ACCESS TO FINANCIAL SERVICES POLICY NOTE

KYRGYZ REPUBLIC

JUNE 2010

THE WORLD BANK
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT
EUROPE AND CENTRAL ASIA REGION
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Preface

The purpose of this policy note is to present an assessment of the current state of access to finance in the Kyrgyz Republic, the impact of the 2008-09 global economic crisis on access to finance, as well as the impact of the events of April 2010. The note presents an analysis of the legal and regulatory framework for enhancing access to finance, other credit infrastructure, recent trends in financial intermediation by banks and nonbank financial institutions, and progress with the privatization of Aiyl Bank and the Financial Company for Support and Development of the Credit Unions, and derives recommendations from this analysis.

This policy note was prepared by a World Bank team led by Brett Coleman, Senior Financial Sector Specialist, and including Bujana Perolli, Financial Analyst, and Nurlanbek Tynaev, Consultant, all under the supervision of Sophie Sirtaine, Sector Manager, ECSPF. Peter Goodman, Senior Agricultural Specialist, ECSSD, and Zyinat Tokтомамбетова, Consultant, were instrumental in collecting data on agriculture finance for the note.

The note is based on data and other information provided by the National Bank of the Kyrgyz Republic, financial institutions and associations, donors, and other stakeholders, as well as World Bank missions to the Kyrgyz Republic in November 2009 and February 2010 and a multi-donor Joint Economic Assessment mission in May 2010. The missions held meetings with senior officials from the National Bank of Kyrgyz Republic and the Ministry of Finance, commercial banks, microfinance organizations, the Association of Microfinance Institutions, the Union of Banks, the Pledge Registry, Kyrgyz Post, donors, and other stakeholders.

The team would like to thank all parties who graciously devoted their time to meet the visiting missions and share information and opinions. The team extends special thanks to the management and staff of the National Bank of the Kyrgyz Republic for their cooperation, fruitful discussions, and provision of data in response to multiple requests. The mission is also grateful to World Bank Country Manager, Roger Robinson, and staff of the World Bank country office for their support during missions and preparation of this policy note.
List of Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<td>AUB</td>
<td>Asia Universal Bank</td>
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<td>BEEPs</td>
<td>Business Environment and Enterprise Performance Survey</td>
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<td>CAR</td>
<td>Capital Adequacy Ratio</td>
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<tr>
<td>CCA</td>
<td>Caucus and Central Asia</td>
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<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<td>CU</td>
<td>Credit Union</td>
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<tr>
<td>ECA</td>
<td>Europe and Central Asia</td>
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<tr>
<td>FCSDCU</td>
<td>Financial Company for Support and Development of the Credit Unions</td>
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<td>FX</td>
<td>Foreign Exchange</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>KAFC</td>
<td>Kyrgyz Agricultural Finance Company</td>
</tr>
<tr>
<td>KGS</td>
<td>Kyrgyz Som (Local currency)</td>
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<td>MCA</td>
<td>Microcredit Agency</td>
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<tr>
<td>MFC</td>
<td>Micro Finance Company</td>
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<tr>
<td>MFO</td>
<td>Microfinance Organization</td>
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<tr>
<td>MSME</td>
<td>Micro, small, and medium enterprises</td>
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<td>NBFI</td>
<td>Nonbank Financial Institution</td>
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<td>NBKR</td>
<td>National Bank of the Kyrgyz Republic</td>
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<tr>
<td>NPL</td>
<td>Non-Performing Loans</td>
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<td>PAR</td>
<td>Portfolio at Risk</td>
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<tr>
<td>ROA</td>
<td>Return on assets</td>
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<tr>
<td>ROE</td>
<td>Return on equity</td>
</tr>
<tr>
<td>ROSC</td>
<td>Report on Observance of Standards and Codes</td>
</tr>
<tr>
<td>USD</td>
<td>US Dollar</td>
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<tr>
<td>VAT</td>
<td>Value added Tax</td>
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<tr>
<td>WEO</td>
<td>World Economic Outlook</td>
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<td>YOY</td>
<td>Year-on-Year</td>
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EXECUTIVE SUMMARY

Access to Finance: Assessment of Current Situation

1. Despite substantial growth in credit to the private sector in recent years, access to formal financial services in the Kyrgyz Republic remains limited. Credit to the private sector increased by an average of 55 percent from 2004 to 2007, although it slowed down to a growth of 26 percent in 2008 and declined by almost 3 percent in 2009 due to the global economic crisis. While this growth has been largely fuelled by credit from banks, it also reflects the credit expansion by non-banks, which have increased outreach to segments of the population that are not serviced by banks, especially in the rural areas. However, despite the expansion of credit, credit and deposit penetration in the Kyrgyz Republic remains shallow, and is one of the lowest in the ECA region. At end-2008, credit to the private sector accounted for 17 percent of GDP and deposits for 20 percent of GDP, compared to about 55 percent and 33 percent in ECA countries, respectively.

2. Access to finance became more limited in 2009 due to the global economic crisis. The global crisis undermined market confidence and caused banks to become risk averse and reduce lending. In an environment of very limited and costly external financing, slow economic growth, and deteriorating asset quality, banks further increased interest rates to maintain profitability, and thus increased costs for borrowers. However, the crisis also led to decreased demand from firms and households for new loans.

3. The events of April 2010 appear to have had limited impact on access to finance in the Kyrgyz Republic so far, but continued instability could have a more serious impact. Bank and non-bank lending fell slightly in April and May, but then increased in June. Most financial institutions reported small drops in demand for loans due to a general loss in confidence in the business sector. The temporary moratorium on public registries prevented financial institutions from making collateralized loans during that period. KGS liquidity is an area of concern. The majority of local currency liquidity in the market was concentrated in AUB, due to the high volume of government accounts held there, and AUB was the main source of KGS liquidity for microfinance organizations (MFOs). The suspension of AUB's operations has created uncertainty for MFOs trying to meet their liquidity needs. In addition, potential further problems in the system, or failure by the authorities to properly address current issues, including to properly restructuring the banks it has intervened, could affect depositor confidence significantly, thereby exacerbating liquidity tensions and further reducing banks' intermediation ability.

4. The supply of loans to micro, small, and medium enterprises is particularly limited, affecting their ability to contribute more to economic growth. Although MSMEs contribute 42 percent of GDP and 42 percent of exports, and employ 95 percent of the workforce, they disproportionately lack access to finance. This limits their capacity to expand operations, and
further contribute to growth. There is no factoring, nearly no leasing for equipment financing, and no trade finance instruments. Elimination of the unequal VAT treatment of leasing would encourage development of leasing. Financial institutions should also improve their risk management and credit assessment skills and develop credit scoring models for small businesses, while the informational opacity of MSMEs needs to be reduced through better reporting requirements and enhanced credit information systems.

5. Although bank lending to the agricultural and rural areas has increased in recent years, it remains limited. Bank lending to agriculture and rural areas is limited due to several reasons, including: (i) limited competition among banks; (ii) lack of financial information on micro-firms due to weak accounting standards and practices; (iii) the limited number of bank branches in rural areas, (iv) the mountainous geography of the country making it unprofitable to service isolated areas using traditional banking methods; (v) the riskiness of agricultural loans; (vi) banks’ lack of sector-specific knowledge and ability to appraise agricultural loans; (vii) banks’ lack of appropriate financial and risk management products; (viii) the unequal taxation of leasing, which limits leasing of agricultural equipment; (ix) the lower value for banks of real estate collaterals in rural areas and the limited acceptance of agricultural land as collateral, and (x) the limited number of pledge offices in the country making it costly for borrowers to travel to these offices to register collateral.

6. Nonbank financial institutions (NBFIs) are filling some of the gaps in access to finance for smaller borrowers, the poor, and the agricultural and rural areas. NBFI credit has been growing fast. They provided 26 percent of all credit from the financial sector at end-2009 and their clients increased from about 100,000 in 2004 to over 300,000 in 2009. The bulk of NBFI lending, 42 percent, goes to agriculture, compared to only 13 percent of bank lending for agriculture.

7. However, NBFIs remain small and face operational and funding costs, as well as legal, regulatory, and institutional constraints, which inhibit their expansion. MFOs’ operational costs are high due to the small average loan size, the remoteness of clients, poor infrastructure, and the high risks of some borrowers, such as farmers. They also have high funding costs because they cannot take deposits, and are thus dependent on international credit lines for financing and on local banks for conducting swaps needed to convert foreign currency funding to local currency funding. Credit unions also face operational costs as they lack the governance and operational skills to become more efficient and lower costs. They have very high funding constraints as they are almost entirely dependent for financing on the Financial Company for Support and Development of the Credit Unions (FCSDCU). However, the FCSDCU cannot obtain funding from international creditors, who are reluctant to lend to a financial intermediary owned by the central bank. Thus, delays in FCSDCU’s privatization constitute a key obstacle to the expansion of the credit unions.

8. Deposit services are virtually non-existent in rural areas. Deposit services provide a significant benefit to households, reducing transaction costs, improving money management, and
contributing to wealth creation. Most rural inhabitants do not have access to deposit services, as banks are the only financial institutions licensed to take deposits. Deposits services should be expanded through: (i) transforming the Kyrgyz Post to provide some financial services, including deposit services and money transfers; (ii) privatizing Aiyl Bank, and granting it a full deposit-taking license; (iii) accelerating the privatization or mutualization of the FDSDCU, (iv) facilitating the acquisition of a deposit-taking license by qualified MFOs and credit unions; and (v) facilitating the transformation of qualified MFOs into fully licensed banks.

9. **Kyrgyzstan receives large inflows of remittances from migrant workers, but only a minority of it is channeled through the financial sector, as nearly 40 percent is estimated to escape the formal financial system.** Most bank branches in Bishkek provide services for multiple money transfer operators, but the majority of recipients are rural and must travel long distances to collect their money. The sender of the remittances in the Russian Federation typically pays in Russian rubles, which in general is converted into U.S. dollars and made available either in U.S. dollars or Kyrgyz soms. The real cost of sending and receiving money from Russia to rural Kyrgyzstan is therefore high and not always transparent.

