PROJECT INFORMATION DOCUMENT (PID)
IDENTIFICATION/CONCEPT STAGE

Report No.: PIDC52427

Project Name	Audit of DEBRA
Region	EUROPE AND CENTRAL ASIA
Country	Kyrgyz Republic
Sector(s)	General finance sector (100%)
Theme(s)	Corporate governance (40%), Regulation and competition policy (20%), Other Financial Sector Development (40%)
Lending Instrument	Lending Instrument
Project ID	P158654
Borrower Name	Debt Enterprise Bank Resolution Agency
Implementing Agency	National Bank of Kyrgyz Republic
Environment Category	C - Not Required
Date PID Prepared	15-Dec-2015
Estimated Date of Approval	17-Dec-2015
Initiation Note Review Decision	The review did authorize the preparation to continue

I. Introduction and Context

Country Context

With a per capita GNI of $1250 (2014), Kyrgyzstan remains one of the poorest nations in the ECA region. Development in the international sphere in the last year have not helped to improve this situation. The country heavily relies on remittance payments from Russia, which have substantially decreased in light of the worsening economic circumstances the Russian Federation is currently facing, and the gold exports. Thus, to foster sustainable economic growth in the future, economic diversification, with the help of a more efficient public spending and the growth of a vibrant private sector, including small and micro enterprises, is necessary. For this, the development of the financial sector plays a key role.

Sectoral and Institutional Context

The Kyrgyz financial sector is bank dominated, although microfinance organizations are playing an important role. As of October 2015 there were 24 commercial banks and a large number of non-bank financial institutions, such as microfinance organizations, credit unions and exchange offices. In June 2015 two banks (Issikul Bank OJSC and Manas Bank CJSC) were recognized insolvent and their licenses were revoked. The banks were transferred to DEBRA to initiate special administration procedure. In October 2015 the Kyrgyz banking sector welcomed a new bank (Chang An Bank OJSC), the founder of which is a former board member of one of Kyrgyz banks. Opening of another bank is expected soon as a result of transformation of a microfinance organization as NBKR issued a preliminary consent early in October 2015. In late August, NBKR introduced direct banking supervision at one bank (Rosinbank OJSC) as result of introducing provisional administration by Bank of Russia in two Russian banks, members of the group to which Rosinbank belongs. For the purposes of strengthening the stability and safety of the banking system, NBKR increased minimum statutory capital requirement for banks early in 2015. Starting July, 2015 all bank should have statutory capital of at least 300 mln KGS, which will be increased to 400 mln KGS and 600 mln KGS within the next two years respectively. All banks are currently compliant with this requirement, while half of them already have statutory capital in excess of 600 mln KGS. Money markets remain shallow and short of instruments, and there are few participants other than banks. The interbank market predominantly serves transactions in foreign currency. Capitalization of the stock market is nascent. There are 17 small insurance companies and one non-state pension fund.

The banking sector remains relatively stable and profitable. As of August 2015, the liquidity ratio stood at 66 percent, more than twice above the minimum regulatory requirement of 30 percent. The capital to risk-weighted asset ratio fell to 21.2 percent, compared to 21.8 percent at end-2014, remaining well above the prudential minimum threshold of 12 percent. Returns on assets and equity were at 1.8 and 12.9 percent (annualized), respectively. Meanwhile, nonperforming loans (NPLs) increased by about 1 percentage point compared to the 2014 year-end and stood at 5.6 percent. Provisions covered 53.5 percent of NPLs classified as substandard (42 percent of NPLs), doubtful (30 percent), and loss (28 percent).

The low level of financial intermediation is broadly in line with income level. The economy remains heavily cash based. Bank private credit to GDP reached 19.8 percent at end-2014 compared to 15.4 percent at end-2013. In addition, MFO's lending accounted 5.2 percent to GDP. Bank credit grew by 9.4 percent (adjusted for national currency depreciation) during January-August of 2015 compared to much higher 25 percent growth rate of the comparable prior year period. The share of foreign currency loans in the loan portfolio declined to 54% from 58% in the beginning of this year. The main contributors to the credit portfolio growth were agricultural loans (4.4 percent increase) and consumer loans (1.1 percent increase), while construction loans decreased by 0.6 percent. Loans with over three-year maturity accounted for 33 percent of total loans and decreased slightly in 2015 compared to previous year. However, despite this growth, financial intermediation in the Kyrgyz Republic remains among the lowest in the region.

