

National Bank of the Kyrgyz Republic

BANKING SYSTEM DEVELOPMENT TRENDS

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BISHKEK, 2005

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Banking System Development Trends

The goal of the publication "Banking System Development Trends" is to analyze and assess the development of the banking system of Kyrgyzstan as a financial agent, identify obstacles for achieving and maintaining stability, as well as to assess stability components of the banking system of Kyrgyzstan. It is published as of January 1 and as of July 1 in Kyrgyz, Russian, and English.

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Bulletin of the National Bank of the Kyrgyz Republic

The NBKR Bulletin contains macroeconomic indicators of the Kyrgyz Republic on the real, financial and external economic sectors, as well as 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, as well as information on international investment position of the Kyrgyz Republic. It is published on a quarterly basis in January, May, July and October.

Review of Inflation in the Kyrgyz Republic

The review contains the description of consumer price dynamics in the republic and in its regions, the analysis of major inflation factors, information on the 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.

Press Release of the National Bank of the Kyrgyz Republic

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

Statutory Acts of the Kyrgyz Republic

The statutory acts of the National Bank are officially published in this publication to provide the commercial banks and the public with normative documents that form the banking legislation of the Kyrgyz Republic. Tentative frequency of the Journal is to publish it 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

In the first half of 2005, the banking system of Kyrgyzstan has continued to increase lending to the real sector. At the same time, a considerable liquidity reserve and a high capital adequacy level of the banking system testifies about the available potential of commercial banks to further expand financial intermediation, increase profitability and effectiveness in the use of assets and capital of the banking system.

The growth in the volume of long-term loans, as well as active banks' operations in the area of housing lending are noted, that may be considered as a stabilization factor for the economy.

The reduction of concentration risk is observed. The reviewed features of the credit risk do not testify about its increase in the current period, although there are factors of its possible growth in the future.

The efficiency of the banking system from the standpoint of using assets and capital continues to improve, and there is observed increase in profitability of credit transactions and securities transactions.

The growth in the loan portfolio of non-bank finance and credit institutions (NFCIs) continues, and it is accompanied by the improvement of its quality. At the same time, there is observed reduction of efficiency in using assets and capital of NFCIs. Loans of NFCIs are primarily aimed at financing agricultural and trade projects, and concentration risks are associated with them.

The growth of the real cash income in the household sector is observed both in nominal and real terms that may testify about the available potential for the banking system at the resource market. At the same time, the reduction of the portion of households' deposits in the deposit structure of the banking system reflects the priority change in forming the sources of financial assets of the banking system.

The increase of money in circulation is stipulated by real needs of the economy in money, and reflects the increased demand for them.

On the whole, the strengthening of the capital of commercial banks takes place, the growth in the loan portfolio of the finance and credit system, expansion of the range and improvement in the quality of bank and payment services, as well as overall improvement of the banking business efficiency are those factors that contribute to the stabilization of the macroeconomic situation in the country.

* * * * *

Section "Special Issues" presents information on trends of improving banking legislation in the Kyrgyz Republic.

I. STATUS OF THE FINANCE AND CREDIT SYSTEM

As of July 1, 2005, the aggregate loan portfolio of the financial and credit system¹ constituted 10546.6 million soms, and its structure is presented in chart 1.1. The banking system continues to occupy a dominant position in the financial and credit system, although in the first half of 2005 its share reduced from 60.6 percent to 58.9 percent in the structure of the aggregate loan portfolio of the financial and credit system given a corresponding growth in the share of non-bank finance and credit institutions (NFCIs). The loan portfolio share of bankrupt banks continues to reduce.

In the first half of 2005, the financial intermediation indicator of the financial and credit system defined as the ratio of the aggregate loan portfolio to gross domestic product (GDP)² has continued to increase, and made up 10.9 percent (see chart 1.2). The noted growth of the financial intermediation level is mainly related to the growth in the loan portfolio of NFCIs. Thus, the growth rates of loan portfolios of the banking system and NFCIs constituted 3.2 and 17.2 percent, accordingly. At the same time, the growth rates of the financial intermediation level of the financial and credit system reduced from 31.9 percent in the second half of 2004 to 6.8 percent in the first half of 2005.

Based on the analysis of the dynamics in the ratio of allowances for loan losses (ALL) to loan portfolios of the banking system and NFCIs, some deterioration is noted in the quality of the loan portfolio of the financial and credit system (see chart 1.3). Thus, ALL of the system of commercial banks increased from 7.7 percent to 8.3 percent for the first half of 2005 given a practically invariable level of ALL in non-bank finance and credit institutions.

Chart 1.1. Structure of Aggregate Loan Portfolio (LP)

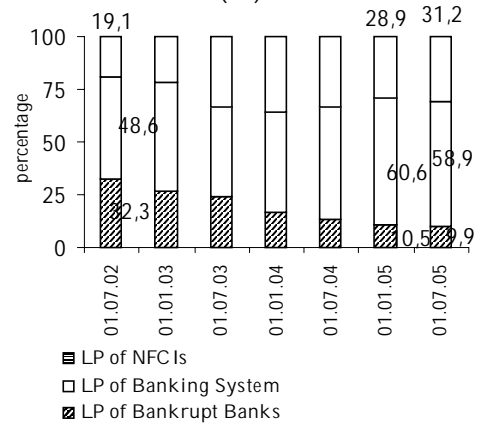
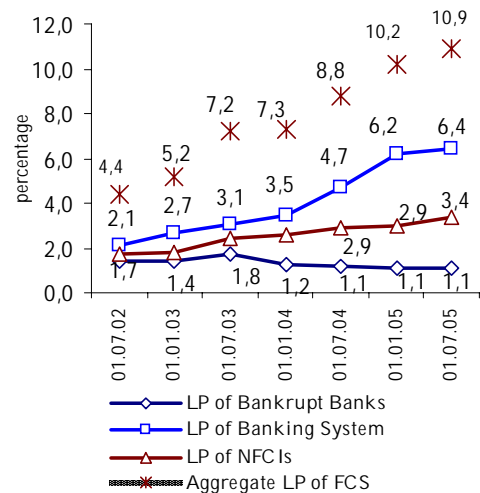


Chart 1.2. Developments in Loan Portfolio (LP) of Financial and Credit System (FCS) in Percentage to GDP



¹ Indicators of active commercial banks, commercial banks in bankruptcy process and non-bank finance and credit institutions licensed by the NBKR are considered here as review indicators of the financial and credit system. Subsequently, the objects of the analysis will expand upon receipt of data on other sectors of the financial and credit system.

² The value of GDP for the period from July 1 of the previous year till July 1 of the year under review is used in calculations.

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

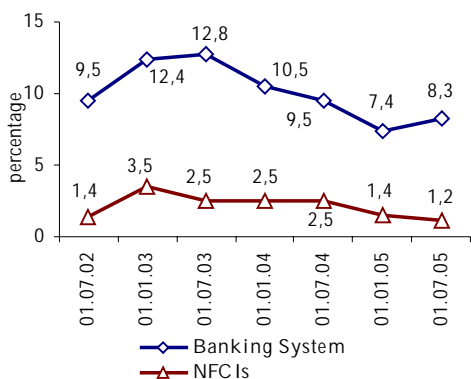


Chart 1.4. "Dispersion" of Average Weighted Interest Rates of Loans of Various FCIs percentages

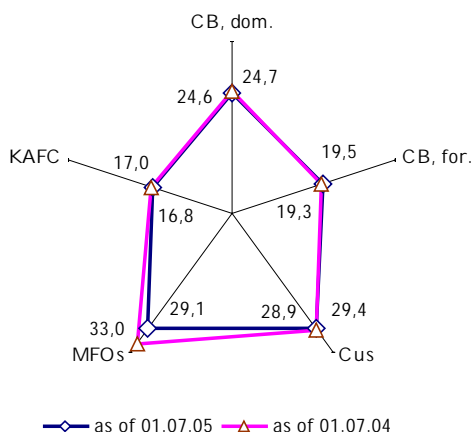


Chart 1.4³ presents the so-called "rose" of average weighted interest rates of loans issued by commercial banks (in domestic and foreign currencies) and non-bank finance and credit institutions⁴, that to a certain extent gives the possibility to assess the level and the direction of change in the cost of credit resources. A considerable reduction of average weighted interest rates is observed only on loans of microfinance organizations. It may be assumed that this arises from the strengthening of competition at the credit services market, where prices for loans of credit unions serve as a competitive price for loans of MFOs, based on similarity of rendered services and categories of borrowers.

The fact that also deserves attention is that the credit unions, being virtually "closed" institutions (when depositors of a credit union are also its borrowers, and in this connection, the prices of services may be set at a lower level), offer sufficiently high interest rates.

Thus, the status of the finance and credit system of Kyrgyzstan in the current period is characterized by:

- Continued growth dynamics of the financial intermediation indicator, where the growth of financial intermediation of NFCIs is characterized by higher rates than the system of commercial banks;
- Improvement of some qualitative features in the loan portfolio of NFCIs, and a more conservative evaluation of the loan portfolio quality in the system of commercial banks.

³ Abbreviations used in chart 1.4.: CB, dom. - commercial banks, domestic currency, CB, for. - commercial banks, foreign currency, CUs - credit unions, MFOs - microfinance organizations, KAFC- Kyrgyz Agricultural Finance Corporation.

⁴ Average weighted rates on lombard loans are not given in chart 1.4. As of July 1, 2004, lombard loans were extended at the average weighted rate of 155.2%, and as of July 1, 2005 - 180.0%.

II. STATUS OF THE BANKING SYSTEM

2.1. Banking System Structure

In the first half of 2005 the banking system of Kyrgyzstan was represented by 19 commercial banks (including, the Settlement and Savings Company and a branch of the National Bank of Pakistan), including 14 banks with foreign shareholdings, of which 9 banks - with more than 50 percent of foreign shareholdings.

In the first half of 2005 the financial intermediation function is characterized by different directions in the dynamics of its components (see chart 2.1.1.). Thus, the reduction of financial intermediation indicators is observed with regard to assets and a deposit base of the banking system. When it is considered that the anticipatory growth of assets and deposits as compared with the growth in the loan portfolio of the banking system, is mainly connected with the increase of quasi-active transactions (i.e. transactions on nostro account and corresponding deposits accounts) of one of banks, then the current reduction of assets that has occurred as a result of reduction in volumes of transactions on nostro accounts of one bank, shall not be considered as a deterioration of financial intermediation. Moreover, the growth of the portion of loans in GDP testifies that the banking system has continued to gradually increase its impact on the development of the country's real sector in the first half of 2005. This way, the value of financial intermediation with regard to loans made up 6.4 percent (6.2 percent as of beginning of the year) as of July 1, 2005. Thus, the expansion of lending in the banking system has served as a main growth factor of financial intermediation in the first half of 2005.

The analysis of the banking system structure (chart 2.1.2) in respect to the market segment occupied by groups of large, medium and small banks⁵, testifies about some reduction in the market share of large banks (from 73 to 69 percent) and medium

Chart 2.1.1. Developments in Assets, Loans and Deposits in Percentage to GDP

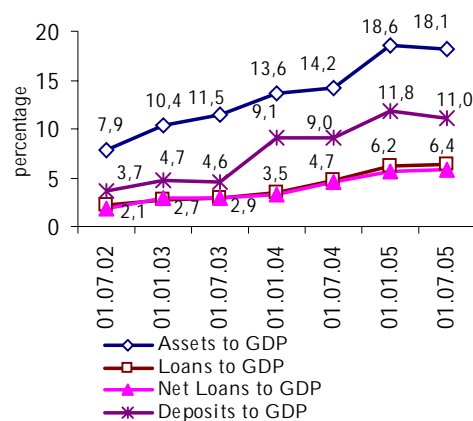
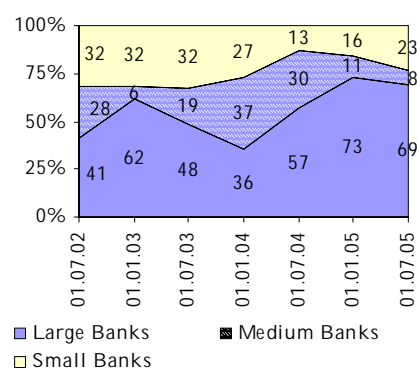


Chart 2.1.2. Change in Banking System Structure



⁵ For analysis purposes of this publication, large banks refer to banks, whose share in the banking market (the average 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.