10. **Enterprise surveys confirm the limited access to finance, particularly for micro, small, and medium enterprises (MSMEs).** Firms of all types (large, medium, small) perceive access to finance as a significant constraint. In 2008, more than half of small firms, 62 percent of medium firms, and 68 percent of large firms perceive access to finance as a significant obstacle. In reality, SMEs appear to be particularly constrained—only 14 percent of small enterprises and 19 percent of medium enterprises have a line of credit or loan, compared to 51 percent of large enterprises. A similar pattern is seen in the proportions of small, medium, and large enterprises with a checking or saving account. Without access to long-term finance, companies face significant problems in financing investments for expansion or acquiring modern technologies. This is a significant obstacle to the expansion of exports, competing in international markets, employment generation, and to private sector growth. Various obstacles impede increased access to financial services, as the next paragraphs describe.

**Obstacles and solutions**

11. **The mountainous geography of the country makes it difficult to reach the agricultural and rural areas.** Since opening up branches in these areas is unprofitable for banks, and even NBFIs in some cases, alternative distribution channels should be considered. In particular, the use of the existing infrastructure of the Kyrgyz Post office network to distribute financial products can be an effective way to expand outreach to underserved areas at low cost.

12. **Interest rates are amongst the highest in ECA and constitute one of most significant constraints for borrowers.** Interest rates remain high due to several factors, most importantly: (i) the limited competition in the banking sector, (ii) lack of adequate financial information on firms due to weak accounting standards and practices; (iii) weaknesses in the credit bureau, (iv) weak risk management and credit assessment skills in financial institutions; (v) low public
confidence in banks, which raises the cost to attract deposits; and (vi) a weak judiciary, leading to poor contract enforcement and occasional corruption, which raises the risks of lending.

13. **Collateral requirements have improved in recent years, but collateral registration and execution is costly and lengthy.** Most loans are secured by real estate, although agricultural land is rarely accepted as collateral. The legal framework for pledging agricultural land needs to be strengthened to make such property more useful for collateral. Moveable collateral is sometimes accepted, but the registration process should be improved by raising the loan size required for the registration of collateral as well as expanding the number of pledge offices in the country, since registering collateral for small loans in remote locations currently can be prohibitively costly. The collateral execution process should also be improved. Out-of-court settlement should be facilitated, in-court settlement needs to be streamlined to shorten the period for executing collateral, and procedures for appraisals and auctions need to be made more transparent.

14. **Obstacles in the legal, regulatory, and institutional framework for NBFIs should be removed to encourage their growth.** The legal, regulatory, and institutional framework for NBFIs has been recently improved, but further progress is needed. The main legal and regulatory constraints to be addressed include: (i) potential interest rate caps on MFOs, which would make it impossible for them to cover their costs and remain financially sustainable; (ii) restricting deposit-taking MFOs to accept only time deposits, limiting their ability to raise inexpensive funding and provide a range of deposit services desired by clients; (iii) lack of fit and proper tests for MFO owners and management inasmuch as some MFOs appear to be run by unscrupulous people and affect the reputation of the sector; (iv) NBKR’s ownership of FCSDCU, limiting its ability to obtain additional funding and thus encourage the growth of the credit unions.

15. **Many small firms are considered unbankable due to their weak management skills and poor financial reporting.** These firms have low levels of technical and managerial skills, obsolete technology, low awareness of financial products, and low confidence in the financial system. It is important that small firms obtain training on technology improvement, basic management skills, financial reporting, and education on financial products.

16. **Thus, the major constraints to access to financing would be improved by:** (i) improving loan conditions via increased competition in the financial sector, improved collateral registration and execution, adoption of good accounting practices, use of scoring models, and improved operation of the credit bureau; (ii) enlarging and diversifying the supply of financial services by undertaking legal, tax, and other reforms to facilitate new financing products such as leasing and factoring, as well as removing legal and regulatory obstacles to NBFIs growth; (iii) providing assistance to small firms to increase their technology and management skills and their knowledge on financial products; and (iv) considering the use of the Kyrgyz Post as an alternative distribution channel for certain financial products especially in remote areas.
## MAIN RECOMMENDATIONS

### A. Short-term responses to events of April 2010

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<td>1.</td>
<td>Re-establishing and maintaining stability and security is a pre-requisite to a healthy financial sector and economy.</td>
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<td>2.</td>
<td>The authorities should reaffirm their commitment to the principle of market-based operations and interest rates in microfinance.</td>
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<td>3.</td>
<td>The authorities may need to provide a temporary facility to ensure MFOs have access to KGS at market interest rates while undertaking appropriate policies to promote the resumption of swaps from commercial banks.</td>
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<td>4.</td>
<td>MFOs and credit unions must remain vigilant in monitoring their performance to ensure minimal defaults.</td>
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<td>5.</td>
<td>Subsidies channeled through Aiyl Bank must avoid distorting the interest rate policy of Aiyl Bank or the financial sector as a whole.</td>
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### B. Other short, medium, and long-term policy recommendations

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<td>1.</td>
<td>Promoting greater access to deposit services in rural areas should be a priority through: (i) redoubling efforts to transform Kyrgyz Post so it can provide limited financial services; (ii) redoubling efforts to privatize Aiyl Bank and grant it a full deposit-taking license; (iii) facilitating that acquisition of a deposit-taking license by qualified MFCs that meet NBKR criteria, and expanding the type of deposits that such MFCs are authorized to accept, subject to NBKR’s discretion to grant such a license to individual MFCs; and (iv) facilitating the transformation of qualified MFCs and MCCs into fully licensed banks.</td>
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<td>2.</td>
<td>The legal framework for pledging agricultural land should be strengthened to make such property more useful as collateral, including amending the Law on Pledge and the Law on Administration of Land of Agricultural Purpose.</td>
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<td>3.</td>
<td>The legal and institutional framework for pledging moveable property should be strengthened, including (i) raising the loan size that requires registration (e.g., to KGS 100,000); (ii) consideration of the Pledge Registry’s budget support request to open 21 new offices; and (iii) upgrading the Pledge Registry’s systems to allow for online registration and searches.</td>
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<td>4.</td>
<td>The regime to execute collateral of all types should be improved, including (i) facilitating out-of-court settlement by eliminating the requirement that both parties agree on the value of the pledge in the pledge agreement; (ii) streamlining in-court settlement to shorten the period for executing collateral; and (iii) making procedures for appraisals and auctions more transparent.</td>
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| 5. | The Microfinance Law and associated regulations should be improved, including (i) resisting any attempt to impose interest rate caps; (ii) introducing fit-and-proper tests for MFO owners and managers, as well as consumer protection regulations, to address questionable behavior by unscrupulous MFOs; (iii) authorizing NBKR to allow qualified
MFCs to take demand deposits and term deposits, at its discretion on a case-by-case basis; and (iv) (vi) revoking the licenses of inactive MFOs.

| 6. | A credit information law should be passed, making membership mandatory for banks, as well as MFOs and credit unions with a minimum number of clients, and optional for other MFOs and credit unions. Participants should be required by law to provide information to the credit bureau. |
| 7. | A strategy to strengthen governance in credit unions and FCSDCU, including privatization of FCSDCU, should be prepared and implemented. Technical assistance for institutional and operational capacity should be provided to the credit unions and FCSDCU. |
| 8. | Financial institutions should develop new products and services demanded by the market, such as factoring, leasing, and trade finance instruments, and should improve their risk management and credit assessment skills, including development of credit scoring models. Donors should provide technical assistance where needed. |
| 9. | The unequal VAT treatment of leasing should be eliminated. |
| 10. | Technical assistance and other support should be provided to small businesses to make them more bankable. |
| 11. | An appropriately simplified IFRS for small businesses should be more strictly enforced, while also providing assistance to firms to apply IFRS and strengthening the local accounting profession. An action plan based on the recommendations of World Bank 2008 Accounting and Auditing ROSC should be prepared and implemented. |
I. INTRODUCTION

1. The purpose of this paper is to report on the level of access to formal financial services\(^1\) in the Kyrgyz Republic, assess the key obstacles to improving access, and make recommendations to overcome these obstacles. The paper is organized as follows. Sections II to IV examine the supply of financial services. Specifically, section II presents a profile of financial intermediation by banks, focusing their supply of financial services, particularly lending and deposits. Section III presents a profile of lending by Aiyl Bank, a specialized bank with a limited license, which is mandated to lend for agriculture. Section IV presents a profile of lending by non-bank financial institutions (NBFIs), including microfinance organizations (MFOs) and credit unions. Section V examines the demand side for financial services, drawing on enterprise surveys to assess firms’ perceptions of their access to finance. Section VI presents a brief analysis of the impact of the events of April 2010 on access to finance. Section VII discusses key obstacles in increasing access to finance from banks and NBFIs. Section VIII concludes with policy recommendations that derive from the preceding analysis.

II. PROFILE OF FINANCIAL INTERMEDIATION BY THE BANKING SECTOR

2. Since 2005, the Kyrgyz banking sector has expanded significantly, but this growth has declined since the global financial crisis began, and the sector remains small. Total banking system assets as a percentage of GDP increased from 25 percent in 2006 to 35 percent at end-2009. The favorable global environment until late 2007 helped fuel a credit boom driven by capital inflows. Bank credit increased on average by 55 percent in 2004-2007, although it slowed down to a 23 percent growth in 2008, and declined by – 1.5 percent in 2009, due to the economic crisis that led to increased risk aversion in banks and thus, to a slowdown in credit. As a share of GDP, credit provided by the banking sector increased from 9.9 percent in 2006 to 14.9 percent in 2007, and fell to 12.8 percent of GDP at end-2009 (Table 1).

<table>
<thead>
<tr>
<th>Table 1. Basic Indicators of the Kyrgyz Banking System</th>
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<td>(in percentage, except number of banks)</td>
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<td></td>
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<tr>
<td>Number of Banks</td>
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<tr>
<td>Asset/GDP</td>
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<td>Assets Growth y/y</td>
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<td>Deposits/GDP</td>
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<td>Deposit Growth y/y</td>
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<tr>
<td>Household deposits/GDP</td>
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<td>Household deposits y/y</td>
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<tr>
<td>Corporate deposits/GDP</td>
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<td>Corporate deposits y/y</td>
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\(^{1}\) This policy note is limited to the formal sector, including banks, microfinance organizations, and credit unions, and does not analyze informal financial services, such as family, friends, and informal moneylenders. No estimates of the size of the informal sector are available, although it is thought to be large.
3. **Bank lending remains limited, partly due to lack of effective competition in the banking sector.** While there are 22 banks in the country, effective competition among banks is limited due to the highly concentrated nature of the banking system. At end-2009, the largest bank accounted for 33 percent of total assets and about 53 percent of deposits, while the 3 largest banks (by assets size) accounted for over 48 percent of assets and the 3 largest banks by deposit size accounted for 70 percent of deposits. Very few banks are active in lending, with most of them being deposit collection entities with small loan portfolios. At end-2009, lending represented only 37 percent of total bank assets. Banks hold a large percentage of their assets in liquid assets (52 percent of total assets) and securities (about 11 percent of total assets) as of end-2009. See Figure 1.