Competition among banks appears limited. Although declining, the state presence in the banking sector remains significant. Most banks operate in niche markets and are small with limited lending activity. Top five banks have about 52 percent of bank assets, 54 percent of credits and 71 percent of deposits. There are two state-owned banks that account for about 14 percent of total banking sector assets. In addition, 10 percent of shares of two other banks belong to the state. The State Kyrgyz Post Office (KPO) having country-wide net of over 900 post offices also offers a limited range of financial services under an agency agreement with banks. There are no plans with clear timeline to privatize the state-owned banks.

Recognizing the importance of developing its financial sector development, especially promoting financial sector stability, the government has been spearheading several reform initiatives including:

-In February 2014 the government renegotiated a US$9.85 million Financial Sector Development Project with the WB (WB) that is aimed at (i) enhancing financial sector stability, and (ii) increasing access to financial services. The project consists of the following three components in the areas of (a) Strengthening the legal, regulatory, and supervisory framework for financial institutions; (b) expanding access to financial services through the national post office network, and; (c) Modernizing the moveable collateral and debt resolution regimes. The project commenced implementation activities on December 18, 2013 with a dedicated project implementati on team.

-In July 2013, the government worked with the WB and the IMF in participating in the Financial Sector Assessment Program which assessed the financial sector's strengths, weaknesses, and vulnerabilities to financial and macroeconomic shocks, as well as its contribution to growth and development. The FSAP concluded with recommendations on the supervisory and regulatory frameworks, financial sector soundness and restructuring, crisis management and bank resolution, access to finance, the role of the state, financial infrastructure, pensions, and insurance.

-On August 18, 2013, the government, partnered with the WB and the Swiss State Secretariat for Economic Affairs (SECO) to establish Kyrgyz Republic Financial Sector Development Project Single-Donor Trust Fund (No. TF072067). On December 12, 2014, the SECO provided additional funds of US$2 million bringing the total size of Trust Fund to US$3.084 of which US$1.052 was disbursed as of November 2015. The Project Development Objective (PDO) of this WB administered Trust Fund (TF) is to enhance financial sector stability by (i) strengthening the legal and regulatory capacity of NBKR as a financial sector regulator; and (ii) improving financial safety net. Specifically, the project includes the following areas/activities:

(i) Developing and adopt the risk based supervision framework for the NBKR in line with international best practices;
(ii) Enhancing NBKR's capacity to undertake dynamic stress tests, and scenario analyses, migrate to macro stress tests and promote bottom-up stress tests for all critical parameters;
(iii) Strengthening of NBKR's position in early identification of problem banks and prompt remedial action framework (PRAF) to prevent aggravation of stressful situations; and
(iv) Strengthening the consumer protection and financial literacy framework in the country.
(v) Strengthening the non-banking sector supervisory capacity of the NBKR
(vi) Strengthening the regulatory and supervisory framework for Islamic Banking
(vii) Strengthening the deposit protection framework,

Relationship to CAS/CPS/CPF

The WBG is committed in assisting the Kyrgyz Republic to develop its financial sector in the framework of the country partnership strategy for 2013-17. Under the area of engagement, business environment and investment climate, the partnership strategy includes a pillar on promoting financial and private sector development. This pillar is closely linked with this project's objective to enhance financial sector stability by (i) strengthening the legal and regulatory capacity of NBKR as a financial sector regulator; and (ii) improving financial safety net".

II. Project Development Objective(s)

Proposed Development Objective(s)

This activity is part of the SECO Funded Kyrgyz Financial Sector Development Project which aims "to enhance financial sector stability by (i) strengthening the legal and regulatory capacity of NBKR as a financial sector regulator; and (ii) improving financial safety net".

Key Results

Audited financial statements of DEBRA and banks under its mandate presented to Ministry of Finance and National Bank of Kyrgyz Republic to expedite the liqudation process of DEBRA's assets.

