

FINANCIAL ANALYSIS

A. Overview

1. Bai Tushum Bank (BTB) has experienced strong growth as a result of rising demand for financial services coinciding with an improved political and economic environment in the Kyrgyz Republic. BTB was established in 2000 as a local microfinance institution, and in 2012 became the first microfinance institution in the Kyrgyz Republic to obtain a banking license.¹ It is a midsized bank and as of December 2014 ranked sixth in the country for total loans and eighth for total assets.² Total assets increased from Som4.80 billion in 2012 to Som7.8 billion in 2014, representing a compound annual growth rate (CAGR) of 27.5%. Gross customer loans grew from Som3.0 billion in 2012 to Som6.4 billion in 2014 (CAGR of 46.1%). Over the same period total customer deposits also grew at a robust CAGR of 182.7%, from Som89.7 billion to Som717.2 billion. BTB's strategic mission is to promote equitable inclusive growth across the country by funding and supporting socially important projects and initiatives.

B. Capital Adequacy

2. BTB's capital adequacy ratio (CAR) is sound, with a Tier 1 ratio of 12.1% and total CAR of 16.8% at the end of 2014. The CAR declined from 2013 (when Tier 1 was 15.3%, and total CAR 19.7%) because of loan growth, and additional costs that accompanied the introduction of new banking operations and procedures and improvements to the regional network in line with National Bank of the Kyrgyz Republic (NBKR) requirements. BTB's CAR remains well above the regulatory minimums of 6% for Tier 1 capital ratio and 12% for total CAR, giving the bank good absorptive capacity.³

3. BTB continues to invest in capital expenditure to meet demand across the Kyrgyz Republic and support increased loan growth. Investments in new branches, cash outlets and ATMs, along with upgrades in information technology, are expected to total about Som323 million by 2018, including enhancing the core banking system. The increase in capital will cover the majority of these expenditures. A continuous upgrading of infrastructure and the integration of the rural branches into the mainstream system will increase BTB's productive capacity.

4. BTB is continually developing internet banking and launched the new integrated ABC system operating in real time in 2015. In partnership with the United States Agency for International Development, Bai-Tushum Financial Foundation and ACDI/VOCA, BTB helps women entrepreneurs to develop and support their business through financial literacy training, technical assistance and the provision of affordable financing. Through this training, user applications via internet banking will become easier to access for them.

C. Asset Quality

5. **Loan portfolio.** BTB's loan portfolio grew from Som3.0 billion in 2012 to Som6.4 billion in 2014. This represented a CAGR of 46.1%, compared with the average banking sector CAGR of 38.9% over the same period. Loan growth for 2014 was 50.6%, an resulted from (i) expansion of the branch network into rural areas; (ii) retail business growth from new market

¹ BTB was established in 2000 by ACDI/VOCA with the support of CARITAS, a Swiss relief agency providing microcredit services to private entrepreneurs, traders, farmers, and micro and small agricultural enterprises.

² European Bank for Reconstruction and Development peer review of Kyrgyzstan Banks.

³ National Bank of the Kyrgyz Republic. 2014. *Annual Report 2013*. Bishkek; BTB. 2014. *Annual Report 2013*. Bishkek.

segments, such as the development of integrated business services for individual clients and the introduction of new customer service technologies on BTB's website; (iii) a strategic emphasis on growth of the bank's micro, small and medium-sized enterprise (MSME) business through entry into new market segments, such as the commercial, agriculture, and machinery sectors; and (iv) effective cross-selling of products and services within the bank.⁴

6. BTB maintains a diversified portfolio in terms of concentration by sector. In 2014 loans for agriculture comprised 33.0% of the loan portfolio, followed mortgages (23.8%), by trade (23.0%), services (5.6%), transport (3.4%), and others (11.2%). At the end of 2014, BTB's top 20 obligors accounted for 29% of its capital.

7. BTB had no loans to related parties at the end of 2014 (in 2013 such loans amounted to 0.1%, with a prudential limit of 15%) reflecting BTB's strict policy on transparency and the avoidance of conflict of interest.

8. **Micro, small and medium-sized enterprise loan portfolio.** At the end of 2014, MSME loans amounted to Som2.5 billion and accounted for 40% of gross loans.⁵ Gross MSME loans were mainly (99.4%) term loans, with lease loans accounting for 0.6%. Maximum tenors were 10 years for term loans and 7 years for lease loans, but these longer tenor loans only accounted for 3.5% of the MSME portfolio in 2014. At the end of 2014, the average MSME term loan size was \$22,000, with a tenor of 2 years. Primary demand for MSME term loans came from the agriculture, transport, trade and manufacturing industries.

