not had a fair test in Azerbaijan and Mongolia. In the PRC the history of divided and uncertain responsibilities undermines effective supervision. The fundamental problems in each country have been an absence of clear objectives for supervision, and a lack of capacity on the part of the supervisory authority.

79. The objectives of SCU supervision should be consistent with those used in microfinance and financial sector oversight more generally. The intensity of regulation and supervision should be matched to the risks of the activities undertaken. Smaller SCUs posing few risks, which are mitigated by the expectation that the mutual self-interest of members is strongest and most easily applied in smaller and simpler organizations, should be subject to a lighter supervisory regime, consisting of licensing and reporting requirements. Larger SCUs which are evolving into more sophisticated financial institutions distinguished only by their cooperative ownership should be subject to more bank-like regulatory requirements and supervision. If SCUs access external financing, then the lender or grant provider, whether a donor or commercial provider of wholesale finance, has to undertake due diligence and take other suitable measures to ensure good governance and prevent fraud, just as they are required to do when funding other microfinance organizations that neither intermediate local savings nor pose systemic risks.

80. Focusing on only the larger SCUs that are more likely to pose risks to members and/or depositors and financial system stability reduces the need for supervisory resources. In China, about 80 percent of staff of CBRC, which is responsible for supervising commercial banks and credit unions, is devoted to the oversight of RCCs, which constitute about 10 percent of assets of the banking system. In the Kyrgyz Republic, about one-third of total supervision staff of NBKR is devoted to credit unions, which collectively have assets equivalent to only about 10 percent of banking assets.

D. Key Considerations for Policy-Makers and Development Partners

81. In a country without an existing legal framework for SCUs, the often overlooked first question should be asked: will the expected benefits from establishing SCUs offset the costs, including those for establishing an appropriate legal regime and supervisory apparatus? With the benefit of hindsight it can now be seen that in the Kyrgyz Republic about 90 cents in development assistance (loans and grants) supports every dollar of SCU assets. Creation of sustainable SCUs may be better achieved through focusing on training and development. On-lending programs can be more efficiently delivered by not concurrently creating the institutions intended to deliver the funds to the end-borrowers.

82. For countries like those examined in this paper which have existing SCUs but also have identified weaknesses in the legal framework and supervision, the question becomes whether to create an appropriate SCU regime or to address the problems by treating SCUs like other financial intuitions. The mandatory re-licensing of SCUs in Azerbaijan is an example of the former approach, while in the PRC the approach to RCCs is an example of the latter. RCCs are subject to bank-like regulation and the reform program is similar to earlier attempts to reform the SOCBs.

83. The legal framework must be established prior to promoting credit union development. An SCU law distinct from a more general cooperative law is required, recognizing that financial intermediation is sufficiently different from non-financial businesses to necessitate a number of distinct requirements. This approach parallels the requirement for a banking law separate from the corporations statute. Licensing provisions are key to ensure that only entities meeting the established minimum requirements are permitted to operate as SCUs, helping to avoid the problems individual adopting the cooperative ownership structure as a matter of legal convenience. As their name implies, SCUs should be permitted to mobilize savings by taking deposits, however SCUs should by law be prohibited from doing business with non-members. Without this restriction, there is little to distinguish SCUs from other financial intermediaries.

84. The SCU law should establish the framework for a supervisory approach that can be graduated to tailor the intensity of oversight to the intensity of the risks. Recognizing that for smaller SCUs cooperative ownership can mitigate the agency problems arising in the management of financial institutions, a lighter regime consisting primarily of licensing and reporting can help to avoid the burden of fully “bank-like” regulation that can hinder development. For larger SCUs, however, it is necessary to recognize that the ability of members to understand and monitor the activities of the SCU weakens, necessitating more bank-like requirements for governance and supervision. While many institutional arrangements are possible for supervision, in transition economies it is preferable to vest responsibility in a government agency that will not be subject to the potential conflicts of interest inherent in self-regulatory systems. External assistance can be helpful in preparing the legal framework and building capacity in the supervisory authority.

85. If development assistance is provided to SCUs it should focus on training and education. Developing the capacity of directors and members to understand and oversee the activities of the SCU is the approach most likely to support sound SCUs. Many of the best SCUs in transition countries were pilot or model institutions, which received more assistance at the outset than was typically the norm in development projects.

86. On-lending programs should not be used to spur SCU formation due to the potential to undermine cooperative ownership and spur rent-seeking behavior. Larger mature SCUs might be suitable vehicles for on-lending programs, much in the same way as commercial banks participate in development finance programs. However, use of external financing clearly makes these larger SCUs more bank-like and further removed from the cooperative ideal—note that PEARLS establishes a zero target for external finance.

87. External assistance could also usefully support development and implementation of standardized management systems, accounting and reporting formats. In addition to technical assistance, there may be a role for grant financing or operating subsidies to support initial development. Such standardization, especially if supported by development partners, helps make the necessary investment in basic systems and controls affordable for start-up and small SCUs. Sound systems and procedures facilitate the transparency necessary for members to effectively discipline management and for the supervisory authority to monitor SCUs primarily through off-site reporting requirements.

V. CONCLUDING OBSERVATIONS

88. The failure of well-intentioned efforts to stimulate SCU development and to use SCUs as vehicles to deliver on-lending programs is evidence that truly cooperative savings and credit institutions are difficult to create, and once established, challenging to nurture. It takes time, probably longer than the lifespan of most development projects, to develop sound cooperatives from scratch. Outside assistance in SCU development has been most successful when it has focused on education of individuals about cooperatives, and in particular the roles and responsibilities of members and directors.

89. In the four transition economics examined in this study, attempts to stimulate growth by providing matching funding or using SCUs to channel subsidized credit programs have actually undermined the principles of member-owned and sustainable financial institutions. At best, this external financing has perpetuated the expectation that financing and the control of credit will continue to be directed by an outside agent, and at worst has provided incentives for SCUs to be fraudulently created so individuals can access the external funds.

90. Despite the obstacles, small numbers of truly cooperative SCUs have emerged. In addition, some of the SCUs that are cooperative in name only perform a useful microfinance function and could continue making a valuable contribution to development in a more appropriate legal structure such as a microfinance organization. A key challenge for the authorities is to provide a supervisory regime that fosters the development of the small number of sound institutions while at the same time addresses the abuses of unauthorized or unsupervised deposit-taking providing financing for imprudent lending.

91. Implementing effective regulation and supervision of SCUs has been hampered by philosophical differences over the appropriate legal framework and institutional structure. Attempts to simply transplant the legal framework and institutional structure from countries with well developed cooperative sectors have failed, not in the least because of conflicts between experts from countries that have divergent approaches. It is more important to focus on the principles of providing protection for depositors and ensuring the stability of the financial system, recognizing that the international experience provides evidence that widely divergent approaches can be effective.

92. The experience with microfinance and financial sector development more generally is germane to SCUs because other types of financial institution perform the same functions as SCUs. The distinguishing feature of cooperative ownership warrants specialized treatment only to the extent that cooperative ownership can effectively mitigate the risks inherent in financial intermediation. This suggests that a lighter regulatory regime could be appropriate for smaller SCUs where the common bond may be the strongest, if not undermined systematically by access to external funding, and that larger SCUs which are well on their way to becoming sophisticated financial institutions should be subject to oversight that is more bank-like.

93. As with financial sector development more generally, in SCU development sequencing is vital. The legal and regulatory framework needs to be established before institutions are established, and building supervisory capacity is at least as important as building capacity in SCUs.

APPENDIX I: CASE STUDIES

A. Azerbaijan

1. Credit unions exist in Azerbaijan solely because of projects which provided external stimulus for their formation. Few members understand the concept of a credit union, but are attracted by the possibility of obtaining financing for agricultural or trading activities. The establishment of credit unions preceded the development of a regulatory framework, which, together with problems in program design and delivery, contributed to very large losses in the credit union system. This history creates challenges in establishing confidence among potential depositors and the supervisory authority, raising considerable questions about the ability of credit unions to develop into self-sustaining financing organizations in the near to medium term.

1. Context for Credit Union Development: Financial Sector Overview

2. In common with many countries, banks dominate the formal financial sector in Azerbaijan. Capital markets are in their infancy, and insurance is also at a very early stage of development. Virtually all savings mobilization is undertaken by banks, which together with some non-bank financial institutions provide the majority of credit (Table A1).

3. Two specialized institutions are targeted at micro-finance and rural credit respectively. The Microfinance Bank of Azerbaijan (MFBA), established in 2002, has become the largest provider of micro-finance in the country. Despite having a banking license, MFBA has not yet introduced deposit products, and is currently funded by wholesale credit lines, largely provided by its shareholders.[10] MBFA does not yet operate outside Baku, so it is not a significant player in rural finance.

4. The second largest provider of micro-finance, which focuses on rural finance, is the government-owned AgrarCredit. AgrarCredit was created in 2001 with two mandates: collection of the problem loans of three failed state-owned banks; and acting as the on-lending agent for internationally funded agricultural credit programs. The government-owned Rural Investment Foundation (RIF), established using funds realized from the sale of agricultural commodities provided under EU food aid programs, was merged into AgrarCredit in 2003. The RIF had provided loans to about 750 rural borrowers.

5. Despite the presence of the two specialized government-owned institutions and 14 micro-finance organizations mostly owned and financed by non-government organizations and international donors, many areas of Azerbaijan do not have ready access to the formal financial sector. Bank branches are located only in urban centers, with the majority in the Baku area. Many of the 59 rayons are not served by any deposit-taking institution, and in some there is no non-bank credit provider. The post office provides some transactions services, delivering pensions and other social payments, and collecting utilities payments, although the availability of these services in rural areas is limited. Azeri Post intends to develop its capacity to deliver financial services, including basic savings and transactions services in its rural locations with assistance from the World Bank Financial Sector Development Project.

[10] The European Bank for Reconstruction and Development, International Finance Corporation, the Black Sea Trade and Development Bank, LFS Financial Systems GmbH, and KfW Development Bank.

Table A1. Azerbaijan: Formal Providers of Financial Services, end-2004.