4. **Bank credit penetration in the Kyrgyz Republic is, therefore, amongst the lowest in ECA.** Bank credit to GDP stood at 12.8 percent of GDP, much lower than in the ECA region (46 percent) and in CCA countries (27 percent). However, according to the financial indicator tool “Finstats,” which controls for countries’ structural factors, bank credit/GDP level has been above the expected median since 2006 and at the expected 75th percentile in 2007 (Figure 2). Loan penetration is low, with only 25 bank loan accounts per 1,000 adults, compared to 192 in Armenia, 349 in Georgia, and 687 in Latvia. See Figure 3.

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<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tbody>
<tr>
<td>Credit/GDP</td>
<td>9.9</td>
<td>14.9</td>
<td>13.6</td>
<td>12.8</td>
</tr>
<tr>
<td>Credit Growth y/y</td>
<td>47.2</td>
<td>83.7</td>
<td>22.8</td>
<td>-1.5</td>
</tr>
<tr>
<td>Household Credit/GDP</td>
<td>2.2</td>
<td>3.3</td>
<td>3.0</td>
<td>2.6</td>
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<td>Household Credit Growth y/y</td>
<td>118.2</td>
<td>83.6</td>
<td>22.7</td>
<td>10.5</td>
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<tr>
<td>Corporate Credit/GDP</td>
<td>6.4</td>
<td>9.8</td>
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</tr>
<tr>
<td>Corporate Credit Growth y/y</td>
<td>34.8</td>
<td>87.4</td>
<td>21.2</td>
<td>3.9</td>
</tr>
</tbody>
</table>

*Source: NBKR*

Figure 1. Bank Lending and Liquid Assets

<table>
<thead>
<tr>
<th>Year</th>
<th>Liquid assets/total assets</th>
<th>Loans/total assets</th>
<th>Securities/total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>30</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>2006</td>
<td>30</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>2007</td>
<td>30</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>2008</td>
<td>30</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>2009</td>
<td>30</td>
<td>30</td>
<td>10</td>
</tr>
</tbody>
</table>

*Source: NBKR*

---

2 CCA countries include: Armenia, Azerbaijan, Georgia, Kazakhstan, Tajikistan, and the Kyrgyz Republic. Bank credit data excludes Tajikistan and Uzbekistan.

3 Finstats benchmarks the Kyrgyz Republic statistically against others countries, by providing the expected median, the expected 25th percentile and the expected 75th percentile, based on the country’s structural characteristics, i.e. by controlling for economic development, population, demographics, and a few other factors.
5. Similarly, penetration of deposit services in the Kyrgyz Republic remains amongst the lowest in the region. At end-2008, deposits accounted for 20 percent of GDP, compared to 32 percent in ECA and 15 percent in the Caucus and Central Asia (CCA) region. While this is above the average for CCA countries, the figure hides the very low outreach of deposit services in the Kyrgyz Republic. In fact, the statistical benchmark suggests that the deposit/GDP level in the Kyrgyz Republic has been in line with its expected median since 2006, but well below the expected 75th percentile, suggesting that there is scope for improvement (Figure 4). In 2008, there were only 115 deposit accounts per 1,000 adults, compared to 572 in Armenia, 661 in Georgia, and 1,218 in Latvia. In the ECA region, only Tajikistan had a lower deposit penetration of 46 deposit accounts per 1,000 adults. See Figure 5. As a result, individual deposits constitute only 24 percent of total deposits, while deposits of legal entities constitute 76 percent of deposits. Moreover, most of the recent growth in deposits has come from legal entities, while growth in individual deposits has lagged behind (Figure 5).
6. There is a limited bank branch network and banks’ perceptions of the high risks and costs of lending in rural areas are self-reinforcing. The Kyrgyz Republic also has one of the lowest bank branch penetration rates in ECA. There were 239 bank branches at end-2009, 38 percent of which are located in Bishkek and Osh oblasts. There are only 6.3 branches per 100,000 adults compared to 15.69 in Armenia, 18.61 in Georgia, 21.58 in Kazakhstan, and 11.96 in Latvia. A few countries such as, Tajikistan, Russia, and Ukraine, have a lower branch penetration than the Kyrgyz Republic. The geographic penetration of branches is also one of the lowest in ECA, with only 0.03 branches per thousand km², compared to 0.28 in Armenia, 0.2 in Georgia, and 0.08 in Latvia. See Figure 7. This low branch penetration makes lending outside of the large cities costly, and these costs in turn discourage banks from expanding their operations outside of the cities.
7. The bulk of bank lending is for enterprises in Bishkek, while lending to agriculture lags behind. At end-2009, 67 percent of bank lending was concentrated in Bishkek, and 68 percent of loans were issued to enterprises, including 41 percent to trade activities, a sector that accounted for 23 percent of GDP. As a share of GDP, loans to enterprises increased from 4.7 percent in 2004 to 9.8 percent in 2007, before decreasing to 8.8 percent at end-2009. Although loans to the agricultural sector have increased in recent years, the financing gap in this sector remains large. In 2005, only 2.9 percent of bank loans were allocated to agriculture, when this sector accounted for almost one third of GDP. In comparison, at end-2009, about 13 percent of loans were allocated to agriculture, which by then accounted for 22 percent of GDP.
Bank lending to households has grown rapidly but still accounts for a small portion of bank lending. Household loans (mortgage and consumer loans), as a share of GDP, increased from 0.8 percent in 2004 to 3.3 percent in 2007, but then decreased to 2.6 percent at end-2009. The growth in household loans was driven by mortgage loans. As a share of GDP, mortgage loans increased from 0.3 percent in 2004 to 2.4 percent in 2007, before falling to 1.6 percent of GDP at end-2009. At end-2009, 12 percent of all loans were issued for mortgages and 8 percent for consumers. See Figure 10.

The maturity of bank loans remains short, although they increased until 2007 and have stagnated since then. The crisis has impacted the issuance of longer term loans in 2009. The volume of loans outstanding with maturities above one year increased from 55 percent in 2005 to 68 percent in 2007. However, loan maturities have remained at a similar level in 2009, with 69 percent of loans maturing in over one year. See Figure 11.
10. The maturity of bank loans has improved across sectors of the economy. Loan maturities have become longer, particularly in the agricultural, trade, and construction sectors. In the agricultural sector, only 26 percent of all loans were above one year in 2005 compared to 69 percent in 2009 (see more on the maturity of agricultural loans from Aiył Bank below). In the trade sector, 22 percent of all loans had maturities of above one year in 2005 compared to 64 percent in 2009. See Figure 12.

Figure 12. Bank Loan Maturities across Sectors of the Economy

Source: NBKR

III. PROFILE OF FINANCIAL SERVICES OF AIYŁ BANK

11. Aiył Bank, previously named the Kyrgyz Agricultural Finance Company (KAFC), was created in 1997 to increase credit to the agricultural and rural sector. KAFC played an important role in the financial sector with a dominant position in rural finance, accounting for over 61 percent of all credit to agriculture at end-2005, and providing credit to one in four borrowers in the financial sector. KAFC provided loans with long maturities, accepted a wider range of collateral, and heavily subsidized its interest rates. At end-2006, KAFC was transformed into Aiył bank. It was allowed to lend only to the agricultural sector and in local currency. Its
license was expanded in November 2009 to allow it to lend in foreign currency, to take deposits up to 25 percent of its capital, and to lend up to 30 percent of its portfolio for non-agricultural activities. Aiyl Bank has generally made loans at lower than-market interest rates, owing to its funding from concessional World Bank and ADB credit lines as well as its operational efficiency, which has been much better than in the rest of the financial sector. For example, KAFC’s operating costs (including provisions) as a percentage of assets was 5-7 percent at a time when commercial banks’ operating costs were 15-20 percent of assets. Hence, the bank remains profitable, with an ROE of 8.04 percent and an ROA of 1.78 percent. Nonetheless, its profit margin declined rapidly from a 34 percent in 2008 to 6 percent in 2009. The bank also has a low share of nonperforming loans (1.5 percent of the loan portfolio).

12. **Aiyl Bank plays an important role in providing financing to the agriculture sector.** At end-2009, its assets stood at KGS 2.6 billion and its lending portfolio at KGS 2.5 billion. See Figure 24. The average loan size is about KGS 88,000, with the vast majority of lending in the form of loans between KGS 40,000 and 200,000. See Figure 13. The number of borrowers has been on the decline since 2007, from 46,172 borrowers in 2007 to 36,821 in 2008, and to 31,405 in 2009. Despite the decrease in the number of borrowers and number of loans, the credit portfolio has increased because the bank has increased its share of group lending.

**Figure 13. Assets and Lending Portfolio of Aiyl Bank**

![Graph showing assets and loans of Aiyl Bank from 2003 to 2009.](source: NBKR, Aiyl Bank)

**Figure 14. Aiyl Bank’s Lending by Loan Size, 2009**

![Pie chart showing the distribution of loan sizes.](source: Aiyl Bank)
13. **The bulk of the credit granted by Aiyl Bank is for cattle breeding.** At end-2009, 77 percent of all lending was for cattle breeding, 10 percent for plant production, and 5 percent for trading activities. See Figure 15. Traditionally, the bulk of the lending has been allocated for cattle breeding. In recent years, however, there has been a substantial increase in lending for plant and production (10 percent in 2009 versus one percent of lending in 2005) as well as a decrease in lending for construction and agricultural buildings (negligible in 2009 versus 4 percent of lending in 2005). Lending in the category of “Others” includes beekeeping, poultry breeding, national handcraft, service operation in the village, tourism, financial services, and production of agricultural facilities and inventory.

