

SECTOR OVERVIEW

A. The Economy

1. In 2010, the Kyrgyz Republic strengthened its democracy after a deep political crisis and an uprising toppled the previous regime. At the end of 2014, economic growth slowed to 3.6% from 10.9% in 2013 as a result of weakening of the economies of the Russian Federation and Kazakhstan. Inflation accelerated to 7.5% and the current account deficit increased to 15.0% of gross domestic product (GDP) because of a decline in exports (reflecting a 16% drop in gold production 16%) and weaker sales of fruit, vegetables, and textiles. Growth is likely to decline to 1.7% in 2015 due to an impending recession in the Russian Federation and sluggish economic performance in Kazakhstan. Growth is expected in the agro-processing sectors, along with increased trade as the Kyrgyz Republic joins the Eurasian Economic Union (EEU) as of 1 May 2015.¹ Given this context, inflation is expected to average 10% in the medium term. Remittances as a percentage of GDP declined from 25% in 2013 to 20% (\$1.8 billion) in 2014. However, this was offset by the services sector, which contributed 50% of GDP in 2014 and grew strongly (4.1%) for the third consecutive year. The strongest gains were in construction (24.9%), trade (7.2%), and hotels and restaurants (9.6%), reflecting higher consumer demand and improved cross-border trade. Growth prospects continue to be tempered by the impact of international sanctions against the Russian Federation, which have led to a depreciation of the Kyrgyz som, and by weaker gold prices. To limit inflation in the wake of currency depreciation, the National Bank of the Kyrgyz Republic (NBKR) sharply raised its policy interest rate from 4.16% at the beginning of the 2014 to 10.50% at the end of the year. However, the full impact of the rate hike was limited by extensive dollarization, as more than half of all bank loans and deposits are in foreign currency and dollarization increased as the currency weakened. The som depreciated in 2014 by 19.1%, to Som58 per US dollar despite central bank interventions that cost \$516 million. By the end of 2014, foreign exchange reserves had fallen to \$1.96 billion, equal to about 4 months of imports, from \$2.24 billion at the end of 2013. Monetary policy will remain cautious in 2015 as the NBKR aims to limit inflation and stabilize the local currency. Nominal interest rates should increase if the som depreciates further.

2. Accession into the EEU is expected shortly and adds uncertainty, as trade may initially falter with countries outside the union, including the People's Republic of China. The political situation remains fragile, with parliamentary elections expected in 2015. The Asian Development Bank expects a positive GDP growth rate of 2% for 2016.²

3. The business environment has improved as a result of reforms to improve the enabling environment for private sector development and foreign investment. Progress has been made with respect to the issuing of business licences and conducting inspections of businesses, but there is a need for strengthened banking system supervision. Increasing confidence in the banking system with regard to good corporate governance and transparency remains a key challenge.

4. **Banking Overview.** As of the end of December 2014, there were 24 operational commercial banks in Kyrgyzstan;³ 16 had foreign ownership comprising more than 50% foreign

¹ A Treaty on the Establishment of the EEU was signed in Astana in May 2014, and the EEU started functioning from 1 January 2015. A roadmap for the Kyrgyz Republic's accession to the EEU was endorsed in May 2014, and the treaty enlarging the EEU to the Kyrgyz Republic was signed on 23 December 2014. The EEU is comprised of Armenia, Belarussia, Kazakhstan, the Kyrgyz Republic and the Russian Federation.

² Asian Development Bank. 2015. *Asian Development Outlook 2015*. Manila.

³ National Bank of the Kyrgyz Republic. 2014. *Financial Sector Stability Report of the Kyrgyz Republic*. Bishkek.

capital.⁴ Despite the large number of banks, the sector is dominated by five banks—Optima, Rosin Bank, RSK Bank, Demir Bank and Kyrgyz Investment and Credit Bank— which together comprise 57.7% of the total sector assets and 64.2% of deposits. In 2010, Kyrgyzstan’s financial sector was restructured, with four banks coming under NBKR’s special supervision, while Asia Universal Bank (AUB), formerly the largest bank, was nationalized due largely to the high number of non-performing loans (NPLs), with its assets placed in Zalkar Bank. The latter was sold in 2013, while three banks remain under conservatorship.⁵ Banks that experienced the most difficulty were closely tied to the previous Bakiyev regime. The banking sector is now well capitalized and relatively stable.⁶