	Credit Unions	Micro-finance[a]	Agrar-credit	MFBA	Banks[a]
Number	55	14	1	1	44
Service locations	80[b]	27	12	6	344
Borrowers	5,000[b]	45,489	—	2,813	—
Loans (manat billions)	18.8[b]	128.9	44.0	31.9	4915.4
Average loan size (manat millions)	3.8[b]	2.8	—	11.3	—
Deposits (manat billions)	0	0	0	0	5147.1

[a] Excludes MBFA.
[b] Estimated from Azerbaijan Credit Unions Association and NBA data. About 80 percent of licensed credit unions are members of the association.
Sources: NBA, Azerbaijan Micro-finance Association, Azerbaijan Credit Unions Association.

6. With the exception of FINCA, the larger micro-finance organizations target larger borrowers, with average loan size in the range of thousands of dollars, versus an average size of a few hundred dollars for most micro-finance borrowers (table A2). Microfinance has grown rapidly, with the number of active clients more than doubling to over 60,000 since end-2003. Credit unions, with about 5,500 members and $7.5 million in loans outstanding at end-September 2005, have shown similarly rapid growth. The driving force for expansion has been the availability of external finance as neither credit unions nor any microfinance organization in Azerbaijan has an internally sustainable funding base.

7. Savings and credit unions are in theory very well suited to bring formal financial services to under-served areas of the country, which is one reason why they have figured prominently in the design of major assistance projects in Azerbaijan. However, in addition to challenges specific to the establishment of credit unions, the broader distrust arising from the closure of over 150 banks since 1994 and the collapse of pyramid schemes have limited support for deposit-taking institutions. Further, much of the rural economy operates on a non-cash basis.

8. Recent trends in monetary aggregates indicates increasing monetization of the economy and increased use of the banking system, albeit from a very low base (Figure 1). Deposits as a percentage of GDP have increased significantly over five years. Cash (M0) relative to GDP has remained relatively constant, which could indicate that the efforts of the NBA to implement electronic payments system are bearing fruit. While there may be some movement away from cash as the exclusive payment mechanism, the relatively constant level of M0 must be interpreted cautiously, as dollarization has been increasing, evidenced by the increases in the foreign currency deposit component of M3. Thus, considering only the manat cash in circulation likely significantly underestimates the importance of cash transactions, many of which are conducted in dollars.

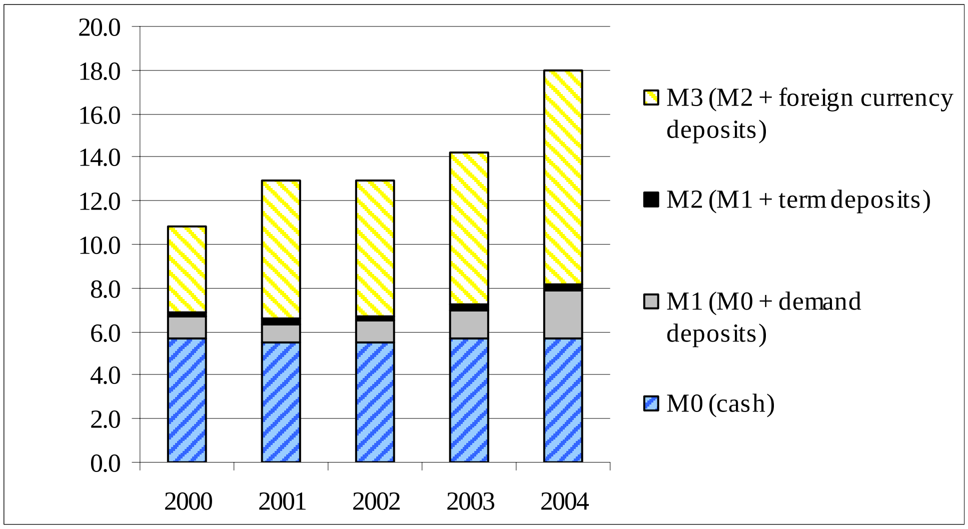
Table A2: Azerbaijan: Microfinance organizations,* end-September 2005

Organization	Active clients	Portfolio outstanding	Average loan size
ADRA Credit	2,394	$944,116	$394
AgrarCredit	3,813	$12,078,000	$3,167
Azeri Star (Save the Children)	3,655	$472,028	$129
CredAgro	1,026	$4,055,737	$3,952
Finance for Development (Oxfam)	2,868	$749,473	$261
FINCA	22,928	$7,818,437	$340
Itday-Credit	483	$84,940	$175
MADAD Credit (Relief International)	254	$146,630	$577
MFBA	4,900	$14,629,705	$2,985
Nakhchivan MicroCredit	1,257	$649,931	$517
Normicro	4,714	$1,510,712	$320
Shore Overseas Azerbaijan	313	$4,436,910	$14,175
Umid-Credit	511	$110,000	$215
Viator Microkredit Azerbaijan	5,721	$2,335,157	$408
World Vision AzerCredit	5,722	$2,199,411	$384
Total	60,559	$52,221,187	$862

* Excludes credit unions and licensed MFIs undertaking only wholesale lending or administering on-lending programs delivered through banks.
Source: Azerbaijan Micro-finance Association.

9. Despite the ongoing development of the financial sector and evidence of increasing public trust in financial institutions, and the potential for the savings and credit union model to be self-sustaining, credit unions are not well positioned to contribute to rural and microfinance development. Their history has created a number of obstacles, as there is considerable reluctance on the part of the regulatory authorities to see credit unions expand their range of product and services. The concept of credit unions is not broadly understood, and the experience to date indicates that building a true grass-roots cooperative movement will be a long term undertaking.

Figure A1. Azerbaijan monetary aggregates (percent of GDP)



Source: NBA 2004 Annual Report.

2. History of SCUs in Azerbaijan

10. The history of credit unions in Azerbaijan is very much the history of financing projects. The three principal drivers to date for the creation and growth of credit unions have been the European Union Technical Assistance to the Commonwealth of Independent States (EU TACIS) programs to support agricultural finance, the Social Fund for Development of Internally Displaced Persons (SFDI), and the World Bank Agricultural Development Credit Project.

11. Large numbers of credit unions were created from 1997 through the early part of 2000 solely to access external funding. When credit union legislation was introduced in 2000, followed by prudential regulations in 2001, only a small portion of the provisionally licensed credit unions obtained licenses (Table A3). Some credit unions made no attempt to obtain a license, while others were unable to meet the new standards. Recent expansion in the number of credit unions is on a sounder footing, however there are still significant concerns that the credit unions may not be sustainable in the long-term as the ability to access external funding is still the driving force for their formation.

Table A3. History of Credit Unions in Azerbaijan

1997	1999	2000	2002	2004
Credit unions first incorporated under the law on enterprises and provisionally licensed by NBA.	128 credit unions provisionally licensed	Only 38 credit unions licensed under new credit union law	28 active credit unions, total membership 760, assets of $689,000.	55 credit unions, total membership 5000, assets of $4.5 million.

a. TACIS Program

12. The first credit unions were established in Azerbaijan in 1997 in response to a TACIS program. The TACIS Regional Agricultural Reforms Project (RARP-1) was funded through the provision of agricultural products at no charge to the government of Azerbaijan, with the sale proceeds being used to support agricultural production. These funds were lent to commercial banks, and later to the newly created credit unions, at concessional rates (five percent) for on-lending to support agriculture. Repayment rates under RARP-1 and its successor project, Support for Rural Banking (SRB) were poor, with default by credit unions being especially high. Credit unions collectively borrowed almost one quarter of the funds disbursed under the two programs, but repaid only 1.4 percent (Table A4).

13. The main motivation for the establishment of the 128 credit unions licensed by end-1999 was to access RARP-1 and SRB funds. In almost all cases, despite the nominal cooperative ownership structure, in substance each credit union was controlled by a single person or family. The higher default rate of credit unions relative to commercial banks suggests that in many cases there may have been little or no intention to repay from the outset, with the formation of a credit union viewed as a vehicle to obtain grants. Even if there had been an understanding of the debt obligation, the commitment to repay government funds originating in a TACIS grant was likely not strong. The higher repayment rate for commercial banks may indicate that banks were more effective in establishing the debtor-creditor relationship with the end-borrower.

Table A4. Azerbaijan: TACIS support for agricultural finance 1998-2000 (manat millions)

	Disbursed		Repaid		Total disbursed (percent)	Repaid (percent of disbursements)
	RARP-1	SRB	RARP-1	SRB		
Credit unions	5,375	6,264	237	447	23.7	1.4
Commercial banks	35,153	2,328	13,592	946	76.3	29.6
Total	40,528	8,592	13,829	1,393	100	31.0

Source: ADB TA 4093AZE: Microfinance Sector Development Project.

b. Social Fund for Development of Internally Displaced Persons

14. The SFDI was established in 2000 to assist people displaced due to the Armenian conflict, with World Bank financial support provided under the Azerbaijan Pilot Reconstruction Project. The SFDI supplied financing to qualified institutions to provide micro-credit to internally displaced persons (IDPs). The basis of a common community bond existed among IDPs originally from the same or neighboring villages in the occupied territories, suggesting that a credit union would be a viable structure. From the perspective of the SDFI, community ownership offered the potential to create a mechanism that could be transferred to the occupied territories if conditions allowed the IDPs to return, and also meant that credit might be better directed within the community than would be the case for NGO administered micro-finance organizations.

15. Seven credit unions obtained just over $1 million financing from the SFDI, or about ten percent of the total support provided through this World Bank project. These seven credit unions benefited from a zero interest rate and grant financing for administrative expenses. Four of these seven credit unions are among the five largest credit unions at end-September 2005 (Nurane, Komak, Agroinvet and Amin), and are among those with the best potential for sustainability.

16. The requirement that credit unions bid in a tender process to obtain SFDI funds, in competition with other institutions, may have helped to avoid some of the earlier problems with the TACIS program. While credit unions were viewed as desirable institutions to on-lend, there were still requirements for field assessment and approval prior to disbursement. The small number of institutions used to on-lend the funds made it more practical to provide closer support and supervision than was the case with the TACIS funds.

