

National Bank of the Kyrgyz Republic

**BANKING SYSTEM
DEVELOPMENT TRENDS**

FIRST HALF OF 2006 (9)

BISHKEK 2006

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Banking System Development Trends

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The NBKR Bulletin contains macroeconomic indicators of the Kyrgyz Republic on the real, financial and external economic sectors, and also on public finances. Materials from the National Statistics Committee, Ministry of Finance, commercial banks, State Commission on the Securities Market under the Government of the Kyrgyz Republic and the National Bank of the Kyrgyz Republic are used in preparing the bulletin. It is published on a monthly basis in Kyrgyz, Russian and English.

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This publication reflects the recent trends in the development of the external sector and contains tables with the balance of payments data according to analytic and standard presentation formats, the structure of foreign trade, international reserves, external debt, and also information on international investment position of the Kyrgyz Republic. It is published on a quarterly basis in January, May, July and October.

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The overview contains the description of consumer price dynamics in the republic and in its regions, the analysis of major inflation factors, information on decisions of the National Bank of the Kyrgyz Republic in the area of monetary policy and presents the inflation projection for the forthcoming period. It is published on a quarterly basis in Kyrgyz, Russian and English.

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The Press Release of the NBKR contains a chronicle of events in the National Bank and in the banking system as a whole, and on-line information on the financial market. It is published on a weekly basis in Kyrgyz and Russian.

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Statutory acts of the National Bank are officially published in this publication in order to provide normative documents that form the banking legislation of the Kyrgyz Republic to commercial banks and to the public. The tentative frequency of publishing the edition is once a month in Kyrgyz and Russian.

All publications are disseminated according to lists approved by the orders of the Chairman of the National Bank of the Kyrgyz Republic and are placed on the Website at the following address: <http://www.nbkr.kg>

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INTRODUCTION

Strong growth has been observed in the first half of 2006 in the banking system of the republic. Volumes of lending to the real sector of economy are increasing, the financial intermediation indicator of the banking system is increasing though its level remains as low as before. At the same time considerable liquidity reserve and high capital adequacy in commercial banks shows the available capacity for further development of the banking system.

The deposit base of commercial banks continues to increase, however, the low growth rate of deposits with the placement term of more than one year imposes restrictions for the development of long-term lending. Observable reduction in the level of dollarization of the deposit base and credit portfolio is a positive trend in terms of the effect of foreign exchange risks on activities of banks.

There is continued growth of the loan portfolio in the sector of non-bank finance and credit institutions that indicates the high demand for credit resources on the part of households, small and medium size businesses, and also increase in returns on operations of non-bank finance and credit institutions.

Stability of the banking system, increase in real income of the population is also reflected in the sustainable trend of increase in the volume of public deposits and lending to the household sector that suggests the improvement of confidence in the banking system.

Volumes of non-cash payments are increasing, however, the strong growth of demand for money and inadequate development level of instruments of conducting non-cash payments stimulate the increase of cash in circulation.

The improvement in the stability of the banking system, the strengthening of capital in commercial banks, the increase in the volume of lending to the real sector of economy, active operations of banks at the deposit market, the expansion in the range and improvement in the quality of banking and payment services are positive components for development and growth of the republic's economy.

* * * * *

Information on the initiative of the World Bank and International Monetary Fund on debt relief for heavily indebted poor countries (HIPC) is presented in section 'Special Issues'.

I. STATUS OF THE FINANCIAL AND CREDIT SYSTEM

Following the results of the first half of 2006 the aggregate assets of the finance and credit system¹ increased by 25.2 per cent in comparison with similar period of 2005, where higher growth rates of this indicator are observed with non-bank finance and credit institutions (NBFIs).

In spite of considerable expansion in the range of services rendered by finance and credit institutions, credits are the main component of their performing assets.

The financial intermediation indicator defined as the ratio of aggregate credit portfolio to gross domestic product (GDP)² increased in comparison with similar period of last year and was 14.0 per cent (Please see chart 1.1). The marked growth in the financial intermediation level is mainly connected with the growth in the loan portfolio of banking institutions. The growth rates of loans of the banking system and NBFIs was 21.3 and 11.4 per cent, accordingly.

The banking system continues to occupy a dominating position in the finance and credit system (chart 1.2) and following the results of the first half of 2006 its share was 63.5 per cent in the aggregate loan portfolio of the finance and credit system.

Based on the movement in the ratio of allowances for loan losses (ALL) to loans in the banking system and NBFIs, the reduction is noted in the quality of the loan portfolio of the banking system (see chart 1.3). Thus, following the results of the first half the share of the ALL in the loan portfolio of NBFIs was 2.8 per cent, and this indicator was 8.2 per cent in the banking system.

Chart 1.4 presents the so-called 'Dispersion' of average weighted interest rates of loans issued by commercial banks (in national and foreign currencies) and non-bank finance and credit institutions³ that, to a certain extent, gives the possibility to assess the level and direction of movement in the cost of credit resources. Following the results of the first half of 2006 the reduction is observed on average weighted interest rates on loans

Chart 1.1. Change in Loan Portfolio (LP) of Finance and Credit System (FCS) as percentage to GDP

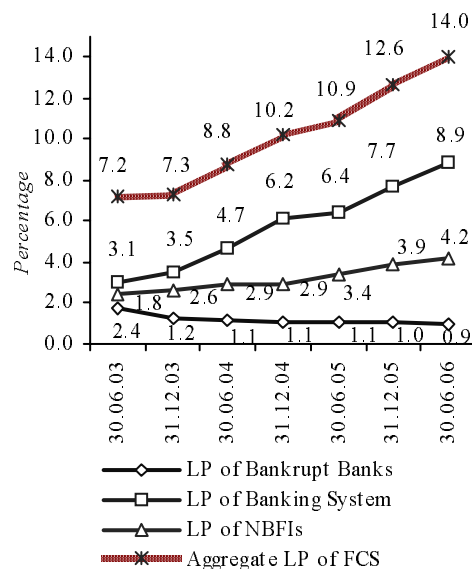


Chart 1.2. Aggregate Loan Portfolio (LP) Structure

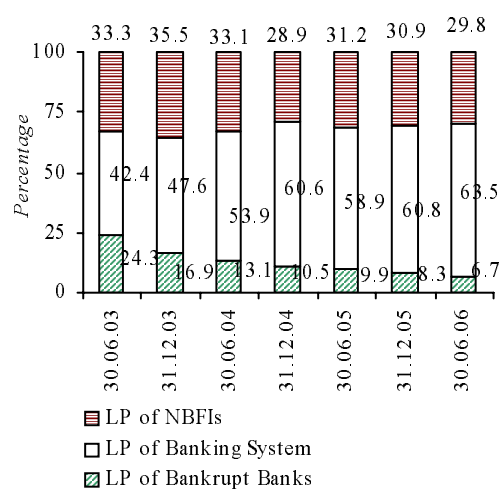
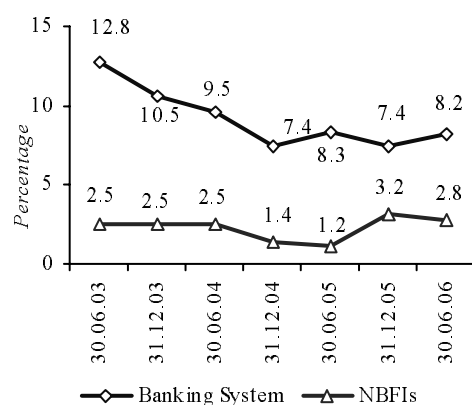


Chart 1.3. Special ALL in Loan Portfolios of Banking System and NBFIs

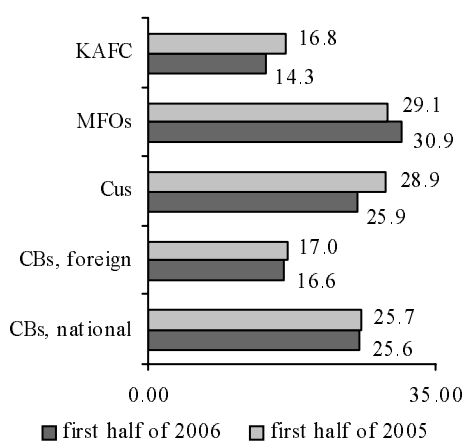


¹ Indicators of commercial banks and non-bank finance and credit institutions licensed by the NBKR are considered here as the review indicators of the finance and credit system.

² Information on actual GDP for the past 12 months is taken into account.

³ Average weighted rates on lombard loans are not reflected in chart 1.4. Following the results of the first half of 2006 this indicator was 144.9% and 155.2% following the results of similar period in 2005.

Chart 1.4. 'Dispersion' of Average Weighted Interest Rates on Loans of Various FCIs, percentages



Note: CBs, national means commercial banks, national currency, CBs, foreign means commercial banks, foreign currency, CUs means credit unions, MFOs means microfinance organizations, KAFC means Kyrgyz Agricultural Finance Corporation.

of credit unions and KAFC as compared with similar period of last year. The increase of the average weighted interest rate in comparison with similar period of last year is noted on loans of microfinance organizations that was 1.8 percentage points.

The reduction of average interest rates is observed on newly accepted loans of commercial banks in national and foreign currencies. Thus, following the results of the first half of 2006 the average interest rate on loans in national currency reduced by 0.2 percentage points and on loans in foreign currency by 0.4 percentage points as compared with similar period of 2005.

Thus, during the period under review the status of the finance and credit system of Kyrgyzstan is characterized by the following:

- continued movement of increase in the financial intermediation indicator, where considerable growth rate of this indicator is noted for the banking system;
- Improvement in some qualitative characteristics of the loan portfolio of NBFIs.

II. STATUS OF THE BANKING SYSTEM

2.1. Banking System Structure

One more bank whose license was issued on December 30, 2005 commenced its activities from the beginning of 2006 in the banking system of Kyrgyzstan. 100 per cent of this bank's capital belongs to foreign investors.

Total of 20 commercial banks (including Settlement and Savings Company and a branch of the National Bank of Pakistan) operated in the first half of 2006. They include 15 banks with foreign shareholdings, in 10 banks out of them the foreign interest was more than 50 percent. All banking institutions of the republic are universal.

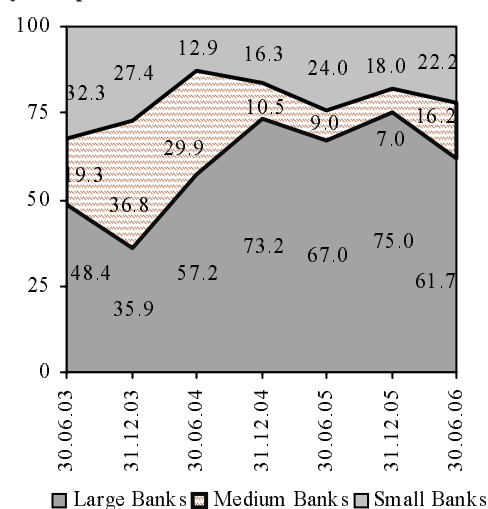
In the first half of 2006 the growth trend on all major areas of activities has continued in the banking system on a whole.

The analysis of the banking system structure (chart 2.1.1) in terms of the market segment occupied by groups of large, medium and small banks⁴ shows the reduction of concentration in the market share of large banks, the share of which reduced by 13.3 percentage points in the reporting period.

In this case the share of medium and small banks in the reporting increased by 9.2 and 4.2 percentage points, correspondingly.

Just as in 2005 the segment of large banks is represented by two banks that occupy 61.6 per cent of the market share (out of which 51.2 per cent belongs to the largest bank in the Kyrgyz Republic). This indicator is achieved on account of high shares of these banks in aggregate deposits of the banking system (37.9 per cent) and aggregate assets (33.6 per cent). Both banks are also

Chart 2.1.1. Change in Banking System Structure by Groups of Banks



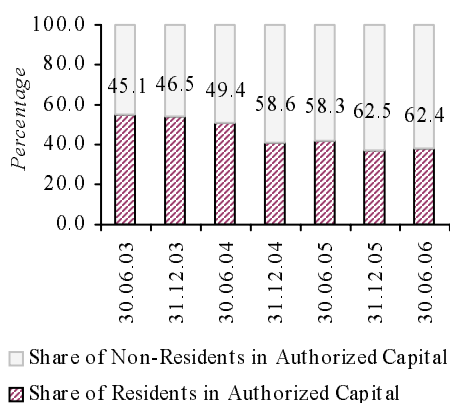
⁴For analysis purposes of this publication, large banks refer to banks, whose share (d_i) in the banking market (the average square share in total assets, loans, deposits and capital) exceeds 10 percent, medium banks from 5 to 10 percent, and for small banks less than 5 percent.

Computed according to the following formula:

$$d_i = \frac{X_i}{\sum_{i=1}^{20} X_i} - \text{share of } i \text{ banks in the banking sector;}$$

$$X_i = \frac{d_A^2 + d_{kp}^2 + d_{\Pi}^2 + d_{O6}^2}{4} - \text{arithmetic average value on following}$$

indicators: (d_A^2) –square share of assets of i bank in aggregate assets of banks, and in loans (d_{kp}^2), deposits (d_{Π}^2) and liabilities (d_{O6}^2), correspondingly.

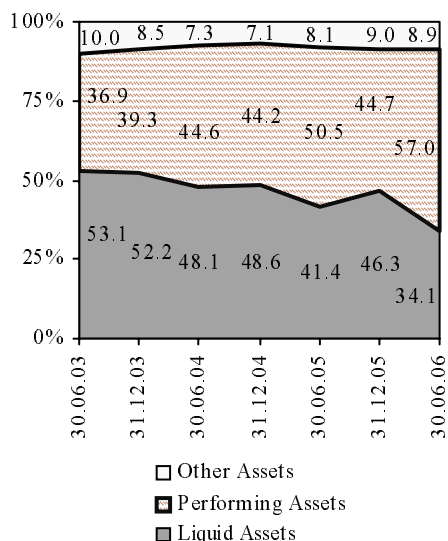
Chart 2.1.2. Change in Authorized Capital Structure of Banking System

part of the group of principal participants at the credit market (22.1 per cent).

Aggregate capital of the banking system increased by 16.3 per cent in the reporting period. The increase in capital was mainly connected with the formation of the authorized capital by the new bank (Som 300 million), with the increase in retained earnings and also with the expansion in volumes of activities in accordance with strategic plans of commercial banks.

The share of foreign capital in the authorized capital of commercial banks had not considerably changed and was 62.4 per cent (62.5 per cent as of beginning of 2006, chart 2.1.2). Total increase in the authorized capital occurred using investments both of non-resident and resident investors of the Kyrgyz Republic. In this case the growth rate in the authorized capital of residents for the first half of 2006 increased in comparison with the previous period and was 18.2 per cent in the reporting period, and the increase in the authorized capital of non-residents was 17.4 per cent (26.1 per cent for the previous six months).

Leading increase in the capital of banks in comparison with the increase in assets points to adequate capacity building for further development of the banking system.

Chart 2.1.3. Change in Asset Structure of Banking System

Increase in assets of the banking system in the first half of 2006 was 0.8 per cent. When considering the change in the structure of aggregate assets⁵ (chart 2.1.3.), it is necessary to note that as of reporting date 57.0 per cent of banks' assets were performing assets and their share increased by 12.3 percentage points. In such case the share of liquid assets in aggregate assets of the banking system reduced from 46.3 to 34.1 per cent, their absolute value reduced by 25.8 per cent. Considering high liquidity of banks' assets in comparison with the standard established by the NBKR, the reduction in liquid assets and direction of released cash for lending to economy is a positive fact.