5. As of December 2014, total banking sector assets were Som137.6 billion and accounted for 82% of total financial sector assets. The Kyrgyz Republic banking sector is growing but remains small; banking sector assets as a percentage of GDP increased from 31.7% in 2013 to 35.4% in 2014.⁷ From 2013 to December 2014, the volume of credit increased by 42.5% amounting to Som76.6 billion, and the number of bank borrowers reached 173,000 persons by the end of 2014.⁸ With assistance from Europe Aid, the United States Agency for International Development and the European Bank for Reconstruction Development, risk management and supervisory measures at NBKR and the Credit Information Bureau have improved. The loan-to-deposit ratio increased from 91.3% in 2013 to 109.7% in 2014, and there was an increase in the loan-to-assets ratio from 48.6% in 2013 to 58.3% in 2014. Deposits also increased by 22.57% in 2014. The NPL ratio of the country’s banks has decreased steadily, from 10.2% in 2011 to 7.2% in 2012, 5.5% in 2013, and 4.5% in 2014, signifying an improvement in the quality of the credit portfolio of the banking system.⁹

6. Despite the challenging economic conditions, the banking system achieved a net profit of Som3.2 billion in 2014, an increase of 18.5% from 2013. In 2014, return on assets was 2.6%, down from 2.8% in 2013, while return on equity increased to 18.7% from 17.9% in 2013. The banks’ liquidity ratios declined from 70% in 2013 to 65.1% in 2014, but remain well above the regulatory requirement of 30%. In general, the industry is also highly capitalized, with a capital adequacy ratio of 21.8%, compared to the prudential requirement of 12%. Key banking sector indicators are in Table 1.

Table 1: Key Banking Indicators
(%)

	2012	2013	2014
Capital Adequacy Ratio	28.3	25.0	21.8
Nonperforming Loans/Total Loans	7.2	5.5	4.5
Return on Assets	3.0	2.8	2.6
Earnings and Profitability	18.5	17.9	18.7
Liquidity Ratio	80.0	70.0	65.1

Source: National Bank of the Kyrgyz Republic

⁴ Asian Development Bank. 2013. *Kyrgyz Republic: Country Partnership Strategy (2013–2017)*. Manila.

⁵ 90% of the shares of “Zalkar Bank” were sold in May 2013 to the Russian company ITB holding. The bank has been renamed Rosinbank (Russian investment bank).

⁶ International Monetary Fund. 2014. *Country Report No. 14/2009: Kyrgyz Republic: 2014 Sixth Review Under the Three-year Arrangement Under the Extended Credit Facility; Staff report; and Press Release*. Washington, D.C.

⁷ National Bank of the Kyrgyz Republic. 2014. *2013 Annual Report*. Bishkek. 2012: Kazakhstan:45.7%; Armenia: 61.8%; Kyrgyz Republic : 28.2%. <http://www.helgilibrary.com/indicators/index/bank-assets-as-of-gdp>

⁸ Review of the lending <http://www.ishenim.kg/>

⁹ National Bank of the Kyrgyz Republic. 2014. *2013 Annual Report*. Bishkek.

7. The 2013 Financial Sector Action Plan identified key weaknesses and made a broad range of recommendations related to (i) the independence and supervisory role of the NBKR, (ii) establishment of a formal financial crisis-preparedness framework, (iii) amendments to the Banking Code, and (iv) auditing of the Debt Resolution Agency to facilitate liquidation of the remaining banks under conservatorship. To address these, NBKR, with support from the International Monetary Fund, submitted a new Banking Code to Parliament that will enable NBKR to more effectively exercise power in the supervision and early intervention and resolution of troubled banks.¹⁰ A deposit insurance scheme has helped maintain the confidence of depositors in the banking system (footnote 7). As part of the Second Investment Climate Improvement Program (Kyrgyz Republic) implemented by the Asian Development Bank,¹¹ the government will sign a contract with one or two rating agencies to obtain a rating for the Kyrgyz Republic. This is expected to be completed by the end of 2015 and should encourage foreign investment in the country

8. Officially, the banking sector is regulated by Basel I. However, the NBKR has adopted Basel I (standardized approach for market risk) and has included a charge for operational risk (basic indicator approach under Basel II). Most banks have adopted Basel I best practice principles with standard prudential ratios. Although NBKR has requested banks to adopt Basel II, no timeline has been set or sanctions imposed if Basel II is not in place. On- and off-site supervision is done regularly and covers many aspects such as credit procedures, credit quality, audit, capital and open positions. Many of the bank's foreign shareholders have been subject to prudential norms in their countries and have introduced strict standards in their investee banks.

9. **Access to financial services.** While credit in Kyrgyzstan has typically been available to the commercial sector and larger businesses, micro and small businesses have found it difficult to obtain credit. The loans required by these businesses are small, and lenders impose high administrative costs relative to the loan size. The provision of financial services to most of the population remains severely constrained, and continued efforts will be required to enhance the availability and use of financial services across the country. High rates of poverty (37.0%) and unemployment (8.3%) in 2014 add to the challenges being faced in rural and urban areas.¹² The NBKR estimates the unbanked population in Kyrgyzstan at 80%. Access to finance was also severely curtailed due to political strife in 2010. The low level of banking intermediation results from (i) the importance of the informal sector; (ii) heavy reliance on cash transactions; and (iii) a continued focus by banks on large, top-tier companies that are perceived to carry less risk. Given that the country is at a nascent stage of financial sector development, financial intermediation is necessary to help expand the provision of formal financial services to remote areas and support the growth of the private sector.