![Figure 15. Aiyl Bank: Credit portfolio by Sector, 2009](image)

14. **Aiyl Bank provides considerably more credit to the regions than other banks.** While banks provide 85 percent of their loans to Bishkek, Chui, and Osh oblasts, Aiyl Bank issues only 45 percent of its lending to these cities/regions and the rest to the other regions of the country. See Figure 16.

![Figure 16. Aiyl Bank’s Lending by Oblast, 2009](image)

15. **In contrast to MFOs, whose loans are predominantly short term, Aiyl Bank’s lending is mostly long term.** In 2009, 97 percent of its loans were for at least one year, including 39 percent longer than three years. Moreover, lending for terms of over three years has grown significantly in recent years, as shown in Figure 17.
IV. PROFILE OF LENDING BY NON-BANK FINANCIAL INSTITUTIONS

16. NBFIs are playing an increasingly important role in providing financing to the private sector, targeting sectors and geographical areas that are not reached by the banking sector. NBFIs provided 26 percent of all credit provided by the financial sector as of end-2009. They are contributing significantly to increasing access to finance to smaller borrowers. Over the past few years, various types of NBFIs have been active in the market, including microfinance organizations (MFOs), credit unions (CUs), and Aiyl Bank. NBFIs’ credit has been growing fast, largely under donor-supported programs, expanding outreach to smaller enterprises, poorer people, the agricultural sector and rural areas. Their assets have increased by an average of about 70 percent per year between 2005 and 2008, slowing to 11 percent in 2009, reaching KGS 11.9 billion (6 percent of GDP). NBFIs’ loans increased similarly and reached KGS 8.9 billion (4.5 percent of GDP) at the end of 2009.

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Figure 17. Maturity of Aiyl Bank Lending

<table>
<thead>
<tr>
<th>2003</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 6 months</td>
<td>&lt; 6 months</td>
</tr>
<tr>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>6-12 months</td>
<td>6-12 months</td>
</tr>
<tr>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>12-36 months</td>
<td>12-36 months</td>
</tr>
<tr>
<td>72%</td>
<td>58%</td>
</tr>
<tr>
<td>&gt; 36 months</td>
<td>&gt; 36 months</td>
</tr>
<tr>
<td>26%</td>
<td>39%</td>
</tr>
</tbody>
</table>

Source: Aiyl Bank

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4Aiyl Bank, formerly Kyrgyz Agriculture Financing Company (KAFC), received a limited banking license at end-2006. The license limited Aiyl Bank to lend only to the agricultural sector in local currency, but did not allow it to accept deposits. In December 2008, this license was expanded to allow it to conduct money transfers. On November 15, 2009, Aiyl Bank’s license was further expanded to allow it to: (i) accept deposits up to 25% of its capital (and join the deposit insurance system), (ii) to make loans in foreign currency, (iii) conduct leasing, (iv) issue guarantees, and (v) lend up to 30% of its credit portfolio for non-agricultural activities. Aiyl Bank is included as a NBFI until 2006 and in the banking sector data as of 2007, unless otherwise indicated.
In recent years, NBFIs have grown in numbers and have expanded their operations. The number of NBFIs has grown from 763 at end-2004 to 1,231 at end-2009. At end-2009, there were 358 MFOs (including 4 microfinance companies, 226 microcredit companies, and 129 microfinance agencies), 238 credit unions, 257 pawn shops, and 377 exchange bureaus.5 See Table 2. NBFIs have been effective in increasing their client base from 85,000 borrowers in 2005 (plus another 31,000 borrowers from KAFC) to 313,495 borrowers as of Q2 2009. See

5 The share of pawn shop credit is negligible, accounting for about one tenth of one percent of financial sector lending in 2009, while exchange offices are limited to currency exchange. Hence, neither is discussed in detail in this paper.
Table 2. Number of NBFIs

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total NBFIs</td>
<td>763</td>
<td>831</td>
<td>870</td>
<td>990</td>
<td>1088</td>
<td>1231</td>
</tr>
<tr>
<td>Microfinance organizations</td>
<td>75</td>
<td>106</td>
<td>147</td>
<td>232</td>
<td>291</td>
<td>359</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>microcredit companies</td>
<td>21</td>
<td>35</td>
<td>57</td>
<td>103</td>
<td>170</td>
<td>226</td>
</tr>
<tr>
<td>microcredit agencies</td>
<td>54</td>
<td>71</td>
<td>89</td>
<td>127</td>
<td>119</td>
<td>129</td>
</tr>
<tr>
<td>micro-finance companies</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Credit unions</td>
<td>305</td>
<td>320</td>
<td>308</td>
<td>272</td>
<td>248</td>
<td>238</td>
</tr>
<tr>
<td>Pawnshops</td>
<td>116</td>
<td>141</td>
<td>145</td>
<td>180</td>
<td>196</td>
<td>257</td>
</tr>
<tr>
<td>Exchange offices</td>
<td>266</td>
<td>263</td>
<td>269</td>
<td>306</td>
<td>353</td>
<td>377</td>
</tr>
<tr>
<td>KAFCAiyil Bank</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: NBKR
19. **NBFIs are expanding to rural areas and poor segments of the population that are not serviced by banks.** While there is a high concentration of loans in the regions of Osh (24 percent) and in Bishkek (19 percent), NBFIs are focusing more on poorer areas and less in the Bishkek and Osh oblasts, which are serviced by banks. For example, credit to Jalalabad has increased from 13 percent of the portfolio in 2006 to 16 percent in Q2 2009, to Talas from 6 percent in 2006 to 9 percent in 2009, and to Batken from 7 percent in 2006 to 9 percent in 2009. See Figure 20.

20. **The bulk of NBFI lending goes to agriculture and trade.** The share of lending to the agricultural sector has increased. NBFIs allocated 42 percent of loans to agriculture as of the end of 2009, compared to 29 percent in 2005. In the trade sector, they allocated 35 percent of lending as of end-2009, compared to 45 percent in 2005. See Figure 21.
Microfinance Organizations

21. **MFOs are the fastest growing segment of the financial system and provide the bulk of NBFI credit.** They account for about 23 percent of all credit provided by the financial system (compared to 13 percent of all credit in 2005) and 89 percent of all NBFI credit. MFOs have been successful in rural lending, although in early years, this segment was dominated by KAFC (now Ayl Bank). The loan portfolio of MFOs increased by 56 to 97 percent each year from 2005 to 2008, before slowing to 25 percent in 2009. See Figure 20. MFO lending increased from 1.5 percent of GDP in 2005 to 4 percent of GDP in 2009. Their client base has also increased rapidly. The number of borrowers doubled from 42,000 in 2004 to 82,000 in 2006, increased to 143,000 in 2007, and to 306,400 in 2009.

22. **Many MFOs have grown rapidly and a few have the potential to be transformed into banks in the near future.** This sector performs well and has the institutional capacity to expand further. Although there were 359 MFOs at the end of 2009, the sector is concentrated in the three largest entities: FINCA, Bai Tushum, and Kompanion account for 75 percent of the loan portfolio of MFOs. These MFOs are supported by strong donors, and their development is dependent on funding from these donors, with some access to commercial credit lines from
financial institutions. A few of the dominant MFOs expect to obtain a license to take deposits in 2011.

23. **MFOs have been successful in expanding credit to rural areas, despite the early domination of KAFC in this segment.** MFOs are primarily concentrated in financing agriculture (41 percent) and trade (35 percent). In previous years, they were concentrated in financing mostly trade (for example, 56 percent in 2005 compared to only 25 percent of lending to agriculture) but have gradually entered the rural markets and compete with the credit unions. See Figure 23.

![Figure 23. MFO Credit Portfolio by Sector and Oblast, 2009](image)

*Source: NBKR*

24. **Despite the seemingly higher risk of agricultural lending, MFOs have maintained high performance in their lending portfolio, particularly the larger MFOs.** The portfolio at risk (PAR) for all MFOs was 3.86 percent at the end of 2009, compared to 8.2 percent for banks. Moreover, it was barely one third of that for the five largest MFOs, which comprise 88 percent of the market and had an aggregate PAR of only 1.33 percent. In contrast, the smaller MFOs that make up the other 12 percent of the market had a PAR of 22.4 percent. Given the strong performance of the larger MFOs, it is noteworthy that a significant portion of their lending is secured by group guarantees rather than physical collateral. Moreover, while data is limited for the sector as a whole, one of the large MFOs, which comprises about 25 percent of the market, reports a PAR of 2.72 percent for its total lending portfolio, but only 0.91 percent for its agricultural portfolio, demonstrating the potential of high performance in agricultural lending.

25. **The tenor of MFOs’ agricultural loans appears to be increasing.** The World Bank surveyed four MFOs in early 2010 – two large MFOs, and two medium sized MFOs – which collectively comprise about 50 percent of the microfinance market. Among these four MFOs, only 7 percent of loans (by amount) had a tenor of less than 6 months; 47 percent had a tenor of 6-12 months; and 46 percent had a tenor of 12-36 months. Moreover, this marked a significant shift from 6-12 month loans to 12-36 month loans since 2007. See Figure 24.
Figure 24. Share of MFO agriculture loans of different terms, 2007 - 2009

Source: World Bank staff estimates

26. The vast majority of MFO lending for agriculture has been in the KGS 40,000 – 200,000 range. Based again on the survey of four MFOs conducted by the World Bank in early 2010, 70 percent of such loans (by amount) were in this range at the end of 2009. This was up only slightly from 68 percent in 2007. The share of larger loans, above KGS 200,000, has fallen from 16 percent in 2007 to only 10 percent in 2009. See Figure 25.

Figure 25. MFO Agriculture Loan Size

Source: World Bank staff estimates

27. These loan sizes are consistent with their primary use for working capital in agricultural and livestock production. As shown in Figure 26 below, in the four MFOs surveyed, 93 percent of MFO agricultural loans are used for livestock production, while only 5 percent is used for agricultural production, and only 2 percent for other purposes (agricultural trade, processing, and services).
Credit Unions

28. Credit unions account for a very small share of credit to the private sector. In 2009, credit unions provided 2.8 percent of total financial sector credit and 10.8 percent of NBFI credit. Their lending portfolio increased by 29 percent in 2005 and has increased slowly since 2006, with a 15 percent growth rate from 2006 to 2008, and 8.7 percent growth in 2009. At end-2009, loans outstanding were KGS 959 million. Credit unions provide larger loans than MFOs and at slightly lower interest rates (30 percent versus 34.5 percent for MFOs). In 2009, the average loan size averaged KGS 52,000, compared to KGS 26,000 for MFOs. Over the years, their client base has been on the decline. The number of borrowers remained at around 21,000 – 22,000 from 2004 to 2007, decreased to 18,800 in 2008, and to 18,274 in 2009. There are 238 credit unions operating in all regions of the country, mainly in the rural areas. At end-2009, the bulk of their credit (50%) is allocated to agriculture, and 33 percent to trade and commerce. See Figure 27.

