

**National Bank of the Kyrgyz Republic**

**BANKING SYSTEM DEVELOPMENT  
TRENDS**

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**SECOND HALF OF 2005 (8)**

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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 Kyrgyz Republic 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 July 1 in Kyrgyz, Russian and English.

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Annual Report of the NBKR is a full report on activities performed by the National Bank in the reporting year, and contains a short description of results of changes in the operation of the real sector of economy, as well as the description of decisions and actions of the National Bank in a monetary and credit spheres. The Annual Report includes information on economic development and monetary policy, financial statements, general data on the National Bank, and statistical annexes. It is published in Kyrgyz, Russian and English.

### ***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. Different materials from the National Statistics Committee, Ministry of Finance, commercial banks, State Commission for Securities Market under the Government of Kyrgyz Republic, and National Bank of the Kyrgyz Republic are used in preparing Bulletins. It is published on a monthly basis in Kyrgyz, Russian and English.

### ***Balance of Payments of the Kyrgyz Republic***

This publication reflects the recent trends in the development of the external sector and contains tables with the balance of payments data according to analytical 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.

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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***

Press Release of the NBKR contains a chronicle of events in the National Bank and the banking system of KR in general, and updated information on the financial market. It is published on a weekly basis in Kyrgyz and Russian.

### ***Statutory Acts of the National Bank of the Kyrgyz Republic***

The statutory acts of the National Bank of KR 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 per month in Kyrgyz and Russian.

All publications are disseminated according to the lists approved by the orders of the Chairperson 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 second half of the 2005 year the banking system of the country shows a sustainable growth. The overall lending to the real sector of economy is increasing, as well as the index of the financial intermediation of the banking system. At the same time, significant liquidity reserves and high level of the capital adequacy of the commercial banks indicate capacity for the further development of the banking system.

There was observed revivification at the market of deposits and banking loans, which indicates positive expectations of the banks regarding the further development of economy, and shall be considered as a factor characterizing the stability of the banking system. However, the structure of deposit base of commercial banks forms potential restrictions for the long-term crediting development. High level of Dollarization of credit portfolio and banking deposits increases vulnerability of the commercial banks from the impact of the external impact.

Positive tendencies remain also in the sector of the non-bank finance and credit institutions; in particular, the credit portfolio index continue to grow, which indicate high demand for credit resources from households, small and medium sized businesses. Nevertheless, there was observed retardation of profitability growth from the operations and activities of the non-bank finance and credit institutions, which is a consequence of high concentration of the activities of this sector's organizations in crediting of some sectors of economy and involved risks.

Stability of the banking system and the growth of the real income of community are also reflected in the sustainable growth tendency of the public deposits and crediting of the households' sector, which again indicates the growing trust to the banking system.

Non-cash turnovers continue to grow, however, the sustainable growth of the demand for money and insufficient level of development of the instruments for non-cash payments conditioned the increase of cash turnover. Nevertheless, the growth rate of cash decreased.

Therefore, the increase of sustainability of the banking system, strengthening of the capital base of commercial banks, growth of the lending to the real sector, revivification of banks at the deposit market, extension of the range and improvement of the quality of the banking and payment services are positive components for the development and growth of the economy of the Kyrgyz Republic.

\* \* \* \* \*

Section "Special Issues" offers information on implementation process of the Kyrgyz payment system modernization projects.

## I. STATUS OF THE FINANCE AND CREDIT SYSTEM

The achieved results of the second half of 2005 indicate continuing growth of activities of the finance and credit institutions<sup>1</sup>.

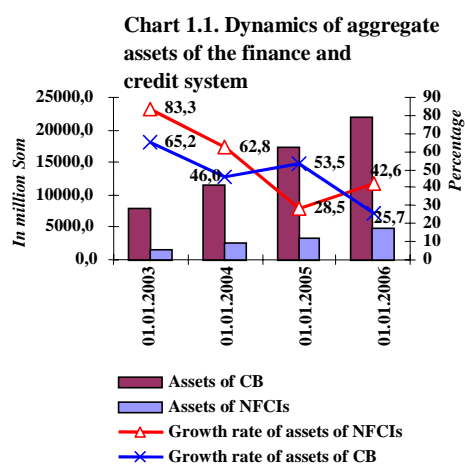
In 2005 the aggregate assets of the finance and credit system in comparison with 2004 increased for 28,4 percent, while the higher growth rate is observed at the non-bank finance and credit institutions (NFCIs).