10. **Micro, small and medium-sized enterprises.** Micro, small and medium-sized enterprises (MSMEs) play a significant role in the Kyrgyz Republic and are the key drivers of

¹⁰ The draft Banking Code (including the Law on Banks and Banking Activity; Law on Conservatorship, Liquidation, and Bankruptcy of Banks; and Law on NBKR), submitted to Parliament is expected to: (i) strengthen the legal framework for early intervention and resolution of problem banks, (ii) limit the scope of judicial review of actions taken by the NBKR, and (iii) enhance legal protection of NBKR staff and agents. It will also (i) establish the NBKR's sole authority to hold and manage official foreign reserves, and (ii) extend the term of engagement of the NBKR's external auditors.

¹¹ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Kyrgyz Republic for the Second Investment Climate Improvement Program*. Manila.

¹² National Statistics Committee of the Kyrgyz Republic. 2014. *Report on the Welfare of the Population in the Kyrgyz Republic 2009-2013*. Bishkek
<https://www.cia.gov/library/publications/the-world-factbook/docs/whatsnew.html>.

employment and economic growth. According to the State Taxation Service of the Kyrgyz Republic, there are 363,701 registered small businesses. The current definition of a small or medium-sized enterprise (SME) is a business having a turnover of Som4 million–30 million per year.¹³ Bank loans and unofficial loans are the main forms of financing for MSMEs. Despite difficulties in lending to the sector, bank financing to MSMEs has grown as Kyrgyzstan banks begin to look increasingly at the MSME sector as a potential opportunity to diversify their lending portfolio and increase interest margins. Main activities of the MSME sector are agriculture, mining, transportation, trade, construction and manufacturing. Total contribution to employment from the MSME sector increased from 15.5% in 2011 to 18.9% in 2013, while their contribution to GDP declined from 39.5% in 2011 to 38.8% in 2013.¹⁴ Growth in the SME sector has been hampered by a number of factors. A 2013 International Finance Corporation study of the SME sector in the Kyrgyz Republic cites political instability, tax reporting, corruption, and limited access to loans as the most “burdensome factors” for doing business.¹⁵

11. Below is a list of prudential requirements from the NBKR.

Table 2: National Bank of Kyrgyzstan Prudential Requirements

I. Credit risk Indicator	II. Value
Maximum risk per a borrower and/or group borrowers (non bank) not connected with the bank (as a share of net capital)	20%
Maximum risk per not connected borrower (bank)	30%
Maximum risk per a borrower (non bank) connected with the bank (as a share of net total capital)	15%
Maximum risk per connected borrower (bank, as the share of net total capital)	15%
Maximum risk on operations with insiders/connected parties (as a share of net total capital)	60%
Maximum total large risk (risk exceeding 10% of net total capital) exposures (as share of net total capital)	500%
Maximum total amount of uncollateralized loans (as a share of net total capital)	50%
Loan loss provisioning policy	
Maximum risk per a borrower/group borrowers (non bank) not connected with the bank (as a share of net capital)	20%
Normal loans (collateral value/loan amount ratio at least 120%)	0%
	2%(0-2,5% on newly disbursed loans starting from May 2, 2015 depending on loan currency)
Satisfactory loans	
Watch loans (past due up to 30 days)	5%-7.5%
Substandard loans (past due 30–60 days)	25%
Doubtful loans (past due 60–90 days)	50%
Loss loans (past due over 90 days)	100%
Liquidity	
Minimal liquid assets and/or short-term liabilities	30%
Aggregate open currency position	20%
Capitalization	
Minimum amount of charter capital for newly established banks and branches of non-resident banks	Som600 million (\$10 million)

¹³ D. Podolskaya. 2014. Kyrgyz government proposes small and medium-sized enterprises to provide report on taxes quarterly. *Bishkek – 24.kg News Agency*. 16 October. <http://www.eng.24.kg/community/172717-news24.html>. While the definition mentions SMEs, loan sizes are small, which includes micro loans (Som4 million to 30 million per year).

¹⁴ State Statistics Committee of the Kyrgyz Republic.

¹⁵ IFC. 2013. *Investment Climate in the Kyrgyz Republic as Seen by Businesses*. Bishkek.

I.	Credit risk Indicator	II.	Value
	Minimum total capital adequacy ratio		12%
	Minimum Tier I capital adequacy ratio		6%
	Minimum leverage level		8%

Source: National Bank of Kyrgyzstan