Source: NBKR
29. **Of the 238 credit unions, only 11 are licensed to raise deposits.** However, they are among the largest credit unions and represent 27.1 percent of the credit market of credit unions. They had a total of KGS 32 million in deposits at the end of 2009. Approximately 10 more credit unions are currently planning to apply for a deposit-taking license. NBKR’s criteria for granting a license include the following criteria: (i) two years of profitable activities; (ii) capital not less than KGS 500,000; (iii) institutional capital not less than 12 percent out of CU’s total assets; (iv) compliance with all NBKR prudential requirements; (v) satisfactory deposit and liquidity management policies; and (vi) satisfactory IT system.

V. **PROFILE OF ENTERPRISES AND THEIR ACCESS TO FINANCE**

30. **MSMEs represent the backbone of the Kyrgyz economy.** MSMEs make up 99.9 percent of all enterprises in the Kyrgyz Republic. Of these firms, 60 percent are farmers and 38 percent are individual entrepreneurs. Only 2 percent are small or medium, while only 0.07 percent are large. The majority of MSMEs work in trade, hotel and restaurants, and the agricultural sector, while the large enterprises are concentrated in the manufacturing and communication sectors in Bishkek. See Figure 29.

**Figure 29. Distribution of Enterprises by Size and Sector of Economy, 2008**

*Source: National Statistics Committee*
31. **MSMEs contribute significantly to GDP, employment and export.** As of 2008, MSMEs employed about 95 percent of the working population, 81 percent of which are farmers. MSMEs contribute 42 percent of GDP, about 42 percent of total exports, and the value of their exports stood at $773 million (about 16 percent of GDP) at end-2008. See Figure 30.

**Figure 30. Contribution of MSMEs to GDP, employment and exports, 2008**

![Pie charts showing the contribution of large, medium, and small enterprises and individuals to GDP, employment, and exports.](chart)

Source: National Statistics Committee

32. **SMEs, however, have significantly less access to financial services than large enterprises.** Only 20 percent of firms have a line of credit or a loan, compared to an average of 30 percent in the southern FSU countries and 45 percent in ECA. SMEs are particularly constrained—only 14 percent of small enterprises and 19 percent of medium enterprises have a line of credit or loan, compared to 51 percent of large enterprises. A similar pattern is seen in the proportions of small, medium, and large enterprises with a checking or saving account. See Figure 31.
33. **Despite the greater access that large firms have, small, medium, and large firms alike perceive access to finance as a significant constraint.** In 2008, more than half of small firms, 62 percent of medium firms, and 68 percent of large firms perceive access to finance as a significant obstacle (a moderate, major, or very severe obstacle). Nevertheless, firms in the Kyrgyz Republic consider other issues, such as electricity, corruption, and tax rates, more severe obstacles than access to finance, as only 16 percent of firms perceive access to finance as the biggest problem to their operations. See Figure 32.

34. **Firms’ perceptions on access to finance have worsened since 2005.** The BEEPs survey of 2008 indicates that more than half of all firms in the Kyrgyz Republic indicate that access to finance is an obstacle to doing business (a moderate or major obstacle), and this has increased from 36 percent in 2005. This is higher than in the southern FSU countries and in the region. Another 7 percent of firms perceive access to finance as a very severe obstacle. In 2005, almost half of all firms indicated that access to finance is not an obstacle to doing business. However, in

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6 BEEPs 2005 and 2008 data are only partially comparable due to a change in survey design. For example, the BEEPs 2005 survey did not include the “very severe” category, but instead “major” obstacle was the most serious option. It is important to look at the trends rather than exact numbers.
2008, only 24 percent of firms indicated that access to finance is not an obstacle to doing business, less than in the southern FSU countries and the ECA region. See Figure 33.

**Figure 33. Access to finance as an obstacle to doing business**

![Chart showing access to finance as an obstacle to doing business](chart)

*Source: BEEP 2008*

35. **However, firms perceive an improvement in loan conditions, including more favorable interest rates.** In 2008, 25 percent of firms indicated high interest rates as the main reason for not applying for a loan (compared to 19 percent in the southern FSU countries and 15 percent in ECA). This represents a significant shift in firms’ perceptions on interest rates since 2005, when almost half of all firms cited high interest rates as the main reason for not applying for a loan (compared to 24 percent in the southern FSU countries). This perception coincides with the fact that average interest rates declined from 29 percent in 2004 to about 20 percent in 2008. However, they still remain relatively high compared to the average rate of 17 percent in the CIS region. Interest rate spreads decreased in 2004-2007, from 18.2 percent in 2004 to 16.2 percent in 2007. However, due to the global financial crisis and the tightened credit by banks in the country, they have started to increase again since 2008, and they stood at above 19 percent at end-2009. See Figure 34.

**Figure 34. Average Bank Lending Interest Rates and Interest Rates Spreads**

![Chart showing average bank lending interest rates and interest rates spreads](chart)

*Source: DDP*

36. **Firms also report lower collateral requirements.** Collateral requirements seem to have eased significantly since 2005, since only 7 percent of firms reported collateral requirements as
the main reason for not applying for a loan in 2008, compared to 28 percent of firms in 2005. See Figure 31. Still, most credit is secured by real estate, with a large share of small firms securing loans with the owners’ personal assets. More than half of all firms reported securing loans with real estate collateral, about 39 percent with machinery and equipment, 9 percent with accounts receivable, and 26 percent with the owners’ own assets. Small firms in particular (more than half of them) reported securing loans with the owners’ personal assets. See Figure 36.

**Figure 35. Share of firms indicating the following issues as the main reason for not applying for a loan**

![Figure 35](image1)

*Source: BEEP, 2008*

**Figure 36. Types of collateral required for a loan**

![Figure 36](image2)

*Source: BEEP, 2008*

37. **Banks serve larger firms, while NBFIs serve a greater proportion of smaller firms.** More than 65 percent of firms reported that their most recent loan was granted from commercial banks, 20 percent from state-owned banks, and 10 percent from NBFIs. The role of NBFIs is particularly important for small enterprises, 46 percent of which obtain financing from private banks, 31 percent from state-owned banks, and 23 percent from NBFIs. See Figure 37.
38. **Due to funding constraints, firms rely mostly on retained funds to finance their fixed assets.** Firms finance more than half of their fixed assets with retained earnings, 19 percent with owners’ contributions, 17 percent from borrowings from private banks, less than 2 percent from state banks, and about 1 percent from credit from suppliers and customers. Small firms finance almost all of their fixed assets with internal funds and owners’ contributions. See Figure 38.

**Figure 38. Share of fixed assets financed by different funding sources, 2008**

39. **The limited access to credit is a key obstacle to private sector growth and poverty reduction.** Without access to long-term finance, companies face significant problems in financing investments for expansion or acquiring modern technologies. Micro, small, and medium enterprises (MSMEs) in particular have difficulty accessing long-term finance. As a result, equipment remains obsolete and firms can neither compete with other firms nor expand.
their activities. This is a significant obstacle to the expansion of exports, competing in international markets, employment generation, and to private sector growth. Similarly, access to short-term finance is essential to finance working capital of enterprises to ensure uninterrupted operations.

VI. IMPACT OF POLITICAL EVENTS OF APRIL 2010 ON ACCESS TO FINANCE

40. The abrupt overthrow of the government in April 2010 appears to have had limited impact on access to finance in the Kyrgyz Republic. Bank lending fell by 1.6 percent in April and by another 0.5 percent in May, but then increased by 1 percent in June. Banks reported relatively little direct impact from the April events, although most reported small drops in demand for loans stemming from a general loss in confidence in the business sector. The 10 day moratorium on any transactions with real estate effectively prevented banks from making collateralized loans during that period. KGS liquidity is an area for concern. The majority of local currency liquidity in the market was concentrated in AUB, due to the high volume of government accounts held there. Additionally, in order to control the devaluation of the KGS, NBKR sold $62 million from the beginning of the year, which reduced the availability of local currency further.

41. The impact on MFO and credit union lending has also mostly been small or temporary. Some MFOs and credit unions had accounts in banks that were put under temporary administration and, therefore, they did not have access to these accounts for 7 to 10 days in April. Moreover, collateral registries were not operating for about three weeks in April, so MFOs and credit unions were unable to register collateral of borrowers. Some MFOs suffered minor damage during the disturbances. For these reasons, some MFOs reduced lending by as much as 30% compared to their targets for April. However, normal lending has largely resumed, and the effects of the slowdown in lending are considered minimal for most MFOs. Hard data is available only on five large MFOs. Relative to April 2009, total disbursements by these MFOs increased in April 2010 by 24 percent; and outstanding loan volumes at the end of April 2010 were 20 percent higher than the end of April 2009. However, this increase was somewhat lower than targeted.

42. The impact on loan recovery has thus far been small, but might grow slightly in the next few months. Non-performing loans began rising (to 9.4 percent) following an earlier improvement as the effects of the 2008 global crisis were wearing off. Return on equity also fell. In the face of uncertainties, banks shifted toward higher liquidity. At the same time, the loan portfolio shrank (partly as a result of a temporary moratorium on transactions involving real estate), and system-wide capital ratios rose. Banks reported low numbers of clients who requested restructuring or rescheduling of their loans, although banks are concerned that there will be further deterioration if the borders remain closed or political instability continues. The

\[\text{7} \quad \text{Disbursements of four of the five MFOs increased in April 2010 compared to April 2009; one MFO’s disbursements decreased by 10 percent. However, the portfolios of all five were larger at the end of April 2010 compared to April 2009.}\]
banks have requested that NBKR reduces its required 25% provisioning to 5% for those loans restructured as a direct consequence of recent events. Most MFOs and credit unions report that their portfolio at risk (PAR) has not changed, or has increased only slightly, since the events of April. For the five large MFOs for which there is data, classified loans increased to 1.73 percent of the loan portfolio at the end of April 2010, compared to 1.44 percent at the end of April 2009. PAR for some smaller MFOs increased to as much as 10% in mid April because bank closures prevented collections; however, they have largely recovered, and PAR has fallen below 5%. Some MFOs report mild concerns that PAR may increase by a couple percentage points in the next few months because some of their borrowers, especially traders, were adversely affected by border closings, which temporarily cut off export markets and lowered the price of agricultural output inside of the Kyrgyz Republic.