Despite the significant extension of the range of services offered by the finance and credit institutions, still the main component of their working assets are loans.

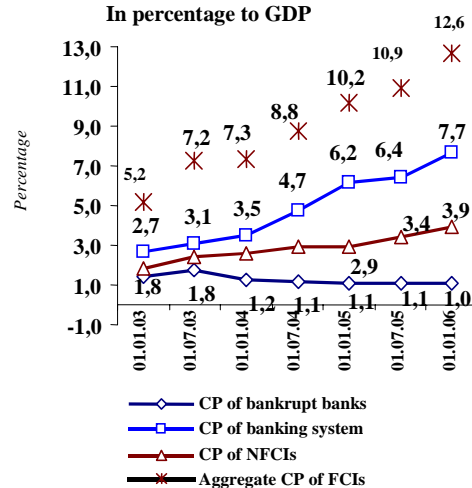
The financial intermediation indicator, defined as the ratio of the aggregate credit portfolio to gross domestic product (GDP)<sup>2</sup>, increased in comparison with the similar period of the last year and made up 12,6 percent (see chart 1.2). The noted growth of the financial intermediation level is mainly related to the growth of the credit portfolio of banking institutions. The growth rate of loans of the banking sector and NFCIs constituted 23,5 and 18,7 percent, accordingly.

The banking system continues to dominate in the financial and credit system (chart 1.3), and based on the results of the second half of 2005 its share reached 60,8 percent in the consolidated credit portfolio of the financial and credit system.

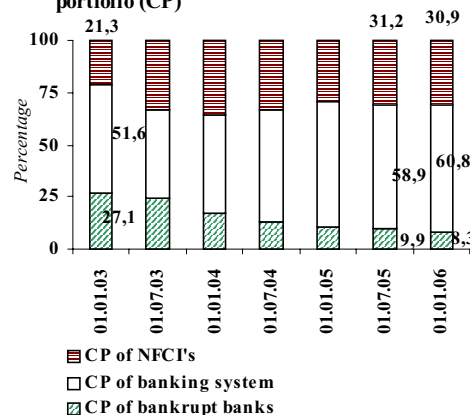
Based on the analysis of the dynamics in the ratio of allowances for loan losses (ALL) to loan portfolios of the banking system and NFCIs, some deterioration is noted in the quality of credit portfolio of NFCIs (see chart 1.4.). Therefore, the weight of ALL in credit portfolio of the commercial banks decreased from 8,3 to 7,4 percent in the second half of 2005, and in the sector of NFCIs the weight of ALL based on the results of second half of 2005 considerably increased and made up 3,2 percent.



**Chart 1.2. Dynamics of changes in credit portfolio (CP) of the finance and credit system (FCS), in percentage to GDP**



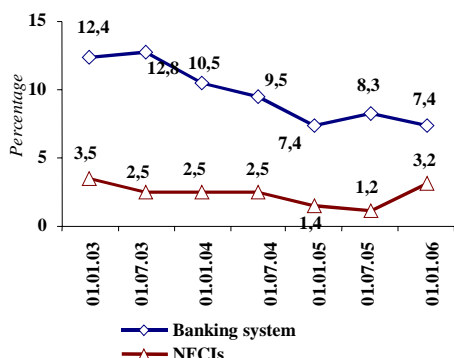
**Chart 1.3. Structure of aggregate credit portfolio (CP)**



<sup>1</sup> Indicators of the commercial banks and non-bank financial and credit institutions, licensed by NBKR, are considered here as review indicators of the financial and credit system.

<sup>2</sup> The calculations include the margin of nominal GDP for 2005.

