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Kyrgyz Republic

FSA | Financial Sector Assessment

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FINANCIAL SECTOR ASSESSMENT

KYRGYZ REPUBLIC

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EUROPE & CENTRAL ASIA REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM¹

A. INTRODUCTION

1. The Kyrgyz financial system is dominated by commercial banks and to a lesser degree by non-bank financial intermediaries that are mostly donor funded. The system is small, with total bank assets of about 7 percent of GDP, and total non-bank financial intermediary assets of about 2.5 percent of GDP. The capital markets, insurance, and pension sectors are all extremely small, if not embryonic, and not systemically significant.
2. In recent years, some progress has been made in terms of consolidation and rationalization of the sector and improvement of financial infrastructure, especially in banking supervision and resolution. Weaknesses remain in corporate governance and the legal and regulatory framework, as well as in the judiciary, which is of major concern and a constrain to development. The system also suffers from a severe lack of public confidence in commercial banks and weak demand for current accounts because of a narrow range of payments services.
3. Given the overall small size of the Kyrgyz financial system, vulnerabilities do not represent a short-term threat to macroeconomic stability, especially if compared with the

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high level of the country's public debt, which peaked at 94 percent of GDP in 2001. Most of this debt is externally held and denominated in foreign currency, thus exposing Kyrgyz Republic to foreign exchange risk. However, if vulnerabilities in the financial system persist, they could lead to disorderly exits of failed banks. This, in turn, could further endanger any restoration of depositors' confidence and undermine the system's capability to support private sector development, which is key to sustainable economic growth and to reducing the country's debt.

B. MACROECONOMIC ENVIRONMENT

4. The Kyrgyz Republic is one of the more liberalized countries in Central Asia. Soon after independence, the country embarked on a comprehensive reform to transition to a market economy. The strategy included the divestiture of state-owned assets, the introduction of the Som, the national currency, and the establishment of a modern financial and legal infrastructure to support private and financial sector development. The Kyrgyz Republic is also the only country in the region that is a member of the WTO (1998).

5. Despite the intense reform efforts of the early 1990s, Kyrgyz Republic has remained one of the poorest countries in the CIS, with a per capita GDP of about US\$308 in 2001. This is due to the country's geographical isolation, the scarcity of natural resources, heavy dependence on gold and agriculture output, and the effects of the Russian crisis of 1998. Despite these adverse conditions, the country's macroeconomic performance has been improving significantly since 1998 – real GDP grew at an average annual rate of 5.5 percent during 1996–2001, although it is expected to turn slightly negative in 2002.² Inflation is under control as the 12-month average inflation rate has declined from 23.5 percent in 1997 to 2 percent in 2002.

C. PUBLIC EXTERNAL DEBT

6. Public external debt rose from 36 percent of GDP in 1995, to 51 percent in 1997 and 94 percent in 2001 – remains a major concern. The reasons for the rapid accumulation of foreign debt include: (a) the relatively large borrowing for the Public Investment Program; (b) the accumulation of a large stock of contingent liabilities through government guarantees of state-owned enterprise borrowings; and (c) the Russian financial crisis in 1998 with the subsequent devaluation of the Som.

7. In the last two years, the government has re-established a positive track record in addressing external debt. The institutional framework has been strengthened with the Law on Public and Non-Public Debt, and a database for domestic and foreign debt has been

² Preliminary figures show a contraction of 0.5 percent in 2002, mainly due to an accident at Kumtor goldmine. According to a World Bank Mining Sector Review, the gold mining sector's share of GDP was around 7 percent in 2001.

developed. At the same time, tight monetary and fiscal policy, improvements in revenue collection, and containment of public expenditures have led to stabilization of the currency and lower inflation. The fiscal deficit also fell from 9 percent of GDP in 2000 to 5 percent in 2001, and it was expected to remain at this level for 2002. In addition, with the support of the IMF, the government designed a comprehensive debt strategy which gained Paris Club support in March 2002, as creditors granted a flow rescheduling of the Kyrgyz debt. The government also signed a 3-year Poverty Reduction Grant Facility (PRGF) program with the IMF, and decided to update and automate treasury operation functions.

D. THE BANKING SECTOR

8. There are 19 commercial banks in the Kyrgyz Republic. In terms of total assets, the banking sector is small and fragile, but on its way to recovery from the crisis in 1998. The crisis brought inflation and devaluation, the collapse of the largest energy conglomerate and the bankruptcy of two of the largest banks in the country. The Kyrgyz State currently owns two banks, the Savings and Settlement Corporation (SSC) and Kairat, which together represent about 12 percent of total assets of the banking sector. SSC has a limited banking license with activities restricted to inter-bank lending, government securities transactions, deposit taking, fiscal and quasi-fiscal payments services, and payments services for budgetary entities. It has the largest branch network in the country. Kairat is also a narrow bank, and its activities range from deposit taking, cash transfers and foreign exchange to inter-bank lending.