17. The requirement that SDFI funds be lent only to legal persons created some challenges, as borrowers had to incur the costs to incorporate, and the original approach to credit union membership had focused on physical persons. In practice, lending to legal persons was generally a legal fiction as the individual small trader or farmer was for practical purposes the borrower, regardless of the legal structure.

c. World Bank Agricultural Development and Credit Project

18. Creating 80 credit unions was one of the objectives of the World Bank's Agricultural Development and Credit project, initiated in 2000. One of the lessons drawn from the TACIS experience was the risks of divorcing the responsibility for disbursements from responsibility for repayment. The World Bank sought to mitigate this through having the implementing agency assume 20 percent of the risk through co-financing. The intent was to establish over time an apex institution to support the credit unions formed through the project. It had been expected that one or more credit union or cooperative bank organizations would bid for implementing agency contract, but despite initial expressions of interest organizations such as Raiffeissen did not bid (although a Rabobank submission was not considered because it was received after the tender deadline). The implementing agency, G and G Consulting, performed adequately, but perhaps did not bring the breadth and depth of credit union development experience that might have been provided by another entity.

19. The initial program design called for the establishment of 100 borrower groups in addition to 80 credit unions. In light of experience, these objectives were revised in a mid-program review, with the target number of credit unions reduced to 30 and the number of borrower groups significantly increased. In the end, 30 credit unions were established and funds were also disbursed through 900 borrower groups, with a total of $11 million disbursed.

20. At the completion of the G and G Consulting three year term in June 2005, the role of implementing agency was transferred to the Azerbaijan Credit Unions Association, which purchased the G and G Consulting ownership stake in the Credit Implementing Agency. There are various perspectives on the future role to be played by the Credit Unions Association. Some clearly hope to develop it into an apex, providing training and centralized services to support credit union development. Leaders of credit unions do not have a unanimous view, and while some would support an expansion of the role of the Association, others view the Association solely as a lobbying vehicle and source of funding.

21. A key lesson from the experience with the Agricultural Development and Credit project is that overambitious targets led to the creation of entities that are credit unions in name only. It takes considerable time, probably longer than the lifespan of most development projects, to develop sound credit unions from scratch in countries with no history of cooperative enterprises, but this time-frame conflicts with the desire of those funding the project to disburse, and for the end-borrower to obtain much needed credit. In Azerbaijan, borrowers generally had no previous knowledge of cooperative credit organizations and looked at credit union membership as a necessary step to obtain credit. The realization that many credit unions only existed to meet the formal requirements to obtain financing through the program was one of the main reasons for the reduction in the target number of credit unions as the program progressed.

3. Regulation and Supervision

22. There was no legal foundation for credit unions when, due to the potential to attract external financing, they began to be established in 1997. Temporary licensing rules for credit unions were established by the NBA in 1998, with the NBA serving as the supervisory authority. The NBA was preoccupied with the larger problems of reforming the banking sector, and this, combined with a general lack of capacity within the NBA, resulted in a regime with little effective oversight of credit unions.

23. The potential for credit unions to on-lend SDFI funds, and the evident problems with credit unions on-lending TACIS funds provided incentive to formalize the regulatory framework. The law on credit unions was introduced in 2000 together with seven prudential norms. Close to 100 credit unions licensed under the temporary provisions either did not apply or did not meet the licensing requirements of the credit union legislation, and seven licenses were subsequently withdrawn by the NBA.

24. The legislation and prudential norms are notable in that they do not explicitly provide for the acceptance of deposits by credit unions. Although the World Bank Agricultural Development and Credit Project supported the drafting of the credit union law and contemplated that credit unions would achieve sustainability by raising deposits, to date there are no plans by the NBA to permit credit unions to raise deposits. This restricts credit unions to funding their activities with member shares and borrowed funds and has meant that the ability to mobilize savings, one of the key benefits expected from credit unions relative to many other micro-finance providers, has not been present in Azerbaijan. This reflects the lack of confidence in credit unions specifically, arising from the TACIS experience, as well as a more general concern about deposit-taking that is a hold-over from the large losses experienced by depositors in the collapse of banks in the 1990s.

25. The regulatory regime requires credit unions to meet seven prudential norms. The areas addressed by prudential requirements are not unusual, but some aspects of the prudential norms may inhibit development and work at cross-purposes to the general objectives of credit unions (Table A5). Some of these conflicts illustrate the difficulties in both encouraging development and ensuring a sound prudential foundation.

Table A5. Azerbaijan: Credit Union Prudential Norms

Norm	Requirements	Comment
1. Minimum share capital	20,000,000 manats	Approximately $400 per member if established by the minimum 11 persons
2. Minimum capital adequacy	0.5 percent for first six months, 0.25 percent thereafter	High requirement when there are no depositors to protect
3. Assets to liabilities	Not less than 1	Member shares effectively cannot be used to fund loans
4. Single borrower limit	10 times a member's share capital; single loan cannot exceed total CU equity	The 10 times share capital limit should be binding for any credit union with the required more than 11 members, unless different members own different amounts of shares
5. Limit on unsecured credit	Total unsecured loans cannot exceed 20 percent of CU equity	Intended to limit losses and abuses, but may limit the ability of credit unions to target the poor, who typically lack collateral
6. Capital reserves	Reserves must be no less than the total of overdue loans	Conservative approach to provisioning, but may be difficult for credit unions to earn enough to meet the reserve requirements
7. Classification of credit	Loan required to be classified in accordance with length of delinquency	Useful in assessing asset quality, but norm 7 requiring a reserve for the total of overdue loans should ensure conservative provisioning

26. Requiring minimum share capital in excess of $4,000 to establish a credit union can be an obstacle in a country with a per capita income of about $3,800. Even in developed countries, share requirements seldom exceed $100 per member, but to establish a credit union in Azerbaijan with the minimum of 11 members, each would have to contribute about $400. Individuals with access to this level of cash resources are not likely to require the small loans that such a credit union could provide. One consequence is that in some cases one or a few wealthy individuals lend the initial capital contribution to other individuals, and in effect control all the shares of the credit union even though on paper the requirement for 11 members is met. There is also an incentive for credit unions to be capitalized with “phantom” share contributions, with shares in fact deducted from loans financed with donor funds.

27. There are positive dimensions to the high share capital requirement. One is to encourage larger numbers of members. Obviously, having 100 founding members reduces the initial share contribution per member to a more manageable amount, although even the equivalent of $40 cash contribution is still significant in the Azerbaijan context. Another aspect is that the high initial share contribution may help to encourage good governance from the outset, as members should take a keen interest in the operations of an entity in which they have a significant financial stake. This is true even in cases where the credit union is effectively controlled by one or a few individuals, although in these cases the concern of the promoters to earn a return on their investment may not be wholly consistent with credit union principles and objectives. Despite this, at a minimum they should have an incentive to ensure sound lending practices.

28. It could also be argued that even the current minimum share capital requirement is not high enough. Sustainable credit unions need to make an investment in infrastructure—basic systems for financial management, credit risk assessment and record-keeping. This issue was in part addressed by the grants provided to credit unions under the SDIP program to support a basic computer-based system. Without such grants, however, even $4,000 in start-up capital may not be enough to put the credit union on a sound footing from the outset.

29. Credit union leaders view the capital adequacy requirements and limits on unsecured lending as unnecessarily restricting the growth of credit unions. In the absence of deposit-taking there is no clear prudential rationale for the high capital adequacy requirements. However, these requirements do reflect concerns that credit unions should be conservatively managed and a view that regulatory restrictions can in some way substitute for the lack of skilled management and the general lack of capacity of members and directors to exercise effective oversight of credit union operations. The problem with this approach is that it can unduly restrict those credit unions able to develop sound managerial capacity and governance, while at the same time likely proving ineffective in restricting the activities of credit unions with poor management or weak governance as restrictions are ignored or circumvented.

30. Credit unions are required to submit quarterly reports to the NBA, which also conducts a program of on-site inspections. Resources devoted to non-bank institutions, although less in terms of staff and budget than those devoted to banks, are disproportionately large in terms of the systemic risk elements. This reflects the conundrum of supervisors, as even with a risk-focused approach, any licensed entity requires a certain minimum level of supervision, so a number of small institutions is disproportionately more expensive to oversee.

31. The NBA’s concerns about a general lack of management skills, internal systems and governance makes it extremely reluctant to consider provision of deposit-taking powers to credit unions. Development of micro-finance regulation is a higher priority than credit unions for the

NBA. However, as with credit unions these are viewed by the prudential supervisory primarily as a means of channeling donor and sophisticated investor funds into rural and micro-credit. Experience with pyramid schemes and bank failures contribute to a reluctance by the by NBA to support the development of self-funding micro-credit organizations.

4. Lessons from the Experience

32. The specific experience in Azerbaijan gives rise to some lessons that are more broadly applicable. In common with the experience in other countries, it has proven a substantial challenge to create a cooperative credit institution when there is no history of cooperatively owned institutions.

33. Individual credit unions, especially in the start-up phase, can be too small to support the necessary infrastructure to manage even a very simple financial institution. There has been some success in Azerbaijan with grant-financed support for those credit unions that bid successfully for SDFI funding, however, this is quite costly given the small size of individual credit unions. Use of an apex organization to gain some degree of standardization and economies of scale is the commonly seen approach to trying to make provision of the necessary training and equipment cost-effective when dealing with small institutions. However, in Azerbaijan as in many other countries, there is something of a “chicken and egg” problem, as a reasonably sized credit union system is required to support an apex, but in a country without credit unions, an apex may be needed to foster development of credit unions.