43. **MFOs report that their funding sources remain solid and reliable.** One MFO, however, reported that international creditors have increased interest rates by just over 1% due to higher perceived risks in lending to Kyrgyz MFOs. Another MFO’s main shareholder delayed disbursement to the MFO in April due to the risks and political uncertainty.

44. **Liquidity in local currency has significantly tightened.** MFOs are allowed to lend only in KGS, but most of their funding comes in USD. To obtain KGS, MFOs typically engage in swaps or back-to-back loans with local banks. However, AUB was the largest source of these operations, accounting for about 80% of the market and charging a spread of 4.5 percent.\(^8\) With AUB’s operations suspended, MFOs have limited options to obtain local currency. KGS liquidity in other banks has tightened since April, as interest rates on government T-bills have risen and as the government has intervened in FX markets to maintain the strength of the local currency. Hence, other banks’ swaps and back-to-back loans are more expensive (spreads of 7 to 9 percent) and have shorter tenors. The uncertainty about AUB’s reopening creates uncertainty for MFOs in obtaining local currency in the future.

45. **Some MFOs suggested that, overall, the environment for their business is safer now than before.** Prior to the events of April, some MFOs felt threatened by the market growth of AUB and AUB-Agro, which were perceived as benefiting from favoritism of the previous authorities. They indicated their expectations of a level playing field in the future.

### VII. Obstacles to Increasing Access to Financial Services

46. **Access to finance in the Kyrgyz Republic, particularly banking services, is low and has become more limited in 2009 due to the global economic crisis.** Due to high uncertainty caused by the crisis, banks have held on to excess liquidity to prepare for a potential deterioration in their financial health. At the same time, the decline in economic activity

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\(^8\) As of May 1, MFOs had foreign-denominated borrowings of $134.8 million, of which $104 million was used for swaps or back-to-back loans.
combined with the decline in remittances (by about 20 percent at end-2009) has led both to low demand for new loans and cautious lending policies by banks.

47. **The supply of financial products to MSMEs is particularly limited due to legal constraints, as well as weak capacity in the banking sector.** There is no factoring (i.e. the purchase of commercial accounts receivable to provide short term finance to small suppliers) despite the fact that all commercial banks (except Aiyl Bank) and four MFCs have licenses that allow factoring. There is also very little leasing for equipment financing, as it is taxed disadvantageously compared to borrowing a loan. Specifically, imported equipment that is purchased with a loan is not subject to value added tax (VAT), whereas imported equipment that is leased is subject to VAT. Moreover, there are inadequate export financing instruments, and no financial instruments for start-ups and innovation financing due to weak and labor-intensive credit assessment skills in the banking sector and the lack of modern credit assessment tools like credit scoring.

48. **Although bank lending has increased in recent years, it remains limited, especially due to limited competition in the banking sector.** There is limited competition in the banking sector, which allows banks to maintain high margins. The lack of competition results from several impediments that should be addressed, including: (i) the practice of allocating of the deposits of public entities in the largest bank, which reduces competition; (ii) the lack of transparency of the bank licensing process, which is an impediment for the entry of new players; (iii) significantly higher capital requirements for newly licensed banks than for existing banks further decreasing incentives for new players; and (iv) lack of progress on the privatization of Aiyl Bank limiting its capacity to expand outreach in rural areas. Enabling increased competition could contribute to lowering the cost of banking services and expanding banks’ services down-market.

49. **Bank lending remains limited especially to the agricultural and rural areas.** The mountainous geography of the country makes it unprofitable to service isolated areas using traditional banking methods. The limited number of bank branches in rural areas means banks do not get to know rural and agricultural clients as easily as urban clients. Agricultural loans are recognized as risky because many farmers are poor, crop prices can be volatile from season to season and year to year, and yields can also vary significantly from year to year, and yields

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9 In recent years, Asia Universal Bank (AUB) has been increasing its share of the market rapidly, most recently in its acquisition of Promstroy Bank and its extensive branch network in 2009, and is perceived to have enjoyed favored status in the government. For example, the bulk of deposits from the Development Fund and the Social Fund were placed in AUB, giving it the dominant share of deposits in the system. Moreover, the de facto (if not de jure) moratorium by NBKR on issuing new bank licenses (unless the applicant agreed to purchase a bankrupt bank and pay off its liabilities) limited new entrants that could compete against existing banks.

10 In more advanced economies, the risk of price volatility can be managed through futures and options. Such markets, however, do not exist in the Kyrgyz Republic and most less developed economies.
of different farmers in the same area are correlated (so a large loan portfolio in a given area can be wiped out in a bad year). These problems are exacerbated by banks’ lack of sector-specific knowledge and ability to appraise agricultural loans, as well as their lack of appropriate financial and risk management products. Moreover, in the Kyrgyz Republic, provisions of the Law on Pledge and the Law On Administration of Land of Agricultural Purpose limit the usefulness of agricultural land as collateral.\(^{12}\) Other disincentives to lend for agriculture include: (i) the unequal taxation of leasing, which limits leasing of agricultural equipment; and (ii) the requirement to register pledge for loans as small as KGS 25,000, which is costly in terms of travel time and expenses since there are pledge offices only in 7 oblasts.

50. **NBFIs are filling some of the funding gaps, but they face operational and funding costs, as well as legal, regulatory, and institutional constraints.** MFOs operational costs are high due the small average loan size, the remoteness of clients, poor infrastructure and the high risks of some borrowers, such as farmers. They also have high funding costs because they cannot take deposits which would lower their cost of funding. Instead, they depend on international credit lines in foreign currency (usually USD) at interest rates of about 10 percent. They then conduct swaps or back-to-back loans with local banks to obtain local currency funds, adding a spread of 4.5 to 6 percent and yielding costs of funds near 16 percent. Only 11 credit unions are licensed to take deposits. Most credit unions depend entirely on FCSDCU for funding. FCSDCU is financed by a credit line from ADB and charges anywhere from 11 to 20 percent on its loans to credit unions, each of which sets its own rates for onlending to its members.

51. **The absence of bank branches in rural areas means that deposit services are virtually non-existent in these areas, and payment services are limited.** Banks are the only financial institutions licensed to take deposits, other than a few small credit unions. Institutions with a strong rural presence, including the large MFOs and the post office, are not currently used to provide deposit services. Hence, most rural inhabitants do not have access to deposit services. As a result, banks mobilize deposits primarily from large corporations, state-owned enterprises and other state funds (e.g., the Social Fund and Development Fund), and urban households (primarily in Bishkek), while neglecting the potential savings mobilization from rural areas. The shortage of bank branches in rural areas also results in inefficient and costly channels for remittances in poor and rural areas for which they represent a crucial source of income.

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\(^{11}\) Farm yields can be affected in several ways (e.g., bad farming practices, insufficient labor, plant disease), many of which can be controlled by appropriate farm management and technology. In contrast, the ability of farmers to mitigate the impact of weather events like droughts, floods, and frosts is limited.

\(^{12}\) For example, under the Law on Pledge (Art 66), (i) the claim for foreclosure against agricultural land may be refused if the debt is considered “very insignificant” and the amount of the pledgee’s claims is, therefore, “incommensurate with the market value of pledged lands”; and (ii) in case of “valid reasons” for default, such as “bad harvest, natural disasters, flood, hail, and other extreme weather conditions” a court may (at the pledgor’s request) postpone the sale of the land for up to a year. Furthermore, the Law On Administration of Land of Agricultural Purpose adds other limitations: (i) agriculture land shares used as collateral and seized by the lender may be sold only to other shareholders in the same plot of land (Art. 25); and (ii) agriculture land used as collateral and seized by the lender may be sold only to other rural inhabitants (Art. 17 and 26).
52. **The mountainous geography of the country makes it difficult to reach the agricultural and rural areas.** Since opening up branches in these areas is unprofitable for banks, and even NBFIs in some cases, alternative distribution channels should be considered. In particular, the use of the existing infrastructure of the Kyrgyz Post office network to distribute financial products can be an effective way to expand outreach to underserved areas at low cost.

53. **The largest constraint in obtaining access to financing has been interest rates, which are among the highest in ECA.** Several structural factors maintain interest rates at very high levels\(^\text{13}\), including: (i) the limited competition in the banking sector; (ii) lack of adequate financial information on firms due to weak accounting standards and practices; (iii) weak risk management and credit assessment skills; (iv) rapid increase in loans, often leading to hidden NPLs to be realized later; (v) low public confidence in banks, which makes it costly to attract deposits; (vi) weak judiciary, leading to poor contract enforcement and occasional corruption, which raises the risks of lending; (vii) a weak (but improving) credit information system; and (viii) high levels of lending in foreign currency, which imposes exchange rate risk on the borrower, resulting in credit risk to the lender.

54. **Collateral registration and execution makes it more difficult to obtain financing, although collateral requirements have improved since 2005.** Most bank lending in the Kyrgyz Republic is secured by real estate. Moveable collateral (vehicles, equipment, livestock) can also be accepted but to a limited degree. Most banks are highly selective in the collateral that they will accept, limiting this to prime real estate in Bishkek and lending primarily to large borrowers in Bishkek. As a result, most of the financial needs of the poor, as well as of MSMEs, located in rural areas and smaller urban areas are underserved. Collateral requirements have improved since 2005, as the value of collateral required has decreased from 191 percent of the loan amount in 2005 to 128 percent of the loan amount in 2009. This remains higher than in other CIS countries, but lower than the average in the ECA region of 133 percent of the loan amount. See Figure 39.