**Chart 1.4. Volume of special ALLL in loan portfolios of banking system and NFCIs**



**Chart 1.5. "Dispersion" of average weighted interest rates of loans of various FCIs, in percentage**

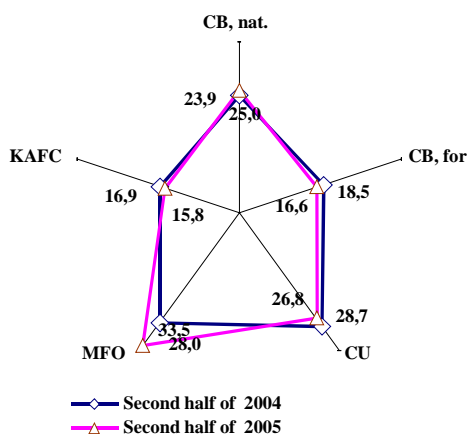


Chart 1.5 represents the so-called "rose" of average weighted interest rates of loans issued by commercial banks (in national and foreign currencies) and non-bank financial and credit institutions<sup>3</sup>, that to a certain extent gives the possibility to assess the level and direction of change in the cost of credit resources. Based on the second half of 2005, in comparison with the similar period of past year, there is a decrease of the average weighted interest rates of loans of commercial banks in foreign currency, credit unions and KAFC. The growth of the average weighted interest rate in comparison with the similar period of the past year was observed in loans of microfinance organizations, which made 5,5 percent, and loans of commercial banks in national currency for 0,9 percent.

In general, for the past several years there was observed a light decrease in the dynamics of the interest rates of loans; however, the rates still remain at quite a high level, and this limits the access to credit resources for different business subjects. This problem has a complex character and requires the development of competition at the crediting market; formation of legislative norms, which shall decrease transaction costs of lending; improvement of the reporting system and transparency requirements fulfillment by company-borrowers. It is also required to take into consideration the assessment by banks of the possible risks related to borrowers, including external risks which characterize political and economical situation in the republic.

Therefore, the status of the financial and credit system of Kyrgyzstan for the current period can be characterized by the following:

- the growth of financial intermediation indicator continued to increase, while significant growth rate of this indicator was observed in the banking system;
- overall tendency of the decrease of average weighted interest rates of loans, though insignificant;
- deterioration of some qualitative characteristics of the NFCIs credit portfolio.

<sup>3</sup> Chart 1.5. does not include average weighted rates of loans issued by pawnshops. For 2005 this indicator made 153,6%, and for 2004 - 162,1%.

## II. STATUS OF THE BANKING SYSTEM

### 2.1. Banking System Structure

The banking system of Kyrgyzstan in the second half of 2005 was represented by 19 financial and credit institutions (including the Savings and Settlements Company and a branch of the National Bank of Pakistan); among them the 14 banks have foreign participation in capital, and the 9 out of them have the foreign participation above 50%. All the banking institutions have a "universal" license.

On December 30, 2005, one more license was issued to a commercial bank with 100 percent foreign capital, which commenced its activity starting on January 2006.

In the second half of 2005 in general in the banking system was observed stable growth tendency, which changed the stagnation period of the first half of the year.

Analyses of the banking system (chart 2.1.1.) from the stand point of the market segment, occupied by "large", "medium" and "small" banks<sup>4</sup>, indicated concentration of "large" category banks. At the same time the market share of "medium" and "small" banks in the reporting period decreased.

It is necessary to note that the segment of "large" banks is represented by two banks which occupy the 75 percent of market share (out of them the 48% belong to the largest bank in Kyrgyz Republic). These banks occupy the 44,2% in aggregate assets of the banking system and 27,6% in aggregate credit portfolio, and compose the group of the main participants of the deposit market.

Chart 2.1.1. Changes of the banking system structure by banking groups

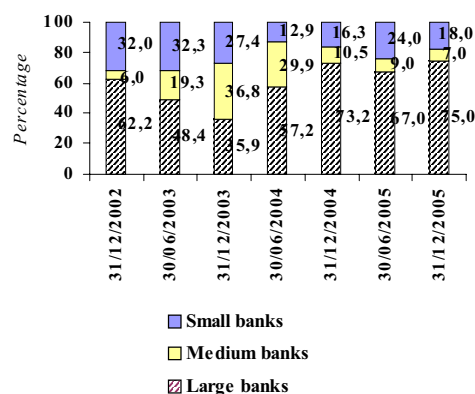
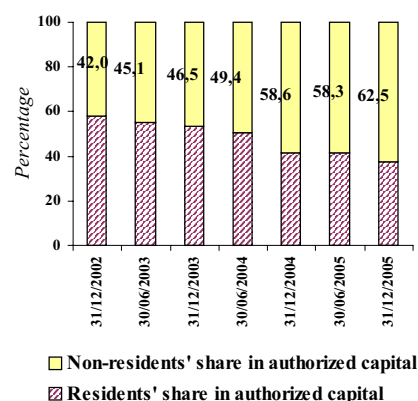


Chart 2.1.2. Change of the structure of authorized capital of banking system



<sup>4</sup> For the purposes of this analysis "large" banks shall be the banks, the share of which at the banking market (averaged weight in summary assets, loans, deposits and capital) exceed 10%, "medium" banks have between 5% to 10%, and "small" banks have less than 5%.