Chart 2.1.3. Correlation of Market Share of Large Bank Group and Their Shares by Market Segments as of July 1, 2005

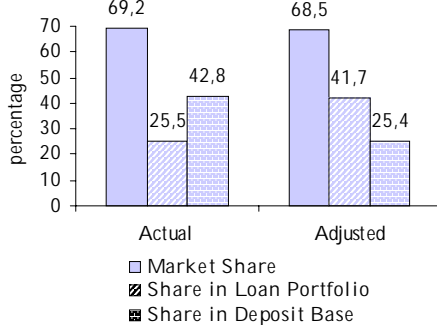


Chart 2.1.4. Change in Deposit Structure of Banking System by Currencies

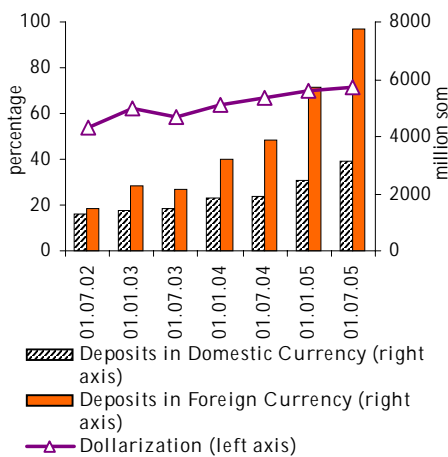
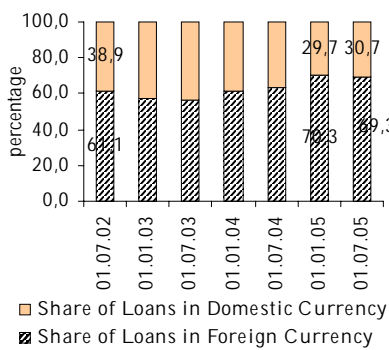


Chart 2.1.5. Change in Loan Portfolio Structure of Banking System by Currencies



banks (from 11 to 8 percent), and the growth in the market share of small banks (from 16 to 23 percent) in the first half of 2005. It shall be noted that the segment of large banks is represented by two banks, and 52.3 percent belongs to one bank based on the value of assets and deposits out of 69 percent of the market share of large bank group. The correlation of the market share of large bank group and their shares in the loan portfolio of the banking system with, and without taking into account the impact of the noted one bank (i.e. adjusted) is shown in chart 2.1.3.

In order to describe the financial intermediation of the banking system, the trends forming primary elements of financial intermediation - a deposit base and assets of the banking system have been considered.

In the first half of 2005, the growth in the deposit base of the banking system has continued, where its increase made up 32.1 percent, but the value of financial intermediation, from the standpoint of the deposit base reduced from 11.8 to 11.0 percent. The level of "dollarization" in the deposit base of the banking system has constituted 71.3 percent, and serves as the largest indicator for the period from July 1, 2002. At the same time, deposits of legal entities in foreign currency (58.9 percent) make up a significant portion. High "dollarization" level of deposits predetermines certain vulnerability of activities of commercial banks from the impact of external factors.

In the first half of 2005 the loan portfolio of the banking system increased by 10.1 percent. A significant share of deposits in foreign currency has determined the loan portfolio structure of the banking system, where loans in foreign currency (69.3 percent) constitute a considerable portion. At the same time, some reduction is noted in the "dollarization" level of the banking system loan portfolio from 70.3 to 69.3 percent (see chart 2.1.5).

The growth of long-term loans is noted: their portion increased from 27.5 up to 30.4 percent in the first half of 2005, and the increase made up 21.9 percent in absolute terms that can be considered as one of stabilization factors in the economy. Short-term loans (69.6 percent) still take up a substantial specific weight in view of some reduction in their portion (see chart 2.1.6).

⁵ For the analysis purposes in this edition, the banks, whose share in the banking market (the averaged share in total assets, liabilities, credits and deposits) is more than 10%, are considered to be large banks, those within the range of 5% to 10% - medium banks, and less than 5% - small banks.

⁶ The analysis is based on the data of operating banks.

Such features as the variation ratio in interest rates of loans, an average rate, and an average weighted rate of loans have been considered to assess the cost of intermediation.

Thus, the following positive factors are noted: (1) an average weighted rate of loans both in foreign and domestic currencies is still lower than an average rate that testifies about the excess of lending at lower than average rates over loans extended at higher rates; (2) the variation ratio on loans in domestic currency has increased (i.e. the increase in the dispersion of interest rates of certain loans relative to an average price on loans) that may testify about an inadequate competition (see charts 2.1.7, 2.1.8).

Thus, in implementing its intermediation function the banking system is characterized by the following trends:

- A high level of "dollarization" is maintained in the deposit base of the banking system;
- A financial intermediation indicator of the banking system has increased relative to loans;
- The growth of long-term loans continues.

Chart 2.1.6. Change in Loan Portfolio Structure of Banking System by Terms of Placement

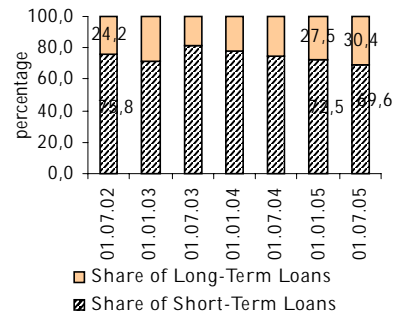


Chart 2.1.7. Change of Interest Rates Features on Loans in Domestic Currency (in percentages)

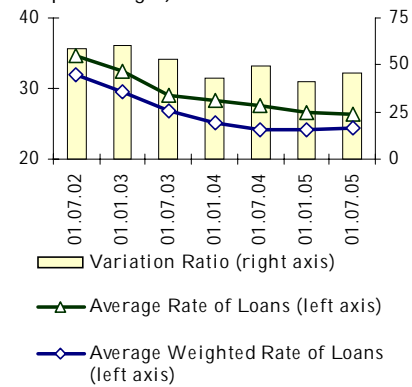
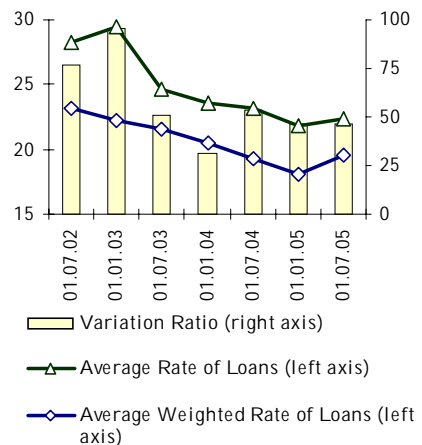


Chart 2.1.8. Change of Interest Rate Features on Loans in Foreign Currency (in percentages)



2.2. Risks

2.2.1. Credit Risk

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

In order to assess the quality of assets, the system of their classification is used that gives the possibility to determine the risk of non-repayment of assets and correlates with the accrued level of allowances for potential losses of the bank. Thus, the asset classification is an expression of various degrees of one factor - a risk of non-repayment. Thus, the assessment of the credit risk of the banking system based on the combination of two factors - a portion of classified assets in assets subject to classification, and a risk indicator for non-repayment of assets (chart 2.2.1.1.) testifies that the quality of banking system assets has not improved.

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 2005, the reduction in the portion of non-performing loans has been observed, while the portion of past due loans has increased (chart 2.2.1.2.). Taking into account that the change of loan terms is mainly connected with the change in the external management environment of borrowers (events in March of this year), the ratio of noted indicators testifies that the credit risk has not increased in the period under review.

The dynamics of loans classified as loans "under supervision" may be considered as one of growth/reduction factors of the credit risk. It shall be noted that the specific weight of such loans in the first half of 2005 remained invariable, at the same time this level is the highest since 2003 (see chart 2.2.1.3). Taking into account the aforesaid dynamics and the

Chart 2.2.1.1. Change of Credit Risk in Assets of Banking System

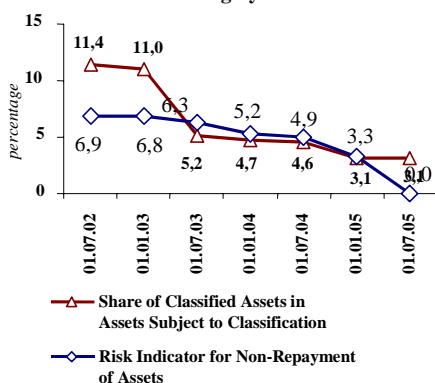


Chart 2.2.1.2. Change in Share of Non-Performing and Pastdue Loans in Bank's Loan Portfolio

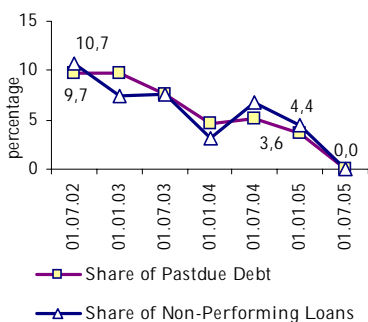
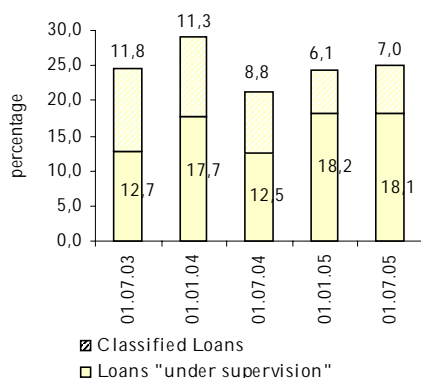


Chart 2.2.1.3. Dynamics of Credit Risk Factors



increase in the portion of classified loans, the failure to pay attention to proper monitoring of loans "under supervision" may become a factor for future increase of risk of non-repayment of banking system loans.

Thus, the reviewed indicators describing the credit risk, on the whole, do not testify about the credit risk increase in the current period though there are factors in place of possible future credit risk growth.

2.2.2. Liquidity Risk

Public confidence in banking system depends on a timely fulfillment of liabilities by banks that is ensured by an adequate liquidity level. For regulatory purposes the liquidity risk is measured with the help of the economic liquidity ratio⁶. An actual level of this ratio maintained by the banking system is still sufficiently high. It constituted 83.5 percent on average for the banking system in the first half of 2005, having increased by 7.6 percentage points as compared with the past period. A substantial excess of the actual value of the liquidity ratio over the standard value testifies about the available potential for expansion of financial intermediation and profitability growth in the banking system.

Taking into account that the liquidity ratio is a generalized feature of the liquidity risk for the banking system, other evaluation indicators have been considered. Thus, chart 2.2.2.1 presents a correlation between the sources and the placement of banks' funds. High liquidity ratio is accompanied by low stability of funds' sources⁷ that constituted 29.1 percent as of July 1, 2005, although some improvements in the dynamics of this indicator have been observed in the first half of 2005. The dynamics of sources to placement of banks' funds⁸ ratio testifies about a continued growth of the liquidity reserve in the banking system and an efficiency reduction in using attracted funds.