The share of other assets had not significantly changed and was 8.9 per cent.

For purposes of a more detailed review of changes in the structure of performing assets the following is given below: the analysis of the deposit structure⁶ as the main

⁵ Liquid assets refer to funds of banks in cash and correspondent accounts. Performing assets represent balances on accounts of loans, deposits placed with FCIs, securities and other placements of banks that yield interest income.

⁶ Deposit base includes deposits of natural and legal persons, and also deposits of the Government and of other authorities.

source of placed resources and changes in the loan portfolio as the main type of banking placements.

In the first half of 2006 there was continued increase in the *deposit base of the banking system*. The increase was 9.3 per cent and the amount of deposits reached Som 14.2 billion. In the deposit structure the share of deposits of natural persons increased from 20.5 to 21.7 per cent. Deposits of natural persons increased by 15.7 per cent.

The share of time deposits of legal entities also increased by 0.4 percentage points and was 12.2 per cent of the total deposit base of banks as of end of the first half of 2006.

In this case the share of demand deposits of legal entity decreased to 58.6 per cent (60.6 per cent as of beginning of 2006).

The remaining share (7.6 per cent) includes deposits of the Government and of other authorities.

The increase in the share of time deposits (chart 2.1.4) gives the possibility for banks to increase the medium term and long term financing of the economy that has been already observed from the beginning of 2006 in the form of increase in the loan portfolio of banks.

In the first half of 2006 there was the first reduction in the level of ‘dollarization’ of the deposit base of the banking system for the past 3 years (chart 2.1.5). This indicator was 68.5 per cent against 73.0 per cent as of December 31, 2006. In this case the level of dollarization in deposits of legal entities reduced by 5.1 percentage points and was 74.1 per cent as of reporting date. The share of deposits of natural persons in foreign currency also reduced by 1.9 percentage points and was 64.6 per cent.

Aggregate credit portfolio of the banking system increased by 21.3 per cent in the first half of 2006. The reduction in the share of foreign exchange deposits is conditioned by the reduction in the share of foreign exchange loans by 3.1 percentage points that was 68.4 per cent as of reporting period end (chart 2.1.6).

Reduction in the level of ‘dollarization’ of deposits and loans positively impacts the decrease in the degree of effect of movement in the exchange rate of the national currency on activities of commercial banks.

In the reporting period there was continued increase in long term loans⁷: their share in the first half of 2006 increased from 34.9 to 36.4 per cent, and in absolute terms

Chart 2.1.4. Change in Deposit Structure of Banking System by Attraction Terms

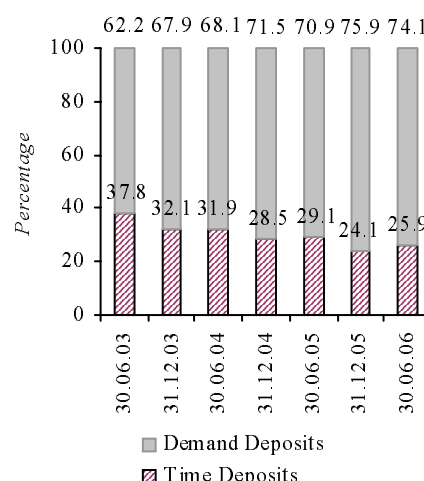


Chart 2.1.5. Change in Deposit Structure of Banking System by Types of Currencies

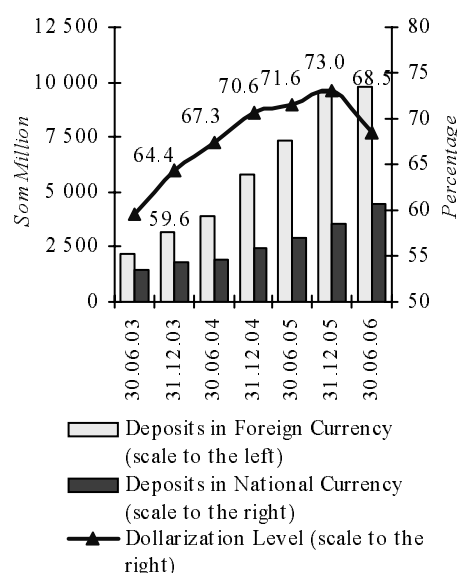
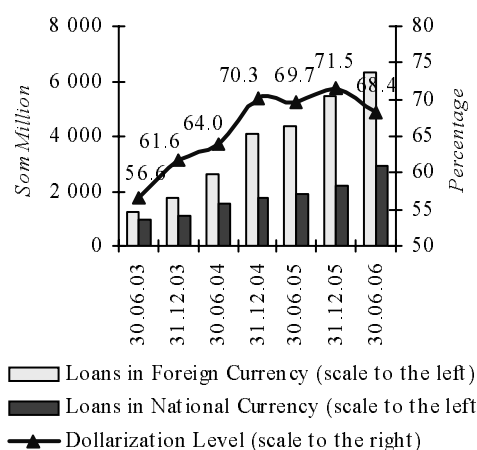


Chart 2.1.6. Change in Loan Portfolio Structure of Banking System by Types of Currencies



⁷ Loans issued for the term more than 1 year refer to long term loans.

Chart 2.1.7. Change in Loan Portfolio Structure of Banking System by Placement Terms

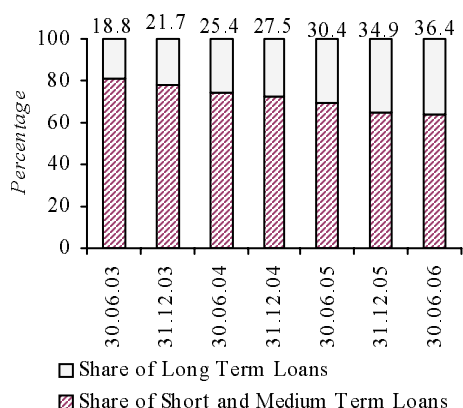


Chart 2.1.8. Change in Interest Rate on Loans in National Currency (percentage)

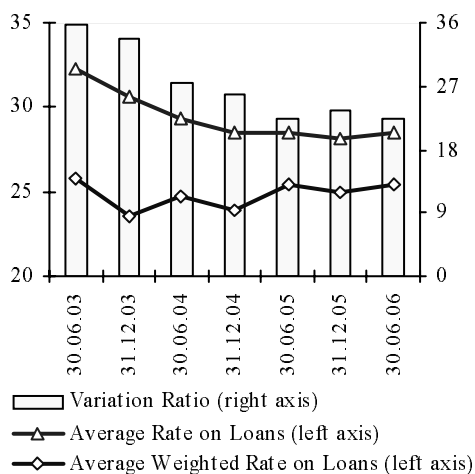
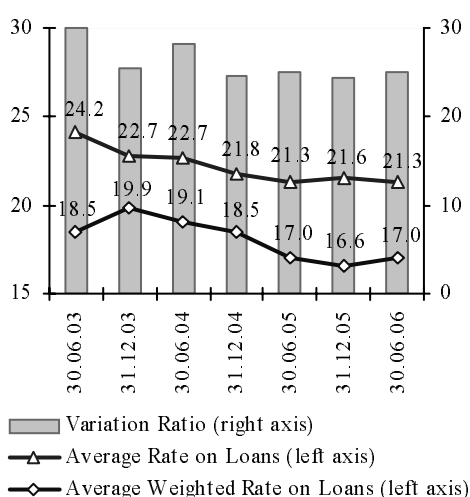


Chart 2.1.9. Change in Interest Rates on Loans in Foreign Currency (percentage)



the increase was 38.5 per cent that may be considered as one of stabilization factors in economy. Loans with less than one year term (63.6 per cent) still continue to take a considerable specific weight given some decrease in their share in the first half of 2006 (see chart 2.1.7).

Such characteristics as the variation ratio of interest rates on loans, the average rate and the average weighted rate on loans have been considered in order to assess the current interest rates on loans.

In the first half of 2006 the average rates (calculated as an arithmetic average value for 6 months) on loans in national currency were 25.7 per cent and 16.6 per cent in foreign currency. In comparison with the first half of 2005 the interest rates reduced by 0.2 and 0.4 percentage points, correspondingly. The variation ratio that shows the value of interest rate dispersion at the credit market also continues to decrease.

Moreover, the average weighted rate on loans both in foreign and national currency continues to remain below the average rate that indicates the excess of the lending volume at lower than average rates over the volume of loans issued at higher interest rates (charts 2.1.8, 2.1.9).

Thus, in the first half of 2006 the following trends have been observed in the banking sector:

- continued improvement of the banking system capitalization;
- increase in the deposit base of banks, including time deposits;
- increase in the loan portfolio and assets as a whole;
- decrease in the level of ‘dollarization’ of loans and deposit base of the banking system given the high share of demand deposits;
- increase in the share of performing assets in aggregate assets of the banking system;

Continued improvement in the share of long term loans to clients in the loan portfolio.

2.2. Risks

2.2.1. Credit risk

Credit risk is one of major risks inherent in banking activity. Active operations of banks bearing credit risk are considered within the framework of this section.

In order to assess the *quality of the loan portfolio*, commercial banks use the system of credit classification⁸ that gives the possibility to determine the possible level of potential losses from non-repayment of loans in advance and timely compensate for them (by minimizing the negative impact on the capital) by establishing appropriate reserves.

In analyzing the loan portfolio quality, greater attention shall be paid to non-performing and past due loans that reflect the first features of deterioration in the loan portfolio quality. In the first half of 2006, the increase has been observed in the portion of non-performing loans in the loan portfolio (chart 2.2.1.1). At the same time, despite some deterioration of qualitative characteristics in the loan portfolio of the banking system in the reporting period, the level of the non-repayment risk remains at the allowable level.

The change in the volume of loans classified as loans “under supervision” may be considered as one of the factors that may impact the increase/decrease of credit risk in the future. Although the share of such loans in the first half of 2006 considerably reduced (see chart 2.2.1.2), they continue to take up a heavy portion in the total credit portfolio (11.7 per cent).

According to data for June 30, 2006 banks created the volume of reserves adequate to the adopted classification of loans. In this case the volume of special reserves created for classified loans with respect to this category of loans was 54.9 per cent that confirms the conservative approach of commercial banks to issues of assessing possible loan losses.

In the event of deterioration in the quality of classified loans and additional accrual of reserves, the

Chart 2.2.1.1. Change in Credit Risk in Banking System Loan Portfolio

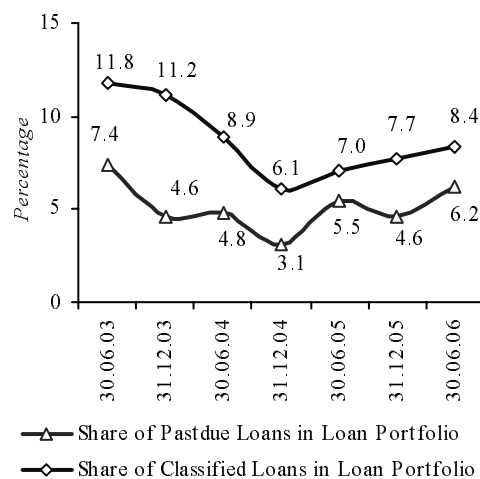
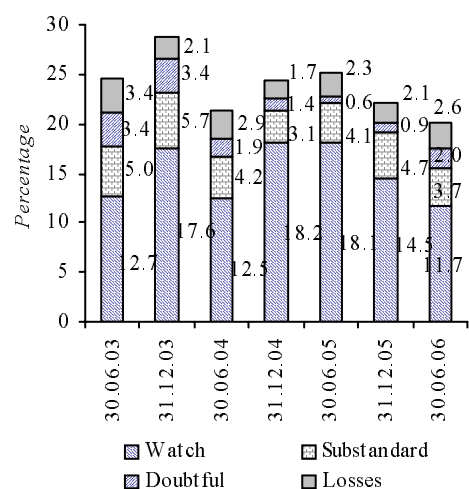
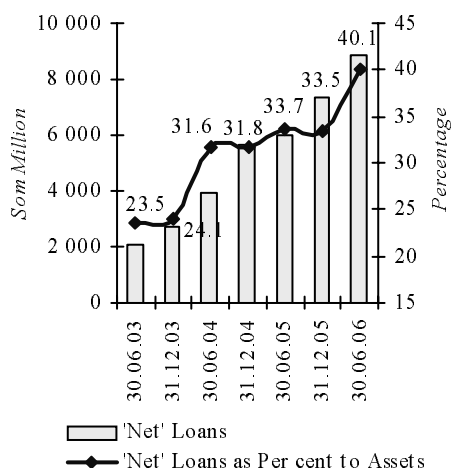


Chart 2.2.1.2. Change in Classification of Banking System Loan Portfolio



⁸ For purposes of assessing the loan portfolio quality it is a common practice to divide all loans into six categories depending on the current capacity of the client to perform his obligations before the bank (given in the order of deterioration of classification): normal, satisfactory, under supervision, substandard, doubtful and losses. Loans of the last three categories as having the most negative characteristics in terms of collection of disbursed funds commonly refer to ‘non-performing’ or ‘classified’. For each of six specified categories the bank shall establish a reserve that is appropriate for that category defined as a percentage of the amount of disbursed loans.

Chart 2.2.1.3. Change in 'Net' Loans



amount of net total capital of banks will reduce insignificantly.

Thus, on the whole the credit risk remains at the acceptable level, however, there are reasons in place that may cause the increase in indicators that define this risk in the future.

As of end of June 2006 the share of 'net' loan portfolio (balances of the principal receivable on loans to clients less established special reserve for possible losses on classified loans) was 40.1 per cent of aggregate assets of the banking system (see chart 2.2.1.3), having increased by 6.6 percentage points in comparison with the beginning of the year. Continued expansion in coverage of the population with credit services had the main impact on this change in the first half of 2006.

2.2.2. Liquidity Risk

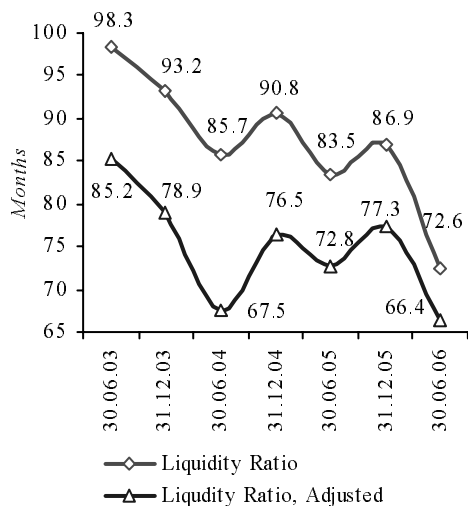
Public confidence in the banking system depends on timely fulfillment of liabilities by banks that implies the presence of adequate liquidity in banks. For regulatory purposes the liquidity risk is measured with the help of the economic ratio of current liquidity⁹.