34. The experience in Azerbaijan illustrates the pitfalls of using “provisional licensing” to permit credit unions to be established and access external funds prior to the implementation of a sound legal basis to regulate credit unions. Many credit unions were created only to access external funds, and the lack of effective oversight increased the scope for abuse. This early unfavorable experience undermined support for credit union development within the supervisory authority, which makes the implementation of later efforts more difficult, even when better conceived

35. Establishing credit unions to deliver external financing invites abuse and in Azerbaijan has done little to foster the development of true cooperative institutions. This raises the question of whether programs to provide external finance can be structured in a way to truly promote credit union development. External financing is contrary to the core concept of sustainability through mobilization of savings. In the absence of the ability to mobilize savings, there is little to distinguish credit unions from other providers of micro-finance, save for an ownership model which may be difficult to truly promote. This raises the broader of question of whether there is any value in the model of a credit union that does not mobilize savings. Channeling donor, government or wholesale funds is likely to be more efficiently undertaken by larger institutions such as banks, or professionally managed micro-finance organizations, rather than newly created institutions that are cooperatively owned in name only, and generally lacking in professional management and good governance.

B. People’s Republic of China

36. Within East and Central Asia, the PCR is unique because rural credit cooperatives (RCCs) have a history of over 50 years, while in the other three countries SCUs are newly created. RCCs also play a comparatively much larger role in deposit mobilization, accounting for about 10 percent of total banking deposits in China, and a much larger share in rural areas. As with the other countries included in this study, the cooperative nature of RCCs largely exists in

name only. Any notion of RCCs being truly member owned and controlled has been undermined though intervention by local government, several rounds of top-down reform and utilization of the RCCs as vehicles for delivery of policy loans and subsidized (agricultural) credit.

37. Since cooperative ownership of RCCs is notional rather than factual, there are clearly questions raised about governance of the RCCs and the potential for abuse by the individuals or local governments that control RCCs in practice. These appear to have been recognized in the latest reform program, although it remains to be seen if the transformation of some RCCs into rural and cooperative banks and making the other RCCs branches of newly established unions of RCCs will be effective in dealing with these issues.

1. Context for Credit Union Development: Financial Sector Overview

38. Banks account for about 90 percent of the total assets of all financial institutions in the PRC. The four state-owned commercial banks (SOCBs) collectively have more than half of all banking assets, with the Industrial and Commercial Bank of China being the largest with close to 20 percent of banking assets. The three other SOCBs are roughly comparable in size with total assets in the range of RMB 5 billion. It is significant that both urban credit cooperatives (UCCs) and RCCs are included in the official banking statistics. This reflects the fact that cooperative ownership of these institutions has long been only notional, that the reform program for UCCs and RCCs has significant parallels with the reform of the SOCBs, and that the same prudential regime applies to the RCCs (and their successor rural cooperative and rural commercial banks) as applies to other banks.

Table A6: PRC Banking Sector end-2005

	Number	**Assets (RMB billions)**
Policy banks	3	5,512
State-owned commercial banks	4	19,658
Joint-stock commercial banks	13	5,813
City commercial banks	115	{2,110
Urban credit cooperatives	626	
Rural credit cooperatives	30,438	
Rural cooperative/commercial banks	57	{3,626
Rural credit cooperative unions	325	
Establishments of foreign banks	238	749
Total	31,494	37,468

Sources: PBC, CBRC.

39. The Post Office Savings Bank, established in 1989, has a network of over 32,000 agencies providing deposit-taking services in all areas of the country. There is also a wide range of non-bank financial institutions, including at end-October 2005, 59 trust and investment companies, 74 finance companies, 12 financial leasing companies, 5 specialized automobile finance companies. There were 1381 listed companies at end-October 2005, with total market capitalization equivalent to less than 5 percent of banking assets. Development of the capital markets has been hampered by uncertainty regarding government's intentions with respect to the non-traded shares that comprise the bulk of the equity of listed companies as well as by poor disclosure and transparency on the part of listed companies, and problems in a number of

brokerages. The insurance sector has been growing rapidly but the 22 life insurance and 35 general insurance companies still account for less than 5 percent of financial sector assets.

40. The situation in rural areas is significantly different than the country-wide overview of the financial services sector would suggest. While the RCCs and their successor rural cooperative and commercial banks account for about 10 percent of total banking assets, they held 85 percent of all agricultural loans outstanding at end-2004. In many rural areas the RCCs are the only institution offering credit products, although there is more competition in the provision of deposit services. Since reform of the Agricultural Bank of China (ABC) began in the 1980s it has focused on commercially more attractive investments by curtailing its lending activities in agriculture and rural areas, although still raising deposits in the now reduced rural branch network. The other state-owned commercial banks have all withdrawn from rural areas as part of the ongoing reforms. The Agricultural Development Bank of China is a policy bank, but does not provide financing for small enterprises and individual farmers, and the Post Office Savings Bank does not make loans.

41. Microfinance was first introduced on a pilot basis in the PRC in 1994 and several hundred microfinance operations have since been tested. Given the size of the country, even hundreds of projects hardly register on the scale of formal providers of financial services. Typically the programs are collaborations involving international donors and Chinese government, financial or research institutions.[11] Since microfinance organizations are not permitted to mobilize savings, they are dependent on donor or government funding. The experience to date has been mixed, with some demonstrating good repayment records at interest rates well above the then existing official lending rates for banks, however the number of microfinance organizations has actually declined, with some being wound up due to problems with fraud and mismanagement.

42. The removal in 2005 of the ceiling on lending rates increases the possibility that market-oriented financial institutions will fill the gap in rural finance. Previously, it was not possible for banks to charge rates that reflected the higher perceived risk in rural lending relative to the commercial lending in the urban areas. However, banks and RCCs are still under significant pressures to lend to projects identified by governments at various levels and there is moral suasion to provide affordable credit, so it remains to be seen if the result of formally removing the interest rate ceiling actually is more credit provided, albeit at the higher price reflecting perceived risk.

2. History of RCCs

43. RCCs were established throughout the PRC in the 1950s although they have long been cooperative in name only. Individuals often purchased shares only because of administrative pressures, and given the long history of losses in RCCs there were generally no profits to be distributed to members. Shareholders in RCCs are nominally responsible for the losses of the cooperative as well as being entitled to its profits, however, in practice the shareholders drifted away and the losses were borne by government.

44. When the ABC was re-established in 1979, the RCCs came under its oversight. Each RCC was regulated by the local branch of the ABC, and required to hold 13 percent of its deposits as reserves with the ABC. Although nominally controlled by its shareholders, each RCC was effectively subject to the control of the ABC.

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[11] Park, Ren and Wang (2004).

a. Previous Reforms

45. Earlier attempts to reform the RCCs began in 1996 in conjunction with the reform of the ABC. The RCCs were removed from the ABC network and placed under the supervision of the PBOC. The intent of this first reform was to turn to RCCs into true cooperatives which would be financially viable and better able to support agriculture. However, the RCCs continued to operate with an implicit government guarantee and remained highly dependent on centralized financing activities. Cooperative ownership remained notional, with the result that the RCCs were controlled by the managers appointed by local government. RCCs were also subject to oversight by the PBOC which extended beyond supervision to direct input into management, and also by the CBRC following its establishment in 2003.

46. As the ABC withdrew from the countryside, the RCCs became the most important source of credit in rural areas. By 2001 RCCs accounted for 78 percent of all agricultural credit, while in 1979 the ABC had provided three-quarters of agricultural credit.[12] However, the growth in the RCC agricultural credit portfolio was outstripped by other lending, so that in 2001 credit township and village enterprises (TVEs) comprised almost 80 percent of the RCC's portfolio. This highlights the concern expressed by many officials over the insufficient supply of agricultural credit as well as one of the major weaknesses of the RCCs. Many of the TVEs were not viable, but the RCCs were influenced by local governments to provide financing support, which in part contributed to the poor financial condition of RCCs. The policy of providing inflation protection for savings deposits from 1994 to 1997 also contributed to the accumulated losses of RCCs, which were directed to pay higher savings rates to depositors while being prohibited from increasing loan rates.

47. The initial efforts to reform the RCCs were largely unsuccessful as the fundamental problems were not addressed. Chief among these were: lack of clear ownership; blurred lines of official responsibility among local government, the PBOC and CBRC; conflicting mandates; and poor management.

b. The Current Reform Program

48. The current reform program began as a pilot in seven provinces and one municipality in 2003. The objectives were to clarify the ownership structure and strengthen governance of the RCCs, transfer administrative responsibilities for the RCCs to local governments and to deal with the accumulated financial problems of the RCCs. In concept, the approach is similar to that already employed for the reform of the SOCBs and UCCs, involving measures to deal with both the existing stock of non-performing assets and reforms intended to check the flow of new non-performing assets. However, it is an open question whether the intended measures are adequate in practice.

49. After less than a year, which provided no real opportunity to assess progress with operational restructuring, the pilot program was declared a success and rolled out in 2004 in all provinces and regions (except Tibet Autonomous Region, which has no RCCs). Key elements of the program address operational restructuring and financial restructuring, however, the best developed part of the program appears to be the plans to legally re-organize the RCCs into banks and unions, while there is considerably more uncertainty about how the operations of the RCCs can be fundamentally changed. Given that the financial support provided by the PBOC covers only half of the accumulated losses, successful financial restructuring will require new

[12] Zhang (2004).

equity investment in the RCCs, perhaps by local governments or domestic or foreign investors, and/or very significant recoveries on impaired assets. For most RCCs, this may not be a realistic expectation.

50. The key element of the operational restructuring is the consolidation of RCCs into larger units which would be transformed into different types of financial institution depending on local conditions. Individual RCCs will be merged into RCC unions (RCCUs) at the county level. Stronger RCCUs would then be transformed into rural commercial banks (typical for Eastern regions), medium performers would be transformed into rural cooperative banks (typical for Central regions), and weaker ones would remain consolidated RCCUs (typical for Western regions). Each regional government is responsible for driving the reform process, and the steps required to quality for financial restructuring assistance are intended to provide incentives to ensure that the operational reforms are actually implemented.

51. RCCUs can quality for financial assistance by having their reform plan approved by the CBRC. If approved, RCCUs receive "redeemable bills" from the PBOC equivalent to half of the losses accumulated to end-2002.[13] Qualifying RCCUs are also eligible to receive cash payments from the PBOC in compensation for losses incurred providing inflation protection from 1994 to 1997. Provided restructuring targets are achieved, at maturity the bills are to be redeemed for cash. Thus, to quality for the first stage of financial assistance there has to be an acceptable plan to reform the RCCU, and to quality for the second stage, the agreed targets, which include achieving specified levels of profitability and success in reducing the volume of non-performing assets, have to be met.