Chart 2.2.2.1. Evaluation of Liquidity Factors of Banking System

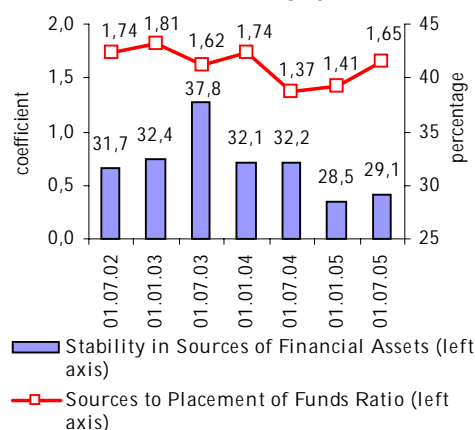
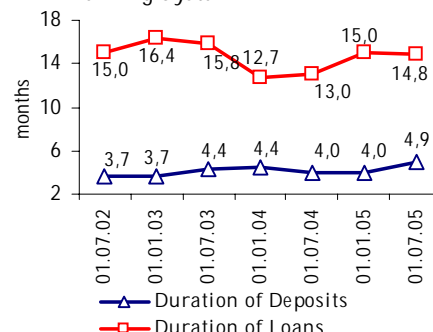


Chart 2.2.2.2. Developments in Duration of Loans and Deposits of Banking System

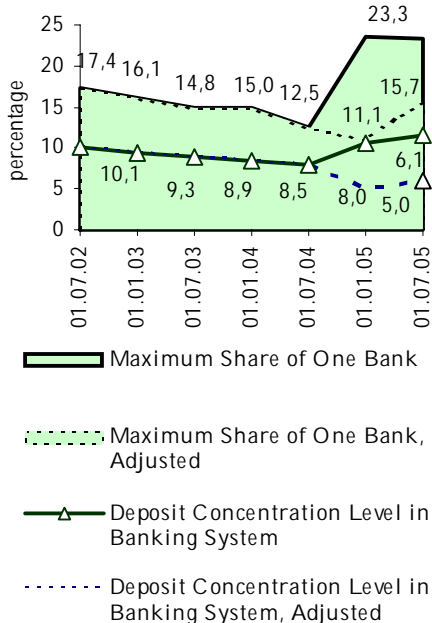


⁶ Economic liquidity ratio is one of the ratios established by the NBKR at the level of no less than 30 percent and is mandatory for execution by a bank.

⁷ A stability ratio for sources of financial assets is characterized by a portion of time deposits in the total amount of banking system deposits.

⁸ "Sources to placement of funds ratio" refers to the ratio of deposits to loans.

Chart 2.2.3.1. Change in Deposit Concentration



Increase in the duration of deposits in the first half of 2005 has not been accompanied by a corresponding growth in the duration of banking system loans (see chart 2.2.2.2.).

On the whole, it may be noted that there are no grounds to make conclusions about the increase of the liquidity risk in the banking system, at the same time a low level is noted in the stability indicator for sources of financial assets.

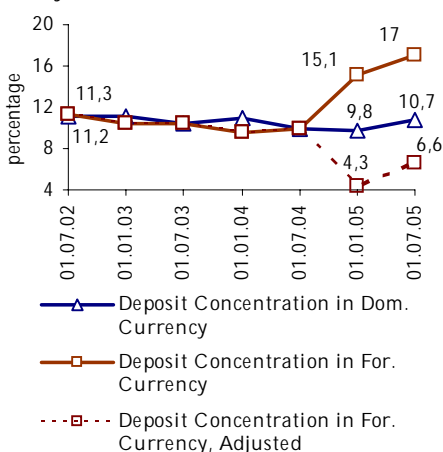
2.2.3. Concentration Risk

Features of deposit concentration. As it is seen in chart 2.2.3.1 the increase of the average deposit concentration level is observed in the banking system during the first half of 2005, given an invariable level of the maximum share of one of banks at the deposit market. The impact of this bank on the available significant gap between a maximum share at the deposit market and an average deposit concentration level is connected with a significant level of deposits in foreign currency (see chart 2.2.3.2) that are balanced by nostro accounts, defined in section 2.2.1 as quasi-active transactions. The increase of deposit concentration is observed without taking into account the deposits of a specified bank (it is marked by a dotted line in charts 2.2.3.1 and 2.2.3.2) that testifies about the reduction of competition at the deposit market.

Evaluation of the concentration level in the banking system with the help of another indicator - "a portion of four large banks by level of deposits" in the first half of 2005 also testifies about the increase of deposit concentration from 52.0 to 57.8 percent. At the same time, the composition of banks has virtually remained invariable, except for one new bank from a group of medium banks according to its share of the deposit market.

Features of credit concentration. The growth in the loan portfolio of the banking system is accompanied by some reduction in loan concentration assessed both by a maximum share of an individual bank at the credit market, and by a level (index) of loan concentration (see chart 2.2.3.3).

Chart 2.2.3.2. Deposit Concentration by Currencies

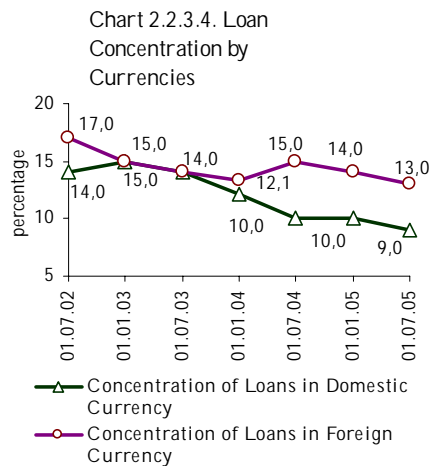
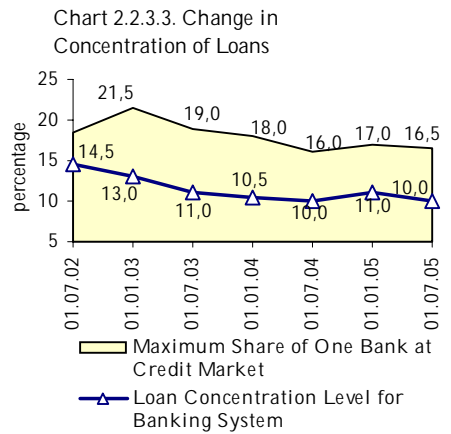


Concerning the indicator of a "share of four large banks" it may be noted that it has significantly increased (by 24.5 percentage points) and made up 80.5 percent. The composition of banks remains invariable, and the increase of the indicator occurred as a result of loan portfolio growth in one of the banks from this group, half of newly issued loans of which have been placed in the construction sector.

The peculiarity of indicators of "four large banks by the level of deposits" and of "four large banks by the level of loans" is that only two banks are part of both groups, where the largest bank by the level of deposits is not a large bank by the level of loans, and vice versa.

The reduction dynamics in the indicator of loan concentration by currencies reflects the growth of competition among banks in issuing loans both in domestic and foreign currencies (see chart 2.2.3.4).

Based on data from table 2.2.3.5, some activity may be noted in banks' operations in the area of housing lending, agricultural lending, transportation, social services sector, procurement and processing. At the same time, the interest of banks in lending to households has significantly reduced.



Evaluation of the loan concentration level by all types of sectors from moderate to high⁹ is preserved in analyzing the loan concentration risk by sectors of the national economy.

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

	1.07.03	1.01.04	1.07.04	1.01.05	1.07.05	Variance (in percentage points)
Industry	13,7	17,1	19,1	20,8	21,8	1,0
Agriculture	39,9	29,2	29,1	25,9	21,6	-4,3
Transportation	33,2	31,2	45,6	31,9	26,8	-5,1
Communication	62,6	26,9	37,2	34,7	38,9	4,2
Trade	12,3	13,4	11	12	11	-1,0
Procurement and Processing	27,9	19,7	25,2	28,8	25,9	-2,9
Construction	17,8	23,7	33,6	28,8	31,1	2,3
Housing Lending	61,6	27,7	21,7	16,3	12,3	-4,0
Households	45,8	13,4	15,6	16	23,2	7,2
Social Services	16,6	67,7	71	44,3	34,1	-10,2
Other	12	12,5	12,2	13,6	13,3	-0,3

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

Thus, a risk concentration analysis shows the increase of banks' activity in placing loans both in foreign currency and in domestic currency, and in lending to sectors of social services, transportation and acquisition of housing.

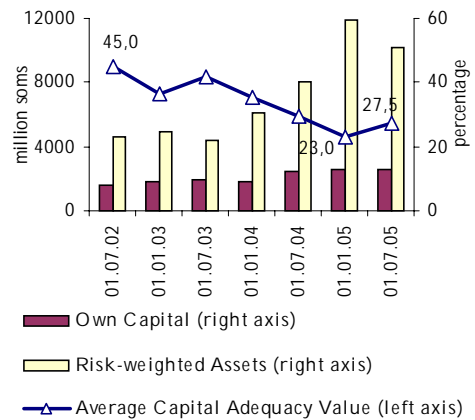
⁹ Evaluation of a concentration risk as high, moderate or low is based on a common scale of the concentration level. Thus, the concentration risk is considered to be low, if the concentration level is less than 10 percent, moderate risk is between 10 to 20 percent, or high - above 20 percent.

2.3. Capital Adequacy

A major feature of the bank's soundness is the compliance of its capital to the scale and nature of performed transactions. An adequate capital forms a peculiar "cushion" that permits a bank to remain solvent and maintain public confidence. An optimal bank's policy in capitalization area shall be focused on maintaining an acceptable risk level, due to the fact of maintaining an adequate level of own capital.

Given an established minimum value of the capital adequacy ratio at 12.0 percent, an average capital adequacy level of the banking system remains sufficiently high, and makes up 27.5 percent (see chart 2.3.1) as of July 1, 2005. The reduction in the value of risk-weighted assets is a main growth factor of the capital adequacy indicator for the banking system, which in combination with the increase in the volume of income-earning assets testifies about a more conservative approach in placing the funds of the banking system. At the same time, the actual capital adequacy level permits to increase the volume of risky and income-earning assets by more than one and a half times without exceeding an allowable risk level in the overall operation of the banking system. Aforesaid testifies about an available explicit potential for expanding financial intermediation level of the banking system.

Chart 2.3.1. Change in Capital Adequacy Indicators for Banking System



2.4. Financial Results

2.4.1. Return

Chart 2.4.1.1. Developments in Net Interest Income of Banking System

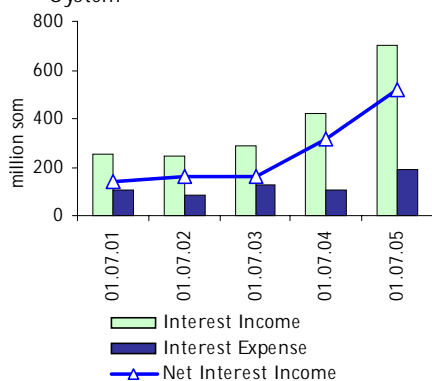


Chart 2.4.1.2. Dynamics of Interest Margin Indicators in Banking System

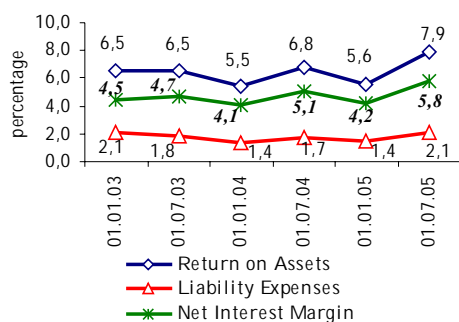


Chart 2.4.1.3. Developments in Return on Performing Assets

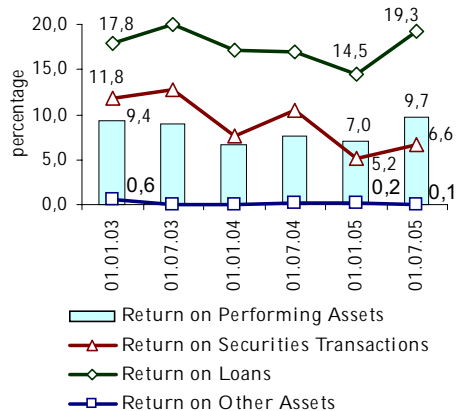
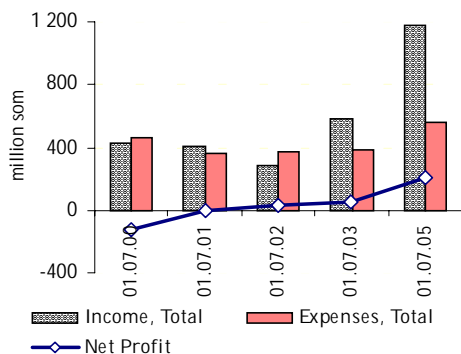


Chart 2.4.2.1. Formation of Net Profit of Banking System



In view of the peculiarity of the banking activity, the interest income serves as a traditional source of income that is also a major profitability feature for active transactions of a bank.