The actual level of the liquidity ratio maintained by the banking system remains sufficiently high. On average for the banking system the calculated value of this ratio following the results of the first half of 2006 was 72.6 per cent having reduced by 14.3 percentage points in comparison with the beginning of the year. Improved liquidity of one bank that specializes in conducting quasi-active operations (operations on correspondent accounts) has considerable impact on the final value of the indicator. The current liquidity level without taking into account this bank was 66.4 per cent as of end of the reporting period (see chart 2.2.2.1).

This indicator decreased in the first half of 2006 due to increase of the loan share in the structure of banks' assets.

Excess of the actual value of the liquidity indicator over the established standard value shows the available potential for further expansion of financial intermediation on one hand, however, on the other hand, reflects insufficient stability of the deposit base. Insufficient stability of deposits is confirmed by data in the duration

Chart 2.2.2.1. Change in Calculated Value of Current Liquidity



⁹ Economic ratio of current liquidity is one of ratios established by the NBKR at the level of no less than 30 percent and is mandatory for execution by a bank.

of deposits and loans, and also by calculation of the stability ratio for sources of funds¹⁰.

During the reporting period (see chart 2.2.2.2) the gap between average terms of attracting deposits and placing loans remained high that tells about hidden disintermediation¹¹ risks that may emerge in some banks in the process of liquidity management through time. However, it is necessary to take into account that a certain part of loans financed by banks using other long-term sources different from deposits (capital, long-term borrowings from financial institutions and so forth). This fact will effect the reduction of the probable emergence of abovementioned risks. Furthermore, it is necessary to implement the Deposit Protection System in order to attract long-term deposits.

Chart 2.2.2.3 presents the change in the stability ratio for sources of financial assets in comparison with the dynamics of change in the ratio of the deposit base to net loan portfolio. A low share of time deposits (25.9 per cent according to data for June 30, 2006) in the deposit base undoubtedly affects the placement volumes and complicates the liquidity management process in the future.

Movement in the ratio of deposits and loans shows some improvement in the efficiency of using attracted funds.

On the whole, we may note that, at present, there are no grounds for the shortfall of funds to perform obligations in the banking system, at the same time the low stability of attracted resources exerts negative impact on the liquidity management process through time, on the increase in the volume of the loan portfolio and, on a whole, on reduction of returns on assets.

At the same time there was some increase in the share of time deposits (i.e. improvement in the stability of financial assets) in the reporting period and, as a result, the increase of the share of loans in banks' assets.

Table 2.2.2.4 cites data on maturities of financial assets and liabilities of banks as of end of June 2006. On the whole, financial liabilities of banks are covered by financial assets, where the gap (excess of assets over liabilities) is Som 4.3 billion, including Som 3.6 billion on loans and deposits. Thus, banks have sufficient assets to

Chart 2.2.2.2. Change in Duration of Banking System Loans and Deposits

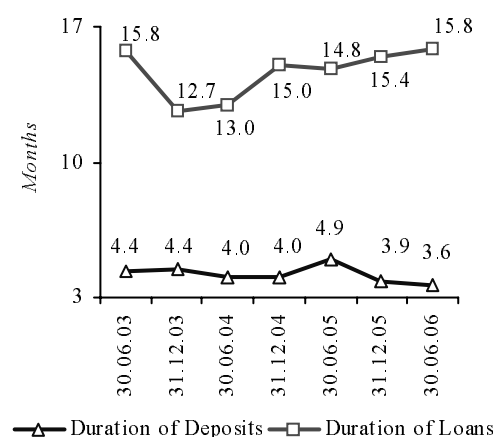
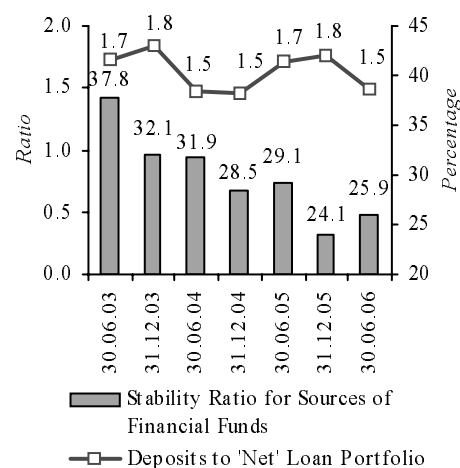


Chart 2.2.2.3. Assessment of Banking System Liquidity Factors



¹⁰ A stability ratio for sources of financial assets is characterized by a portion of time deposits in the total amount of banking system deposits.

¹¹ Disintermediation is the process of mass withdrawal of deposits by the public before the agreed term as a result of panic caused by escalation of inflationary expectations and/or negative expectations.

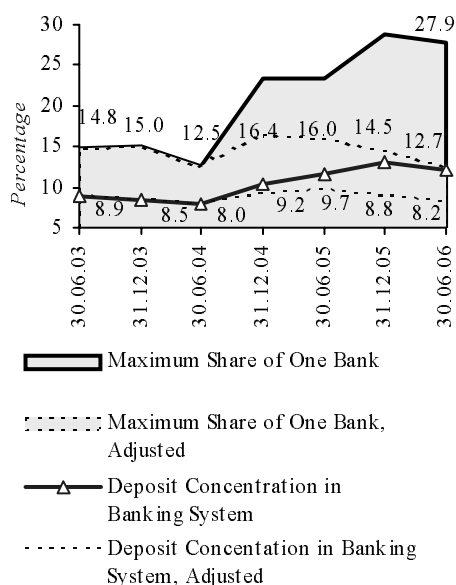
perform their financial liabilities. Considering sufficient liquidity level in banks, increase in own capital, improvement in stability of sources of banks' financial assets and also the specific nature of demand deposits, the negative gap in the period up to 30 days can not have material effect on performance of financial obligations by banks.

Table 2.2.2.4. Maturity of Financial Assets/Liabilities
(in som million)

Name	Maturity					Total
	30 days	31 - 90 days	91 -180 days	181 - 365 days	over 365 days	
1. Total Financial Assets	10 325.2	1 517.2	1 800.5	3 395.9	5 165.7	22 204.4
<i>including loans and financial lease to clients</i>	<i>514.3</i>	<i>591.2</i>	<i>1 160.3</i>	<i>2 493.8</i>	<i>3 581.2</i>	<i>8 340.8</i>
2. Total Financial Liabilities	12 166.0	1 298.0	1 219.4	1 457.9	1 798.4	17 939.7
<i>including deposits of natural persons and time deposits of legal entities</i>	<i>1 644.0</i>	<i>689.0</i>	<i>768.9</i>	<i>985.5</i>	<i>700.3</i>	<i>4 787.7</i>
3. Gap Total	-1 840.9	219.2	581.1	1 938.0	3 367.3	4 264.7
<i>including gap on loans and deposits</i>	<i>-1 129.6</i>	<i>-97.9</i>	<i>391.4</i>	<i>1 508.4</i>	<i>2 880.9</i>	<i>3 553.2</i>

2.2.3. Concentration Risk

Chart 2.2.3.1. Change in Deposit Concentration



Features of deposit concentration. As it is seen in chart 2.2.3.1 the decrease of both average deposit concentration level in the banking system and of the maximum share of one bank at the deposit market is observed in the first half of 2006 in contrast to the previous period. Reduction in the volume of deposits in one of commercial banks that in its turn is connected with withdrawal of a large time deposit of a legal entity had major influence on the change of these indicators. This fact resulted in the decrease in concentration of this category of deposits (see chart 2.2.3.2).

Without considering deposits of this bank the distribution of the deposit market among participants¹² is low (more than 10 participants) and for the past three years remains at approximately the same level.

Evaluation of the concentration level in the banking

¹² Evaluation of the concentration risk as high, moderate or low is based on a common scale of the concentration level. Thus, the concentration risk is considered to be low, if the concentration level is less than 10 percent, moderate risk is between 10 to 20 percent, or high – above 20 percent. For example, concentration index that equals to 50 per cent is equivalent to the presence of 2 participants with equal shares in the market, and 33 per cent to 3 participants and so forth.

system with the help of another indicator that is ‘the share of four large banks by the deposit level’ in the first half of 2006 also shows the decrease of deposit concentration from 59.6 to 53.7 per cent. At the same time, in terms of composition, positions of the first three commercial banks by their size practically remain unchanged.

Features of loan concentration. The increase in the loan portfolio of the banking system in 2004-2006 has been accompanied by some decrease of loan concentration assessed both by the maximum share of an individual bank at the credit market and by the level (index) of loan concentration (see further chart 2.2.3.3).

This is related with active operations of two commercial banks at the credit market.

Concerning the indicator of the ‘share of four large banks’ in terms of credit concentration we may note that it reduced by 5.1 percentage points and was 46.1 per cent in the reporting period. The composition of banks somewhat changed that was related to the fact that banks which take positions from the third through the six according to their share in aggregate loan portfolio have virtually equal shares of participation.

Reduction dynamics for the credit concentration indicator by types of currencies reflects the improvement of competition among banks in issuing loans both in national and foreign currencies (see chart 2.2.3.4).

Evaluation of the credit concentration level by all types of sectors from ‘moderate’ to ‘high’ remains in analyzing the risk of credit concentration by sectors of the national economy.

On the basis of data from tables 2.2.3.5, 2.2.3.6 we may note some movement in banks’ activities in the area of lending to transportation, social services and private sector. High concentration of loans extended for communication needs, procurement and processing, housing lending indicates the concentration of these operations with only a limited number of banks that results in a low share of similar loans in the total loan portfolio of the banking system.

Thus, the moderate concentration of deposits and loans by currencies and sector purpose is noted in the banking system of the Kyrgyz Republic on the whole. Some decrease of concentration indicators by participants of this market causes the increase in activities of two commercial banks. This activity is not accompanied by any material changes in interest rates in view of (1) attraction of considerable resources at the international

Chart 2.2.3.2. Deposit Concentration by Types of Currencies

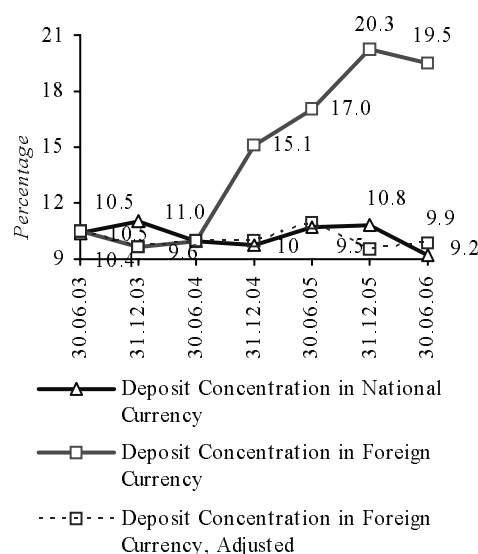


Chart 2.2.3.3. Change in Credit Concentration

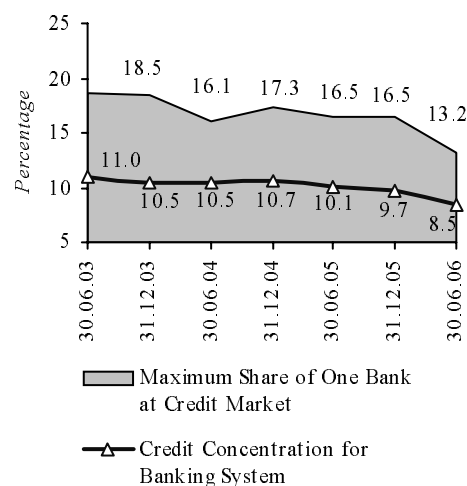
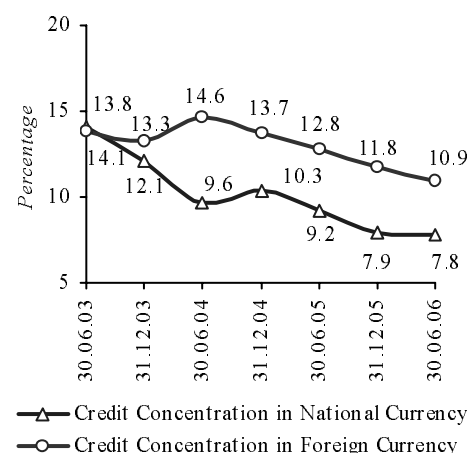


Chart 2.2.3.4. Credit Concentration by Types of Currencies



interbank deposit market and (2) the low saturation level of the republic's economy with credit resources.

Table 2.2.3.5. Concentration of Banks' Activities on Lending to Sectors of National Economy (percentage)*

	31/12/2003	30/06/2004	31/12/2004	30/06/2005	31/12/2005	30/06/2006	Variance (percentage points)
Industry	17,1	19,1	20,8	21,8	17,0	20,2	<u>3,2</u>
Agriculture	29,2	29,1	25,9	21,6	21,0	20,1	<u>-0,9</u>
Transportation	31,2	45,6	31,9	26,8	32,5	15,7	<u>-16,8</u>
Communication	26,9	37,2	34,7	38,9	51,2	48,8	<u>-2,4</u>
Trade	13,4	11	12	11	10,7	9,1	<u>-1,6</u>
Procurement and Processing	19,7	25,2	28,8	25,9	27,9	55,1	<u>27,2</u>
Construction	23,7	33,6	28,8	31,1	26,8	21,9	<u>-4,9</u>
Housing Lending	27,7	21,7	16,3	12,3	14,7	28,4	<u>13,7</u>
Households	13,4	15,6	16	23,2	21,4	16,3	<u>-5,1</u>
Social Services	67,7	71	44,3	34,1	30,6	12,0	<u>-18,6</u>
Other	12,5	12,2	13,6	13,3	14,6	18,0	<u>3,4</u>

* Concentration is defined on the basis of a Herfindahl index that is calculated as the sum of squares of shares of banks in the total volume of lending to the sector. A concentration index equaling to 100% means complete monopolization of the market, 50% means 2 participants with equal shares and 33% means 3 participants, and so forth.

Table 2.2.3.6. Credit Portfolio Structure of Banks by Sectors of National Economy

	31/12/2003	30/06/2004	31/12/2004	30/06/2005	31/12/2005	30/06/2006	Variance (percentage points)
Industry	21,7	21,5	20,5	18,8	17,3	12,7	<u>-4,6</u>
Agriculture	2,8	2,4	2,0	1,9	2,0	3,0	<u>1,0</u>
Transportation	1,5	1,5	1,2	1,3	0,8	0,9	<u>0,1</u>
Communication	1,8	1,6	0,6	0,5	0,4	0,1	<u>-0,3</u>
Trade	39,2	39,4	46,6	44,5	42,9	44,7	<u>1,8</u>
Procurement and Processing	2,4	1,4	1,3	1,0	0,9	0,8	<u>-0,1</u>
Construction	2,8	5,9	4,9	6,3	6,1	6,1	0,0
Housing Lending	3,1	3,9	4,9	5,4	7,0	8,6	<u>1,6</u>
Households	7,3	8,3	8,0	8,2	8,0	8,7	<u>0,7</u>
Social Services	0,0	0,0	0,3	0,2	0,2	0,1	<u>0,1</u>
Other	17,3	14,1	9,8	12,0	14,5	14,2	<u>-0,3</u>

2.3. Capital Adequacy

Eventually all risks inherent in banking activity are reflected on the financial result from this activity (both as having already developed in the form of direct losses and as having high degree of probability of future losses through expenses for establishing appropriate reserves) and affect the size of own funds of the bank that is its capital. Therefore the capital amount defines the bank's stability before present and future negative changes in external and internal environment.