Chart 2.1.3. Change of banking system assets' structure

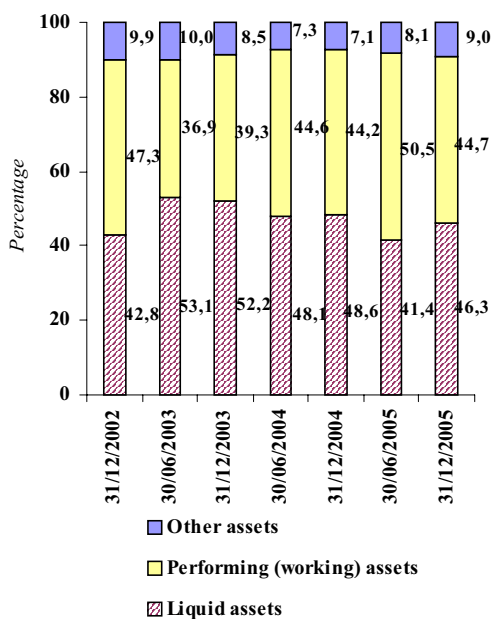
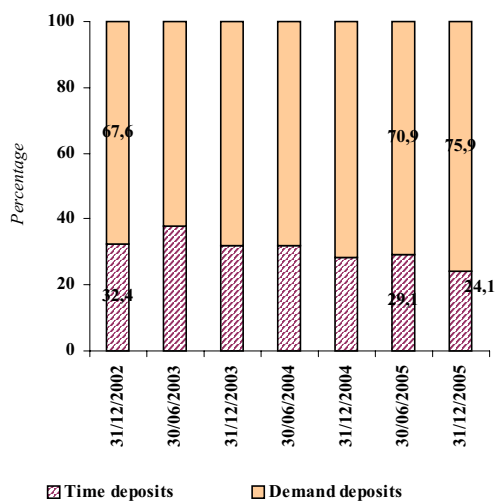


Chart 2.1.4. Change of the structure of deposits of the banking system by time period of placement



In the reported period of time the aggregate capital of the banking system increased for 23,7 percent. Such a high capital growth was related to the necessity to implement the NBKR requirements on minimal capital (own means), as well as to the extension of activities according to the strategic business plans of the banks.

The share of foreign capital in the authorized capital of commercial banks made 62,5 percent (58,3 percent based on the data of the first half of 2005, chart 2.1.2.), which is initiated by additional investments into three banks by main foreign shareholders. At the same time the overall growth rate of the authorized capital of non-residents in the reporting period made 26,1 percent, and the growth of capital from residents made 5,8 percent. The growth of foreign capital indicates a continuing integration of the banking sector to the international system of financial services, which shall positively influence the growth of the range of banking services and their quality improvement.

The growth of capital base of the banks, commensurable with the growth of assets, indicates the formation of sufficient capacity for the further development of the banking system.

The growth of assets of the banking system in the second half of 2005 made up 23,9 percent. Reviewing the change of the structure of the banking system from the point of view of aggregate assets' structure (chart 2.1.3.), we can note that for the date of reporting the 45 percent of assets are performing assets<sup>5</sup>.

At the same time, despite some decrease, the weight of liquid assets<sup>6</sup> in aggregate assets of the banking system remain at high level, which indicates capacity for the further extension of banking activity and growth of the financial intermediation.

The sustainable growth (1 percent point each six month of 2005 year) is observed for assets of "other" category, which is mainly conditioned by the growth of the volume of operations related to purchase and sale of foreign currency.

<sup>5</sup> Performing (working) assets include the residuals on the accounts of loans, deposits, securities and other placements which bring income.

<sup>6</sup> Liquid assets represent the means of the banks in cash and on correspondent accounts.

For the purposes of more detailed review of changes in the structure of performing assets, below presented are the analysis of the structure of deposit base<sup>7</sup>, as the main source of placed resources, as well as the changes in the credit portfolio, as the main type of banking placement.

In the second half of 2005 continued the growth of deposit base of the banking system, its growth in the reviewed period of time made up 27,6 percent. In the structure of deposits the share of deposits of natural persons did not change and for the reporting date made up 20,5 percent.