A steady increase of net interest income from 2001 is observed with the loan portfolio growth that constitutes a major portion of income-earning assets of the banking system. At the same time, a significant increase in the interest income of the banking system (the increase made up 62.4 percent) is noted in the first half of 2005 as compared with the similar period of the previous year (see chart 2.4.1.1).

An analysis of the net interest margin formation in the banking system shows that, although, the return on assets increases slowly (41.1 percent) than the expenses on liabilities (50 percent), and in view of its cyclic nature, a net interest margin has a growth trend in the end (see chart 2.4.1.2).

The contribution of various types of performing assets in the formation of aggregate return of the banking system is shown in chart 2.4.1.3. At the same time, the return on credit transactions is almost three times higher than an overall return on performing assets. Such substantial difference is related to the fact that a specific weight of loans in the composition of performing assets made up 42.9 percent, securities - 13.6 percent, while other performing assets with 0.1 percent yield constitute 43.6 percent.

¹¹ Taking into account the cyclical nature of Profit and all its derivatives (for instance, the Yield spread), the dotted line indicates the trend of the Yield spread.

2.4.2. Net profit

The increase in the net profit of the banking system is noted¹⁰ as compared with the similar period of the previous year by more than 2.5 times (see chart 2.4.2.1), where a considerable excess of growth rates is observed in income of the banking system (103.1 percent) over the growth rates in expenses (43.9 percent).

A profit spread may be considered as a feature in the formation of net profit of the banking system¹¹ (chart 2.4.2.2). Thus, the increase of income-earning assets during the first half of 2005 lead to the increase of banks' profit spread that may testify about the improvement of efficiency in fulfilling a financial intermediation function by the banking system between investors and a real sector.

It shall also be noted that some reduction of non-interest expenses takes places on the whole (see chart 2.4.2.3.), although the increase is observed in banks' personnel expenses.

2.4.3. Efficiency

Rates of return on assets (ROA) and return on capital (ROE) (see charts 2.4.3.1, 2.4.3.2) have been considered in assessing the efficiency of the banking system. In the first half of 2005, the rate of return on assets increased and constituted 2.3 percent. In comparison with similar period of 2004, this indicator increased by 0.4 percentage points, and the return on capital for the period under review made up 17.3 percent, and the increase constituted 5.6 percentage points.

Thus, the efficiency indicators of the banking system testify about overall positive dynamics. At the same time, the comparison of growth rates in ROA and ROE, as well as a high average value of the capital adequacy ratio for the banking system suggests that active transactions of banks have expanded less productively relative to opportunities that the potential of own capital of the banking system presents. On the other hand, the rate of return on assets may be substantially improved in reducing low income-earning assets.

Chart 2.4.2.2. Developments in Qualitative Rates of Return of Banking System (percentages)

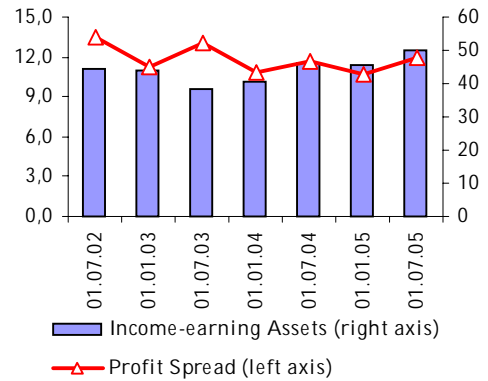


Chart 2.4.2.3. Dynamics of Individual Expense Indicators of Banking System

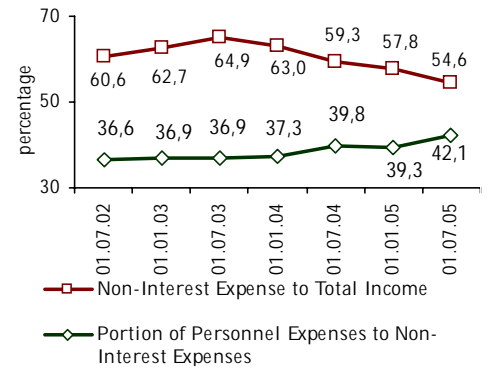


Chart 2.4.3.1 Change in Return on Assets (ROA)

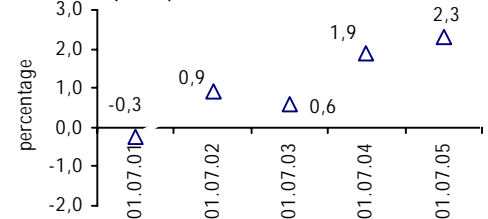
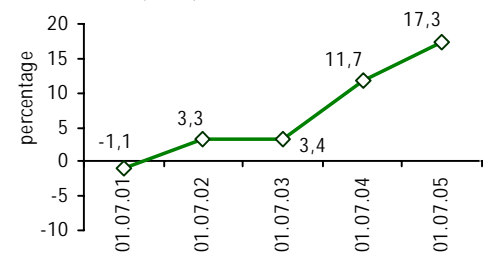


Chart 2.4.3.2 Change in Return on Equity (ROE)



¹⁰ In analyzing the Profit indicator and its derivative indicators, it shall be remembered that the statements reflect the accumulation of this indicator from the beginning of the year. This explains the use of values in charts separately based on the results of six months.

¹¹ Profit spread refers to the difference between interest income to the value of income-earning assets ratio, and interest expenses and liabilities on which these expenses are paid.

2.5. Role of the Banking System

Chart 2.5.1. Dynamics of Deposits and Deposits to GDP Ratio

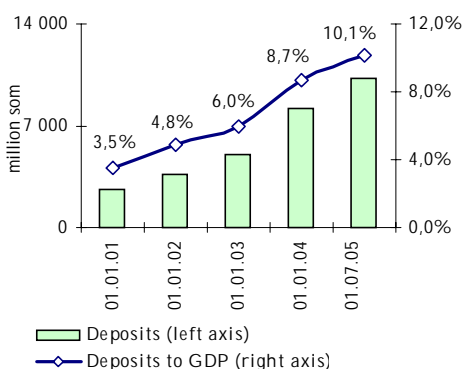
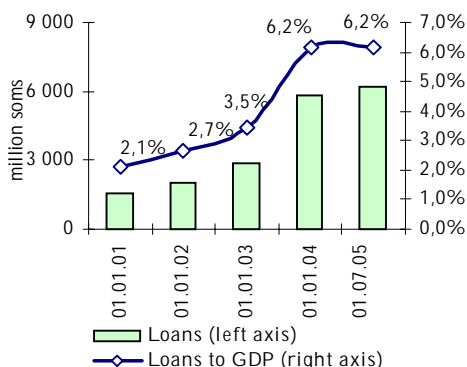


Chart 2.5.2. Dynamics of Loans and Loans to GDP Ratio



The importance 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 its development and efficiency of operation.

In the development of the system of commercial banks some deceleration has been observed in their activities during the first half of 2005 in comparison with the previous year, as after events in March some outflow of deposits occurred that together with repayment problems of previously issued loans lead to temporary suspension in the issuance of new loans by individual banks.

As of July 1, 2005, the ratio of deposits to GDP made up 10.1 percent (based on results of 2004 its value constituted 8.7 percent). The increase of this indicator is stipulated by higher growth rates of deposits in the reporting period. Thus, the general increase of deposits in the first half of 2005 made up 24.8 percent and is related with the increase of deposits of legal entities by 33.2 percent. The volume of deposits of the public in the period under review has not virtually changed.

The increase in the ratio of deposits placed with commercial banks to monetary aggregates outside them (M0) has continued and reflected the level of public confidence in the banking system. As of reporting date, this indicator constituted 90.4 percent (as of beginning of the year - 73.4 percent).

The growth is observed in relation to the volume of loans, although its rates significantly yield to the growth rates for the similar period of the last year.

Considering the flows of newly issued loans, it shall be noted that the volume of disbursed loans for the first half of 2005 made up 4.0 billion som that is 10.9 percent higher than the volume of loans issued for the similar period of 2004. As of July 1, 2005 the portion of total loans issued to clients to GDP constituted 6.2 percent and has not virtually changed as compared with the end of 2004.

Growth in lending for trade (by 13.3 percent or by 0.2 billion som) is noted in the structure of loans as compared with the similar period of 2004, and the increase in volumes of lending against the pledge of real property (by 57.1 percent or by 0.1 million som). At the same time, the reduction is observed in the volume of issued loans to industrial enterprises (by 35.2 percent or by 0.3 billion som), to procurement and processing, transportation and communication sectors.

The ratio of loans to deposits of the public, and enterprises made up 60.9 percent against 71.2 percent as of beginning of the year.

¹² In this section, deposits imply to deposits of public, enterprises, as well as Government and other public authorities of the Kyrgyz Republic

¹³ Data was calculated to projected GDP for 2005 (100.8 billion som).

Substantial fluctuation of average interest rates has been observed in January-June 2005 on newly issued loans - from 23.5 to 27.5 percent in domestic currency, and from 15.8 to 18.3 percent in foreign currency.

Considering financial results of commercial banks' activities, it shall be noted that as of July 1, 2005, the ratio of "net" interest income to average monthly level of banks' assets on which interests are paid constituted 7.1 percent (5.3. percent as of end of 2004) overall for the banking system (annualized), an average value of interest margin made up 6.7 percent (5.1 percent as of end of 2004).

The increase in the ratio of "net" interest income to average level of assets, and margin in commercial banks is caused by the reduction of costs per issued loan that is connected with the recent substantial increase of loan debt and interest income, correspondingly. However, on the other hand, this hinders the development of economy, as despite the increase of income in lending area, banks do not reduce interest rates. Such state of affairs may testify about an inadequate credit supply at the market, or about a high level of demand for new loans that implies insufficient competition at the credit services market, and 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, as well as relative protectability of the system against the interest rate risk.

In respect to the level of financial intermediation, there shall be noted the suspension in the increase of total assets to GDP ratio. Thus, as of July 1, 2005 this ratio made up 17.6 percent (18.8 percent based on the results of 2004).

Considering that fact that despite the sustainable growth for the past two-three years, most indicators of financial penetration and intermediation have relatively low values, there is still potential for further development and improvement of the efficiency in the operation of the banking system.

Evaluation of banking risks showed that no considerable change of situation is anticipated in the banking system in the short run. It is presumed that the role of the banking system will further improve in the economy of the country. However, possible deterioration in the financial standing of a number of large borrowers (mainly from the trade area) related to events in March 2005 testify about possible increase of potential losses in the medium term that are presently hidden in the loan portfolio of commercial banks. At the same time, the analysis shows that these losses shall not lead to the substantial deterioration of the overall financial status of the system.

Chart 2.5.3. Developments in Loans to Deposits Ratio

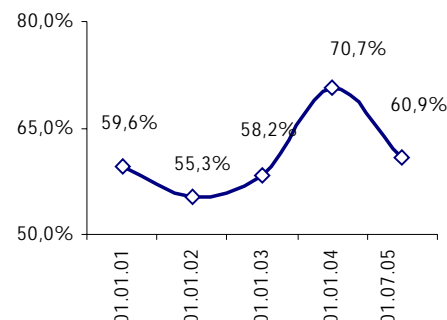
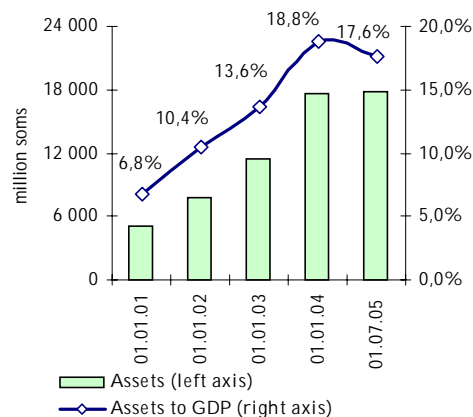


Chart 2.5.4. Dynamics of Assets and Assets to GDP Ratio



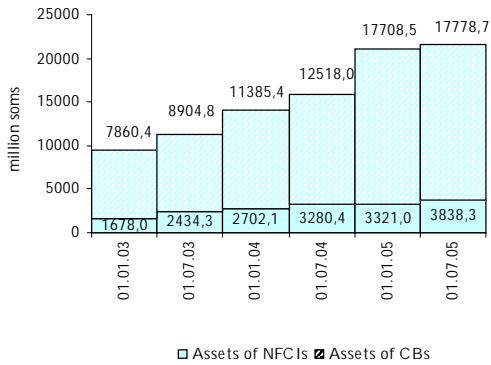
¹⁴ Calculations are made taking into account the data on average performing assets and liabilities of commercial banks.