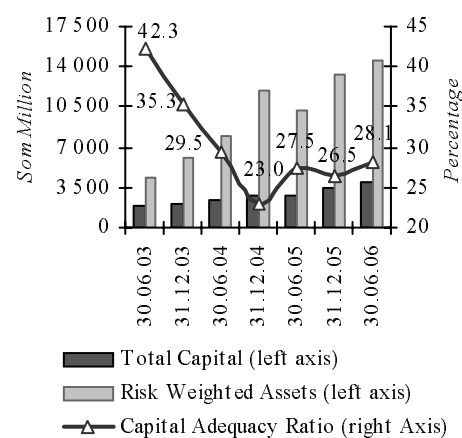
In analyzing the financial standing of the bank the conformity of the size of its capital to the scale and nature of operations to be performed (capital adequacy ratio) is the main feature of its soundness. Adequate capital forms the peculiar 'cushion' that permits the bank to remain solvent and maintain public confidence. In light of this, the bank's policy in the capitalization area shall be aimed at maintaining such level of capital that will be sufficient to cover losses caused by emergence of those or other banking risks.

In establishing the minimum value of the capital adequacy ratio at 12.0 per cent, on the average for the banking system this indicator remained sufficiently high and was 28.1 per cent according to data of June 30, 2005 (see chart 2.3.1). As it is seen from the given chart, the increase in the capital of commercial banks became the main factor for increase of the capital adequacy indicator in the reporting period. The review of the movement for the past three years showed the increase of risk weighted assets that in its part, was caused by the increase in volumes of lending to economy.

At the same time the actual capital adequacy level (28.1 per cent) permits to additionally increase the volume of risky and income-earning assets by more than two times without exceeding the allowable risk level in the overall operation of the banking system.

Aforesaid shows the stability of the banking system against negative shocks at present time. Moreover, there is potential for expanding financial intermediation level and improving efficiency in the future.

Chart 2.3.1. Change in Capital Adequacy Indicators of Banking System



2.4. Financial Results

Table 2.4.1. Main Profitability Indicators of the Banking System (percentage)

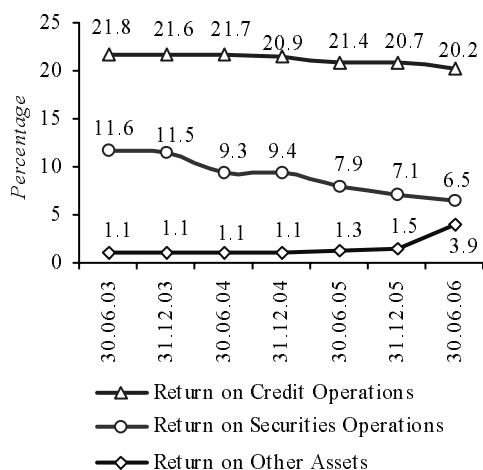
	31.12.2003	31.12.2004	31.12.2005	30.06.2006
Income and Expense Items as % of Average Assets				
Interest Income	9,0	10,2	10,4	11,1
- including interest income on loans	7,1	8,8	9,1	9,5
Interest Expenses	2,3	2,6	2,6	2,8
- including interest expenses on deposits	1,8	1,7	1,6	1,6
Net Interest Income	6,7	7,6	7,7	8,2
Allocations to ALL on Loans	1,2	0,8	1,1	1,7
Net Interest Income after Allocations to ALL	5,5	6,8	6,7	6,6
Non-interest Income	9,8	8,0	6,7	8,8
Non-interest Expenses	0,6	0,5	0,6	3,0
Operating Expenses	11,3	9,9	8,6	8,4
- including personnel expenses	4,9	4,6	4,3	4,2
Net Income (Loss) before Tax	3,4	4,3	4,1	3,7
Allocations to ALL on Non-credit Operations	0,5	0,1	0,0	0,2
Profit Tax	0,6	0,8	0,8	0,3
Net Profit (Loss)	2,4	3,5	3,3	3,5
Interest Expenses as % of Average Liabilities	3,2	3,3	3,2	3,6
SPREAD of Interest Income and Expenses	5,8	6,9	7,2	7,5

Return on assets defined as the ratio of profit received to average assets is the main profitability indicator of the banking activity. Following the results of the first half of 2006 the annualized return on assets was 2.9 per cent in the banking system of the Kyrgyz Republic (2.6 per cent following the results of last year).

However, due to low profitability indicators of one bank and considerable effect of this fact on distortion of aggregate indicators, further profitability analysis is given on the basis of the banking system data without including into the total aggregate of this bank (table 2.4.1).

In this case as it is seen from table 2.4.1 the annualized average return on assets of the banking system was 3.5 per cent having increased in comparison with the results of 2005.

Chart 2.4.2. Return by Certain Types of Operations



The reason for the increase in the final profitability indicator is the increase in the spread of interest income and expenses, and non-interest income of commercial banks, and also the decrease in profit tax deductions (in connection with amendments and additions to the Tax Code of the Kyrgyz Republic).

Moreover, it is necessary to take into account the growth of the credit portfolio share in the structure of banks' assets. At the same time, the indicator of the return on credit portfolio defined as the ratio of interest income on loans to average balances of principal receivable (annualized) has not practically changed. This indicator was 20.2 per cent following the results of the first half of 2006 having decreased by 0.5 percentage points in comparison with 2005. (chart 2.4.2).

The level of interest expenses increased in comparison with last year due to the increase of time deposits both in absolute terms and in their shares.

The increase of non-interest income had been noted in the first half of 2006 the ratio of which to average annualized assets was 8.8 per cent. The increase of this ratio by 2.1 percentage points was one of the reasons of improvement in the overall return on assets and was the result of increase in the share of

banks' income from rendering services and operations in foreign currency.

Considerable increase of non-interest expenses of banks was noted in the first half of 2006 that increased by 2.4 percentage points and was 3.0 per cent in comparison with the beginning of the year. This increase resulted from losses incurred by commercial banks from foreign exchange operations.

In connection with the increase of non-interest income to average assets of banks, their level exceeded operating costs by 0.4 percentage points that affected the increase of the resulting return on assets.

Expenses for ALL to annualized average assets increased from 1.1 per cent for 2005 to 1.7 per cent following the results of the first half of 2006 that was connected with the increase of lending on the part of commercial banks and was the main factor affecting the reduction of earnings from lending activity.

It is also necessary to note that, on the other hand, introduction of amendments and addenda to the Tax Code of the Kyrgyz Republic according to which the rate of profit tax had been reduced from 20 to 10 per cent starting January 1, 2006, affected the increase of earnings in commercial banks.

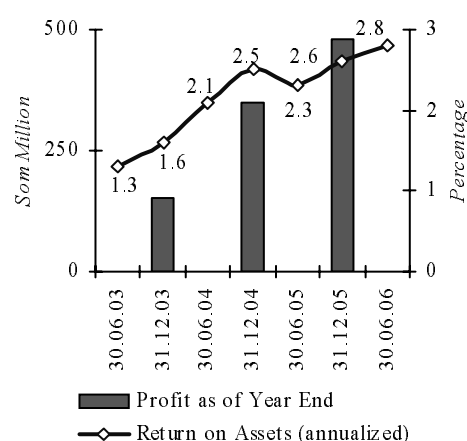
We may consider the *spread of interest income and expenses*¹³ (chart 2.4.3.) as the feature of improving efficiency in performing functions of the financial agent by the banking system between investors and the real sector. Thus, the increase in lending volumes and in income on them in 2006 resulted in the increase of this indicator in the reporting period.

In absolute terms the net profit of the banking system was Som 0.31 billion for the first half of 2006, and Som 0.20 billion for similar period of 2005 i.e. the increase was 55 per cent.

Total assets to the number of employees reduced from Som 4.9 million to Som 4.4 million per employee. This decrease is connected with lossmaking activities of two banks from the beginning of 2006 and this indicator will increase in accordance with their active operations in the future.

Thus, profitability indicators of the banking activity show, in general, the positive movement and improvement in attractiveness of the banking system in terms of

Chart 2.4.3. Change in Return on Assets



¹³ *Spread of interest income and expenses* refers to the difference between interest income to the value of average assets, and interest expenses to average liabilities.

additional investments. At the same time high average capital adequacy ratio suggests that there is possibility for additional expansion of active operations of banks. On the other hand, the efficiency in the use of assets may be considerably improved with reduction of the share of low income-earning assets.

2.5. Financial Intermediation Indicators

The role of the banking sector as a financial agent accumulating financial resources for their further allocation among sectors of economy directly depends on the level of development and efficiency of its operation.

Following the results of the first half of 2006 the volume of deposits¹⁴ to GDP¹⁵ was 13.6 per cent (13.0 per cent as of beginning of 2006, chart 2.5.1.). The increase in this indicator was conditioned by higher growth rates of deposits in comparison with GDP growth in the reporting period. Thus, under the overall increase of nominal GDP by 4.4 per cent in the first half of 2006, the increase in deposits was 9.3 per cent.

There was decrease in the volume of deposits placed with commercial banks to money outside banks (M0) that also reflected the level of public confidence in the banking system. As of reporting date, this indicator was 105.0 per cent (as of beginning of the year – 117.0 per cent).

The credit portfolio growth has continued in the reporting period. In this case the growth rates of loans (21.3 per cent) outgo the growth rates of deposits (17.4 per cent). The increase in loans occurs, to a certain extent, due to flow of banks' funds from liquid assets into loans.

According to data of June 30, 2006 the share of total disbursed loans to clients to GDP was 8.9 per cent, having increased by 1.2 percentage points in comparison with the beginning of the year (chart 2.5.2.).

For the reporting period the volume of disbursed loans was Som 7.2 billion that was 80 per cent more than the volume of loans extended in similar period of 2005.

In the structure of loans the highest increase in lending is noted in trade (54.5 per cent or for Som 1.5 billion), mortgage lending (by 1.4 times or for Som 0.5 billion) in comparison with similar period of 2005. There is also marked increase in lending for construction (by 45.3 per cent or for Som 0.2 billion).

Loan portfolio to deposits was 65.4 per cent against 59.1 per cent as of beginning of the period that was connected with the increase in the share of loans (chart 2.5.3).

The dynamics of decrease in average weighted interest rates on newly issued loans in national currency

Chart 2.5.1. Movement in Deposits and Deposits to GDP

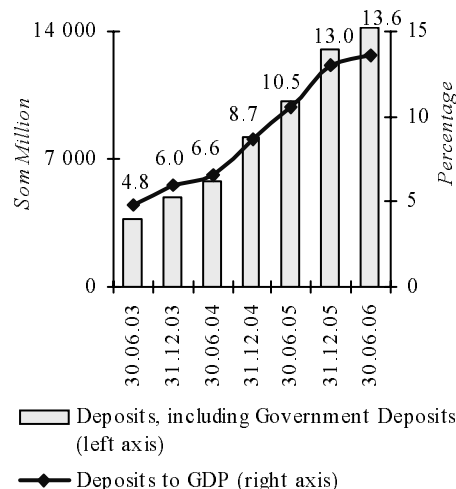


Chart 2.5.2. Movement in Loans and Loans to GDP

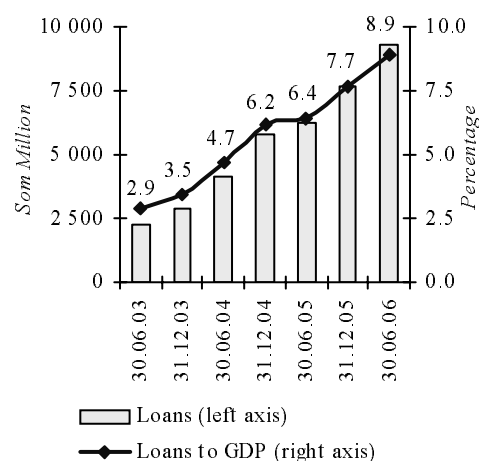
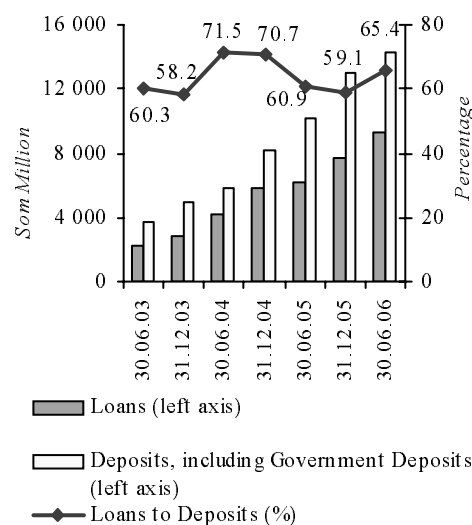


Chart 2.5.3. Movement in Loans to Deposits



¹⁴ In this section, deposits mean deposits of the population, enterprises, and also of the Government and other public authorities of the Kyrgyz Republic.

¹⁵ Actual GDP data for the past 12 months is taken into account.

has been observed during the first half of 2006. As a result, for the reporting period interest rates in national currency reduced by 1.3 percentage points and were 25.7 per cent in June 2006. Interest rates on newly disbursed loans in foreign currency increased by 1.2 percentage points and were 16.8 per cent in June 2006.

Considering financial results of commercial banks' activities, it shall be noted that the "net" interest income to average monthly assets of banks on which interests are paid, overall for the banking system¹⁶ (annualized) was 7.9 per cent according to data of June 30, 2006 (following the results of 2005 this indicator was 6.0 per cent) that also shows the increase in return on credit activity in the Kyrgyz Republic.

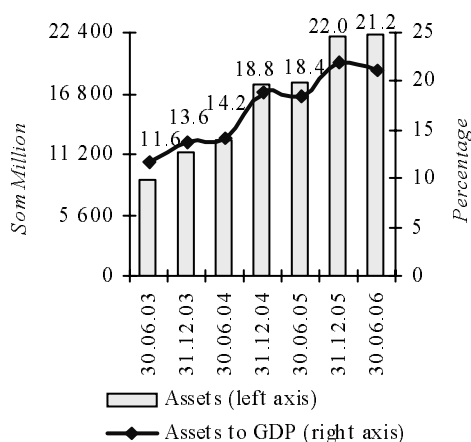
The increase in "net" interest income to average assets in commercial banks is caused by the increase during the past years of principal receivable and interest income, correspondingly. However, on the other hand, this hinders the development of economy, as despite the increase of income in lending, banks do not actively reduce interest rates. Such state of affairs may both point to inadequate supply of credits at the market and to the high level of demand for new loans, or implies insufficient competition at the credit services market, and in the first place is also the result of low level of transparency in activities of business entities.

The dynamics of aforesaid indicators suggests the increase in profitability of the banking system and also relative protectability of the system against the interest rate risk.

In terms of financial intermediation level, it is necessary to note some decrease in total assets to GDP (chart 2.5.4.). Thus, following the results of the first half of 2006 this ratio was 21.2 per cent and 22.0 percent at the beginning of the year. However, this decrease occurred only due to the excess of GDP growth rates (4.4 per cent) over asset growth for the first half of 2006 (0.8 per cent).

Considering that fact that despite the sustainable growth for the past two or three years, some financial intermediation indicators have a relatively low value and there is still potential for further development, and improvement of efficiency in operation of the banking system. This is confirmed by a relatively high capital adequacy indicator of the banking system that was 28.1 per cent at the end of the first half of 2006.