Up to 60,6 percent increased the weight of demand deposits of legal entities (54,8 percent for the first six months of the year), at the same time the time deposits of legal entities decreased for 5,1 percent, and as of December 31, 2005 made up 11,8 percent of the whole deposit base. The increase of demand deposits (chart 2.1.4.) is a positive factor from the point of view of the growth of earnings from the current activities; however, on the other hand, this significantly limits the possibilities of the banks to increase the medium term and long term economy financing.

The level of "dollarization" of the deposit base of the banking system (chart 2.1.5.) made up 73,0 percent and is the largest indicator for the past three years. At the same time the level of dollarization of deposits of the legal entity as of the date of reporting made up 79,2 percent. High level of "dollarization" of deposits predetermines the vulnerability of activities of the commercial banks from the impact of external factors.

Aggregate *credit portfolio of the banking system* in the second half of 2005 increased for 23,8 percent. Significant share of deposits in foreign currency characterizes also the structure of the credit portfolio of the banking system, where the significant share is comprized of loans in foreign currency (71,5 percent as of the end of reviewed period, chart 2.1.6.).

There was noted a growth of long-term loans<sup>8</sup>: their weight in the second half of 2005 increased from 30,4 to 34,9 percent, and in absolute expression the growth made up 38,7 percent, that can be reviewed as one of the stabilization factors of economy. Significant specific weight still occupied by loans issued for less than one year maturity (65,1 percent), though their weight slightly decreased (see chart 2.1.7).

Chart 2.1.5. Change of the structure of deposits of banking system by currencies

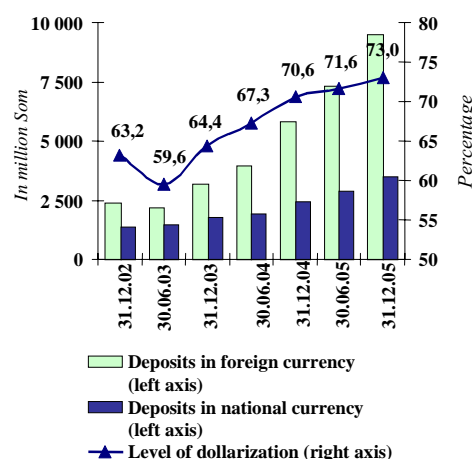


Chart 2.1.6. Change of the structure of the credit portfolio of the banking system by currencies

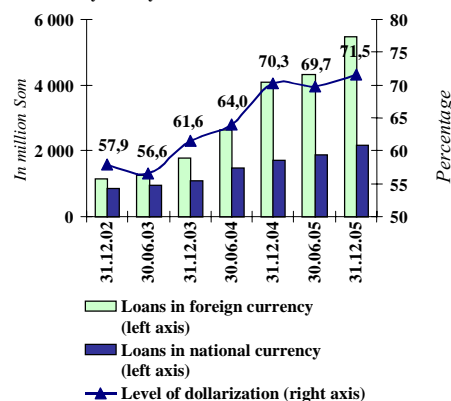
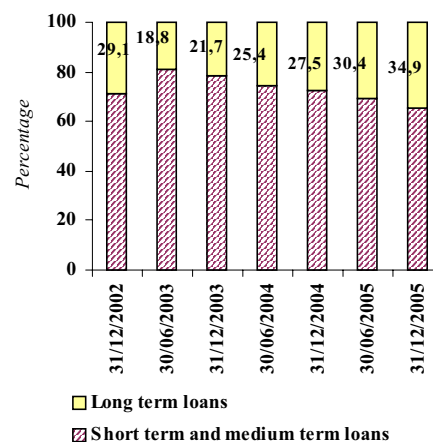


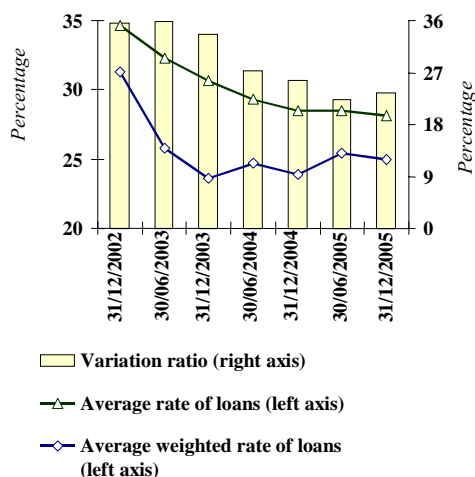
Chart 2.1.7. Change of the structure of the credit portfolio of banking system by time term of placement



<sup>7</sup> Deposit base includes the deposits of natural persons and legal entities, as well as the deposits of the Government and other branches of power.