¹⁵ Margin is a difference between average rates of borrowing funds and their placement.

III. NON-BANK FINANCE AND CREDIT INSTITUTIONS

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

Chart 3.1.1 Assets of NFCIs and CBs



The system of non-bank finance and credit institutions (NFCIs) 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 (CU);
- Microfinance organizations (MFOs), including microcredit companies (MCC) and microcredit agencies (MCA);
- Lombards;
- Exchange offices.

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

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

Name	2002	2003	2004	1st half of 2005
Specialized finance and credit institutions (KAFC, FCSDCU)	2	2	2	2
Microfinance organizations (MCA and MCC)	0	72	104	128
Credit unions	349	303	305	312
Lombards	85	108	116	127
Exchange offices	234	261	266	258

On the whole, the developments in the number of NFCIs show:

- Market saturation with such type of an institution as a credit union (CU);
- Increase in the number of MCA and MCC that demonstrates the demand for their services and the flexibility of regulatory frameworks offered by the state.

In the first half of 2005, the portion of assets of NFCIs in aggregate assets of finance and credit institutions (chart 3.1.1.) increased from 15.8 percent to 17.8 percent.

As of July 1, 2005, assets of NFCIs constituted 3838.25 million soms, where the increase of assets for the first half of 2005 made up 15.6 percent. KAFC assets take up the largest specific weight in the structure of assets of NFCIs - 50.2 percent, and microfinance organizations - 33.6 percent.

The largest growth of assets is observed with MFOs. In the first place, the growth in assets of NFCIs is stipulated by the growth in assets of large MFOs and establishment of new lombards, and MFOs.

3.2. Loan Portfolio Structure

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

As of July 1, 2005, an aggregate loan portfolio of non-bank finance and credit institutions as compared with similar period of last year increased by 29.2 percent and made up 3304.8 million soms.

In the structure of aggregate loan portfolio of non-bank finance and credit institutions (chart 3.2.1.), KAFC loans constitute 51.4 percent, loans of microfinance organizations - 32.2 percent, loans of lombards - 0.4 percent, and 15.9 percent - loans of credit unions, where loans obtained by CUs from FCSDCU constitute 49.4 percent of their total loan portfolio.

The main portion of the loan portfolio broken down by regions (chart 3.2.2.) is concentrated in Osh, Jalal-Abad, Issyk-Kul, Chui Regions, and city of Bishkek.

In the first half of 2005, the largest volume of NFCIs loans was targeted for agriculture - 56.5 percent and trade - 28.4 percent.

Such allocation of credit resources is stipulated by the peculiarity of activities of KAFC and microfinance organizations. Thus, KAFC with the largest specific weight in aggregate loan portfolio of NFCIs directs 83.4 percent of its loans to agriculture, and MFOs have targeted 58.8 percent of loans to the trade sector.

Chart 3.2.1. Aggregate Loan Portfolio as of July 1, 2005 by Non-Bank Finance and Credit Institutions (million soms)

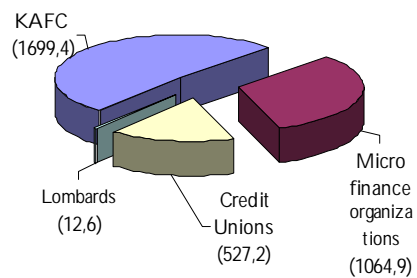


Chart 3.2.2. Aggregate Loan Portfolio of Non-Bank Finance and Credit Institutions by Regions (million soms)

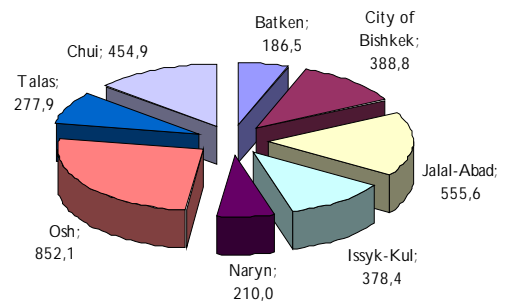


Chart 3.3.1. Loan Portfolio Growth in Non-Bank Finance and Credit Institutions (million soms)

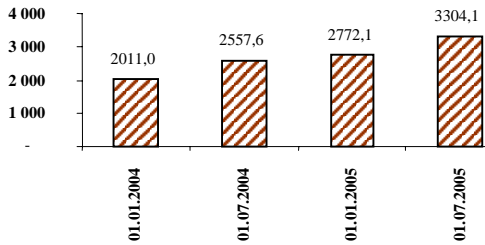
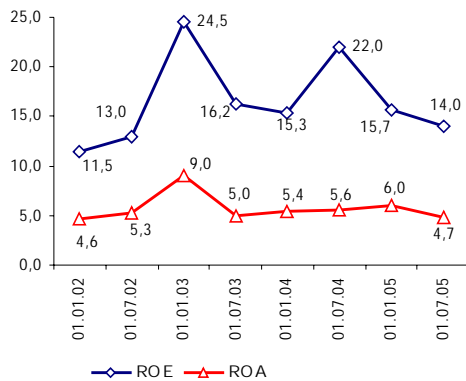


Chart 3.3.2 Developments of ROA and ROE in NFCIs



Development of the loan portfolio by sectors and regions showed the stability of preferences in crediting of NFCIs, where agriculture and trade is their main niche. The regional activity is the highest in the south of the country in view of a higher population density and its economic activity in agricultural and trade sectors.

3.3. Loan Portfolio Development

Given the asset growth in the system of NFCIs by 15.6 percent, its loan portfolio increased by 19.2 percent. It shall be noted that the portion of the loan portfolio in assets of NFCIs for the past two years, as a rule, has been increasing during the first six months and reducing by the end of the second half year. Such cyclic dynamics arises from the pronounced seasonal nature of operation of the majority of NFCIs, and the linkage of borrowers' business to the agricultural cycle.

As of July 1, 2005, the total loan portfolio of NFCIs constituted 3304.8 million soms. As a whole, the loan portfolio of NFCIs (chart 3.3.1.) has a stable growth trend for the past four years.

In the first half of 2005 some reduction is observed in rates of return on assets (ROA) and return on equity (ROE) (chart 3.3.2.) in the system of NFCIs.

3.4. Primary Risks

Activities of NFCIs are characterized by a high concentration of loans, primarily, in agriculture and related business located in rural area. As is well known, crediting of this area is connected with high risks due to dependence on weather and climatic conditions, and relatively small income of rural population.

Apart from agriculture, lending of NFCIs covers trade and catering. The turnover of resources is much higher in trade than in agriculture, however, risks related pricing as well as high competition reduce economic efficiency from the use of obtained loans.

Interest rates of loans issued by NFCIs are still at sufficiently high level that is explained by the pursuit of NFCIs to cover their high risks connected with the peculiarity of their operations, and continued high demand for these types of loans from the public. At the same time, the size of the interest rate on NFCI loans has a stable downward trend. Thus, from the beginning of half year most NFCIs reduced their interest rates as a result of general reduction of rates, as well as improvement in competition. An average interest rate on NFCI loans for the reporting period made up 29.1 percent in MFOs, 28.9 percent in CUs, 16.8 percent in KAFC and 16.6 percent in FCSDCU.

IV. PAYMENT SYSTEM

4.1. Bank Products, Tariffs and Services

During the reporting period, commercial banks of the Kyrgyz Republic provided a wide range of banking services. The analysis of tariffs for these banking services shows the lack of any significant changes.

Currently, banks continue active introduction of international systems of remittances. Commercial banks remit money through eight international systems - Western Union, MIGOM, Money Gram, Contact, VIP Money Transfer, Ànelik, Xpress Money, Unistream. Main advantages of remittance systems are their speed, security and lack of need to open an account in banking institutions, as well as the possibility to remit money virtually to any country of the world.

Lately, Internet-Banking is actively used at the banking services market. Internet-Banking permits to make payments with current and future dates, purchase, sell and remit currency, receive information about funds flow on accounts, receive bank statements, and monitor account balances from any place with an Internet access. Such system permits to keep an archive of transferred data on payment documents, and prepare an account forecast.

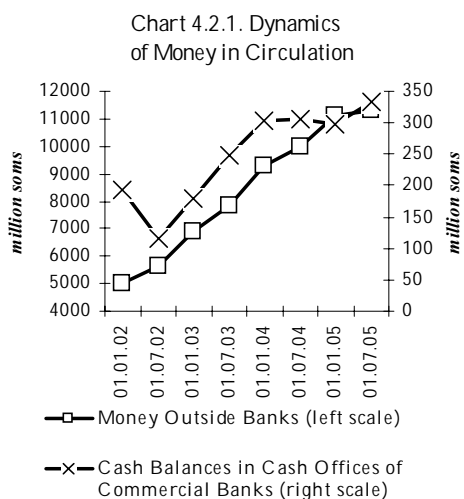
As of June 1, 2005, 2 commercial banks provide Internet-Banking services. Connection to the system is free of charge.

4.2. Cash and Non-cash Turnovers

Cash turnovers. As of July 1, 2005, the total amount of cash in circulation made up 11640.4 million soms. The increase of money in circulation in the first half of 2005 constituted 215.3 million soms as compared with the second half of 2004, and the growth made up 1.9 percent.

Out of the total amount of money in circulation, 333.1 million soms or 2.9 percent were in cash offices of commercial banks.

The dynamics 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 cash from the developing small and medium businesses, low occurrence of non-cash payment means.

The return of cash to cash offices of commercial banks is a main indicator describing the level of cash turnover development. In the first half of 2005, an average return to cash offices of commercial banks made up 99.0 percent that is higher by 0.6 percentage points than in the second half of 2004. The dynamics of the cash return rate is reflected in chart 4.2.2.

In the first half of 2005 the highest rate of cash return has been for the city of Osh - 143.1 percent, and the lowest for Batken Oblast - 32.0 percent (see chart 4.2.3.). The return of cash for city of Bishkek constituted 110.2 percent, and for Chui Oblast - 109.0 percent. The highest percent of cash return for city of Osh, city of Bishkek, and also for Chui Oblast is connected with a more saturated consumer market, concentration of many banking and finance institutions, as well as trading and industrial enterprises. It shall be noted that the percent of cash return is the lowest overall for Osh Oblast.

In the first half of 2005, 29651.0 million soms have been issued from cash offices of commercial banks that is lower by 3178.2 million soms, or by 10.7 percent than in the second half of 2004. The structure of cash issues is presented in chart 4.2.4. The issue of cash reduced on the following expense items:

- Purchase of foreign currency for 599.9 million soms or for 31.1 percent, and made up 1926.6 million soms;
- Other expenses for 2799.3 million soms or for 13.1 percent, and made up 21358.9 million soms.

Payments on pensions and benefits item increased by 214.7 million soms or by 8.4 percent. Total of 2770.2 million soms was disbursed for these purposes. The increase in the issue of cash on pensions and benefits item is connected with the full repayment of past due debt on this item.

3595.2 million soms have been directed to budgetary organizations for payment of salaries, and this indicator remains at the same level as compared with the similar period of 2004.