Chart 2.5.4. Movement in Assets and Assets to GDP



¹⁶ Calculations have been made by taking into account data on average performing assets and liabilities of commercial banks.

Evaluation of banking risks showed that no considerable change of situation is anticipated in the banking system in the short run. According to available dynamics of development for the past years and also in compliance with plans of commercial banks, it is expected to further improve the effect of the banking system on the country's economy.

III. NON-BANK FINANCE AND CREDIT INSTITUTIONS

3.1. Status of the System of Non-Bank Finance and Credit Institutions

Table 3.1.1. Movements in the number of non-bank finance credit institutions

Name	2002	2003	2004	2005	01.07.06
KAFC	1	1	1	1	1
FCSDCU	1	1	1	1	1
Microfinance organizations	0	72	104	136	149
Credit unions	349	303	305	320	315
Lombards	85	108	116	140	149
Total	436	485	527	598	615

Chart 3.1.1. Movement in Aggregate Assets of NBFIs

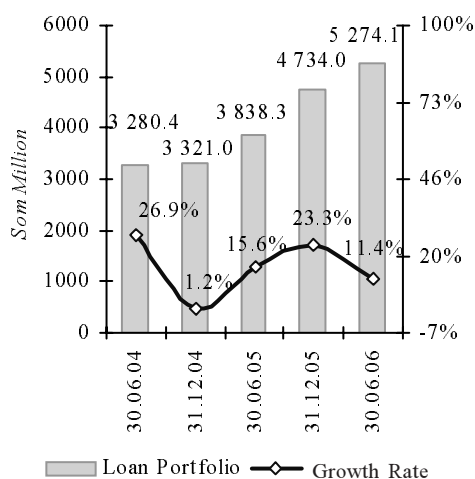
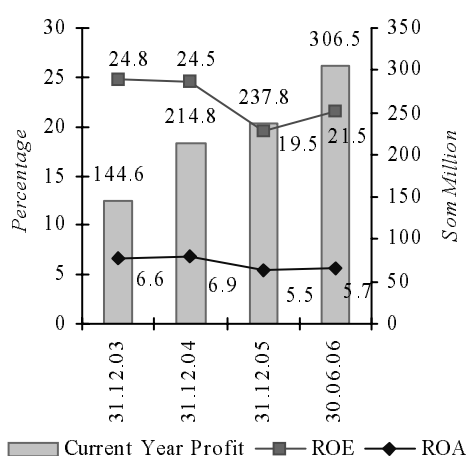


Chart 3.1.2. Movement in ROA and ROE of NBFIs



The system of non-bank finance and credit institutions (NBFIs) includes the following institutions that are subject to regulation and supervision by the NBKR:

- Specialized finance and credit institutions: Kyrgyz Agricultural Finance Corporation (KAFC); Financial Company for Support and Development of Credit Unions (FCSDCU);
- Credit unions (CUs);
- Microfinance organizations (MFOs), including microcredit companies (MCCs), microcredit agencies (MCAs) and microfinance companies (MFCs);
- Lombards;
- Exchange offices.

The increase in the number of non-bank finance and credit institutions is observed on an annual basis (table 3.1.1.).

The increase in the number of NBFIs demonstrates the demand for their services and indicates the eligibility of regulatory frameworks proposed by the state.

According to the presented regulatory reporting the aggregate assets of NBFIs (chart 3.1.1) increased by 11.4 per cent in the first half of 2006 and were Som 5 274.1 million¹⁷ as of June 30, 2006. In this case the growth rates of own capital of NBFIs were 5.2 per cent and aggregate liabilities of NBFIs increased by 4.1 per cent.

In the first half of 2006 the rate of increase in profit as compared against the first half of 2005 increased by 61.2 per cent (or by 28.9 per cent¹⁸ on an annualized basis) in the system of NBFIs. This was connected with the increase in the share and volume of the loan portfolio that is the main income-earning asset of NBFIs.

As a result of aforesaid there is some increase noted in return on assets (ROA) and return on capital (ROE) (chart 3.1.2.).

¹⁷ Hereinafter assets and loan portfolio of NBFIs are shown without assets of FCSDCU that is related to the fact that the loan portfolio of FCSDCU is already included in assets of CUs.

¹⁸ Due to the seasonal nature of activities of NBFIs, autumn and winter periods account for a considerable volume of income.

3.2. Structure and Development of Loan Portfolio

Lending is the main direction in activities of non-bank finance and credit institutions.

In the reporting period the loan portfolio portion in aggregate assets of NBFIs increased from 82.9 per cent of December 31, 2005 to 83.3 per cent of June 30, 2006.

For the first half of 2006 the aggregate loan portfolio of NBFIs increased by Som 445.7 million or by 11.4 per cent and was Som 4 367.9 million.

The increase in volumes of the loan portfolio of NBFIs had been characterized by increase in the number of borrowers, where their number increased by 10.5 thousand or by 9.1 per cent, and had been 126.5 thousand as of reporting date.

It shall be noted that the loan portfolio portion in assets of NBFIs for the past three years, as a rule, increased during the first six months and reduced by the end of the second half year. Such cyclical movement arises from the seasonal nature of the borrowers' business in most NBFIs.

On the whole, the loan portfolio of NBFIs has a sustainable growth trend over a period of several years (chart 3.2.1.).

In the structure of the aggregate loan portfolio of non-bank finance and credit institutions (chart 3.2.2.) KAFC loans account for 45.7 per cent, 39.3 per cent is loans of microfinance organizations, 14.6 per cent is loans of credit unions and loans of lombards account for 0.4 per cent, where loans received by CUs in FCSDCU constitute 50.1 per cent of their total loan portfolio.

In comparison with similar period of last year the loan portfolio structure of NBFIs by sectors and regions has not practically changed. Thus, by oblasts (chart 3.2.3) the main portion of the loan portfolio is concentrated in Osh, Jalalabad and Chui Oblasts. On the whole, the regional activity is the highest in the south of the country and in the capital in view of higher population density and its economic activity in agriculture and trade sectors.

In the first half of 2006 the highest volume of loans of NBFIS was aimed at agriculture that was 54.5 per cent and 28.2 per cent for trade (chart 3.2.4). Such distribution of credit resources is conditioned by the specific nature of activities of the KAFC and microfinance organizations: KAFC by having the largest share in the aggregate loan portfolio of NBFIs aims 81.7 per cent of its loans at agriculture and MFOs have targeted 52.3 per cent of loans to the trade area.

Chart 3.2.1. Movement in Loan Portfolio of NBFIs

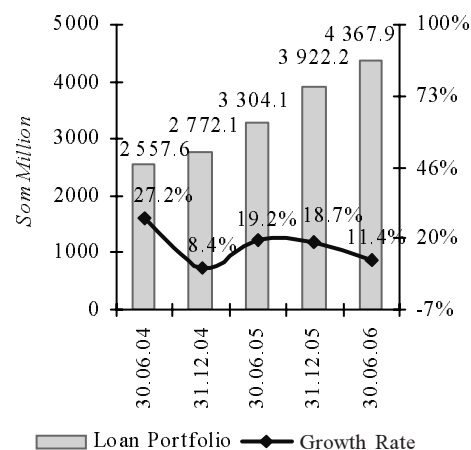


Chart 3.2.2. Aggregate Loan Portfolio by Types of NBFIs (Som Million)

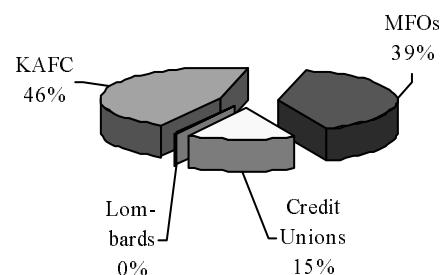


Chart 3.2.3 Aggregate Loan Portfolio of NBFIs by Oblasts (som million)

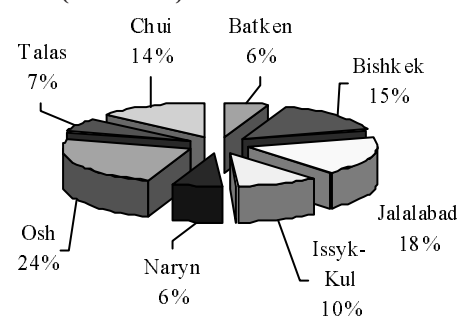
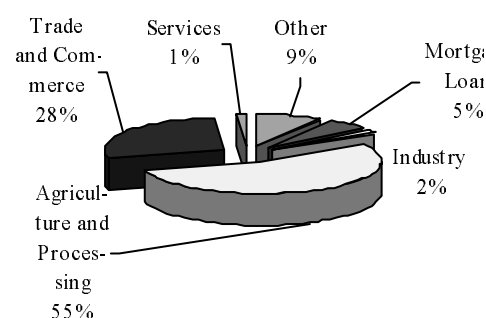


Chart 3.2.4. Aggregate Loan Portfolio of NBFIs by Sectors of Economy (som million)



3.3. Primary risks

Activities of NBFIs are characterized by high concentration of loans in sectors of economy and by types of institutions.

In the first half of 2006 KAFC had the main portion of the loan portfolio of NBFIs as in previous periods.

By sectors of economy the loan portfolio of NBFIs is primarily concentrated in agriculture and related business that is located in rural area. Lending to this area is connected with high risks due to dependence on weather and climatic conditions, and relatively small income of rural population.

At the same time in the reporting period there was the trend of decrease in concentration of loans by types of institutions in the system of NBFIs. Thus, the reduction in the KAFC share has been observed: if the KAFC share was 46.9 per cent as of December 31, 2005 then as of June 30, 2006 it was 45.7 per cent. There was seasonal increase in the share of loans to agriculture by sectors of economy. The share of agriculture increased from 53.4 per cent to 54.5 per cent.

Interest rates of loans issued by NBFIs are still at sufficiently high level that is explained by the pursuit of NBFIs to cover their existing high risks and continued high demand for these types of loans from the population. The average interest rate on loans of NBFIs for the reporting period was the following: 30.9 per cent in MFOs i.e. decreased by 2.6 percentage points (33.5 per cent in the second half of 2005); 25.6 per cent in CUs (against 26.8 per cent in the second half of 2005), 14.3 per cent in KAFC (15.8 per cent in the second half of 2005) and 144.9 per cent in lombards (against 153.6 per cent in the second half of 2005).

IV. PAYMENT SYSTEM

4.1. Banking Products, Tariffs and Services

Commercial banks of the Kyrgyz Republic render a wide range of banking services to the population and organizations.

At the market of banking services, the tariffs for rendered services are set in accordance with the internal bank strategy.

Banks apply different approach to collecting a fee for the same services:

- fixed tariffs for conducting one transaction;
- tariffs depending on the amount of the transaction or balances on the account;
- the payment for the period irrespective of conducted operations;
- Individually, according to the agreement.

On the whole, in spite of the fact that the range of prices is different for certain types of services in commercial banks, the tariffs for package services rendered by banks are approximately similar.

As of today commercial banks render such services as:

- Cash and settlement services;
- Documentary operations;
- Securities operations;
- Loan disbursement operations;
- Payment card servicing (by types);
- Servicing under 'e-Client' system and so forth.

When rendering cash and settlement services to clients for a fee, commercial banks of the KR often offer an operation on opening an account on a gratuitous basis. Thus, for the reporting period there were ten commercial banks that offer the service on opening a settlement account for legal and natural persons in national and foreign currencies on a gratuitous basis at the market that was higher by 4 banks in comparison with similar period of the previous year. Remaining banks charge a fee within the range of Som 10 to \$US 70.

Today it is impossible to imagine the financial credit system without letters of credit that act as a lending mechanism and a means of payment. In the course of settlements under the letter of credit, the payer gives an order to the bank (issuer) either to open a letter of credit or make payments to the receiver, or transfer these

Table 1. List of Banks Servicing Money Transfer Systems

Money Transfer System	Commercial Bank Name
Western Union	1. OJSC 'Bakai Bank'; 2. OJSC IB 'Issyk-Kul'; 3. CJSC 'INEXIMBANK'; 4. JSCB 'Kyrgyzcredit'; 5. OJSC 'Kyrgyzpromstroybank'; 6. JSCB 'Kyrgyzstan'; 7. CJCB 'Tolubay'; 8. OJSC 'Ecobank'; 9. OJSC 'Energobank'
Money Gram	1. OJSC RK 'Amanbank'; 2. CJSC 'KICB'; 3. OJSC 'Kazkommertsbank'
Contact	1. OJSC RK 'Amanbank'; 2. CJSC 'Bank Asia'; 3. OJSC IB 'Issyk-Kul'; 4. OJSC 'Halvk Bank Kyrgyzstan'; 5. JSCB 'Kyrgyzstan'; 6. OJSC 'Energobank'; 7. OJSC 'FinancCreditBank KAB'
Anelik	1. OJSC 'AsiaUniversalBank'; 2. OJSC RK 'Amanbank'; 3. OJSC IB 'Issyk-Kul'; 4. CJSC 'INEXIMBANK'; 5. JSCB 'Kyrgyzcredit'; 6. JSCB 'Kyrgyzstan'; 7. OJSC 'Ecobank'; 8. OJSC 'FinancCreditBank KAB'
VIP Money Transfer	1. OJSC 'AsiaUniversalBank'; 2. OJSC RK 'Amanbank'; 3. OJSC IB 'Issyk-Kul'; 4. JSCB 'Kyrgyzcredit';
Migom	1. OJSC RK 'Amanbank'; 2. CJSC 'Bank Asia'; 3. OJSC IB 'Issyk-Kul'; 7. OJSC 'Ecobank';
Strana Express	1. OJSC 'SSC'
Bystraya Pochta	1. JSCB 'Kyrgyzcredit'; 2. OJSC 'SSC'
UNIstream	1. OJSC 'AsiaUniversalBank'; 2. OJSC RK 'Amanbank'; 3. CJSC 'Bank Asia'; 4. OJSC IB 'Issyk-Kul'; 5. OJSC 'Halyk Bank Kyrgyzstan'; 6. JSCB 'Kyrgyzcredit'; 7. JSCB 'Kyrgyzstan'; 8. CJCB 'Tolubay'; 9. OJSC 'Ecobank'; 10. OJSC 'Energobank'; 11. OJSC 'FinancCreditBank KAB'
Xpress	1. OJSC RK 'Amanbank';
InterExpress	1. JSCB 'Kyrgyzstan';
STB-express	1. OJSC 'Ecobank';
Travelex	1. OJSC 'Ecobank';

authorities to another bank (designated bank). For the reporting period, the cost of the service for issuing (opening) a letter of credit was 0.2 up to 1 per cent of the amount of the letter of credit.

For the reporting period the highest commission fees for issuing a bank guarantee were 5-8 per cent. The cost of this service depends on the guarantee's security. For example, for issuing a guarantee secured by a cash deposit or by liquid securities 0.3 per cent of the guarantee amount is charged for each period up to 6 months (inclusive), the minimal amount is Som 2500. In case if the guarantee is secured by another type of collateral then up to 8 per cent of the amount, the minimal amount is \$US100 (excluding a commission fee of the confirming bank).