9. **Security.** At the end of 2014, 99.7% of BTB's loan portfolio was secured. The securities included leased assets (0.3%), cash (0.4%), property (90.6%), movable assets (1.8%), and personal guarantees (6.9%).⁶ BTB requires that all of its loans be backed by collateral, with a loan-to-value ratio of 70% of the liquidation value for mortgages; or alternatively, a maximum loan-to-income ratio of 80% for business loans, 50% for income based on salary, and 60% if a dollar loan is required. Collateral requirements are 120%. For loans up to Som150,000 (currently 0.3% of total loan portfolio), collateral is not necessary, but such loans must be accompanied by two individual guarantees.

10. **Asset quality.** BTB uses the NBKR standard loan classification specification. The nonperforming loan (NPL) ratio peaked at 15.8% in 2010 because of the impact of the political crisis, which ended with a new government in 2011. Since becoming a bank in 2012, BTB's asset quality has improved from 3.8% to 2.3% in 2014. This reflected better economic conditions and the results of the government's efforts to restore confidence, and resulted from BTB's use of improved risk management tools, such as rating models and strict underwriting and monitoring standards.⁷ Given that BTB's clients are from the lower middle income sector, they are particularly sensitive to interest rates and susceptible to political and global economic slowdowns. The bulk of the NPL's were in Bishkek (23%), Osh (21%) and Jallabad (25%). The largest contributors to gross NPLs by economic sectors were trade (23.0%), construction

⁴ BTB 2014 business plan.

⁵ The total small and medium-sized enterprise loan portfolio includes a portion of leasing and factoring, depending on the borrower's turnover and loan size.

⁶ Banks are not allowed to make investments, grant large loans, or extend other credit facilities to individual entities or related group of entities in excess of an amount that represents a total of 60% of the total regulatory capital.

⁷ BTB participated in a technical assistance (TA) assignment together with International Finance Corporation, Triple Jump and Business Finance Consulting from May 2013 to December 2014. TA included an institutional and market assessment, optimization of MSME's banking operations, pilot implementation of improved lending processes and credit risk management and controls.

(23.0%), and cattle breeding (31.0%). BTB plans to maintain its gross NPL ratio below 5.0% at all times.⁸ The slowdown in the country's economy has resulted in stricter underwriting requirements, and BTB monitors loan concentration levels (internal limits) and dollar loans more rigidly. Additionally, US dollars will be on-lent to customers that have foreign currency income.

11. The bank classifies loans as nonperforming as soon as they become overdue and makes provisions according to its provisioning policy.⁹ These loans remain classified as NPLs until all the arrears are settled, which results in loans being classified as NPLs even though they are not in default. Additionally, BTB has collateral of up to 120% of the forced sale value on 99.7% of all loans. The bank plans for an increase in provisioning annually to take into account a possible slowdown of the economy. BTB's provisioning standards are above IFRS and NBKR norms.

12. **Earnings and profitability.** Net income grew by 224.8% in 2014 (up from 70.8% in 2013), increasing from Som62.0 million in 2013 to Som201.5 million in 2014; this was faster than the sector average of 18.9% in 2014 (11.6% in 2013), and driven by loan expansion and increased fee and commission income. BTB's net interest margin increased from 12.1% in 2013 to 13.2% at the end of 2014 due to higher yields from MSME and retail loans (the banking sector average was 8.3% in 2014). Operating income increased by 46.0% in 2014 from 2013, reflecting the bank's focus on fee income from money transfers, remittances, and guarantee issuances to complement interest income. The cost-to-income ratio improved from 82.6% in 2013 to 74.9% in December 2014 as a result of a focus on business optimization programs within the bank leading to cost efficiency, and as a result income growth. The bank has invested heavily in branches, IT and employees as part of its transition plan. The cost-to-income ratio is expected to decline to 69.0% by 2018 as a result of operational efficiency gains. Return on asset (ROA) increased to 2.8% in 2014 from 1.1% in 2013 and return on equity (ROE) rose to 20.7% from 7.7% in 2013. This was above the 2014 banking sector averages of 2.6% for ROA and 18.7% for ROE, even with higher funding and operational costs. BTB targets an ROA of 2.4% and ROE of 20.5% by 2018.