9. Following the Russian crisis, the government and the National Bank of Kyrgyz Republic (NBKR) devoted considerable efforts in reforming the sector. The NBKR closed nine problem banks, increased the minimum statutory capital requirement and introduced a new minimum threshold for Tier 1 capital. The NBKR also strengthened its banking supervision department and introduced a Regulatory Response Policy based on CAMEL ratings. The government supported NBKR's efforts by providing financial resources to close two banks and to rescue a third from bankruptcy.

10. Despite these achievements, the financial condition of Kyrgyz commercial banks remains fragile as they face difficulties in generating income and developing capacity and a product base. In this regard, the main problems include: (a) the inability of banks to assess credit risk, due to the lack of banking skills and transparency in the real sector; (b) judicial uncertainties, which make lending difficult and risky; and (c) inability to generate sufficient revenues from operations due to the low demand and low marginal value of banking transactions partly due to inefficiencies in payments system infrastructure. Bank lending has been declining, with total bank credits to the real sector decreasing from 6.5 percent in 1995 to 3.8 percent of GDP in 2001. Banks currently invest about one-third of their assets in short-term securities and correspondent bank accounts whose returns are declining with interest rates. In addition, lack of confidence in the banking system imposes high cost of funds for banks.

11. Asset quality is a major concern. The ration of total non-performing loans (NPLs) to total loans was around 14 percent at end-2002, but generally worse for larger banks, due to their lending concentration in certain sectors of economy. While most banks reported profitability, in some cases profits could have been overstated due to roll-overs of non-performing credits. The NBKR is aware of this problem and has intensified its efforts to verify financial reporting. In addition, the total capital of some banks may have been overstated due to cross-shareholding.

12. There are pressures to introduce deposit insurance as a step to restore confidence in the banking system. However, preconditions for a system include healthy and sound banks, strong supervision, and improved accounting and auditing, corporate governance and judiciary systems. At present, these preconditions are largely not in place in the Kyrgyz Republic. As a result, the introduction of deposit insurance should be delayed and considered only as a medium-term objective.

E. BANKING SUPERVISION AND RESOLUTION

13. The NBKR is the supervision and licensing authority for the banking sector. The legal framework is based on the National Bank Law and the Law on Banks and Banking Activities. The law provides the NBKR with extensive powers to issue both general and specific regulations and instructions to banks. Should a bank fail to comply with these regulations and instructions, the NBKR can impose a full range of corrective measures and penalties, including revoking a bank's license.

14. The overall framework for banking supervision and resolution is in place, although gaps and inconsistencies remain. The annual NBKR on-site inspection program is largely satisfactory. The effectiveness of on-site inspections benefits from unhindered access to banks' books, accounts, documents, and employees, as granted to the NBKR by the Banking Law. Off-site supervision has some room for improvements. Given the number of tasks required of off-site examiners, it appears there is limited time available for thorough analysis. The NBKR is currently in the process of implementing an automated data collection and analysis program that will greatly improve the effectiveness of off-site supervision.

15. Despite the large number of banks closed or liquidated during the past few years and improvements in supervision, there is need to strengthen bank resolution. There have been delays in the NBKR interventions, mainly due to weaknesses and inconsistencies in the legal and regulatory framework combined with weak financial information disclosure and corporate governance. Moreover, bank resolution is frequently hampered by the courts, where corruption is rampant.³

³ NBKR decisions have been challenged in civil court, where outcomes are sometimes unpredictable. The appeals process is often protracted, and this hampers the banking resolution efforts of the NBKR and increases transaction costs for banks.

F. CREDITORS' RIGHTS AND CORPORATE GOVERNANCE

16. The legal and institutional frameworks supporting credit and creditor rights in the Kyrgyz Republic are inadequate and inefficient. Creditor rights remain weak, collateral systems – other than for traditional mortgages – are poorly developed, and the enforcement procedures of the courts are slow and unreliable. These weaknesses create distortions in the lending market, as lenders require fully secured loans and sometimes as high as 200 percent collateral.

Efforts to Work Out Problem Portfolios of the Banks

The government of the Kyrgyz Republic established the debt resolution agency (DEBRA) in 1996 to facilitate bank resolution through the conservation and liquidation of assets of failed banks. DEBRA's performance has been weakening throughout the years. The main problems include: (a) its legal status as a department in the MoF, which does not guarantee the necessary independence; (b) inadequate funding; and (c) weak technical and operational capacity. The authorities recognize the need to strengthen the role of DEBRA as mean to enforce credit discipline and, in the long run, to establish a credit culture in the country. In the summer of 2002, the Parliament enacted an amendment to the Bankruptcy Law. According to the amendment, DEBRA shall be the sole liquidator of failed banks. The government will restructure DEBRA, transform it into an independent agency and strengthen and enhance its technical and operational structure.