It is also necessary to note that at present, the service of 'money transfer without opening a bank account' is in great demand among population. Currently, 13 international money transfer systems operate on the territory of the Kyrgyz Republic such as «Western Union», «Money Gram», «Contact», «Anelik», «VIP Money transfer», «Xpress Money», «Migom», «UNIstream», «Strana Express», «Bystraya pochta», «InterExpress», «STB-express» and «Travelex» (Table 1). Prompt and safe remittances without opening an account virtually to any country of the world are the main advantage of money transfer systems.

Lately, Internet-Banking, being one of the most common types of electronic commerce becomes increasingly popular at the banking services market. Internet-Banking permits to make payments with current and future value dates, receive information about movements on accounts, receive bank statements, monitor account balances, purchase, sell and remit currency from any place with an Internet access. Such system permits to keep an archive of transferred payment documents and prepare an account forecast. Connection to the Internet-Banking System ranges between \$US 40 to Som 4200.

At the banking services market the following types of services are also in great demand that are as follows:

- Servicing of exchange offices;
- Safe deposit services in the bank;
- Provision of the NBKR discount rates;
- Internships;
- and others

the cost of which is set by each bank individually on the basis of expenses.

4.2. Cash and Non-cash Turnovers

For the first half of 2006 the total amount of *cash in circulation* was Som 14 971.0 million. The increase of money in circulation in the first half of 2006 was Som 1557.2 million as compared with the second half of 2005, and the growth was 11.6 percent.

In cash offices of commercial banks there were Som 423.6 million or 2.9 percent out of the total amount of money in circulation.

The movement of money in circulation is presented in chart 4.2.1.

The increase of money in circulation is connected with the increase of state payments on the social package, the growth of demand for them on the part of developing small and medium size businesses, low occurrence of non-cash resources and means of payment.

The return of cash to cash offices of commercial banks is the main indicator describing the level of cash turnover development. For the first half of 2006, *the return of cash to cash offices of commercial banks* was 97.2 percent that is higher by 3.1 percentage points than in the second half of 2005. The movement in cash return rate is reflected in chart 4.2.2.

In the first half of 2006 the highest rate of cash return had been for the city of Osh, it was 119.8 percent and the lowest rate of cash return of 38.2 percent had been for Batken Oblast (see chart 4.2.3.). The return of cash for city of Bishkek remained at the same level and was 106.4 percent, and 101.4 percent for Chui Oblast. The highest percent of cash return for city of Osh, city of Bishkek and for Chui Oblast was connected with their more saturated consumer market (although, it should be noted that the percent of cash return was low overall for Osh Oblast) and with concentration of banking and finance institutions, trading and industrial enterprises in the capital of the republic and in Chui Oblast. Overall for the republic the cash return has insignificantly increased by oblasts.

In the first half of 2006, Som 44 969.6 million has been issued from *cash offices of commercial banks* that is higher by Som 5 003.4 million or by 12.5 percent than in the second half of 2005. The issue of cash increased on the following expense items:

- Purchase of foreign currency by Som 986.9 million or by 27.8 percent, and up to Som 4 532.1 million;

Chart 4.2.1. Movement of Money in Circulation

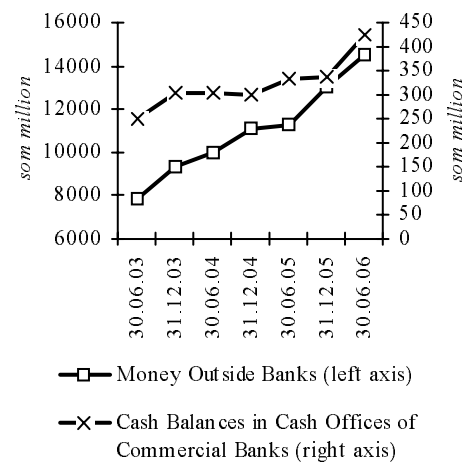


Chart 4.2.2. Movement in Cash Return Indicator

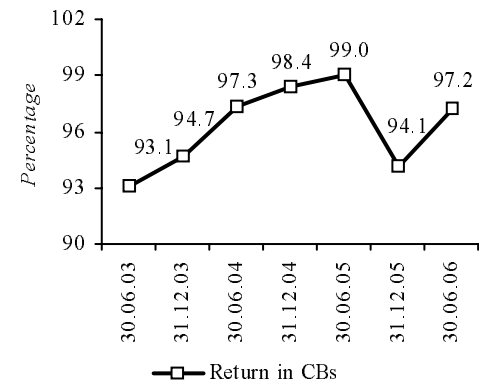


Chart 4.2.3. Rate of Cash Return to Cash Offices of Commercial Banks

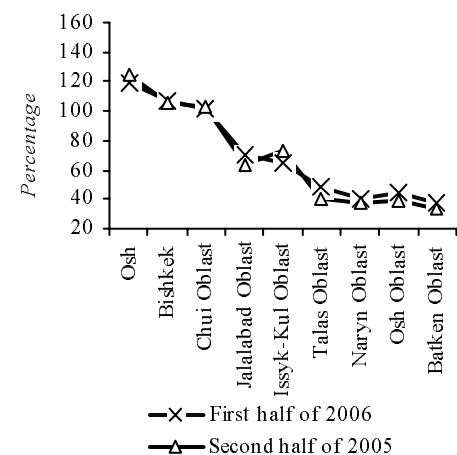
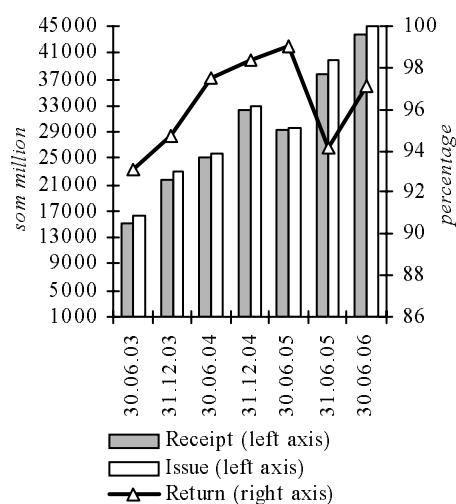


Chart 4.2.4. Receipt, Issue of Cash and Its Return to Cash Offices of Commercial Banks



- Other expenses by Som 4 443.2 million or by 15.3 percent, and up to Som 33 410.8 million.

Payments on 'Pensions and Benefits' item reduced by Som 136.9 million or by 4.8 percent and was Som 2 865.3 million.

For paying out salaries to state-financed organizations Som 4 161.5 million were targeted that was lower by Som 289.7 million or by 7.0 per cent in comparison with the second half of 2005.

In the first half of 2006, Som 43 693.4 million have been received into *cash offices of commercial banks* that is greater by Som 6 074.7 million or by 16.1 percent than in the second half of 2005. Cash receipts increased on all receipt items:

- Taxes, duties by Som 90.7 million or by 2.4 percent, up to Som 3847.9 million;
- Sale of foreign currency by Som 1063.8 million or by 36.5 percent, up to Som 3 974.9 million;
- Other receipts by Som 4920.2 million or by 15.9 percent, up to Som 35870.6 million.

Change in indicators of receipts, issues of cash and their return to cash offices of commercial banks is presented in chart 4.2.4.

Thus, the increase of cash in circulation is conditioned by real needs of the economy in cash and reflects the increase of demand for it.

Non-cash turnovers

In the first half of 2006, 914.3 thousand payments totaling to Som 77451.6 million have been made through interbank payment systems of the Kyrgyz Republic. As compared with indicators for similar period of 2005, the volume of payments increased by 17.1 percent, the number of payments increased by 78.9 per cent as a result of the increase in the number of clearing transactions.

The flows of interbank payments are distributed by payment systems of the Kyrgyz Republic as follows:

- Interbank system of gross settlements, designed for conducting large and due payments, ensuring prompt and final settlements on transactions at interbank financial markets, further integration into international payment systems.
- Interbank system of clearing payments, designed for performing retail and regular payments of banks and their clients on which immediate final settlement is not required;
- Payment systems with the use of bank payment

cards, designed for timely and safe conduct of retail, regular payments with the use of cards on the territory of the Kyrgyz Republic.

System of large payments

In the first half of 2006 26 881 payments for the amount of Som 53 173.03 million have been conducted through the gross settlement system. The volume of payments increased by 18.6 per cent (chart 4.2.5) in comparison with similar period of last year.

In spite of the overall increase in the volume of payments in the gross system, the reduction in the volume on credit operations (-74.3 per cent) has been noted during the reporting period.

In the structure of the number of incoming and outgoing gross payments the payments of the National Bank (26.9 per cent and 26.1 per cent, accordingly) account for the largest share.

System of retail and regular payments

The volume of payments made through the clearing system of payments increased by 13.8 per cent and was Som 24 278.66 million in comparison with similar period of 2005. Total number of payments increased by 80.8 per cent or by 396.8 thousand payments (chart 4.2.6) that is conditioned by the increase in the number of payments on income operations.

Following the results of the first half of 2006 Chui Oblast and city of Bishkek are leaders in the regional structure on the number and volume of clearing payments. Their share accounts for 81.2 per cent of the volume and 52.9 per cent of the number of clearing payments (chart 4.2.8). The situation remained almost unalterable as compared with similar period of 2005.

Settlement systems with bank payment cards

The National Bank of the Kyrgyz Republic pays considerable attention to the development of such progressive payment instrument as bank plastic cards in the payment turnover.

Following the results of the first half of 2006, 15 (out of 20) finance and credit institutions, 9 of which are issuers and issue cards of international (7 banks) and local systems (4 banks) provide acquiring, cash and settlement services to clients with the use of bank cards.

CJSC 'Demir Kyrgyz International Bank' is the leader in the number of performed operations, where

Chart 4.2.5. Volumes and Number of Payments Through Gross System

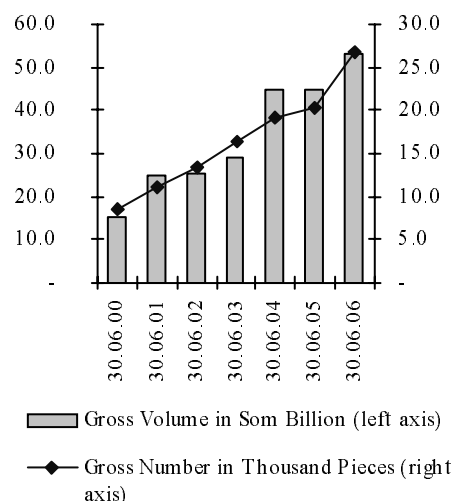


Chart 4.2.6. Movement in Volumes and Number of Payments Through Clearing System

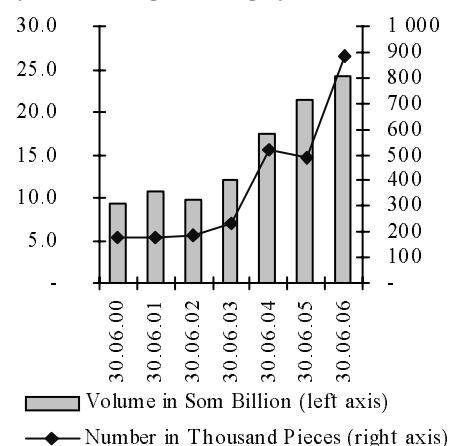


Chart 4.2.7. Movement in Number of Issued Cards

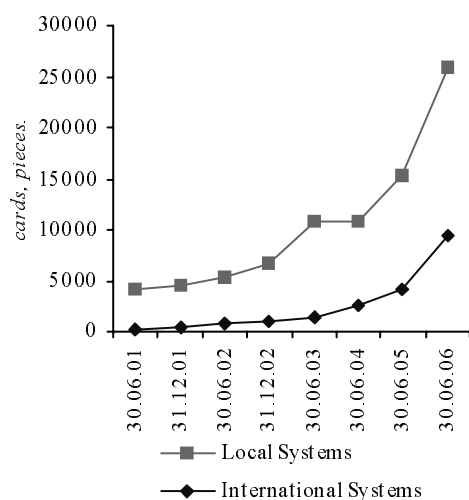
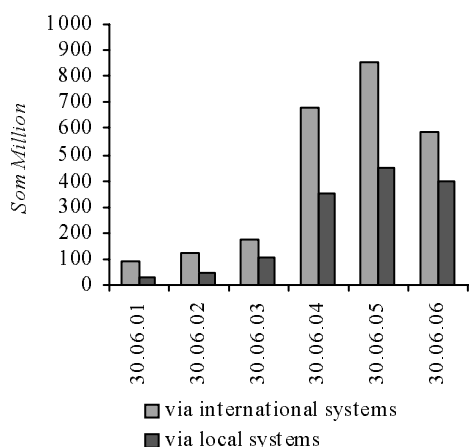


Chart 4.2.8. Movement in Transactions with Use of Plastic Cards



the total number of its operations is 124.1 thousand operations (that is 38.6 per cent of the total number of operations).

OJSC 'Kazkommertsbank Kyrgyzstan' holds a leading position in the volume of performed operations that is Som 394.8 million (that is 71.4 per cent of total transactions and 67.1 per cent of transactions through international systems).

During the reporting period there is greater activity noted in the market of payment cards that points to the increase in the number of issued cards and transactions with their use. Thus, the total number of issued cards for the first half of 2006 reached 25.8 thousand items that is greater by 59.2 per cent (chart 4.2.7.) in comparison with similar period of 2005.

The total number and volume of performed operations on cards in relation to similar period of 2005 reduced by 31.5 per cent and 11.9 per cent, correspondingly (chart 4.2.8.).

Cash withdrawal operations traditionally accounted for the main volume of performed operations that was Som 910.4 million; the turnover in the trade and service network was Som 77.3 million. Thus, the ratio of cash withdrawal operations to non-cash payments in trade outlets were 92.8 per cent and 7.8 per cent, correspondingly. This fact points out that majority of issued cards are 'salary' cards and the infrastructure of their servicing is not sufficiently developed.

Implementation of 'salary' projects on the basis of international and local system cards is one of priority directions in the development strategy of banks that are leading at the market of payment cards of Kyrgyzstan. Namely due to these projects banks achieve notable increase in the issue of cards and operations that permits to make a significant step forward in the direction of strengthening banks' positions at the market of banking cards. Currently four commercial banks carry out activities on implementation and expansion of 'salary' projects on the basis of international and local system cards that are as follows: OJSC Settlement and Savings Company, CJSC 'Demir Kyrgyz International Bank', OJSC 'Kazkommertsbank Kyrgyzstan' and OJSC 'Ecobank'. On the whole, within the framework of 134 projects banks sold 16.2 thousand cards that accounted for 62.7 per cent of the total number of issued cards.

Commercial banks continue implementing activities on developing the infrastructure on receipt and servicing

of cards. The total number of operating terminals as of June 30, 2006 was as follows:

- Alai Card system - 79 terminals and 5 automated teller machines;
- Demir 24 system - 58 terminals and 17 automated teller machines;
- Union card system - 2 imprinters;
- International systems– 221 terminals, 15 imprinters and 15 automated teller machines.

Transborder payments, including remittances

Presently, 20 commercial banks are SWIFT members in the Kyrgyz Republic that is greater by 4 banks than in the first half of 2005. 5 banks out of them independently operate with SWIFT interface and 16 banks (including NBKR) operate through general interface of SN of SWIFT NBKR¹⁹.