D. Liquidity and Funding

13. **Funding structure.** BTB's main source of funding was borrowings, which accounted for 86.0% of total liabilities as of December 2014, down from 90.0% in 2013; this contributed to higher funding costs. Deposits accounted for 10.4%, up from 6.2% in 2013, while other sources of funding were 3.6% of total liabilities at the end of 2014. Customer deposits grew 103.9% as of December 2014, a decrease from 291% growth in 2013, but faster than the sector average deposit growth rate of 22.0% in 2014. BTB began taking deposits only recently and is starting from a very small base, resulting in very high percentage growth rates. BTB intends to continue to increase the deposit base significantly and reduce its share of borrowing, with the goal of reaching almost equal percentages by 2018. Because the country is at a nascent stage of capital market development, corporations and banks face obstacles to issuing debt, particularly bonds. BTB has relationships with several IFIs, and has existing credit lines with Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden, European Bank for Reconstruction and Development and International Finance Corporation. Discussions for new facilities are underway with Deutsche Bank and the International Finance Corporation. BTB will continue to

⁸ The average BTB NPL ratio during 2012–2014 was 2.9% (sector 5.73%). NPL projections are 2.2% for 2015 and 2.3% for 2016 (sources: Kyrgyz Republic Sixth Review under the 3-year arrangement, under the extended credit facility; a staff report dated July 2014; and selected banking industry financial performance indicators from NBKR)

⁹ NBKR's regulations place loans on non-accrual status 1 day after they are overdue; in other jurisdictions placement of loans on non-accrual status for loans less than 90 days overdue due is more flexible.

develop relationships with local and international commercial banks.

14. **Liquidity.** BTB's liquidity position is assessed and managed by the BTB Board of Directors on a monthly basis, based upon prevailing economic and market conditions, and in line with NBKR guidelines. BTB's liquidity ratio was high (98.8%) and above the 30% requirement by NBKR as of the end of 2014.¹⁰ The liquidity ratio is dependent on the lending season as well as the release of collateral deposits under maturing back-to-back loans, in which sizable amounts are accumulated on the correspondent accounts. These ratios can fall within a day when repayments have to be made. Active marketing efforts are being carried and new deposit products developed for different customer segments to increase deposits at BTB; for example, loan programs that include time deposits as down payments, remittance deposits and various time deposits catering to the MSME, retail and corporate segments. Stress-testing of BTB's liquidity position under different stress scenarios is carried out quarterly.

15. Foreign currency risk is minimal at BTB. Local currency loans dominate BTB's loan book, with foreign currency loans representing 38.4% of gross loans in 2014. BTB hedges open positions with regard to foreign exchange exposure. BTB uses forward exchange contracts to hedge foreign exchange risks and any dollar loans provided to MSMEs have dollar income to prevent currency mismatches; BTB requires that 50% of income from borrowers be in US dollars to obtain a US dollar loan. Hedging is done via The Currency Exchange Fund, local interbank swaps and via back-to-back loans.¹¹ The Assets and Liabilities Committee at BTB is primarily responsible for maintaining and monitoring limits on currency exposure.

16. BTB's audited financial statements are prepared according to IFRS and audited by KPMG Bishkek. Financial highlights are presented below. The audited income and financial statements are in supplementary documents 2 and 3.

Bai Tushum Bank Financial Highlights
(in million Som)

Item	2012	2013	2014
Total assets	4,801	6,536	7,924
Gross customer loans	3,043	4,239	6,384
Total deposits from customers	89.7	351.7	717.2
Total shareholder equity	729.1	880.2	1066.2
Net income	36.3	62.0	201.5
Net interest margin	14.6%	12.1%	13.2%
Cost-income ratio	80.3%	82.6%	74.9%
Gross NPL ratio (>90 days), per ADB ^a	3.8%	2.6%	2.3%
Gross NPL ratio (>90 days), per BTB	1.3%	1.0%	0.8%
Return on average equity	4.9%	7.7%	20.7%
Return on average total assets	0.8%	1.1%	2.8%
Capital adequacy ratio (%)	21.9%	19.8%	16.8%
US dollar-som average exchange rate	47.4	49.3	58.9

> = greater than, ADB = Asian Development Bank, BTB = Bai Tushum Bank, NPL = nonperforming loan, US = United States

^a Includes loans on non-accrual status for which full payment is doubtful, based on the assessment of management, and restructured loans that would otherwise be past due or impaired.

Source: Bai Tushum Bank and ADB.

¹⁰ Ratio of liquid assets to short term deposits (demand deposits and term deposits with maturity of less than 30 days). Sector average in 2014 was 65.1%.

¹¹ A back-to-back loan is a loan agreement between two commercial banks in which the currencies remain separate but the maturity dates remain fixed. BTB uses this to obtain local currency in exchange for dollars, but tenors are short, often up to 1 year.