55. **The collateral registration process has improved, although further weaknesses remain.** The Central Pledge Registry registers pledges in moveable collateral, while the

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\(^{13}\) Interest rates of NBFI loans are high, but they reflect higher operational and funding costs. At end-2009, the average interest rate was about 35 percent for MFO loans and 30 percent for credit unions. The interest rates of NBFIs have increased in the last year: the average interest rates of MFOs increased from 32.5 percent in 2008 to 34.5 percent in 2009; and of credit unions from 28 percent to 29.6 percent. Credit unions’ interest rates vary from about 25 to 30 percent, depending on the length of membership, number of previous loans, and credit history of the borrower.
Department of Cadastre and Registration of Rights to Immovable Property (the State Registry) registers immovable collateral. While these registries work reasonably well in oblast centers where their offices are located, registering collateral by borrowers in more remote locations can be prohibitively costly. The law requires that collateral for all loans greater than KGS 25,000 be registered and that the registration process be made at a pledge or real estate registration office. There are currently only 7 permanent pledge registry offices and 2 temporary offices in the country, located at the oblast level. For borrowers located in remote areas, the costs of making trips to the center where the registry is located make using collateral prohibitively expensive, which in turn restricts their access to bank and non-bank lending. In contrast, there are 50 registration offices for registering immovable property in the country.

56. **Shortcomings also exist in the regime to execute collateral.** Out-of-court settlement is allowed in principle but is almost never used because of obstacles such as the required consent of both parties on the value of the pledge. There are numerous obstacles to efficient in-court settlement as well. Enforcement of both secured and unsecured debts tends to be a long and involved process. The time for execution of collateral or seized assets can range from 3 months for moveable property (in an ideal case with no debtor objection) to 2 to 4 years for execution on real estate. These long delays diminish the value of assets and reduce recovery based on time value of money. Debtors can find ways to obstruct or even frustrate execution proceedings by different forms and methods, some of them abusing of the legal system and sometimes through illegal means.

57. **The slow execution of collateral in courts is also shown by the estimates of the cost of contract enforcement relative to the cost of a debt contract.** Lenders in some countries with high creditor rights (as shown by the strength of legal rights index) encounter high costs in enforcing a contract. The Kyrgyz Republic has a high cost 29 percent of the debt to enforce a contract through the courts, one of the highest in ECA countries. See Figure 40. Moreover, procedures for appraisals and auctions are also not often transparent. For example, there is no central institution or database for obtaining information on auctions.

![Figure 40. Cost to enforce a contract (% of claim)](image)

Note: This measure indicates the cost of enforcing a contract through the court system

58. **Weaknesses in the credit information sharing infrastructure need to also be addressed to expand access to finance.** Doing Business 2010 indicates that the credit information index is 3, down from a score of 5 in 2009, and compares to 5 in Romania, 5 in Estonia, 5 in Russia

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14 The depth of the credit information index measures the degree to which the rules of a credit information system facilitate lending based on the scope of information distributed, the ease of access to information, and the quality of information.
and 6 in Kazakhstan. There is no public registry coverage and the private credit bureau covers only 5.9 percent of the population (a small increase from 3.7 percent in 2008), compared to 68 percent in Poland, 29.5 percent in Kazakhstan, and 30.2 percent in Romania. See Figure 38. The credit bureau was first established in 2003 and began operating in 2004, initially with only seven banks as members. Membership is voluntary, as there is no specific credit information law. Currently, 18 of the country’s 22 banks are members, along with the three largest MFOs and two credit unions. Similarly, participating banks are not required by law to provide information to the credit bureau. As a result, participants express doubts about the value of the information they get from the credit bureau. A working group has been set up to begin work on drafting a law.

59. **Other aspects of the financial infrastructure have improved in recent years, but legal, regulatory, and other weaknesses remain.** The financial architecture supporting credit decisions has been strengthened (including with the establishment of a property registry, a business registry, and upgrades in creditor rights and insolvency laws), and the legal framework for NBFIs has been improved substantially – but further progress is still needed in all these areas. Doing Business 2010 ranks the Kyrgyz Republic 15th on the *Getting Credit* indicator, which is up from a rank of 28 in the DB 2009. See Table 3 and Figure 42. There has been a dramatic improvement in the Strength of Legal Rights Index with a maximum score of 10 (compared to 9 in Ukraine, 8 in Romania, 5 in Kazakhstan, and 3 in Russia), showing that the legislation supporting access to finance has improved.

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15 Two active banks (Aiyyl Bank and Tolubay Bank) are not members, along with two bankrupt banks that have not been liquidated (Akyl Bank and Insan Bank).

16 The working group includes NBKR, the Union of Banks, Microfinance Association, the Credit Bureau, and IFC.

17 The *Getting Credit* indicator measures the sharing of credit information and the legal rights of borrowers and lenders.

18 The Strength of the Legal Rights Index measures the level of protection of the rights of borrowers and creditors as measured by the laws and regulations. Higher numbers mean stronger protection.
Table 3. Doing Business Getting Credit Indicator, 2008-2010

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<td>Private Bureau Coverage (% of adults)</td>
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Source: Doing Business

Figure 42. Doing Business Getting Credit Indicator, 2010

Source: Doing Business

60. Another obstacle to expanding access to finance in the Kyrgyz Republic is Aiyl Bank’s liquidity constraints. It has so far been fully dependent on donor funding for financing, although the recent decision to allow it to collect deposits should improve its ability to obtain more funding and satisfy more demands for loans. However, its current restriction to accept deposits up to only 25 percent of its capital will limit its ability to mobilize significant deposits to finance its lending. Hence, it will continue to remain dependent on credit lines until it obtains a full banking license.

61. Aiyl Bank’s status as a state-owned bank with a mandate to lend to agriculture limits its ability to lend at commercial interest rates and, therefore, be sustainable without recourse to subsidized credit lines. While Aiyl Bank has been committed to privatization since its creation, momentum for this appears to have slowed in recent years. The economic downturn in the wake of the global financial crisis seems to have reduced interest of potential strategic investors. Moreover, both the previous government and the new interim government have seemed intent on capping Aiyl Bank’s interest rates (currently at 12 percent). Such restrictions simultaneously make Aiyl Bank appear less suitable to a strategic investor and may entrench it in its current mode of soliciting limited funds from donors and onlending at below market interest rates. This also risks distorting rural financial markets in general and competing on an uneven playing field with market-oriented financial institutions that do not benefit from Aiyl Bank’s subsidies. Aiyl Bank, and the financial sector as a whole, would benefit from its privatization and obtaining a full deposit-taking license.
62. Obstacles in the legal and regulatory framework for MFOs should be removed to encourage their growth and further expand access to finance.\textsuperscript{19} The framework has been strengthened in recent years, but more progress is needed.\textsuperscript{20}

- The current law guarantees that MFOs are independent and may freely set interest rates and fees as agreed with their clients, but there is pressure to impose interest rate caps. In 2009, a proposal to set interest rate caps was debated in parliament. After objections from MFOs, NBKR, and international donors, compromise language was inserted allowing NBKR to set interest rate caps if it determines that MFOs are behaving monopolistically. While parliament passed this and other amendments in March 2010, the law was not signed by the president before a popular uprising overthrew the government on April 6-7, 2010. Since these events, the interim government and even some officials in NBKR have revived the idea of interest rate caps on MFOs.

- The current law and its implementation limit the ability of MFOs to provide deposit services to their clients. As noted above, most banks do not operate in rural areas, but are the only financial institutions authorized to take deposits. As a result, the vast majority of the Kyrgyz population does not have access to safe, regulated deposit services. The Law on Microfinance limits deposit-taking MFCs to accept time deposits only. No MFCs currently have a deposit-taking license, but in principle this provision would limit MFCs’ ability to raise inexpensive funding (thereby contributing to high microfinance interest rates), and prevent rural households from benefiting from the same range of deposit services that banks offer, including savings and current accounts. As three MFOs are in the process of seeking deposit-taking licenses, this provision of the law may become more relevant in the near future.

\textsuperscript{19} The “Law on Microfinance Organization in the Kyrgyz Republic” was enacted in 2002 and appropriately allows for three types of MFOs, all of which must be licensed by NBKR: (i) Microfinance company (MFC) must be established as a joint stock company and may extend microcredits to legal and physical persons from their own funds, as well as attract funds from donor organizations and local and international financial organizations; with authorization from NBKR, an MFC may be allowed to take time deposits;(ii) Microcredit company (MCC) may be established as any type of commercial organization and may extend microcredits to legal and physical persons from their own funds, as well as attract funds from donor organizations and local and international financial organizations; and (iii) Microcredit agency (MCA) generally must be established as a non-commercial organization and may extend microcredits to legal and physical persons from their own funds or funds of donor organizations and local or international financial organizations.

\textsuperscript{20} Recent regulations have further improved this framework. Resolution of the NBKR Management Board #36/3 of May 26, 2010, approved amendments to the “Provisional regulation of activity of micro finance companies” and to the Regulation “On Minimum Requirements on Credit Risk Management in Commercial Banks and other MFI Licensed by the NBKR” under which MFO loans provided under a group guarantee are considered to be secured and decreased the capital adequacy ratio for MFCs from 18 percent to 8 percent and allows deduction from total assets of the amount of assets in foreign currency provided as a security on loans in KGS. Further improvements could be considered for calculating capital, including applying risk weights to all MFC assets; if this is done, however, NBKR may wish to adjust CAR upwards again, as 8 percent could be dangerously low for MFCs if risk weights were applied to all assets.
• The current law does not impose any fit-and-proper tests on owners and management. There are some reports of MFOs that are owned or managed by unscrupulous persons. This has had the unfortunate consequence of prompting some government officials to call for interest rate caps, rather than addressing the unscrupulous behavior more directly, e.g., through fit-and-proper tests for owners and managers. In addition, a large number of MFOs are reportedly totally inactive but are not closing down because of problems encountered in closing their business.

63. Credit unions could provide an important source of financing for the agricultural sector, but have not developed further partly due to funding constraints as well as limited institutional and operational capacity. Credit unions have grown from local credit cooperatives, and they lack the governance and operational skills to manage larger credit portfolios. Credit unions are highly dependent on donor funding. The sector was created through a project from the Asian Development Bank, which provided a US$ 10 million credit line to the Financial Company for Support and Development of the Credit Unions (FCSDCU). The FCSDCU was constituted as a daughter of the Central Bank and it is expected that it will be privatized. Its objective is to provide funding and technical assistance to the credit unions. The FCSDCU provides loans to credit unions at 11-20 percent interest rates for 4 years. It supervised credit unions until 2004, when this function was transferred to the NBKR. The FCSDCU remains fully dependent on funding from the ADB and it has attempted to access other sources of financing. However, it faces limitations as long as there is uncertainty over the privatization process.