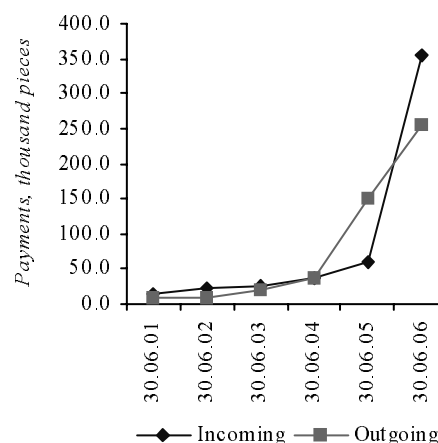
The analysis of payments through SWIFT network demonstrates an active increase of indicators both on the number of payments and on volumes of remittances. Thus, the number of outgoing payments was 254.9 thousand pieces for the first half of 2006 that was greater by 1.7 times than in the first half of 2005. The number of incoming payments was 355 thousand pieces that was greater by 6 times than in the first half of 2005 (chart 4.2.9).

The sustainable increase in the number of payments is conditioned by the increase in the number of banks that are directly connected or through SN of SWIFT NBKR to the SWIFT system, and, correspondingly by the increase in transactions of banks' clients that often perform international payments.

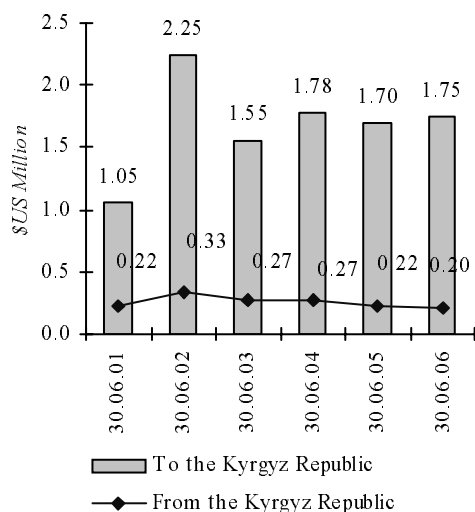
A range of commercial banks actively conduct operations with checks (9), such as 'American Express', 'MasterCard', 'Visa' and personal checks of non-resident banking institutions of the Kyrgyz Republic. 'American Express' checks are the most popular among them. In the first half of 2006, 1 438 operations have been conducted for the amount of Som 43.8 million that was 95.3 per cent and 90.6 per cent of the total number and volume of performed operations with checks, correspondingly.

The number of operations with the use of traveler's checks was 1 508 operations with the total volume of Som 48.3 million in the first half of 2006. As compared

Chart 4.2.9. Movement in Transactions through SWIFT Network



¹⁹ Shared Unit of SWIFT NBKR.

Chart 4.2.10. Movement in Postal and Money Transfers

with the first half of 2005 the number of operations increased by 32.5 per cent and the volumes of operations decreased by 51.9 per cent.

It is essential to note that the traveler's check is still not in demand by the population of the Kyrgyz Republic due to its specific nature.

In addition to banking institutions of the Kyrgyz Republic, a state-owned enterprise 'Kyrgyz Pochtasy' renders remittance services, where all of its branches receive and pay postal and telegraphic transfers.

The total volume of postal money transfers to the Kyrgyz Republic for the first half of 2006 was US\$1.751 million, including from CIS countries and foreign countries in the amount of US\$1.7455 million and US\$5500, correspondingly. At the same time the transfers from the Kyrgyz Republic were only US\$203.8 thousand. Moreover, transfers were made only to CIS countries. The positive difference between postal transfers to and from the Kyrgyz Republic was US\$1.3 million for the reporting period (chart 4.2.10).

The comparative analysis of postal transfer indicators from foreign countries and CIS to the Kyrgyz Republic in the reporting period with the data for similar period of 2005 shows the increase in cash flows by 1.8 per cent.

V. STATUS OF THE REAL SECTOR

5.1. Households

In the first half of 2006 the increase in real income of the population exceeded the increase in the cost of basic consumer goods which were supported by low inflation rates in the first place.

In January-June 2006 the nominal average monthly salary was Som 2788.3 and increased by 17.9 per cent in nominal terms and by 11.2 per cent in real terms as compared with similar period of 2005. In its turn, the average monthly minimal consumer budget was Som 1971.0 in January-June 2006 and increased by 6.1 per cent in comparison with similar period of 2005.

5.1.1. Liabilities to Finance and Credit Institutions

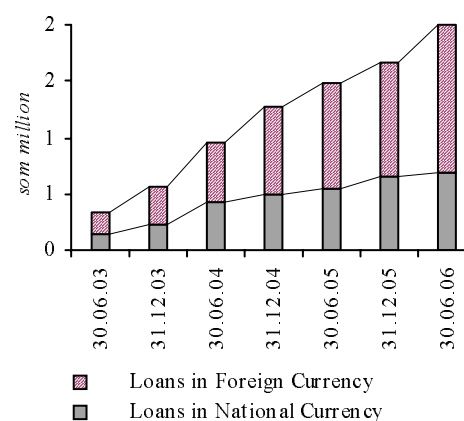
As of June 30, 2006, the liabilities of the household sector to the banking system were about Som 2.0 billion and increased by 19.8 per cent from the beginning of the year. In the structure of liabilities, the growth tendency of loans in foreign currency is observed as before (see chart 5.1.1.1).

Liabilities in foreign currency increased by 28.7 per cent and as of June 30, 2006 they were Som 1.3 billion, they increased by 5.7 per cent in national currency and were Som 0.7 billion. From the beginning of the year in the structure of loans the following changes are observed: the share of loans in national currency decreased from 38.8 per cent to 34.2 per cent, and the share of loans in foreign currency increased from 61.2 per cent to 65.8 per cent.

In the first half of 2006 as compared with the first half of 2005 the total volume of newly disbursed loans increased by 78.9 per cent. They include loans for procurement and processing that considerably increased by 4.4 times and also loans disbursed for agriculture that increased by 3.3 times, mortgage loans by 2.8 times and construction loans increased by 2.7 times. Trading still remains the main area of lending and takes up 45.6 per cent of total disbursed loans. Altogether in the first half of 2006 the volume of loans issued for trade increased by 83.3 per cent as compared with the first half of 2005.

The share of loans issued for construction increased and was 11.5 per cent as compared with 7.7 per cent in

Chart 5.1.1.1. Liabilities of Natural Persons to Banks



January-June 2005 that was explained in the first place by the growth in housing and participatory share construction. This had also been accompanied by the growth in mortgage loans and increase of their share in the structure of disbursed loans from 4.0 per cent in January-June 2005 to 6.2 per cent in January-June 2006. The share of loans extended for agriculture was 2.9 per cent that was considerably higher than in previous years (1.6 per cent in January-June 2005).

In this context the share of lending to industry decreased and was 7.2 per cent of total volume of issued loans in the first half of 2006 as compared with 12.5 per cent in the first half of 2005.

In the first half of 2006 the average weighted rate on consumer loans disbursed in national currency was 25.8 per cent and on loans in foreign currency was 23.0 per cent. The volume of consumer lending increased in the first half of 2006 by 70 per cent as compared with similar period of 2005 that indicated the expansion in rendering such kind of banking services to the population.

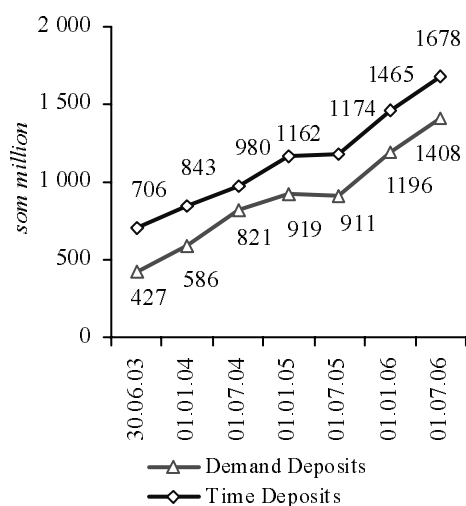
5.1.2. Public Savings

In the first half of 2006 there was continued growth trend of deposits of natural persons in active commercial banks (see chart 5.1.2.1). As of June 30, 2006 their volume was Som 3.1 billion and increased by 48.0 per cent per year. Further strengthening of the banking system resulted in the increase of savings of natural persons placed on deposits of the banking system.

In the structure of deposits of the population as before the deposits in foreign currency that were 64.6 per cent accounted for the largest share. However, from the beginning of the year 2006, the deposits in national currency increased at more rapid rates (the increase was 22.4 per cent) than in foreign currency (the increase was 12.6 per cent). Such movement is the result of strengthening of the exchange rate for Som and indicates the improvement of public confidence in national currency.

The share of time deposits that was 65.4 per cent prevailed in the structure of deposits of the population in national currency. At the same time the demand deposits slightly exceeded time deposits in the structure of deposits of the population in foreign currency.

Chart 5.1.2.1. Deposits of Natural Persons



5.2. Corporate Sector

5.2.1. Liabilities to Finance and Credit Institutions

As of June 30, 2006 the number of officially registered business entities was 332.8 thousand entities and increased by 7.2 per cent as compared with 2005. A significant portion of business entities was registered in agriculture that was 42.6 per cent, 29.7 per cent in trade, repair of vehicles and household goods and 6.4 per cent registered in transportation and communication. The prevailing part that was 86.2 per cent of all legal entities was in private ownership. The number of active business entities was 67.2 per cent of the total number.

The share of individual entrepreneurs in the total number of active business entities, excluding farm enterprises, was 73.1 per cent, of 'small'²⁰ enterprises was 17.6 per cent, of 'medium' enterprises was 3.6 per cent and the share of 'large' enterprises was 1.8 per cent as of June 30, 2006.

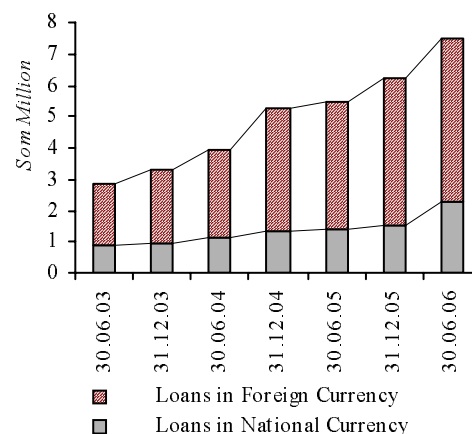
The aggregate debt of enterprises and organizations to active commercial banks has had an upward trend. As of June 30, 2006 it was Som 7.5 billion having increased by 20.2 per cent as compared with the beginning of the year (see chart 5.2.1.1.). In this case the loans in national currency increased by 49.5 per cent and their share increased from 24.3 per cent to 30.2 per cent of total loans of real sector enterprises.

The decrease in average weighted interest rates on loans in national currency had been noted in all categories, other than industry, that was 24.6 per cent (23.8 per cent in the first half of 2005), 28.7 per cent (24.5 per cent) in agriculture, and 29.1 per cent (25.8 per cent) in procurement and processing.

On June 30, 2006 the average weighted interest rates on loans issued in national currency were 21.5 per cent for transportation and communication, 27.0 per cent for trade and 20.5 per cent for construction in the first half of 2006.

The average weighted interest rates on disbursed loans in foreign currency in the first half of 2006 reduced as compared with similar period of 2005 on all types of loans and as of June 30, 2006 they were 13.6 per cent for industry, 20.9 per cent for agriculture, 20.1 per cent for

Chart 5.2.1.1. Movement in Corporate Sector Debt to Commercial Banks



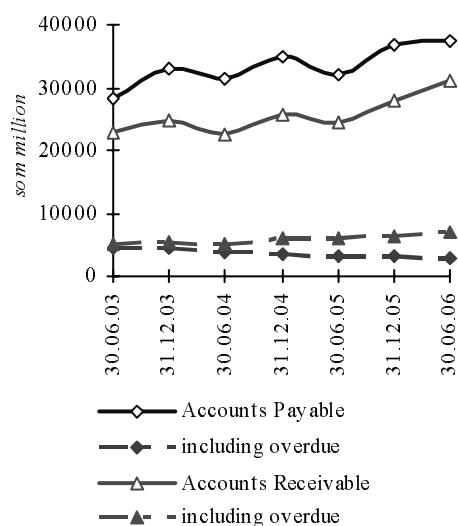
²⁰ In the classification of the NSCKR 'small' enterprises refer to enterprises with up to 50 employed people, 'medium' enterprises refer to 51-200 people and 'large' enterprises refer to the number above 201 people.

transportation and communication and 19.5 per cent for trade.

In the course of past years, there is continued reduction of interest rates on newly disbursed loans that is conditioned by the strengthening of the financial sector in recent years that is argued by that fact that the share of long term loans increased from 14.1 per cent in the first half of 2003 to 37.1 per cent for similar period of 2006. In addition, the strengthening of the non-bank sector caused the improvement of competition at the lending market with banking institutions that also has positive impact on reduction of rates on loans.

5.2.2. Status of Accounts Receivable and Accounts Payable

Chart 5.2.2.1 Movement in Accounts Receivable and Accounts Payable of Corporate Sector



In the course of past years insignificant increase in amounts of both accounts payable and accounts receivable is observed in enterprises (see chart 5.2.2.1).

As of June 30, 2006 the accounts receivable²¹ of enterprises and organizations was Som 31142.4 million in absolute terms and increased by 11.0 per cent in comparison with the beginning of the year. The share of accounts receivable formed with business entities of the republic was 77.9 per cent.

In the total volume of accounts receivable the industry enterprises accounted for the largest share of 60.2 per cent, including 41.5 per cent for power generation and distribution enterprises, 16.7 per cent for transportation and communication and 13.4 per cent for organization of trade, repair of vehicles, household and personal goods.

Past due accounts receivable increased by 13.5 per cent in comparison with the beginning of 2006 and was Som 7.1 billion or 22.7 per cent to total accounts receivable as of June 30, 2006. Enterprises on generation and distribution of power, gas, steam and water accounted for the largest share of past due accounts receivable (75.9 per cent) and processing industry accounted for 12.7 per cent.

Accounts payable had an upward trend and as of June 30, 2006 they were Som 37.6 billion, where the share of domestic accounts payable was 77.9 per cent.

Overall for the corporate sector the ratio of overdue accounts payable to total accounts payable had the

²¹ According to preliminary data of NSC KR.

downward trend and was 7.3 per cent as of June 30, 2006 (8.9 per cent as of December 31, 2005).

The indicator describing the excess of accounts payable over accounts receivable had rapidly reduced from 31.5 per cent at the beginning of the year to 20.8 per cent of June 30, 2006.

5.2.3. Financial Results

The operating profit of real sector enterprises was Som 2.3 billion in the first half of 2006 that was lower by 39.8 per cent than in the corresponding period of 2005. The balance sheet profit reduced by 25.3 per cent and was Som 1.9 billion.

The number of enterprises that made profit in the first half of 2006 was 34.7 per cent as compared with 32 per cent in the first half of 2005.

The volume of proceeds received by enterprises in January-June 2006 increased by 14.0 per cent and was Som 54.8 billion.

Industry enterprises received the main share (47.3 per cent) of all proceeds of real sector enterprises. This was lower for similar indicator of the first half of 2005 when this share was 52.6 per cent. This occurred in the context of active growth in trade and decline in industry.