<sup>8</sup> Long-term loans are the loans issued for more than 1 year time period.

**Chart 2.1.8. Change of characteristics of interest rate of loans in national currency (in percentage)**



For the purpose of assessment of current interest rates of loans the following characteristics were reviewed: variation ratio of interest rates of loans, average and average weighted rates of loans.

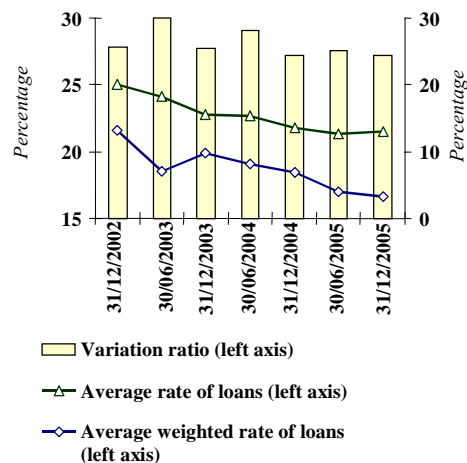
Therefore, the positive factors include: (1) continuing tendency of decrease of the average rates of loans both in foreign and national currencies; (2) the rate of decrease of the variation ratio indicates the decrease of the scatter of interest rates at the loan market and testifies the growth of competition in this segment of banking activities.

Besides, the average weighted rate of loans issued both in foreign and national currencies remain below the average rate, which testifies excess of lending on rates below average over the lending with higher rates (charts 2.1.8, 2.1.9).

Therefore, in the banking sector in the second half of 2005 there were observed the following tendencies:

- significant growth of capitalization of the banking system;
- revivification at the deposit market and, as a result, the revivification of the growth of the credit portfolio and assets in general;
- continuation of the high level of "dollarization" of the deposit base of the banking system under high share of demand deposits;
- continuing growth of the specific weight of the long-term loans in credit portfolio of clients;
- continuing decrease of the average interest rates of loans, initiated by the competition growth at the credit market.

**Chart 2.1.9. Change of characteristics of the interest rate of loans in foreign currency (in percentage)**



## 2.2. Risks

### 2.2.1. Credit Risk

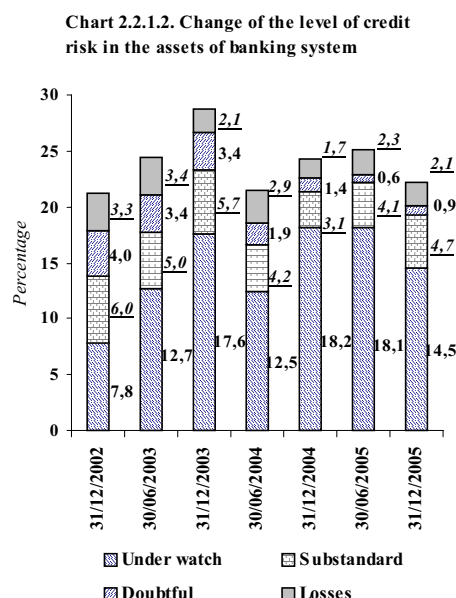
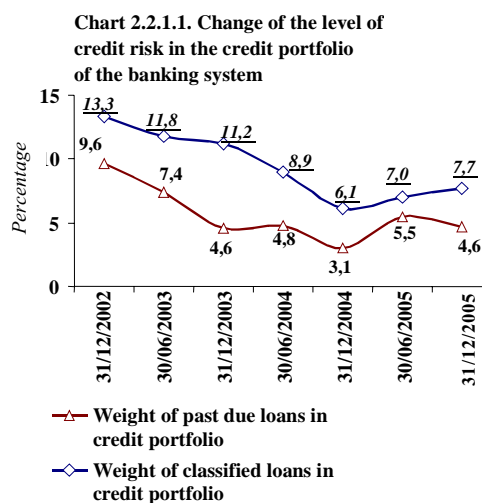
Credit Risk is one of the main risks inherent to banking activity. This section reviews the active operations of banks with credit risk.

For the assessment of the *credit portfolio quality*, the commercial banks use the classification system of loans<sup>9</sup>, which gives an opportunity to evaluate in advance possible potential losses from non-payment of loans, and compensate them in time (to minimize negative impact on capital) by forming proper reserves.