In the first half of 2005, 29356.6 million soms have been received into cash offices of commercial banks that is lower by 2943.3 million soms or by 10.0 percent than in the second half of 2004. Cash receipts reduced on all receipt items:

Chart 4.2.2. Dynamics of Cash Return Rate

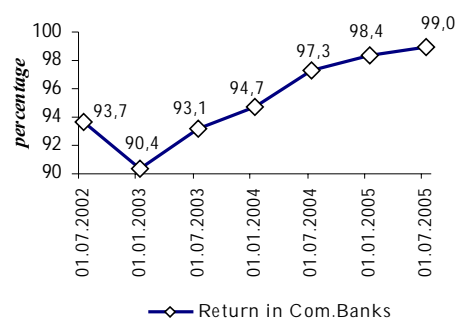


Chart 4.2.3. Rate of Cash Return to Cash Offices of Commercial Banks

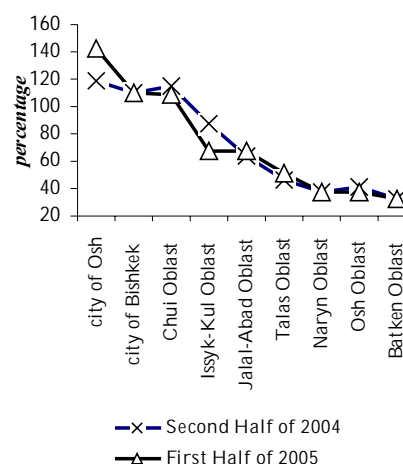


Chart 4.2.4. Structure of Cash Issue for First Half of 2005

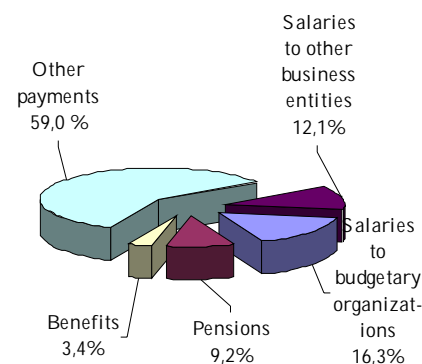
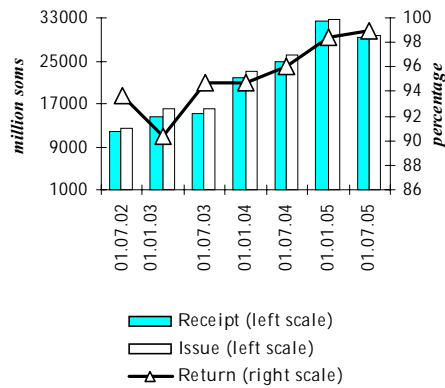


Chart 4.2.5. Receipt, Issue of Cash and Its Return to Cash Offices of Commercial Banks



- "Taxes, duties" - by 222.5 million soms or by 8.5 percent, and made up 2607.3 million soms;
 - "Sale of foreign currency" - by 199.6 million soms or by 9.4 percent, and made up 2122.3 million soms;
 - "Other receipts" - by 2521.2 million soms or by 10.2 percent, and made up 24627.0 million soms.

Change in indicators of receipts, issues of cash and its return to cash offices of commercial banks is presented in chart 4.2.5.

Non-cash turnovers. On the whole, 511075 interbank payments totaling to 66115.0 million soms have been made in the first half of 2005 (chart 4.2.6.).

As compared with the previous half year, the volumes of payments reduced by 6.7 percent and increased by 6.4 percent with the similar period of 2004.

The number of payments made as compared with the similar period of 2004 reduced by 5.2 percent.

Reduction in the number of interbank payments in the reporting period resulted from the reduction in the number of payments in interbank clearing system (-5.6 percent).

Budgetary payments - payments of the Central Treasury and Social Fund of the Kyrgyz Republic constitute a considerable portion of interbank payments. The total volume of budgetary payments (made in gross and clearing systems of interbank settlements) based on results of six months constitutes 28061.2 million soms that is 42.4 percent of the total volume of interbank payments for the reporting period.

The total number of budgetary payments for the first half of 2005 made up 336 078 payments. As compared with the similar period of last year, this indicator reduced by 4.3 percent.

The structure of interbank payments by types and by the purpose of payments is presented in table 4.2.1:

Chart 4.2.6. Dynamics of Volume and Number of Interbank Payments

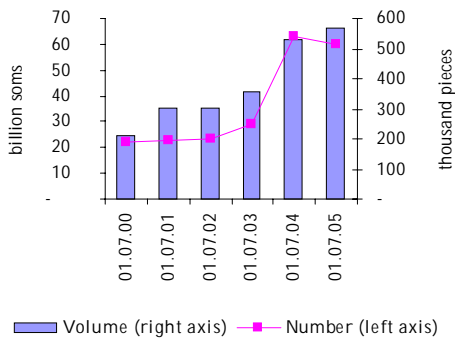


Table 4.2.1. Structure of Interbank Payments By Types and Purpose of Payments

Payment Type	Number	Volume (million soms)
Payments for inventory holdings and services	227 386	11430,4
Income transactions	167815	4997,4
Deposit transactions	712	153,1
Credit transactions	5632	7399,3
Foreign currency transactions	838	4264,3
Securities transactions	1051	6491,2
Specific payments, interbank settlements and remittances, transactions with regional departments and cash office	47 919	28136,7
Payments on mandatory state social insurance	55180	2857,8
Payments reflecting income of the population	4542	384,8
Total:	511 075	66 115

System of large payments. In the first half of 2005, the total volume of interbank payments made through the gross settlement system constituted 44.8 billion soms, and increased by 0.5 percent in comparison with the similar period of last year (chart 4.2.7). In the total volume of interbank gross payments, 97.5 percent and 92.3 percent of the total number is on payments between banks located in Chui Oblast and in city of Bishkek, accordingly. Based on the results of the reporting period, in comparison with the first half of 2004, the maximum increase in the number and volume of payments is in Batken Oblast (41.0 percent and 135.0 percent, accordingly). The reduction in the number and volume of payments is observed in Jalal-Abad Oblast (-33.5 percent and -27.5 percent, accordingly), Talas Oblast (-11.1 percent and 44.2 percent, accordingly), and also by the volume of payments in Chui Oblast and city of Bishkek (-0.3 percent).

In the first half of 2005, 490.7 thousand payments totaling to 21.3 billion soms (chart 4.2.8) have been made via the clearing payment system.

The growth in the total volume of payments based on results of six months in comparison with the similar period of last year is stipulated by the increase of clearing payments. The increase of the volume is virtually observed on all types of clearing payments, except for payments related to settlements on foreign exchange transactions (-89.2 percent), and securities (-56.6 percent).

In regional aspect, Chui Oblast and city of Bishkek are leaders in the number and volume of clearing payments, based on results of the first half of 2005, 83.4 percent of the volume and 76.9 percent of the number of clearing payments constitute their portion (chart 4.2.9).

Transborder payments, including remittances.

Currently, commercial banks render transborder payment services through SWIFT, Telex, Bank-Client systems and e-mail. Selection of the system for making a payment is defined by contractual relationships with correspondent banks. During the first quarter of 2005 in light of the provider's denial to render services via Sprint system, payments have not been made through this system.

Presently 17 banks are SWIFT members in the Kyrgyz Republic. 4 banks out of them independently operate with SWIFT interface and 13 banks (including the NBKR) operate through general interface of SWIFT shared unit (SN). Within the framework of updating SWIFT system, the transfer of banks to the new version of SWIFT Alliance Access 5.5 interface has been completed in May.

Chart 4.2.7. Dynamics of Volumes and Number of Payments Via Gross System

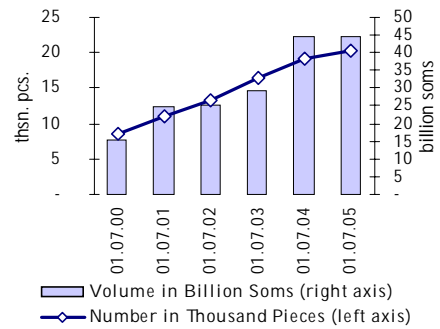


Chart 4.2.8. Dynamics of Volumes and Number of Payments via Clearing System

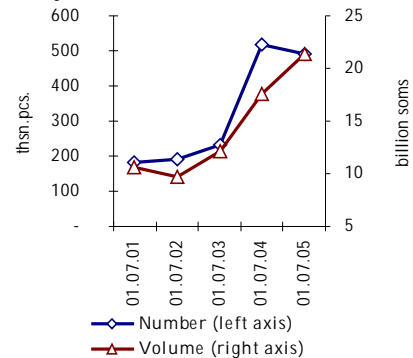


Chart 4.2.9. Volumes of Payments via Clearing System by Regions

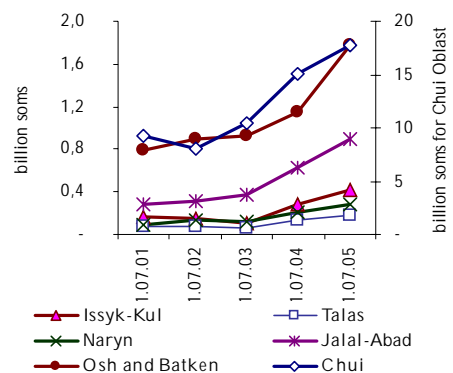
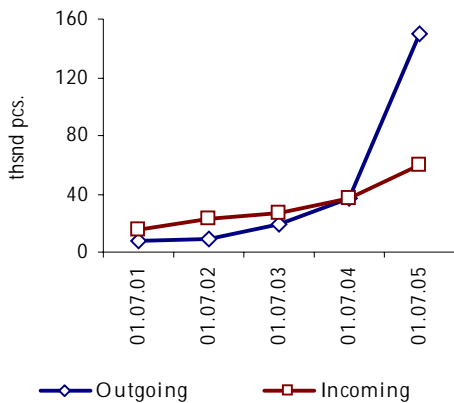


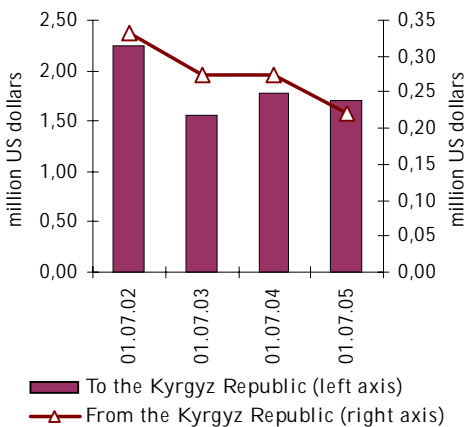
Chart 4.2.10. Dynamics of Transactions via SWIFT Network



Analysis of payments via SWIFT network demonstrates an active increase of indicators both on the number of payments, and on the volume of remittances. Thus, the number of outgoing payments came to 149.8 thousand pieces for the first half of 2005 that is greater by 113.3 thousand payments than in the first half of 2004 (chart 4.2.10).

Bank-Client, Internet-bank, e-mail and others refer to other systems that the banks use in making transborder payments. If Telex and SWIFT are internationally recognized systems that ensure safety and soundness in transferring payments, then the risks of using Bank-Client systems and e-mail are stipulated when correspondent banks conclude agreements. These systems are cheaper but riskier.

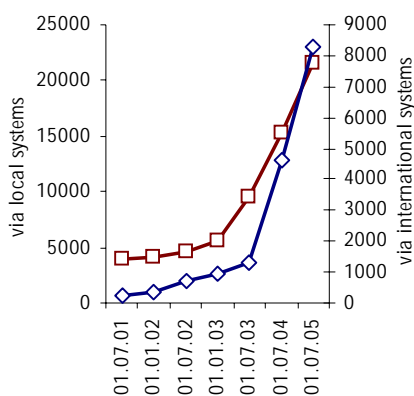
Chart 4.2.11. Dynamics of Postal Money Orders



The total volume of postal money orders to the Kyrgyz Republic made up 1701.7 thousand US dollars for the first half of 2005, including 811.6 and 890.6 thousand US dollars from NIS countries and foreign countries, accordingly. At the same time, remittances from the Kyrgyz Republic totaled to 221.9 thousand US dollars. At the same time, remittances were only made to NIS countries. A positive difference between postal orders to and from the Kyrgyz Republic came to 1479.9 thousand US dollars (chart 4.2.11) for the reporting period.