17. Lack of good corporate governance and a good accounting and auditing framework and practice are significant weaknesses. To remedy this situation, a new Law on Accounting, enacted in April 2002, introduces improved financial reporting requirements and an ambitious timetable for switchover to IAS. All banks and other financial institutions have now switched over. All other legal entities are required to comply by end-2004. This timetable is very ambitious, as there are not enough accounting and auditing professionals in the country capable of implementing IAS and monitoring compliance.

18. The audit profession is in its infancy and the audit firms are struggling to grow professionally and in size. In addition, the regulatory authority for the audit profession has weak disciplinary and governance arrangements. The Law on Auditing prohibits external auditors from disclosing information to third parties, including the NBKR. The NBKR is not entitled to share information with other domestic enforcement agencies without prior consent by the banks and their clients. Furthermore, the framework on internal audit and control has serious gaps. The Banking Law itself, for example, does not require that internal auditors be independent and report directly to the board.

G. AML/CFT

19. The AML/CFT framework is weak, exposing financial institutions to the risk of abuse by money launderers and other criminals. At present, the legal framework: (a) lacks criminal provisions that meet international standards; (b) does not provide for mandatory suspicious transaction reporting to a Financial Intelligence Unit; (c) has limited provisions for confiscation, freezing or provisional measures; (d) does not require sufficient minimum requirements for customer identification or application of fit-and-proper tests; and (e) discourages early involvement of law enforcement in investigations, due limits on the disclosure of banking secrets.

20. The weaknesses in the legal and regulatory framework impede the development of necessary supervision framework. One notable risk arises from the provisions of the Law on Licensing, which impedes the full application of the fit-and-proper test for bank managers and shareholders. This undermines an important measure to prevent criminals and unqualified persons/entities from becoming shareholders, directors, and/or senior managers of financial institutions. In addition, another impediment is the stringent legislation on banking secrecy in the country. The NBKR has prepared a draft AML law, which is an encouraging step forward.

H. PAYMENT SYSTEM

21. The National Payments system is operated by the NBKR and consists of a gross inter-bank settlement system and a net clearing system. The system still relies on paper documents and does not provide affordable, convenient payment services. The NBKR is currently developing a payments system reform strategy, with the objective of making payments cheaper, more reliable and more transparent. The strategy aims to establish: (a) a Real Time Gross Settlement System (RTGS); (b) a clearing system for small and recurrent payments; (c) a card clearing system; and (d) the general ledger of the NBKR. The expected outcome of the strategy would be to enable banks to provide efficient payments and banking services in order to expand their customer base and, ultimately, to help restore depositors' confidence.

I. THE NON-BANK FINANCIAL INSTITUTIONS (NBFIs) AND CAPITAL MARKETS

22. The NBFIs are playing an increasingly important role in the financial sector by providing the bulk of credit to small- and medium- sized enterprises as well as rural borrowers. Microfinance programs in the Kyrgyz Republic currently have about 33,000 customers. A concern in this area is the interest rate subsidies from competing institutions, which are causing distortions in the credit market. In the long run, this could lead to a reduction of services for the target borrowers, because pervasive, subsidized rates discourage new entrants, reduce outreach, and may, in the extreme, induce market-based microfinance intermediaries to exit the market altogether.

23. The Parliament enacted a new Law on Microfinance Organizations in August 2002. The law assigns supervisory and regulatory responsibility to the NBKR and enables MFIs to collect deposits. The new law represents a major challenge for the NBKR which needs to develop the framework for supervision, monitoring and resolution for a sector that is already

developed and that could complement banks in delivering financial and basic banking services in the most remote areas of the country.

24. Capital markets, insurance and pension sectors are extremely small. The development of these sectors should remain a long-term objective, as the supervisory and regulatory framework and enforcement capacity are extremely weak.

J. CONCLUSION

25. There a number of structural weaknesses and developmental issues in the Kyrgyz financial system, resulting in the low degree of intermediation of banks and lack of financial support to private sector growth. The FSAP mission prepared a number policy recommendations, which have been incorporated in the government's and the NBKR's financial sector strategy section of the National Poverty Reduction Strategy now under implementation. The government has requested the Bank to help with the implementation of the strategy and coordination of donors' assistance.

26. The authorities have already started measure to:

- improve the effective management of external debt;
- enhance supervision, governance and the framework for creditor rights;
- further consolidate the banking system;
- initiate the payments system reform;
- initiate legal and judicial reforms; and
- develop the AML/CFT framework.

27. The medium-term outcomes of the strategy are expected to include:

- implementing the payment system reforms;
- addressing key legal and judicial measures;
- implementing the framework for AML/CFT;
- developing the micro finance sector that could serve to complement the banking sector in delivering financial and basic banking services in the rural areas;
- setting up a deposit insurance scheme provided that banks are more sound and supervision, corporate governance and transparency are improved; and
- addressing weaknesses and delays in the framework for accounting and auditing.