III. Preliminary Description

Concept Description

Following the reforms under the current initiatives, the urgency for additional reforms focusing on bank resolution become more apparent. Currently, the resolution framework consists of complex and ineffective tools for bank resolution. Conservatorship is neither designed nor used as a resolution tool, but rather is used as a tool to restore the problem bank's financial soundness and adherence to prudential norms. During conservatorship, shareholders remain in place and may eventually become the beneficiaries of the NBKR's efforts. Most of the resolution procedures, including liquidation, restructuring and rehabilitation, take place under court supervision, with the participation of creditors and shareholders, and the Bank Reorganization and Debt Restructuring Agency (DEBRA) acting as the sole liquidator.

Importantly, dysfunction of DEBRA significantly undermines the effectiveness of the resolution framework. The DEBRA was established as an entity under the NBKR in 1996, initially to help manage and privatize state-owned banks. This original mandate was to end after five years; however, it subsequently evolved into an asset management company with multiple tasks, and became a more independent entity reporting directly to the President. The DEBRA's current roles include: (i) the mandatory "special administrator" (liquidator and rehabilitator) of banks in liquidation; and (ii) the collector of debts on behalf of the MOF. The DEBRA considers the rehabilitation of failed banks as its major task hamstringing the bank resolution regime. Many of the liquidation cases that it handles have been lingering for more than a decade, despite the legal time limit of two years. Meanwhile, the DEBRA's financial reports have not been published nor audited by professional auditors. The bank estates that it manages also require external audits.

Hence, the termination of DEBRA's bank resolution functions following the liquidation of banks under its management will be key to complement ongoing reform efforts as recommended by 2013 Financial Sector Assessment Program (FSAP). To address identified weaknesses, the authorities have prepared a new Banking Law which is currently before parliament. One of the aims of the Law is to restrict the potential interventions of the courts, while enhancing the effectiveness of the administrative resolution tools, and enhancing the NBKR's ind ependence and accountability. However, these reforms could not yield intended results on the resolution framework without the termination DEBRA's related functions. Accordingly, 2013 FSAP recommends to terminate DEBRA's functions and granting them to the NBKR.

The first step to achieve termination of the DEBRA's resolution function is to facilitate external audit of the institution and banks under its management. In line with this, SECO and IMF approached the World Bank to take the lead on the implementation of the audit in June 2014. On the preparation stage of the additional financing proposal in December 2014, this component was designed as a bank-executed activity. Nevertheless, during the consultations with relevant departments, the team was informed that execution by the World Bank could not be possible for this particular area of work and the existing trust fund should be transformed into a hybrid one with this component being executed by the recipient. Based on this, SECO decided to provide the initially agreed amount of US$2 million in December 2014 upon the condition that US$336,300 (including taxes) of this amount would be allocated for the DEBRA audit when the authorities decides to implement the audit with a recipient-executed approach. As a result this amount was allocated as contingency to other components until the execution of DEBRA audit.

At the beginning of 2015, the World Bank and IMF met with the institutions involved in the audit of DEBRA (DEBRA, the President's Office, the Ministry of Finance and NBKR) and all parties agreed on the recipient-executed approach and drafted an action plan (see Annex 1 and 2). According to the plan, DEBRA will be the recipient of grant while the Project Implementation Unit at the NBKR will responsible for the implementation. The Ministry of Finance sent their confirmation on DEBRA's eligibility as a grant recipient in November 2015 (please see Annex 3).

IV. Safeguard Policies that Might Apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01		✕	
Natural Habitats OP/BP 4.04		✕	
Forests OP/BP 4.36		✕	
Pest Management OP 4.09		✕	
Physical Cultural Resources OP/BP 4.11		✕	
Indigenous Peoples OP/BP 4.10		✕	
Involuntary Resettlement OP/BP 4.12		✕	
Safety of Dams OP/BP 4.37		✕	
Projects on International Waterways OP/BP 7.50		✕	
Projects in Disputed Areas OP/BP 7.60		✕	

V. Financing *(in USD Million)*

Total Project Cost:	0.3363	Total Bank Financing:	0
Financing Gap:	0		

Financing Source	Amount
Free-standing TFs for ECA PF Sector Unit	0.3363

VI. Contact point

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