A comparative analysis of indicators on postal orders from foreign countries and NIS to the Kyrgyz Republic for the reporting period with the data for similar period of 2004 shows the reduction in cash flows by 4.6 percent. This reduction is explained by gradual change of public preferences on remittances by means of the banking system. Banks provide a wide range of remittance services within shorter terms, and permit to considerably expand the geography of countries that use the systems of bank remittances.

Chart 4.2.12. Number of Issued Cards



Settlement systems with bank payment cards

As of July 1, 2005, 15 (out of 20) finance and credit institutions provide acquiring, cash and settlement servicing of clients using bank cards, 8 of which serve as issuers and issue international system cards (7 banks), and local system cards (3 banks).

4 banks have the status of an associated member of the international payment system Visa International (Close-end Joint Stock Company (JSC) DKIB, Open-end JSC "Kyrgyzstan", Open-end JSC "Kazkommertsbank Kyrgyzstan", Open-end JSC "Energobank").

In the first half of 2005, the cash has been moved using the following types of cards: Visa, Master Card, Alai-Card, Demir 24 and Union card.

Indicators on the number of issued cards demonstrate their sustainable growth that is explained by active operations of banks on attracting new clients, popularization of banking cards among the public, and the overall development of the infrastructure. Thus, as of July 1, 2005 the total number of issued cards made up 15 266, and increased in comparison with similar period of 2004 by 41.1 percent (chart 4.2.12.). By types of cards, the number of issued cards constituted:

via international systems - Visa - 3 042 (47 corporate);
Master Card - 1 089 (174 corporate);

via local systems - Alai-Card - 7 135 (157 corporate), out of them 158 cards are with magnetic strip; Demir 24 - 3 948; Ukrcard -52 (50 corporate).

One of commercial banks of the Kyrgyz Republic issues Ukrcard magnetic cards that are used for servicing only on the territory of the Republic of Ukraine within the framework of salary projects. Ukrcards are not accepted for servicing in terminals and ATMs on the territory of the Kyrgyz Republic.

Due to the damage caused to the equipment after events on March 24, 2005, and in view of complexities in settings during the new connection of the number of commercial banks, no transactions on cash withdrawal using international cards have been performed during the second quarter of 2005.

In the first half year, the number of transactions via local systems made up 163 310 transactions (chart 4.2.13.). Out of them 87 335 transactions (34 percent of the total number of transactions through local and international systems) went

Chart 4.2.12. Changes in Volumes and Number of Payments in Clearing System

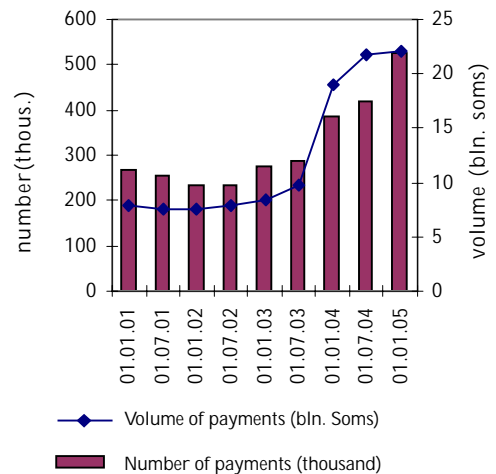


Chart 4.2.13. Volumes of Payments in Clearing System by Regions

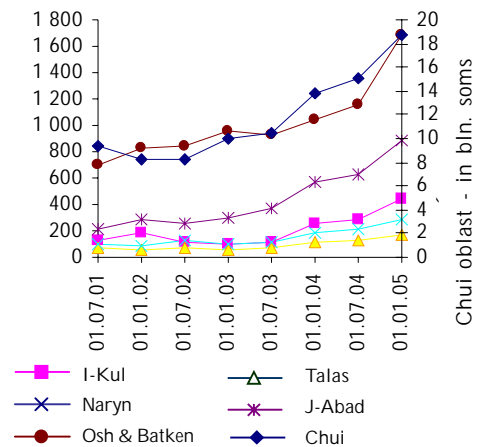


Chart 4.2.14. Dynamics of transactions through SWIFT network (thous. units).

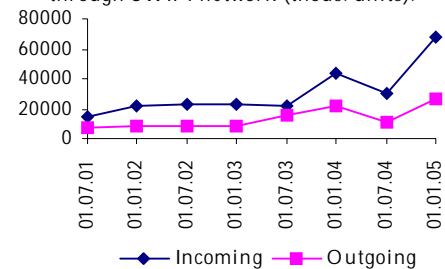


Chart 4.2.15. Changes in postal money remittances

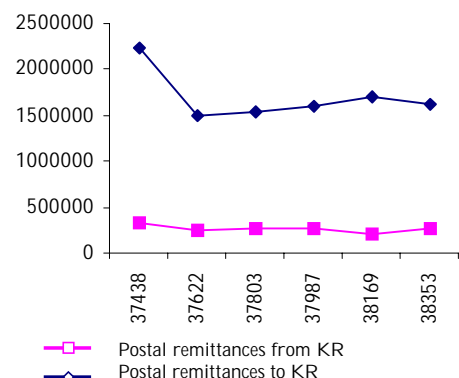


Chart 4.2.13. Dynamics of the Number of Transactions

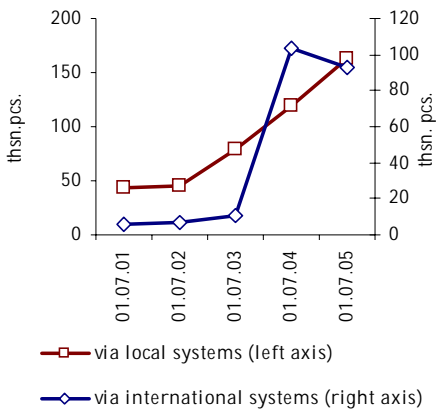
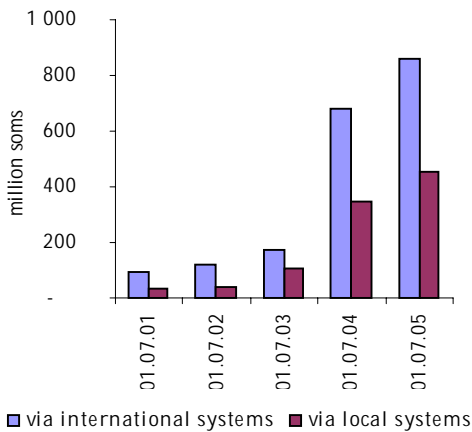


Chart 4.2.14. Dynamics of Volumes of Transactions



through "Alai-Card", "Demir 24" - 75 953 (29.6 percent) and via Union card - 22 (0.02 percent). The number of transactions via international systems constituted 93 456 transactions. 69 763 and 23 693 transactions (27.2 percent and 9.2 percent of the total number of transactions through local and international systems) were performed through Visa and Master Card, accordingly.

The volume of transactions via local systems made up 297.3 million soms (chart 4.2.14.). Out of them 151.0 million soms (19.9 percent of the total volume of transactions through local and international systems) went through Alai-Card, 146.0 million soms (19.2 percent) via Demir 24, 0.4 million soms (0.05 percent) through Union card. The volume of transactions via international systems constituted 462.3 million soms. Volumes through Visa and Master Card made up 360.0 and 102.3 million soms, correspondingly (47.4 percent and 13.5 percent).

Three commercial banks continue their work on expanding salary projects on the basis of international and local system cards. On the whole, 90 salary projects with the total number of 8 033 cards have been implemented. Due to the implementation of these projects there is an increase of payment cards at the market, in particular, more than half of the issue of cards via local systems comes to "salary" cards.

V. STATUS OF THE REAL SECTOR

5.1. Households

In 2004 the actual consumption of households has increased by 9.9 percent and constituted 82004.5 million soms that makes up 87.2 percent of GDP (for instance, in 2002 this indicator made up 75.4 percent of GDP).

In the first half of 2005, the nominal average monthly salary made up 2364.6 soms, and in comparison with the corresponding period of 2004 increased by 15.3 percent in nominal terms, and by 10.3 percent in real terms. In its turn, the cost of the minimal consumer budget in January-June 2005 made up 1856.8 soms (in the first half of 2004- 1722.83 soms).

5.1.1. Liabilities to Finance and Credit Institutions

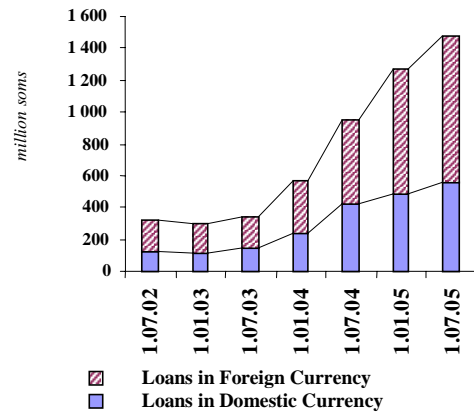
As of July 1, 2005, liabilities of the household sector to the banking system constituted 1.5 billion soms, and increased by 4.7 times for the past 3 years, and by a factor of 1.6 in comparison with July 1, 2004. In the structure of liabilities, the growth tendency of loans in foreign currency is observed as before (see chart 5.1.1.1).

As of July 1, 2005, liabilities in domestic currency made up 555.9 million soms and increased by 4.5 times for the past 3 years, by 4.8 times in foreign currency, and made up 922.3 million soms. As a result, the structure of loans has been formed as follows: 37.6 percent in domestic currency and 62.4 percent in foreign currency (as of July 1, 2002 - 39.1 and 60.9 percent, correspondingly).

In comparison with July 1, 2004, loans issued for construction and acquisition of immovable property materially increased by 42 percent, for agriculture by 16.9 percent, for trade by 13.3 percent. In the first half of 2005, the portion of these loans made up 48.3 percent in the total volume of issued loans, including for trade - 37.1 percent, industry - 10.4 percent, construction - 9.8 percent.

Along with that, loans for procurement and processing reduced by 77.4 percent, transportation and communication by 46.5 percent, and industry by 35.2 percent.

Chart 5.1.1.1. Liabilities of Physical Entities to Banks



In the first half of 2005, the volume of loans issued to private citizens increased in comparison with the corresponding period of 2004 by 26 percent, but its portion in the total volume of issued loans gradually decreased from 9.1 percent to 8.6 percent. Total flow of newly issued consumer loans in the first half of 2005 constituted 414.8 million soms. An average weighted rate on loans issued in the first half of 2005 to private citizens in domestic currency made up 28.2 percent and on loans in foreign currency - 21 percent.

The growth in crediting the population was stipulated by an improved economic activity of the population and a stable macroeconomic situation for the past years.

Low level of public income is still a main factor constraining the development of financial intermediation level of the banking system.

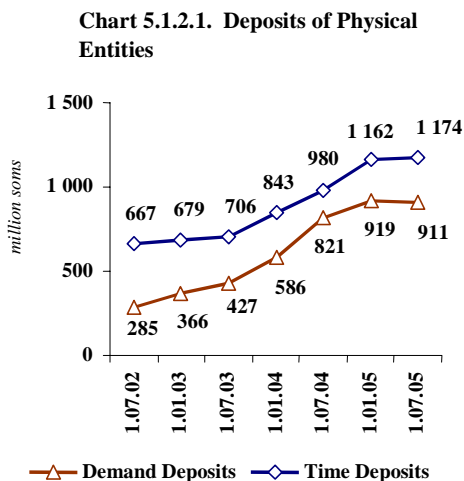
5.1.2. Public Savings

For the past three years, the volume of deposits of physical entities in commercial banks according to regulatory reporting data of active commercial banks increased by 2.2 times (see chart 5.1.2.1) and as of July 1, 2005, it made up 2085.1 million soms. For comparison: as of July 1, 2004 - 1801.3 million soms. This occurred due to macroeconomic stabilization achieved during the past years, reduction in the inflation rate, and the growth of real income, and public savings.