Analysis of the credit portfolio quality gives largest attention to the non-performing and past due loans, which reflect the first signs of deterioration of credit portfolio quality. In the second half of 2005 there was observed the growth of non-performing loans, while the share of past due loans in credit portfolio decreased (chart 2.2.1.1.). This dynamics testifies that for assessment of the loan quality and financial status of borrowers, in addition to quantitative, the banks use also the qualitative characteristics (changes in the external environment of borrowers, related to the events occurred in March of 2005). At the same time, despite some deterioration of the qualitative characteristics of the credit portfolio of the banking system in the reviewed period of time, the risk of non-payment remains at the tolerance level.

As one of the factors which can influence the growth/decrease of the credit risk in future can be used the change of the weight of loans classified as loans "under watch". Though the specific weight of such loans in the second half of 2005 significantly decreased (see chart 2.2.1.2), they remain to occupy significant share of the total credit portfolio (14,5 percent).

As of December 31, 2005, the banks formed reserves adequate to loan classification. At the same time the volume of special reserves formed for classified loans to this category of loans made up 49,1 percent, that testifies a conservative approach of commercial banks to the issue of evaluation of possible loan losses.



<sup>9</sup> For the purposes of evaluation of credit portfolio quality it was decided to use the six loan categories depending on current possibilities of the client to fulfill its liabilities to the bank (listed in order of deterioration of classification): normal, satisfactory, under watch/supervision, substandard, doubtful and losses. The loans of the last three categories, which have the most negative characteristics from the point of repayment of issued means, are referred as "non-performing" or "classified" loans. For each of six indicated categories the bank is obliged to form relevant to each category reserves, determined as percentage of the past due sum of issued loans.

Chart 2.2.1.3. Change of the weight of "net" loans

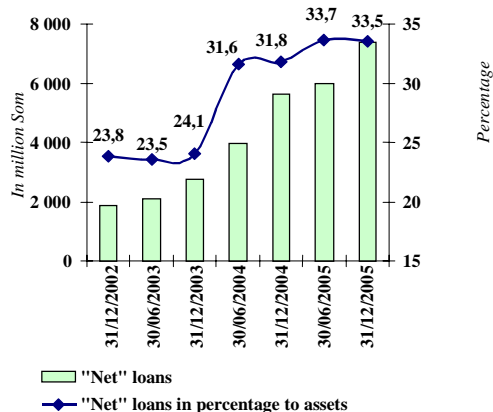


Chart 2.2.2.1. Dynamics of change of current liquidity ratio

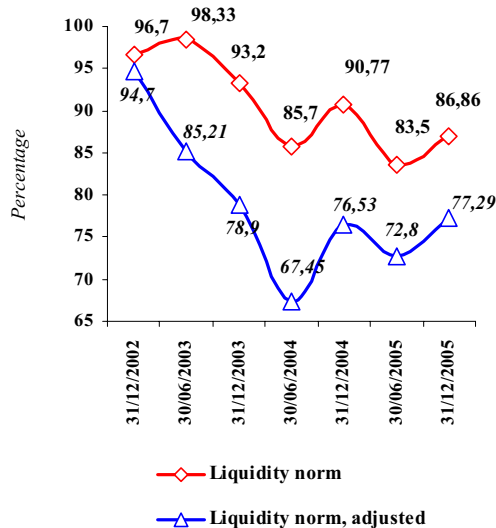
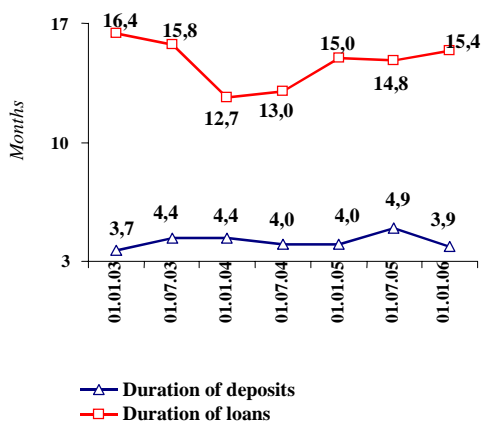


Chart 2.2.2.2. Dynamics of change of the duration of loans and deposits of the banking system



Therefore, in general the level of credit risk remains at tolerable level, however, there are reasons which in future can raise the growth of indices characterizing this risk.