52. The focus on both operational and financial restructuring, and making financial assistance dependent on achieving specified milestones, is widely recommended in bank restructuring to ensure that the underlying problems of the financial institution are actually addressed. However, this incentive system can only work properly with well conceived milestones and accurate reporting of performance. Requiring improvements in NPL ratios is a laudable objective, however, it appears that many RCCs are meeting this objective through rapid growth in the portfolio rather than by an actual reduction in NPLs. Without evidence that lending practices have improved, the risk is that new losses will quickly wipe-out the new equity.

53. Lack of clarity of ownership and objectives that are not necessarily consistent with commercial viability have been perennial problems with RCCs, and it is not clear that these are addressed in the current reform. RCCs have long been cooperative in name only, and are effectively controlled by local governments. Pressure for policy loans to support various local initiatives seems likely to continue as the RCCs are restructured into RCCUs and banks. Seeking outside investors is one way to address this issue, but as with the reform of the UCCs, only a small portion of the resulting commercial and cooperative banks are likely to attractive to foreign investors.

54. If financial performance does not actually improve, once the one-time payments for inflation-protection losses have been received, the RCCs will continue as they have for many years to consume deposits to cover their operating losses. RCCs were officially reported to have returned to profitability in 2004, for the first time in 10 years. However, analysis of available data suggests that profitability is largely due to the cash payments by the PBOC for the "inflation protection" losses, and that there has been little or no real improvement in operating efficiency.

[13] The transaction is structured as a sale of non-performing assets to the PBOC, with the purchase price paid in redeemable bills. The RCC continues to manage the non-performing assets

Even though employees may have contractual incentives to ensure the RCC achieves high rates of loan repayment, deposit mobilization and profitability, in the absence of effective monitoring and oversight the targets are often not met despite financial reporting that would indicate otherwise. Rolling over or "evergreening" loans is common, which means that the performance objectives are met on paper while in fact large losses are accumulated.

55. The scale of the problem is huge, with some 30,000 RCCs to be addressed. There is an enormous demand for the commercial banking skills required to successfully manage reformed RCCs, and it is far from clear that the necessary management expertise is available. The reform program reduces complexity by substantially reducing the total number of financial institutions under supervision and by giving a clearer perspective on the ultimate regulatory and supervisory regime, which will be the same as for other banks. However, merging RCCs into larger units rather than resolving the weakest RCCs before the consolidation may have undesirable long-term effects as it will create a number of weak banks, at least some of which will ultimately prove to be unviable.

c. Progress to Date

56. Although progress is being made with the legal reorganization and consolidation, implementing fundamental change in the management of the RCCs is proving a daunting task, as "the fundament problems of inadequate risk controls, poor corporate governance and a shortage of qualified staff have yet to be solved."[14] The reported profitability and improvement in asset quality of the various rural financial institutions has clearly been over-stated given the public statements by the CBRC regarding the need to correct the fraudulent inflation of reported capital adequacy by RCCs.[15]

57. The ADB is providing technical assistance to support RCC reform and microfinance development in Guizhou province and Inner Mongolia Autonomous Region. Work to date has confirmed the challenges inherent in the design of the reform program and in establishing microfinance sustainable microfinance organizations. Technical assistance can address the need for capacity building, but this will have limited effectiveness if the fundamental problems of ownership and governance are not satisfactorily resolved or if the financial support for restructuring proves inadequate.

58. At end-October 2005 10 rural commercial banks and 41 rural cooperative banks had been established, with a further 9 approved but not yet incorporated. A total of 325 county level RCCUs had been established, and a further 200 approved.[16] Discussions have been ongoing with Rabobank, Australia and New Zealand Banking Group and the International Finance Corporation regarding the purchase of an ownership stake in rural banks in Tianjin, Huangzhou and Shanghai, although it is significant that the banks attracting foreign interest are rural in name only, as they are located in major urban centers. There will be little interest by foreign investors in the vast majority of the rural financial institutions.

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[14] Tang Shuangning, Vice-Chairman of the CBRC, quoted in "Rural credit co-ops give China a headache" Reuters, March 1, 2006.

[15] Statement by Vice Chairman Tang Shuangning, available at http://www.cbrc.gov.cn/mod_en00/jsp/en004002.jsp?infoID=2337&type=1

[16] China Banking and Regulatory Commission "Latest Developments in China's Banking Reform, Opening-up and Supervision," December 5, 2005.

C. The Kyrgyz Republic

59. Efforts to develop SCUs as key suppliers of rural finance in the Kyrgyz Republic have been very successful in terms of the formation of credit unions and attraction of members, but less successful in creating the supporting infrastructure for sustainability. A small number of credit unions appears to have the potential to be sustainable, but the majority of SCUs exist only because of the availability of ADB provided external financing. Since credit unions are not licensed to accept deposits, most are dependent on external financing. An apex organization or central credit union has not emerged to provide services and ongoing development support for credit unions. A credit union law and economic norms are in place, but the envisioned system of off-site and on-site supervision and enforcement of economic norms is not functioning effectively.

1. Context for Credit Union Development: Financial Sector Overview

60. Although commercial banks dominate the financial sector in terms of assets, all components of a developed financial sector currently exist in the Kyrgyz Republic, albeit at an embryonic stage. There are three stock exchanges, but only six listed companies. About 400 other joint stock companies are traded. The government debt market is very small, and the 12 insurance companies earned premiums in 2004 equivalent to about 0.2 percent of GDP. The only domestic life insurer failed in 2003, and there is a single private pension fund. Apart from more than 320 credit unions, more than 130 microfinance institutions operate in the country.

61. The Kyrgyz banking sector comprises 20 commercial banks, 10 of which have significant foreign ownership. In addition to the government-owned Savings and Settlement Company (SSC), there are two banks with a branch network covering most regions of the country. The average loan size for commercial banks (excluding micro-finance programs) is equivalent to about US$6,600, so even large loans in the Kyrgyz Republic tend to be quite small by international standards. This is quite consistent with an average bank size of about $20 million total assets and $3 million capital. The small average size of Kyrgyz banks contributes to high operating costs and inefficiency, with spreads between lending and deposit rates averaging more than 22 percent for domestic currency loans. Despite recent increases, bank deposits are equivalent to only about 9 percent of GDP. Cash is still the primary means of payment. This suggests that there is still an overhang of distrust of the banking system arising from the collapse of many banks after rapid expansion in the 1990s.

62. The distinguishing feature of the Kyrgyz Republic financial sector is the wide array of formal providers of microfinance, many with extensive penetration in rural areas. In part, this is due to three specific policy initiatives in the mid-1990s intended to expand financial services in rural areas:

(i) SCU development, supported by the ADB rural financial program, has resulted in the establishment of a large number of SCUs, although only a small proportion of these are sustainable.

(ii) The National Bank of the Kyrgyz Republic (NBKR) established the SSC to provide transfer and savings services throughout the country. The SSC began operations in July 1996 from a network of branches formerly belonging to collapsed state-owned banks. The SSC has a branch in every district and a regional office in each oblast, and a network of agencies operating in about 1000 post office branches. The SSC will engage in microfinance lending starting in 2006.

(iii) The Kyrgyz Agricultural Finance Corporation (KAFC) was established in 1996 as a state-owned joint-stock company and began lending operations in 1997. Aided by considerable international technical assistance and funding, KAFC quickly grew into the largest single provider of credit in the country. Privatization is scheduled for 2006.

63. The total of microfinance credit extended in the Kyrgyz Republic (including that provided by five commercial banks through 44 lending outlets supported by the European Bank for Reconstruction and Development (EBRD) Micro and Small Enterprise Finance Facility (MSFF) and an additional lending facility provided by the ADB), is equivalent to two-thirds of the conventional bank credit outstanding (Table A7). This is in sharp contrast to the usual situation of microfinance amounting to only a small portion of formal credit in the economy. While this can partly be explained by the nascent state of bank development, it is mainly due to efforts to stimulate rapid growth in microfinance. Many of the credit unions and microfinance organizations are very small, and a shakeout or consolidation is inevitable, as these organizations will have to grow to more sustainable sizes, or wither when financial incentives and technical assistance are reduced.

Table A7: Kyrgyz Republic: Formal Providers of Financial Services, end-2004.

	SCUs	Micro-finance organizations	KAFC	SSC	Banks (MSSF)[a]	Banks[b]
Number	305	104	1	1	5	19
Service locations	305	120[c]	54	48[d]	44	112
Borrowers	21,650	41,900	36,300	0	8,707	17,542
Loans (som millions)	440	785	1,528	0	470	4,813
Average loan size (som 000s)	20	19	42	—	54	274
Deposits (som millions)	3	0	0	414	0	7,569

[a] EBRD Micro and Small Enterprise Finance Facility

[b] Commercial banks excluding Savings and Settlement Company (SSC), exclusive of MSSF program.

[c] Estimate: Most microfinance organizations have only one location. The four largest (FINCA, Bai-Tushm, Kompanion and Leasing-Mortgage Company) account for 85 percent of loan volume.

[d] Excludes agency offices in 1,000 post offices, which accounts for about 3 percent of SSC deposits.

Sources: NBKR, SSC.

2. History of SCUs in the Kyrgyz Republic

64. The driving force behind the development of SCUs in the Kyrgyz Republic was the ADB Rural Finance Institutions Project, initiated in 1997. The key objectives of the project were to establish 280 credit unions across all regions, supported by an apex organization, which in addition to supporting the development of credit unions would also undertake the supervisory function. Grant and loan financing was provided for technical assistance, and a credit line for on-lending to SCUs. Although the numerical targets for establishing credit unions were met (table A8), relatively few appear to be sustainable, and neither the intended apex organization nor effective supervision has been put in place.