Changes also occurred in the deposit structure. Thus, the increase of deposits in foreign currency is observed for the past three years. If as of July 1, 2002, only half of deposits were in foreign currency, and as of July 1, 2005, the portion of these deposits increased up to 63 percent that is lower by 0.6 percentage points in comparison with similar period of 2004.

The strengthening of the banking system and expansion of banking services lead to the increase of funds on current accounts of physical entities, and consequently improved the intermediation role of banks in making payments.

As compared with July 1, 2004, the largest increase has been observed on demand deposits in domestic currency by 32.2 percent. For this period the increase on time deposits in foreign currency made up 27.2 percent, and in domestic currency - 11.4 percent.



Changes in the structure of deposits have been accompanied by changes in rates. Thus, during the past three years, the rates of demand deposits have been characterized by their small increase, from 0.22 to 0.26 percent on deposits in foreign currency, and reduced in domestic currency from 1.16 to 1.13 percent, accordingly.

On the whole, despite the absolute increase in deposits of households, their portion in the deposit structure of the banking system reduced from 48.5 percent as of July 1, 2004 to 45.2 percent as of July 1, 2005.

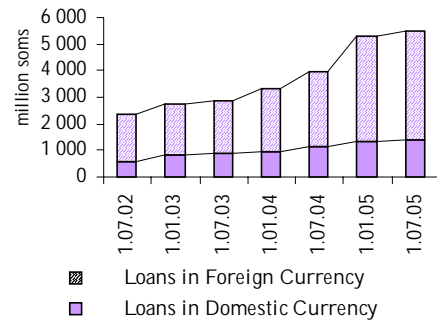
5.2. Corporate Sector

5.2.1. Liabilities to Finance and Credit Institutions

As of July 1, 2005, the number of legal entities constituted 62.7 thousand entities and increased by 7.7 percent in comparison with similar period of 2004. A significant portion of the total number of legal entities is registered in the areas of trade, repair of vehicles and household goods - 27.7 percent, areas of public utilities and social services - 18.8 percent, industry - 12 percent. The prevailing part - 86.4 percent of all enterprises of the republic is in private ownership. According to the size of enterprises, organizations are divided into "small" , the share of which made up 88.2 percent as of beginning of 2005, "medium" - 8.1 percent and "large" - 3.7 percent.

An aggregate debt of enterprises and organizations to active commercial banks for the past three years has an upward trend. As of July 1, 2005, it made up 5488 million soms, having increased by 38 percent for the past year (see chart 5.2.1.1). As a result of a more rapid increase of loans in foreign currency, their specific weight increased by 2.3 percentage points and as of July 1, 2005 constituted 73.8 percent of the total amount of liabilities of enterprises.

Chart 5.2.1.1.
Dynamics of Corporate Sector Debt to Commercial Banks



As of July 1, 2005, average weighted interest rates on issued loans in domestic currency made up 23.8 percent per annum for industry, agriculture - 24.5 percent, transportation and communication - 23.5 percent, and trade - 28.2 percent.

As of July 1, 2005, average weighted interest rates on issued loans in foreign currency constituted 16.3 percent, agriculture - 21.9 percent, transportation and communication - 21.5 percent, and trade - 18.7 percent.

For the past three years, there is a continued reduction of interest rates on newly disbursed loans that is stipulated by the reduction of the inflation rate, strengthening of the financial sector in recent years, and continued enhancement of competition at the credit market on this background, including between bank and non-bank institutions.

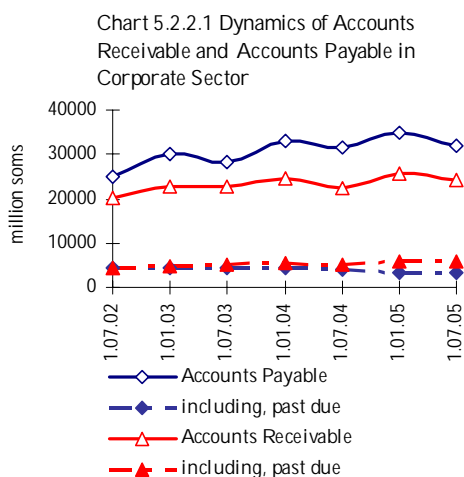
Rates on loans in domestic currency increased from 24.1 up to 24.3 percent, and in foreign currency from 18.0 up to 19.55 percent during the first half of 2005.

5.2.2 Status of Accounts Receivable and Accounts Payable

During the past three years some increase in amounts of both accounts payable and accounts receivable is observed in enterprises of the real sector. At the same time some reduction is noted based on results of the first half of 2005 (see chart 5.2.2.1).

As of July 1, 2005, the accounts receivable of enterprises and organizations constituted 24311.5 million soms in absolute terms and reduced from the beginning of the year by 5.4 percent. The portion of internal accounts receivable made up 78.9 percent.

66.7 percent of industry enterprises take up the largest specific weight in the total volume of accounts receivable, including 45 percent of power generation and distribution enterprises; organization of trade, repair of vehicles, household



¹⁶ "Small" enterprises in the classification of the NSCKR refer to enterprises with up to 50 employed persons, "medium" - 51-200 persons, "large" - above 201 persons.

and personal goods - 15.5 percent, transportation and communication - 8.6 percent, construction organizations - 5.4 percent.

The volume of past due accounts receivable has not actually changed in comparison with the beginning of 2005, and made up 5981.7 million soms or 24.6 percent to the total volume of accounts receivable as of July 1, 2005. 68.5 percent of past due accounts receivable is due from enterprises on generation and distribution of power, gas, steam and water, 15.4 percent - from the processing industry, and 4.6 percent is due from transportation and communication enterprises.

Accounts payable have a growth trend and as of July 1, 2005 made up 31916.5 million soms, where the portion of internal accounts payable constituted 70.9 percent.

On the whole, the ratio of past due accounts payable to the total volume of accounts payable has a downward trend for the corporate sector and as of July 1, 2005 made up 10 percent (as of July 1, 2004 - 12.5 percent). The highest level of this ratio as of July 1, 2005, according to the data of NSC KR and NBKR computations was with the enterprises and organizations of the following types of activities:

- Provision of public, social and personal services - 36.9 percent;
- Mineral resource industry - 35 percent;
- Financial activity - 28.3 percent.

The highest excess of accounts payable over accounts receivable is noted in chemical production, where the value of this ratio as of July 1, 2005 constituted 8.5 percent, in hotel and restaurant business - 3.1, in woodworking and production of woodwork - 2.8, and in mineral resource industry - 2.5.

5.2.3. Financial Results

Despite the fact that in the first half of 2005, the profit of the real sector enterprises from operating activities increased by 9 percent in comparison with similar period of 2004, and made up 3805.8 million soms, the balance sheet profit reduced by 2.8 times and constituted 2553.5 million soms. The main reason is that the enterprises of metallurgy industry obtained considerable income from non-operating activities in 2004.

VII. SPECIAL ISSUES

7.1. Deposit Protection System as One of Financial Stability Elements

Implementation of economic reforms in the country will be successful under conditions of stable financial and banking system. As a rule, in conducting reforms, the need of the real sector in cash increases that given the growth in savings of the population notably enhances dependence of the banking system from the behavior of existing potential depositors. Relationships with depositors have an important meaning for normal operation of the banking system, since banks' activities, mainly, depend on the volume of attracted funds. The experience shows a significant effect of even subjective factors on behavioral motivation of the bank's depositors, which in its turn may provoke massive and sudden outflow of savings from this bank, which may result in a crisis situation.

Bankruptcy of banks, apart from bankruptcies of other business entities, does not occur so often, however, they may have more dangerous consequences for the overall economy because the banking system, given its internal nature, is exposed to dangers under *domino principle*. Losses of the society resulting from bank bankruptcies, as a rule, are large scale and result in numerous and difficult to project economic and social consequences. The deposit protection system in a similar situation may be the mechanism of restraining massive withdrawal of deposits from banks (it shall be noted that it already successfully operates in many countries of the world), which will guarantee their repayment.

Implementation of the Deposit Protection System (DPS) in the Kyrgyz Republic is viewed as a prerequisite of improving confidence of the population in the banking system and is an integral element of ensuring financial stability in the country. In the meantime, we would like to caution against delusion that confidence in banks may be restored within a short term. Confidence is a fragile thing, which depends on many factors and which shall be permanently maintained. In this case, the deposit protection system is one of core components of confidence in the banking system.

There was a long-felt need to establish DPS in the Kyrgyz Republic and adopt legal framework to enforce it. The National Bank of the Kyrgyz Republic set the objective to develop an edifice and effective deposit protection system, which would consider peculiarities of Kyrgyzstan, unify other components of confidence in the banking system in a balanced manner, and would be smoothly implemented with low losses.

The draft Law *On Protection of Bank Deposits*, which was developed by the National Bank, defined major mechanisms of protecting savings of the population. Numerous types and forms of establishing deposit protection system, already used throughout the world, were considered, their viability and possibility of their adaptation in the Kyrgyz Republic were assessed in view of limited resources in the process of its development.

Provisions of the proposed draft law represent an edifice system of interconnected elements of the deposit protection system. The law defines the legal framework for forming, administering and financing deposit protection system, establishing and implementing activities of the independent Deposit Protection Agency of the Kyrgyz Republic. The objective of

establishing deposit protection system is to protect the most financially vulnerable sections of the population, irrespective of the particular operating bank, in which he/she is serviced. The problem of protecting interests of such depositors has a distinct social context, considering that small depositors, as a rule, form the main share in the overall structure of deposits in banks. In addition, the deposit protection system contributes to the stability of the financial system in the country, stimulates inflow of funds in the banking system, reduces cash turnover and increases domestic investment resources.

The deposit protection system during the period of its formation shall be with mandatory participation of commercial banks, irrespective of their size and other factors, and with limitation of the reimbursement amount (compensation amount) on the deposit. It shall be noted that the principle of voluntary joining of DPS by banks does not ensure attainment of the main goal of the draft law.

It shall be noted that the majority of countries with developed financial markets also chose the principle of compulsory participation in deposit insurance. The world practice shows that voluntary participation of commercial banks in DPS results either in participation of weak banks, or only of strong banks that, as a rule, increases the risk of emergence of the new systemic crisis in the banking system. In this case, it shall be noted that adoption of the *Law On Protection of Bank Deposits* does not hinder possible voluntary deposit insurance within the framework of Article 49 of the *Law On Banks and Banking Activity in the Kyrgyz Republic*, which envisages parallel establishment of voluntary unions of banks, and according to the *Law On Insurance Organization in the Kyrgyz Republic*.

Principal amount and interests on deposits of individuals in national and foreign currency shall be subject to protection. In this case, compensation payments on deposits of individuals in foreign currency will be made only in national currency at the official exchange rate of NBKR at the date of license revocation and in the amount not exceeding the coverage amount. Compensation on the individual's deposit will be made on the basis of the amount per depositor in each participating bank of DPS, and, in aggregate, shall not exceed Som 20 000.

Since it is assumed to implement a completely new system with mandatory participation of banks, the draft law *On Protection of Bank Deposits* set the requirement to include banks in DPS through application filing procedure. In this case, DPS has the possibility to control risks, which it takes by setting a requirement to join the deposit protection system, which may also improve the discipline of commercial banks in their compliance with requirements of legislation and standards. At the same time, newly established banks shall join the system concurrently with obtaining a banking license.

A Deposit Protection Fund (DPF), which is managed by the Deposit Protection Agency, shall serve as financial provision for deposit protection. All activities of the Agency will be aimed at assisting in prompt satisfaction of claims from individuals when a particular commercial bank is recognized to be bankrupt. According to the draft law, the initial DPF will be formed of contributions of the Government of the Kyrgyz Republic comprising fifty percent of DPF, and contributions of commercial banks (remaining fifty percent). According to the estimates made on the basis of data provided by commercial banks, the amount of initial contributions of banks will be 0.2% of the total deposit base of the bank, or 3.8% of the bank's annualized retained earnings before tax.