The main volume of the balance sheet profit in the first half of 2006 was noted in communication enterprises where it was Som 1.0 billion, Som 815 million in metallurgy industry and Som 487 million in wholesale trade organizations and agent trading. Enterprises on production of foodstuffs incurred considerable balance sheet losses for the period under review of 2006 in the amount of Som 1 billion and enterprises on production and distribution of electricity, gas and water incurred losses in the amount of Som 345.6 million.

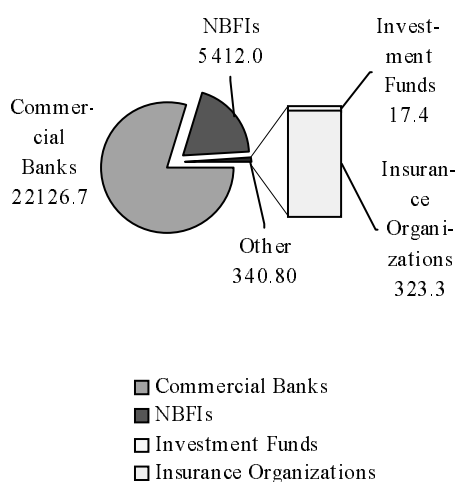
Whereas, the real sector enterprises altogether somewhat impaired their financial results in the first half of 2006, the share of unprofitable enterprises reduced by 3 percentage points for the period under review as compared with similar period of 2005 and was 40.0 per cent of the total number of reported enterprises.

VI. FINANCIAL SYSTEM DEVELOPMENT TRENDS

Some peculiarities and main trends in the development of the financial system of the Kyrgyz Republic and also its impact on the overall economy of the country are considered in this section.

In the first place it shall be noted that the financial system represents the complex of and interaction of all financial institutions. The financial sector of the Kyrgyz Republic is represented by such financial institutions as banks, non-bank finance and credit institutions (credit unions and microfinance organizations), lombards, insurance companies, pension and investment funds, stock exchange and others.

Chart 6.1. Financial System Assets (som million)



Banking sector is one of the largest segments of the financial market of Kyrgyzstan (see chart 6.1). Banking services are one of effective mechanisms of operation of the market economy, instruments for mobilization of financial resources of enterprises and savings of the population, for optimal reallocation of funds in the economy, improvement in investment activity of entrepreneurs and population. The development level of this sector is one of objective indicators that describe the availability of financial and credit resources to entities of the economy.

In spite of observed positive trends in the development of commercial banks, the overall role of the banking sector is still insignificant in the economy of the republic. The banking industry is still in the process of its development. However, it may be objectively noted that the role of the banking system is improving in the development of the economy of the Kyrgyz Republic and the volume of intermediary services is increasing at the financial market.

The market of banking services of the Kyrgyz Republic increasingly attracts foreign banks from year to year and is the most attractive sector of economy for foreign investors. Constant inflow of new foreign investments into the banking system is observed that beneficently influences its development, stabilizes commercial banks, and expands their capabilities on lending not only to small size businesses but also to medium size and large businesses. At present, 20 banks operate in Kyrgyzstan, the share of foreign participation in which is 62.3 per cent in the aggregate volume of the authorized capital of the banking sector.

The increase of banking resources in the first half of 2006 as compared with similar period of 2005 has resulted in the increase of lending to the economy of the country. On the whole, the volume of newly disbursed loans increased by 70.4 per cent as compared with the first half of 2005 and was 6.5 per cent to GDP. The share of loans extended for developing the entrepreneurial sector was 3.8 per cent to GDP.

Trade with 45.3 per cent and construction with 11.9 per cent account for the largest share in total loan portfolio of banks. Mortgage and industry account for 9.5 per cent and 7.6 per cent, correspondingly. Transportation and communication, agriculture, provision and processing altogether account for 4.6 per cent. Other finance and credit institutions (credit unions and microfinance organizations) actively lend to these sectors.

Extension of loan terms, as a rule, indicates positive expectations of banks with respect to further development of economy and stability of the banking system. If we consider the structure of loans of commercial banks by their terms, the volume of long term loans represents the greater share of total loans and is 37 per cent. It shall be noted that the share of long term loans that are disbursed lately has a stable growth trend in the total volume of issued loans.

With the increase in the amount of banks' capital and volume of deposits there is increase in resources that need to be placed, require more effective use of assets available with banks that involves the growth of the republic's economy in those sectors in which funds are invested in the form of credits.

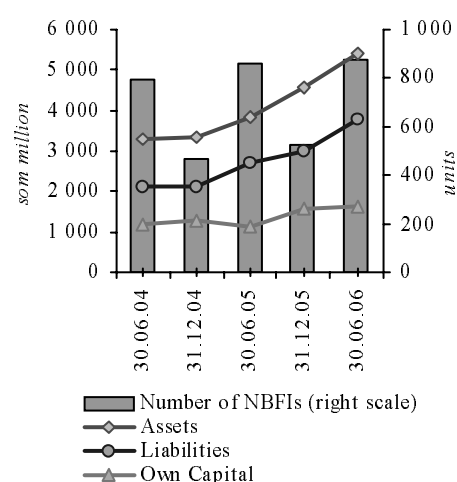
Non-Bank Finance and Credit Institutions

The demand of the real sector in credit resources is sufficiently high. Sources of its coverage other than banks are the following: mutual lending of enterprises within the real sector and resources of the non-bank financial sector, in particular of microcredit organizations.

As of end of the first half of 2006 the assets of non-bank finance and credit institutions (NBFIs) were Som 5412 million or 5.2 per cent to GDP, and increased by 18.3 per cent in comparison with similar period of 2005. Own capital increased by 2.6 per cent. As of June 30, 2006 the liabilities of NBFIs were Som 3 809.1 million and increased by 26.5 per cent (chart 6.2).

The credit structure by sectors has not practically

Chart 6.2. Movement in Assets, Liabilities and Own Capital of Non-Bank Finance and Credit Institutions



changed as 54.5 per cent of loans disbursed by NBFIs is used in agriculture and 28.2 per cent in trade.

Capital of NBFIs maintains the growth trend that will be further maintained and supported by implementation of activities envisaged by the Medium Term Microfinance Development Strategy oriented at expanding access to financial services for the population.

Securities market (stock market) is another important segment of the financial sector. Assessment of the development in this segment of the financial market is ambiguous. In the development context of the government securities market, inadequate development of the corporate securities market is particularly notable. Nevertheless, there are certain changes noted in this segment of the financial market.

Kyrgyz Stock Exchange is the main trading platform of the republic, the trading volume on which amounted to Som 1.34 billion as of June 30, 2006 that was 78 per cent of total securities trading in the republic²², and increased by 35.3 per cent as compared with the previous period (the trading volume for the first half of 2005 was Som 254.1 million) (chart 6.3).

Performance indicators of **investments funds**, as before, point to their insignificant impact on the economy of the republic. As of June 30, 2006 assets and investments to GDP were 0.02 and 0.01 per cent, correspondingly. Revenues of investment funds, that were extremely low earlier, reduced by another 15.4 per cent and were 0.00063 per cent to GDP (table 6.1.).

Chart 6.3. Movement in Trade Volume at Kyrgyz Stock Exchange

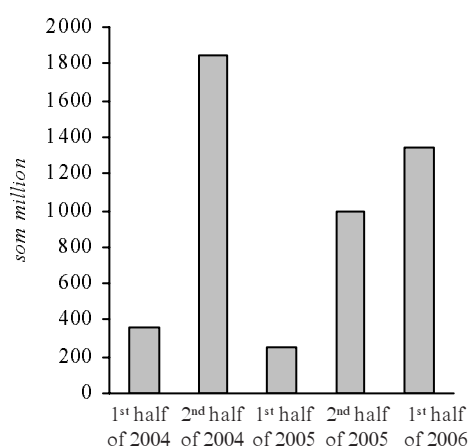


Table 6.1. Ratio of Performance Indicators of Investments Funds to Macroeconomic Indicators
(som million)

	1 st half of 2004	2 nd half of 2004	1 st half of 2005	2 nd half of 2005	1 st half of 2006
Assets	16.1	14.7	15.9	17.2	17.4
Assets as % to GDP	0.02	0.03	0.02	0.03	0.02
Income of Investment Funds	0.6	1.5	0.8	0.6	0.7
Income of Investments Funds as % to GDP	0.00063	0.00258	0.00081	0.00103	0.00063
Investments of Investment Funds	11.8	12	12.3	14.3	14.7
Investments of Investment Funds as % to GDP	0.01	0.02	0.01	0.02	0.01
Investments of Investment Funds per Capita, Som	2.0	2.3	2.4	2.8	2.8

²² Two (2) licensed trade organizers that are Stock Trading System and Central Asian Stock Exchange operate at the stock market in addition to KSE.

The non-bank financial sector provides important financial services to the economy of the Kyrgyz Republic, in particular, **insurance**. Insurance companies carry out insurance and investment activities, and perform financial transfers. These services are instrumental in strengthening the capital market and attracting financial resources for corporate investments into the economy. A steady operating insurance market is an essential element of any developing market as it accumulates small savings and transforms them into productive investments. Successful investments facilitate the increase in GDP. Successfully developed insurance schemes provide protection to various sectors of economy, natural and legal entities from potential losses caused by natural phenomena and also influence the poverty reduction level.

However, in spite of progressive increase in overall indicators in the second half of 2005, the performance of insurance organizations in the first half of 2006 was considerably lower than indicators of previous periods.

Thus, from the beginning of the year 2006 the assets of insurance companies and also insurance premiums to GDP were 0.3 and 0.04 per cent, correspondingly. Receipt of premiums into insurance organizations increased by 18.4 per cent in comparison with similar period of 2005 (table 6.2).

Table 6.2. Ratio of Performance Indicators of Insurance Organizations to Macroeconomic Indicators
(som million)

	1 st half of 2004	2 nd half of 2004	1 st half of 2005	2 nd half of 2005	1 st half of 2006
Assets	371.2	335.4	402.4	291.6	323.4
Assets as % to GDP	0.4	0.6	0.4	0.5	0.3
Receipt of Insurance Premiums	48.3	122.8	37.1	68.1	43.9
Receipt of Insurance Premiums as % to GDP	0.1	0.2	0.0	0.1	0.0
Receipt of Insurance Premiums per Capita, Som	62.7	64.4	78.2	56.4	62.3

VII. SPECIAL ISSUES

Initiative for Heavily Indebted Poor Countries – HIPC

The HIPC Initiative (Initiative for Heavily Indebted Poor Countries) was proposed by the World Bank (WB) and International Monetary Fund (IMF) in 1996. The objective of this initiative is steady implementation of integrated poverty reduction programs and acceleration of economic reforms.

In the process of development of the Initiative, international organizations, bilateral creditors, governments of HIPC participating countries and civil society from the outset engaged in an intensive dialogue on the program's strengths and weaknesses that resulted in significant changes of initial conditions and emergence of the enhanced HIPC Initiative that became available in 1999.

The HIPC Initiative, being the first comprehensive approach to debt burden relief of the poorest countries that have the largest debt is an important step to consider the issue of debt relief within the framework of the overall poverty reduction program and to achieve Millenium Development Goals²³ (MDG), formulated by UN. According to MDG, countries with low level of income shall overcome poverty by 2015.

Reduction of the country's debt relief within the framework of the HIPC Initiative implies the passage of two important points.

The first point is to analyze the debt sustainability in order to determine the country's demand for its relief. If the ratio of the country's external debt after applying traditional relief mechanisms (the restructuring within the framework of the Paris Club of Creditors) is still higher than the gross debt amount to export (or in special cases, of income of the state) then the country meets the requirements for obtaining assistance within the framework of the HIPC Initiative. In this case the government of the country on a voluntary basis addresses IMF and WB on the intention to join the HIPC Initiative. After receiving a written application the Breton wood institutions consider this appeal together with the government of the country and discuss conditions of possible joining the Initiative. On the one hand, the government of the country assumes obligation to perform certain reforms, and on the other hand, international donors assume obligations to provide relief in servicing external debt upon completion of successful implementation of specified reforms. In the event of achieving mutual consent on conditions of the country's entrance to the HIPC Initiative, the Executive Boards of IMF and WB assign the HIPC status and international community is committed to reduce the country's debt to the sustainable level. This process is called the **decision point**.

When the country reaches the decision point, it may immediately start receiving intermediate relief in servicing its external debt. However, in order to continue receiving full relief under the HIPC Initiative, the country shall show positive results in implementation programs during the **decision point** and **completion point**. Duration of the second period that is the **completion point** depends on the following:

- 1) satisfactory execution of key reforms agreed upon at the decision point;
- 2) support the macroeconomic stability;
- 3) Adoption and execution, at least, within one year of the *Poverty Reduction Strategy paper* that is the strategy aimed at poverty reduction. If the country already meets these criteria

²³ Development Goals (Millenium Development Goals) formulated in the Millenium Declaration were developed on the basis of agreements and resolutions of international conferences organized by UN. These goals are called to help the world community to achieve material, measurable successes in the process of improving lives of people. They set criteria for assessing results not only for developing countries but also for rich countries that help to finance development programs, and for international organizations that render assistance to countries in implementing these programs. These goals are complementary and called to reduce the scales of the poverty problem in all of its manifestations.

then it may achieve the completion point under which it is expected that creditors will provide the debt reduction as they committed themselves during the decision point.

In order for the country to use the debt relief within the framework of the HIPC Initiative, it shall meet certain criteria.

Eligibility criteria:

- The poorest countries that are entitled to receive loans on concessionary terms from International Development Association²⁴, and also within the framework of PRGF program²⁵ of IMF within the period from October 1, 1996 through December 31, 2006 qualify for the HIPC Initiative;
- the country is in the state of unstable debt even after applying traditional debt reduction mechanisms (Naples terms of debt restructuring by Paris Club involving up to 67 per cent of debt write off in net present value²⁶ (NPV)
- Country's debt indicators as of end of 2004 shall be at higher thresholds than are established within the framework of the HIPC Initiative: thresholds are 150 per cent for NPV indicators to export of goods and services, and 250 per cent for NPV indicator to income of the republican budget. If the country meets only the last criteria then the ratio of export to GDP shall be, at least, equal to 30 per cent, and the minimal threshold of public income shall be no less than 15 per cent of GDP.

Below is the list of countries involved in the HIPC Initiative:

- 1) *countries that passed 'completion point' (20)*: Benin, Bolivia, Burkina Faso, Cameroon, *Ethiopia, Ghana*, Guyana, Honduras, Madagascar, Mali, Malawi, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, Zambia;
- 2) *countries at the 'decision point'(9)*: Burundi, Chad, Democratic Republic Congo, Congo, Gambia, Guinea, Guinea-Bissau, San Tome e Principe, Sierra Leone;
- 3) *Countries that potentially have the right to join the Initiative (11)*: Central African Republic, Comoro Islands, Cote d'Ivoire, Eritrea, Haiti, Kyrgyz Republic, Liberia, Nepal, Somalia, Sudan, Togo.

²⁴ International Development Association is part of the World Bank group.

²⁵ IMF extends loans to assist the poorest country members in ensuring stable economic growth and improving living standards of the population through the concessionary mechanism that is the Poverty Reduction and Growth Facilitation Program (PRGF).

²⁶ Hereinafter refers to the write off, reduction, relief of debt in net present value (NPV). NPV is the amount of all future liabilities on servicing (principal amount and interests) existing debt discounted at the market rate of interest.