65. The gross number of credit unions established since 1997 is over 400, with in excess of 100 having either been closed by the NBKR or voluntarily wound-up. The motivation for the formation of many of these credit unions was to access external funding through a credit line, administered by the Financial Company for the Support and Development of Credit Unions (FCCU). Although notionally cooperative, in practice many SCUs are controlled by an individual or family or small group of individuals. Reported financial performance of credit unions is impressive, with return on assets of almost 15 percent for the system overall in 2004, and non-performing loans of only 2.5 percent of the total portfolio. However, there are concerns that some credit unions are misreporting in order to remain eligible for FCCU funding, and that some were formed only to obtain FCCU financing utilizing phantom member contributions. Estimates vary, but at least one hundred SCUs are not viable due to either fraud or incompetence, and perhaps only 40 to 60 or about 15 percent of the total would prosper without external support.

66. SCUs in the Kyrgyz Republic currently operate largely as micro-finance organizations because they do not mobilize deposits. With the exception of a pilot project that ended in 2004, the NBKR has been reluctant to authorize deposit mobilization, with the result that SCUs by law are limited to funding themselves with member shares and external financing.

Table A8. Kyrgyz Republic: Development of Credit Unions

	1997	1998	1999	2000	2001	2002	2003	2004	2005 Q2
Number	3	83	166	191	275	350	303	304	310
Members	76	2,849	7,350	11,085	21,313	24,979	24,688	27,707	28,972
Borrowers	42	n.a.	n.a.	n.a.	16,361	18,700	19,134	21,650	23,124
	(som 000s)								
Total assets	n.a	14,994	54,715	101,905	242,382	265,345	317,232	487,554	587,533
Loans	431	13,875	49,490	95,398	227,418	244,247	283,907	440,244	535,071
Deposits	--	--	--	--	--	--	17	2,554	544
External funding	186	4,903	19,583	35,087	88,136	91,285	122,259	215,396	290,508
Share capital	245	8,509	28,991	49,199	117,596	126,720	138,278	160,720	171,962
Institutional capital	--	--	--	1,154	5,720	12,714	26,313	43,940	93,189
Total capital	245	8,509	28,991	50,353	123,315	139,433	164,510	204,660	265,151

Source: Financial Company for the Support and Development of Credit Unions.

67. FCCU, which is fully owned by the NBKR, was established to provide the foundation for an apex organization. The FCCU initially served to provide training and development support for individual credit unions, to administer the ADB on-lending program which enabled SCU to borrow amounts matching their total member share capital, and to undertake supervision of individual SCUs. By the end of the ADB project, FCCU was intended to become an apex organization providing the full range of credit, payment, and treasury services for SCUs, with the expectation that FCCU would then be privatized, preferably through sale to individual SCUs.

68. FCCU exits currently only to administer the ADB on-lending program. Performance in the early years of the project was cause for serious concern due to increasing problems of non-performing loans to SCUs and high operating costs. FCCU's operational performance has improved since 2004. However, much of the improvement in asset quality and operating efficiency was due to rapid growth of the loan portfolio rather than reductions in non-performing loans or expenses. FCCU's profitability arises from the spread of about 15 percent between the interest it pays to the Government for the ADB credit line and the rate charged to borrowing SCUs.

69. It is not clear that the leaders of SCUs view FCCU as the best option to provide needed apex functions such as training and development, liquidity management and information technology support. Creating a new SCU owned entity to provide apex services, or purchasing the services from banks or the SSC is frequently seen by SCU leaders as a more cost-effective options than purchasing and reforming FCCU. There are currently three associations of credit unions in the Kyrgyz Republic, which have somewhat divergent views on the best course of action vis-à-vis FCCU and with regard to SCU sector development in general.

70. In addition to the ADB program, the German Corporation for Technical Coopeation (Gesellschaft fuer Technische Zusammenarbeit; GTZ) and the Soros Foundation provided support for credit union development. Soros Foundation invested in training and the development of manuals for SCUs. GTZ participated in a multi-year capacity-building program for FCCU and selected SCUS, which included work with 10 pilot credit unions to develop a deposit-taking system. The deposit-taking pilot project was viewed as successful by the SCUs and GTZ, as it built capacity in SCUs and developed a licensing mechanism. However, the NBKR declined to issue permanent deposit-taking licenses on the grounds than none of the credit unions was able to meet the licensing requirements. Central payment services and liquidity management also remained issues, as FCCU did not develop the capacity to provide these services.

71. Costs incurred to date to develop the SCU sector in the Kyrgyz Republic have been substantial. The disbursed loans and grants are equivalent to about 90 cents of every dollar of SCU assets (Table A9). While the loans are repayable and thus at least in theory not outright expenditures for SCU development, failure by SCUs to repay the on-lent ADB funds will have adverse fiscal implications since the Government will have to repay the ADB loan regardless of the repayment capacity of SCUs and/or FCCU.

Table A9. Kyrgyz Republic: Financial Support for Credit Union Development ($US)

	Total
ADB Rural Financial Institutions Project (credit-line and capacity building for FCCU)	9,949,000
ADB Grant for capacity building (in FCCU, NBKR, and SCUs)	555,000
GTZ (capacity building in SCUs and FCCU)	3,500,000
Soros Foundation (credit union manual and training)	n.a.
Total	14,004,000

Source: Asian Development Bank estimates.

72. Government faces difficult decisions as the ADB project concludes. About 40 to 60 credit unions are likely viable as micro-finance organizations. A fraction of this number are truly member-owned financial institutions, with the balance being effectively controlled by one or a few individuals operating under the legal structure of an SCU due to the benefits of being able to attract external finance. The current legal framework and approach to supervision is not conducive to the growth and development of these organizations, but has also not effectively addressed concerns about the large number of credit unions that may not be financially viable.

3. Regulation and Supervision

73. SCUs are governed by the 1999 Law on Credit Unions and prudential norms established by the NBKR pursuant to the legislation. One of the challenges from the outset was the

divergence between the ADB program design, which stressed the necessity of SCUs becoming self-sustaining through the mobilization of deposits, and the NBKR reluctance to have credit unions raise deposits. There were several reasons for the NBKR's position:

(i) A general concern that SCUs provided a ready vehicle for promoters of pyramid schemes and other fraudulent activity.

(ii) Specific concern that many SCUs were in fact controlled by individuals or small groups, and existed primarily to access the ADB credit line.

(iii) Specific concern that the FCCU did not exercise effective oversight, coupled by reluctance on the part of the NBKR to assume supervisory responsibilities directly due to the resource requirements and potential for blame should there be major losses in SCUs.

74. The concerns were real, so the cautious approach to providing deposit-taking powers was not unfounded. The difficulty is that no system of regulation and supervision can actually prevent fraudulent activity, and a restrictive regulatory regime impedes the development of legitimate SCUs. Most of the prudential standards established are quite appropriate, but others, such as the restrictions on external borrowing and on the raising of deposits, exist only to attempt to use prudential standards as a substitute for effective governance and controls.

75. Despite extensive technical assistance there is still no effective supervision of SCUs in the Kyrgyz Republic. The original program design envisioned that the FCCU would exercise most supervisory authority under the overall direction and responsibility of the NBKR. This was intended to replicate the role played in many countries by a system-owned auditing association or stabilization fund, which was predicated on the WOCCU model of savings mobilization requiring prudential oversight to protect unsophisticated depositors.

76. When the anticipated system of on-site and off-site supervision by FCCU was not implemented some five years into the program, a decision was taken to transfer responsibility for supervision to the NBKR, in effect revoking the delegation of powers that had initially been established. The NBKR approach, developed with technical assistance but not yet fully implemented, can be characterized as "bank-like," incorporating a regime for off-site and on-site supervision similar to that employed by the NBKR in bank supervision. This approach is common when dealing with SCUS that mobilize deposits and effectively operate as cooperatively owned banks. However, SCUs in the Kyrgyz Republic operate more like micro-finance organizations, financing their lending with member shares and external credit lines.

4. Lessons from the experience

77. The experience in the Kyrgyz Republic has significant parallels with the experience in Azerbaijan and Mongolia. External financing is a strong incentive for groups or individuals to form SCUs for the sole purpose of accessing external funds. In most cases the founders of these credit unions have no interest in employing their own savings or developing a truly member-owned financial institution. Thus, rather than helping cooperative institutions grow, in the Kyrgyz Republic as well in other countries, the potential to access external funds in many cases eliminated any incentive to create cooperative institutions.

78. Some of the lessons from the Kyrgyz experience arise uniquely from the nature of the project. A continuing issue throughout was inadequate oversight of the management of FCCU,

arising in part from the NBKR's perception that it was the owner of FCCU in legal form only. The NBKR tended to view FCCU as a vehicle for the implementation of government policy for the development of credit unions, a function lying outside the narrow mandate of the Central Bank. This divergence between legal structure and policy implementation hampered attempts to address issues as they arose, because government would look to the NBKR as the owner of FCCU to take the initiative and make decisions, while the NBKR looked to government for leadership. One result was slow decision-making followed by inadequate implementation.

79. The chasm between the legal ownership of SCCU and the policy decision-making process combined with the incentives for government and parliamentarians to produce an environment where there was little impetus to address identified problems with the ADB program. Many parties had an interest in maintaining the flow of on-lending funds to SCUs, but no entity within government was anxious to assume the responsibility for the program, especially as concerns began to emerge over the quality of the FCCU loan portfolio.

D. Mongolia

80. Initial efforts to create SCUs in Mongolia were successful in establishing a small number of truly member-owned and focused organizations. Many of the SCUs established in 1996 and 1997 appear to continue to operate well, but the fact that these can only be said to "appear" to operate well is telling. A legal framework for regulation and supervision has not been established in the ten years since the first SCUs were formed, and one consequence is that detailed financial information on SCUs, or even very basic data such as the number of operating SCUs, is not available. By all accounts, the number of credit unions has expanded at a rapid rate, but much of the recent growth is in no way an indication of successful establishment of an SCU sector.