64. Many small firms are considered unbankable due to their weak management skills and poor financial reporting. There is a lack of adequate financial information on firms making the loan process labor-intensive, and increasing the cost of lending. Lack of adequate information results from the fact that IFRS principles are not applied uniformly, there is a lack of qualified accountants and auditors, and a limited use of scoring models. Many small firms have low levels of technical and managerial skills, obsolete technology, low awareness of financial products, and low confidence in the financial system. It is important that they obtain training on technology improvement, basic management skills, financial reporting, and education on financial products.

VIII. POLICY RECOMMENDATIONS

A. Short-term responses to events of April 2010

65. Banks, MFOs and credit unions, like all businesses, need stability and security to operate. Civil disturbances and risks of violence prevent clients from engaging in their normal economic activities and prevent MFO and credit union staff from disbursing and collecting loans. Similarly, open borders are essential for traders, who represent more than 30 percent of
microfinance clients. Re-establishing and maintaining stability and security is a pre-requisite to a healthy microfinance sector and economy.

66. **The authorities should reaffirm their commitment to the principle of market-based operations and interest rates in microfinance and the banking sector.** Some politicians, members of the IG, and NBKR are reviving the idea of capping interest rates. This should be avoided, as such caps would distort loan allocations to less efficient uses and jeopardize MFOs’ sustainability and the availability of foreign credit lines, as most foreign creditors will lend only to MFOs that operate on market principles and are sustainable. The Kyrgyz microfinance sector has been among the most successful in the world largely because it has followed market principles. A reaffirmation of such policies would contribute to continued access to finance for the Kyrgyz population. This may be especially important as MFO costs may rise in the short run as KGS liquidity has dried up and swaps become more expensive. Similarly, the authorities should reaffirm that market principles apply to banks also, including Aiy Bank. From time to time in the past, Kyrgyz governments have promised cheap loans, which would partly come from subsidies, but partly as pressure on commercial banks to lend at lower interest rates. While an efficiently functioning financial market should provide loans at affordable rates, lowering the rates should not result from political pressure, but instead should come from competition and greater efficiency.

67. **With AUB’s operations suspended, the authorities may need to provide a temporary facility to ensure MFOs have access to KGS at market interest rates while undertaking appropriate policies to promote the resumption of swaps from commercial banks.** KGS liquidity will likely remain tight in the coming months, which could limit MFO operations and increase their costs. In the long term, local currency liquidity facilities and/or derivatives markets (including swaps), as well as deposit taking by qualified MFOs (including transformation into banks for some), may provide the best alternative to MFOs’ KGS liquidity needs.

68. **The authorities will need to carefully manage the nationalization and rehabilitation of AUB, as well as other banks that they have intervened.** There is potential for further problems in the system, and failure by the authorities to properly address current issues, including to properly restructuring the banks it has intervened, could affect depositor confidence significantly, thereby exacerbating liquidity tensions and further reducing banks’ intermediation ability in the long term.

69. **MFOs and credit unions must remain vigilant in monitoring their performance to ensure minimal defaults.** There may be a lag in the effects of the April events, and delinquency may rise in coming months.

70. **Subsidies channeled through Aiy Bank will need to be done in a way that does not distort the interest rate policy of Aiy Bank or the financial sector as a whole.** While the closure of AUB-Agro is viewed positively by most market participants, Aiy Bank’s access to subsidized credit lines and plans to extend loans at 12 percent interest rates are also being viewed
with concern. The authorities will need to monitor the effect of Aiyl Bank’s loans on the market and ensure that Aiyl Bank remains independent in setting its interest rates to ensure that the competitive microfinance market that has developed over many years is not undermined. A reaffirmation of the government’s commitment to privatize Aiyl Bank through a strategic investor would be useful to reassure the market. Furthermore, to promote competition and a level playing field, in programs where the government feels that subsidized lending is necessary, such programs should be open to all banks that meet certain criteria to participate and wish to apply, rather than always limiting such programs to Aiyl Bank. Although state-owned, Aiyl Bank should operate as any other (private) commercial bank.

B. Other short, medium, and long-term policy recommendations

71. Over the longer term, the discussion above points to several recommendations to improve policies, laws, and regulations, as well as provide targeted technical assistance to institution and capacity building. Implementation of these recommendations can be expected to positively impact the access to finance of Kyrgyz enterprises and households.

72. Promoting greater access to deposit services in rural areas should be a priority. Not only will greater access to deposit services mobilize local resources to finance economic growth, but such services provide a significant benefit to households who can access them. Deposit services should be expanded through: (i) redoubling efforts to transform Kyrgyz Post so it can provide limited financial services, including deposit services and money transfers; (ii) expanding the deposit-taking license of Aiyl Bank, provided that it meets all standard NBKR criteria for such a license; (iii) facilitating the acquisition of a deposit-taking license by qualified MFCs that meet NBKR criteria, and expanding the type of deposits that such MFCs are authorized to accept, including demand deposits, but at NBKR’s discretion to consider on a case-by-case basis; and (iv) facilitating the transformation of qualified MFCs and MCCs into fully licensed banks.

73. Efforts to privatize Aiyl Bank should be redoubled. Privatizing Aiyl Bank with a strong strategic investor with international experience in rural and agricultural finance will help ensure that Aiyl Bank continues to grow as a market-oriented provider of rural financial services, strengthens its governance, improves its operations, strengthens the capacity of its staff and management, reduces costs, promotes competition in the financial sector, attracts additional financial resources to the country, and develops new products and services to meet the demands of its clients.

74. The legal framework for pledging agricultural land should be strengthened to make such property more useful as collateral. The Law on Pledge should be amended to eliminate the power of a court (i) to refuse foreclosure if the debt is considered “very insignificant” and the amount of the pledgee’s claims is, therefore, “incommensurate with the market value of pledged lands”; and (ii) to postpone sale of agricultural land if default occurs because of “valid reasons” such as “bad harvest, natural disasters, flood, hail, and other extreme weather conditions”. The Law On Administration of Land of Agricultural Purpose should be amended to eliminate the
requirements that (i) agriculture land shares may be sold only to other shareholders in the same plot of land; and (ii) agriculture land may be sold only to other rural inhabitants.

75. **The legal and institutional framework for pledging moveable property should be strengthened.** The current requirement to register pledge for loans as small as KGS 25,000 is prohibitively costly for small loans since there are pledge offices only in 7 oblasts. The loan size that requires registration should be raised, e.g., to KGS 100,000. Moreover, consideration should be given to the Pledge Registry’s budget support request to open 21 new offices, at an estimated cost of KGS 1.5 million to KGS 1.8 million. In the medium term the Pledge Registry’s systems should be upgraded to allow for online registration and searches, which would significantly lower costs and increase access to the Pledge Registry.

76. **The regime to execute collateral of all types should be improved.** Out-of-court settlement should be facilitated by eliminating the requirement that both parties consent on the value of the pledge. In-court settlement needs to be streamlined to shorten the period for executing collateral (often more than a year for moveable collateral and two to four years for real estate). Procedures for appraisals and auctions need to be made more transparent. A publicly accessible central database to obtain information on auctions is needed.

77. **The Microfinance Law and associated regulations, despite many strengths, should be improved.** First, the authorities should resist any attempt to impose interest rate caps, to ensure that MFOs operate independently, sustainably, and on market principles. Second, fit-and-proper tests for MFO owners and managers, as well as consumer protection regulations, could be introduced to address questionable behavior by unscrupulous MFOs. Third, the law should authorize NBKR to allow, at its discretion, qualified MFCs to take demand deposits and well as term deposits. Fourth, the NBKR should consider treating group-guaranteed loans the same as loans secured by physical collateral for provisioning purposes. Fifth, the NBKR should harmonize the calculation of CAR for MFCs with that of banks, while maintaining the discretion to set higher CAR requirements for MFCs based on their risk profile. Sixth, the NBKR should revoke the licenses of inactive MFOs.

78. **The credit information sharing infrastructure needs improvement.** A credit information law should be passed, making membership mandatory for banks, as well as MFOs and credit unions with a minimum number of clients, and optional for other MFOs and credit unions. Similarly, participants should be required by law to provide information to the credit bureau.

79. **The legal and institutional framework for credit unions should be improved, and institutional and operational capacity should be built in the credit unions and FCSDCU.** A strategy to strengthen governance in credit unions and FCSDCU, including privatization of FCSDCU, will help realize the potential of credit unions in the Kyrgyz Republic. Credit unions continue to suffer from poor governance. NBKR’s ownership of FCSDCU greatly limits its access to resources. A commitment to, and strategy for, privatization of FCSDCU is needed to
ensure the safe, sound growth of credit unions so they can fulfill their potential to increase access to financial services in rural areas. The authorities should redouble efforts to build capacity in FCSDCU and prepare it for privatization. They should also provide assistance to build capacity and improve governance in credit unions and continue the process of consolidating small, unsustainable credit unions into larger credit unions.

80. **Technical assistance and other capacity building efforts are needed in banks, MFOs, and credit unions to increase the range and quality of financial products available to enterprises and households, and legal impediments to developing these products should be removed.** A strong consumer protection regime, coupled with improved customer service, is necessary to build public confidence in financial institutions and, therefore, mobilized deposits for economic growth. Financial institutions should develop new products and services demanded by the market, such as factoring, leasing, trade finance instruments, and agricultural lending products.\(^{21}\) Elimination of the unequal VAT treatment of leasing would encourage development of this important financial service. Financial institutions should also improve their risk management and credit assessment skill; credit scoring models for small businesses should be developed.

81. **At the same time, technical assistance and other support should be provided to small businesses to make them more bankable.** Most businesses do not use international financial reporting standards (IFRS), resulting in a lack of adequate financial information that banks and MFIs can rely on in making credit assessments. An appropriately simplified IFRS for small businesses should be more strictly enforced, while also providing assistance to firms to apply IFRS and strengthening the local accounting profession. An action plan based on the recommendations of World Bank 2008 Accounting and Auditing ROSC should be prepared and implemented. Assistance should also be provided to SMEs in the areas of management skills, financial management, and technology improvement.

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\(^{21}\) Some training of banks under the World Bank’s Agribusiness and Marketing project on new financial products for agriculture has helped, but more needs to be done.