81. The legal form of an SCU has become attractive as a means to avoid the consequences of improved regulation and supervision in other parts of the financial sector. Existing financial businesses such as pawn shops have registered as SCUs to avoid being subject to the provisions of the other laws. While prudential restrictions on insider transactions and the improving quality of bank supervision make it more difficult to operate "pocket banks," a number of SCUs appear to have been created to fulfill this role. Despite their nominal cooperative ownership, in substance they are controlled by commercial interests, and appear to exist largely to raise deposits to provide financing to related businesses.

82. Of approximately 700 SCUs registered at end-2005, perhaps 300 are in actual operation, with only a fraction of these operating as truly member-owned financial institutions. The growth in deposits held by SCUs, which at end-2005 is estimated to be equivalent to eight percent or more of the total deposits of the banking sector, is a serious policy concern. Much of the growth appears concentrated in organizations that are SCUs in name only, which heightens concern that depositors' funds may be lost through poor investments or outright fraud.

1. Context for Credit Union Development: Financial Sector Overview

83. Despite the small population and low population density Mongolia is well served by formal financial institutions compared to other countries at similar stages of economic development. The 17 licensed banks comprise by far the largest portion of the financial sector, although the number of non-bank financial institutions has grown rapidly, with 37 new licenses granted in 2005, bringing the total of licensed NBFIs to 150.

84. The Mongolian banking system has been significantly reformed through privatization, with only one bank (Savings Bank) remaining majority state-owned, and four banks having significant foreign ownership. A broad range of products and services are offered, including credit and debit cards, ATMs and telephone and internet banking, although deficiencies in communications infrastructure and lack of rural electrification limits the penetration of non-cash payment methods and electronic banking to urban areas. The quality of regulation and supervision has improved, however, questions remain about the quality of management and potential abusive self-dealing by parties related to banks.

85. Three banks have very broad outreach, with Mongol Post Bank and Xacbank having branches in all aimags, and Xaan Bank having branches in 20 amaigs as well as numerous smaller outlets covering the entire country. At end-2004, over 50 percent of Xaan bank's loan and deposit business was in rural areas. Both Post Bank and Xacbank are expanding their rural branch network, and Xacbank has a rapidly growing "franchising" program which brings Xacbank services to suoms in conjunction with local SCUs. Average loan size of both Xaan Bank and Xacbank is around $US 600, reflecting a high proportion of micro-credit and SME lending in the portfolio of both banks.

86. The role of SCUs in the financial sector must be cautiously interpreted due to the lack of hard data. Credit unions are required only to report to the tax office, and with the exception of a first quarter 2004 survey conducted jointly by the tax office and BOM, there is a no comprehensive data available for the sector (Table A10). Nevertheless, by extrapolating from the 2004 survey data and drawing on estimates from informed observers in the credit union system, BOM and FRC, a tentative picture emerges.

Table A10. Mongolia: The 2004 Survey of Credit Unions

	Ulaanbaatar	**Outside Ulaanbaatar**	**Total**
Total registered SCUs	328	242	570
SCUs located by BOM inspectors	166	116	282
Number with assets greater than MNT 500 million	14	0	14
Number with assets MNT 100 – 500 million	24	0	24
Number with assets less than MNT 100 million	128	116	244
Total SCU assets (MNT billions)	44.5	2.5	47
Members	15,400	6,800	22,200

Source: Bank of Mongolia.

87. More than half of the 700 registered credit unions do not operate. In 2004, thirty-eight large credit unions, all located in Ulaanbaatar, accounted for 98 percent of SCU assets, and this distribution of assets is likely unchanged. Many of these SCUs are cooperative in name only, and might more appropriately be considered as unregulated banks or other types of financial enterprise. There are likely about 150 SCUs currently operating in rural areas, and a much larger proportion seems likely to be truly member-owned financial institutions.

88. Some bankers privately indicate that in the Ulaanbaatar area credit unions effectively controlled by commercial interests are major competitors for deposits. The presence of these commercially owned SCUs is evident in the estimated average size of credit union loans, which is more than four times the average loan size of Xaan Bank and Xacbank, both of which have a strong micro-finance and SME orientation. The larger average size of credit union loans also reflects that older credit unions in the Ulaanbaatar area, which are more likely than newer credit

unions to operate as true cooperatives, tend to focus more on the emerging middle class and relatively prosperous traders, and are much larger than the average SCU in rural areas.

89. Of the 150 licensed non-bank financial institutions, thirteen NBFIs are partially or wholly foreign owned, and collectively account for about 30 percent of all NBFI assets. Two of the largest of these, Credit Mongol and Vision Fund Mongolia, are engaged in micro and small business lending, financed by EU TACIS and World Vision respectively. The majority of the NBFIs undertake lending activity, primarily short term consumer loans and loans to small and medium sized business. One third of the NBFIs are licensed to do foreign currency exchange, with this business frequently undertaken in conjunction with other activities. Other licensed activities include financial leasing, trust services, factoring, remittance services and electronic payments. NBFIs are concentrated in Ulaanbaatar, with only about 15 percent of licensed institutions operating in other areas of the country.

90. The NBFI law prohibits deposit-taking. The types of institutions usually subject to prudential regulation in order to protect depositors and policy holders and the stability of the financial system are specifically excluded from the NBFI law.[17] Thus, the rationale for the prudential limits (capital requirements and leverage restrictions) contained in the NBFI law is not clear. Consumer protection provisions such as required disclosure to borrowers ("truth in lending"), which often provide the underlying policy rationale for licensing and oversight of NBFIs, are not contained in the law, leaving it unclear what public policy objectives are met by the current requirements for licensing and supervision of institutions that do not take deposits. Absent any clear public benefit from the current regime, it can be expected to come under increasing criticism as the newly established Financial Regulatory Commission (FRC) begins to levy fees on licensed institutions to offset the cost of supervision.

Table A11. Mongolia: Formal Providers of Financial Services, end-2005.

	Credit Unions	**NBFIs**	**Post Bank**	**Xaan Bank**	**Xacbank**	**Other Banks[a]**
Number	700[b]	150	1	1	1	14
Service locations	300[b]	n.a.	85	404	65[c]	725*
Borrowers	30,000[b]	51,200	n.a.	177,540	50,000	n.a.
Loans (tughrik billions)	100[b]	18.8	62.0*	134.4	37.8	625.2
Average loan size (tughrik thousands)	3,300[b]	367	n.a	757	756	n.a.
Deposits (tughrik billions)	80	0	70.0*	179.6	55.0*	712.4

*estimates, awaiting final 2005 data.

[a] All banks excluding Post Bank, Xacbank and Xaan Bank (formerly Agriculture Bank).

[b] Actual data is not available. Of about 700 registered SCU, observers estimate that only about 300 operate. The reported rapid growth of commercially controlled SCUs suggests that the volume of SCU loans and deposits may have doubled since the only reliable data was gathered at the beginning of 2004 (Box 1). Some observers estimate that SCU deposit and loan volumes could be much higher.

[c] Includes 31 "franchised" SCUs.

Sources: Bank of Mongolia, Financial Regulatory Commission, Xacbank, Postbank, Xaan Bank.

91. The insurance industry remains in a very early stage of development. With the privatization of Mongol Daatgal in 2004, the insurance industry is entirely privately owned. Life insurance has yet to emerge as a significant product. Despite reported underwriting profits (premiums collected less claims paid) of 80 percent, the recent failure of two insurance companies raises concerns about the accuracy of reporting and quality of supervision. The FRC is assuming responsibility for oversight of the insurance industry.

[17] Banking, insurance, security business, pension funds, saving and loan cooperatives and pawnshops are governed by separate laws.

92. The almost 400 companies listed on the Mongolian Stock Exchange reflect the history of using public listings in the privatization of state-owned enterprises. Despite the relatively large number of listings, there is very little market intermediation in Mongolia, with total market capitalization of MNT 55.7 billion (end 2005) equivalent to only about 4 percent of total banking assets. The regulatory and supervisory responsibilities of the Mongolian Securities Exchange Commission have been transferred to the FRC.

2. History of SCUs in Mongolia

93. Savings and credit unions began to be established in Mongolia in 1996 and 1997 through a project funded by the ADB, with five initially formed in Ulaanbaatar, four sponsored by NGOs. In 1999 SCUs began to be established in rural areas, supported by the donor funded Cooperative Training Centre, which promoted multipurpose cooperatives. By March 2001 there were 86 SCUs operating in Mongolia, 46 in Ulaanbaatar and 37 in rural areas, mobilizing about MTN 1.7 billion in member shares and savings. Over the next three years the number of credit unions mushroomed, although many credit unions quickly ceased operation when the expected external financing did not materialize (Table A12).

Table A12. History of Credit Unions in Mongolia

1996	1999	March 2001	March 2004
5 SCUs established in pilot program in Ulaanbaatar	First SCUs established in rural areas	86 SCUS 2,153 members	570 SCUS registered 278 SCUs operating 22,200 members

94. Two associations of credit unions emerged very early in the development of SCUs, although with a combined membership of about 160, it is clear that the majority of SCUs belong to neither organization. The first association, the Mongolian Confederation of Credit Unions (MOCCU), was established in 1998 and currently has about 90 member CUs. A number of the member CUs have not been paying membership fees, likely because the Confederation exists primarily as a “talking shop” and is currently not in a position to offer much in the way of training and support to credit unions.

95. The second SCU association, the Union of Mongolian Savings and Credit Cooperatives (UMSCC), was established in anticipation of the ADB Rural Finance Project, with the expectation that it would be able to become involved in the delivery of training and support services. There are currently about 70 member SCUs, and like MOCCU, UMSCC currently exists primarily as a “talking shop.” The former head of UNMCC has joined the FRC, which provides the new supervisory agency with considerable knowledge of the SCU system.

a. ADB Rural Finance Project

96. The rural finance project was approved in October 2001, intending to build on the success with the original five credit unions established in 1996-97 and the subsequent creation of additional SCUs in both rural and urban areas. Project design called for the creation of a credit union service organization (CUSO) to promote SCU development and provide training and capacity building to new SCUs, which would be delivered through a head office and four

regional centers. The program also envisioned the creation of a Supervision Development Unit (SDU) for the oversight of SCUs, and the provision of a $4.9 million credit facility to be on-lent to SCUs.

97. The project had been in the pipeline since 1999, and the prospect that there would be an ADB program to support credit unions was well known. This had the effect of encouraging SCU formation, as this was viewed as a means of positioning individuals to receive IFI funding. Among the 37 rural credit unions in existence in March 2001 (date of the ADB loan fact-finding mission), the average number of members was 11, one more than the minimum ten required to register a credit union. While this may be a function solely of recent establishment, it may also reflect the fact that SCUs were registered with the expectation that by meeting the bare legal requirements to found an SCU, a family or small group of individuals would be able to access IFI funds.

98. There was a long delay between project approval and the fielding of consultants to support the development of the CUSO and SDU, with TA field work commencing in March 2004. One result was that many SCUs had been established well in advance of the establishment of the infrastructure that was intended to support their development. The independent services provider originally expected to act as the CUSO was purchased by Xacbank prior to project implementation. A decision was taken to establish the CUSO as a division of the pre-existing Mongolian Cooperative Training and Information Centre (MCTIC), using MCTIC's regional information centers as the regional delivery points for training to support SCU development. While this offered some synergies with the training and support being provided to non-financial cooperatives, it diluted the focus on the specialized nature of financial cooperatives.

99. The framework for regulation and supervision of SCUs intended in the original program design was never introduced. Establishment of the SDU was hindered by the lack of consensus on the appropriate approach to regulation and supervision of SCUs. There were differing views on whether a separate SCU statute was required, with some participants, including consultants and donors supporting multi-purpose cooperative development, advocating that the most cost-effective approach was to deal with SCU within the framework of the general cooperative law. At other points in the debate it was suggested that SCU oversight should be addressed through the NBFI law, or through the dedicated SCU statute drafted with ADB technical assistance. Those interested primarily in ensuring that SCUs remained essentially unregulated may have exploited legitimate differences of opinion over the best approach to unnecessarily prolong the discussions and delay action.

100. The difficulties in establishing the SDU were compounded by the rapid growth of SCUs, and in particular concern that many SCUs in the urban areas were engaging in questionable practices. An unclear mandate, lack of legal foundation, and large resource requirements made the assignment to oversee SCUs one that any official agency might be reluctant to assume. This reluctance would have been reinforced by the likelihood of criticism and political pressure from previously unregulated SCUs, and also the possibility of incurring blame should depositors lose money in SCUs, even if the circumstances leading to the loss existed before the agency assumed the mandate for oversight.

101. The expanding rural outreach of the banking system and the proliferation of SCUs had by 2005 clearly called into question the original premise of the rural finance project. Xaan Bank as well as Post Bank and Xacbank have a well established and growing network of rural service delivery points. Concern over the activities of many SCUs and the absence of effective oversight makes SCUs generally unsuitable vehicles for an on-lending program, notwithstanding

that there are some which operate soundly with true cooperative ownership. The authorities and the ADB agreed that the program should be cancelled.

b. GTZ

102. GTZ has actively supported the development of cooperatives in Mongolia, and as part of the program advocated the creation of multi-purpose organizations. Technical support was provided through the MCTIC for training and development. Operating under the general cooperative law, multi-purpose cooperatives would provide financial services as an adjunct to commercial activities to support agriculture in rural areas. This multi-purpose approach has the potential benefit of not requiring multiple cooperate structures in sparsely populated areas, as a single entity would provide both financial and non-financial services. In this model, oversight of cooperatives, including those offering financial services, would be undertaken by cooperative federations. The Mongolian legal framework, which included provisions for SCUs in the general cooperative law, was broadly consistent with this approach.

103. The multi-purpose cooperative approach may have offered advantages in the rural areas. Given true cooperative ownership, small scale and simple operations, active oversight by individual members and a relatively light regulatory regime may be entirely appropriate to foster growth. Unfortunately, in Mongolia the rapid emergence of relatively large SCUs controlled by commercial interests, essentially operating as small banks taking deposits from the public, ran counter to the intended pure cooperative nature of the multi-purpose organizations advocated for rural areas.

c. The Current Situation

104. The proliferation of SCUs controlled by commercial interests and essentially operating as unregulated financial institutions creates serious risks to financial sector development in Mongolia. Should there be large losses among the depositors of these SCUs, there is the risk that confidence will be lost in the SCUs that truly operate on a cooperative basis, and the further risk that a loss of confidence might spread to the banks, undermining the progress made in recent years in reforming the banking sector. An additional concern is that these SCUs are bidding aggressively for deposits, driving up the cost of funds for the banking system.

105. The outlook for truly cooperative savings and credit institutions is uncertain. There is a small number of truly cooperatively owned SCUs currently operating in both rural and urban areas, although there is no firm data on their precise number and size. The challenge for policy-makers is to implement an approach to crack-down on the SCUs that exist only to escape more onerous regulation, but at the same time providing an environment that would allow true SCUs to continue. One option would be a re-licensing regime which would apply bank-like regulation to the larger SCUs (the approximately 38 accounting for 98 percent of SCU assets), while leaving the smaller SCUs subject a lighter regime of licensing and reporting.

3. Regulation and Supervision

106. SCUs in Mongolia have been essentially unregulated from the outset. It had been expected that the NBFI law, prepared with ADB technical assistance, would provide for SCU regulation, but this did not materialize. Subsequently a specific SCU law was drafted with ADB technical assistance, but this statute has yet to be enacted. One factor contributing to the lack of progress with SCU oversight is the lack of a consensus on the appropriate structure. The

original Rural Finance Program contemplated a variation on the self-regulatory approaches seen in many credit union systems, with the SDU operating as a part of the CUSO. Lack of progress in establishing self-regulation was a serious concern, but there was little enthusiasm on the part of the BOM to take on oversight responsibilities.

107. As an interim measure to address concerns about the rapid proliferation of unregulated SCUs, the BOM promulgated Regulation 576 in December 2003, establishing some minimum prudential standards for credit unions. Concurrently, an Interim Supervision and Development Unit (ISDU) was established at the end of 2003 pursuant to an MOU between the Ministry of Finance and Economics and BOM, however, the ISDU was disbanded in April 2004, leaving no body with the responsibly for SCU oversight. In any case, the absence of a licensing regime for SCUs, lack of legal foundation requiring prudential reporting and absence of a means to enforce application of the prudential standards, meant that regulation and supervision of SCUs remained ineffective. SCUs continue to be subject only to a passing reference in the general cooperative law, requiring them to be registered with the General Department of National Taxation.

108. The FRC, which is commencing its operations in early 2006, is expected to assume responsibility for oversight of SCUs. However, the legal foundation for SCU oversight remains as tenuous as ever, as the NBFI law specifically refers to SCUs being governed by a specific statute rather than the NBFI law. The SCU law has not been introduced, so despite the inclusion of SCUs within the FRC mandate, the only legal basis for SCU oversight remains the scant provisions of the general cooperative law. Without a basis in law to establish a sound licensing regime, it is difficult to see how the FRC will be able to stop entities registered as SCUs from operating in an essentially unregulated manner.

4. Lessons from the experience

109. The experience in Mongolia highlights a number of issues that have broader application in SCU development. One key point is that the lack of consensus on a model for development and regulation will be counter-productive. In Mongolia there were conflicting views on key questions:

(i) Should financial services be restricted to specialized SCUs, or should they be offered by multi-purpose cooperatives?

(ii) Should there be self-regulation of financial SCUs, or is there a need for a government agency to function as the supervisory authority?

110. For each of these points, there is evidence in other countries to support divergent positions. Unfortunately, in Mongolia the differences were never resolved into a coherent vision of SCU development, so on the one hand it was continued as an adjunct to general cooperative development, but on the other hand considerable resources were devoted to the preparation of a specialized SCU law and various attempts to establish an effective supervisory function within a government agency.

111. One possible solution to the divergent views of SCU development and regulation is to differentiate among SCUs based on their size and complexity. Smaller SCUs, say with fewer than 50 members and below a specified asset size might be considered as early stage institutions where it could be appropriate to have minimal regulation and oversight. The regime could rely on licensing and periodic reporting, building on the expectation that in a small and

simple organization, the member-owners can act to protect their own interests by ensuring prudent management of their savings. This could be undertaken pursuant to the general cooperative law, or possibly under a specialized SCU law that provides that the supervisory agency might exclude small SCUs from prudential requirements.

112. SCUs that have a larger number of members and/or exceed a specified asset size are on their way to becoming true financial institutions distinguished from others solely by their cooperative ownership. Increasing size and complexity leads to the need for professional management and puts increased responsibility on directors. It also becomes necessary to have prudential standards to protect depositors, who although they may be members, are less likely to understand the entire business of the SCU and to be able to effectively monitor performance as SCUs start to resemble small banks.

113. There are examples in many countries of the oversight of SCUs being undertaken by an apex organization or system-controlled auditing association. However, the potential conflict between the provision of services and development support by an apex organization, and the requirement for a supervisory authority to enforce requirements that may curb growth can create conflicts. In the context of developing and transition economies, it may be better to more clearly separate the development and supervisory function by having a government agency responsible for supervision.

114. In Mongolia, as in the Kyrgyz Republic and Azerbaijan, the potential to attract external financing spurred the establishment of many SCUs. In all three cases, however, it is clear that many SCUs were established solely to get the external funds. Forming an SCU was simply a vehicle to access funding, so in most cases there was no real grass-roots commitment to building a financial institution. Unlike in the Kyrgyz Republic and Azerbaijan, in Mongolia the external credit line was never disbursed. This had the consequence of causing many SCUs to go dormant very shortly after their establishment, clearly confirming that many SCUs had been registered for the sole purpose of accessing the external funds, and when these did not materialize, the “members” had no interest in continuing to own a small financial institution.

115. In one sense, the quick disappearance of many registered SCUs was a very positive result of the sequencing of the rural finance project. Access to the on-lending credit line was not to be provided until the CUSO and SDU were established. As progress with the first two phases of the project was unsatisfactory, the credit line was not disbursed and the project was ultimately cancelled.

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