By the end of the second half of 2005 the specific weight of "net" credit portfolio (residuals of loan debt of loans of the clients less formed special reserves for possible losses of classified loans) made up 33,5% of aggregate assets of the banking system, decreased in comparison with the middle of the year data (for 0,2 percent). This change was mainly influenced not by the deterioration of the credit portfolio quality, but by reduction in the first half of the year of quasi-active operations by one bank (operations with correspondent accounts) and, correspondingly, by growth of the specific weight of other bank placements in aggregate assets.

### 2.2.2. Liquidity Risk

Trust of community to the banking system depends on timely fulfillment of liabilities by the banks, which assumes sufficient liquidity level at banks. For the regulatory purposes the risk of liquidity shall be assessed with the help of the economic norm of current liquidity<sup>10</sup>.

The factual liquidity norm, supported by the banking system, remains quite high. In the end of the second half of 2005, in average the banking system's weight of this norm made up 86,9 percent, i.e. increased in comparison with the past period for 3,4 percent. Significant influence on final index was caused by increased liquidity level of one commercial bank, which is specialized on quasi-active operations (operations with correspondent accounts). Without such bank the current liquidity as of the end of reviewed period made up 77,3 percent.

The excess of factual liquidity above the determined norm also testifies capacity to extend the financial intermediation on the one hand, and on the other hand reflects low assessment of stability of the deposit base made by commercial banks.

Low assessment of the stability of deposits confirmed by the data on changed duration of deposits and loans, as well as calculation of the stability ratio of financial assets<sup>11</sup>.

Within the reviewed time period (see chart 2.2.2.2.) the gap between the average maturity term of attracted deposits and loan placement remain high, which testifies hidden disintermediation<sup>12</sup> risks, which can raise at the banks in the process of liquidity management in time.

<sup>10</sup> Economic liquidity ratio - one of the mandatory ratios for execution by a bank, and established by NBKR at the level of no less than 30 percent.

<sup>11</sup> Stability ratio for financial asset sources is characterized by a portion of time deposits in the total amount of banking system deposits.

<sup>12</sup> Disintermediation is a process of mass withdrawal of deposits by public before the agreed maturity term as a result of a panic initiated by the escalation of inflation expectations and/or other negative expectations.

Chart 2.2.2.3. represents the change of stability ratio of sources of financial assets in comparison with the dynamics of changing correlation of deposit base to "net" credit portfolio. Low share of time deposits (24,1 percent as of December 31, inclusively) in the deposit base will influence the volume of placements and complicate the process of liquidity management in future.

Dynamics of correlation of deposits and loans also testifies the reduction of efficiency of the use of attracted funds.

In general, it is possible to conclude that at present there are no grounds for lack of means in the banking system for fulfillment of liabilities. However, instability of attracted resources influences the difficulties in the process of liquidity management in time, growth of the volume of credit portfolio and, on the whole, reduction of earnings of assets.

### 2.2.3. Concentration Risk

*Features of deposit concentration.* As it is seen in chart 2.2.3.1, in the second half of 2005 is observed the increase of average deposit concentration in the banking system, as well as the increase of the maximum share of one bank at the deposit market. The main influence on change of these indicators was provided by significant growth of deposits in two commercial banks, that, in its turn, related to attraction of demand deposits by foreign finance and credit institutions at one bank and placement of a large time deposit at another bank. In both cases involved bank transactions in foreign currency, and within these time periods we observe the growth of concentration of this category of deposits (see chart 2.2.3.2).

Without deposits of these banks the concentration of deposit market among the participants<sup>13</sup> is low (more than 10 participants) and within the three past years remained approximately at the same level.

Chart 2.2.2.3. Assessment of liquidity factors of the banking system

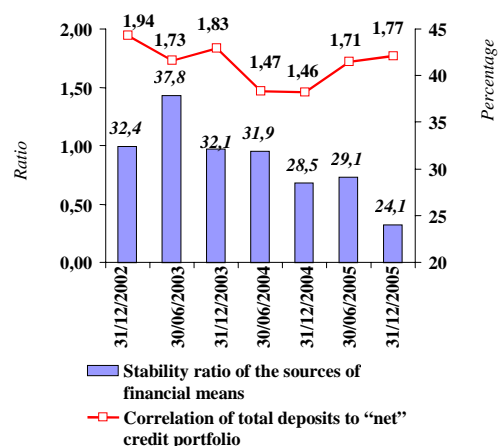
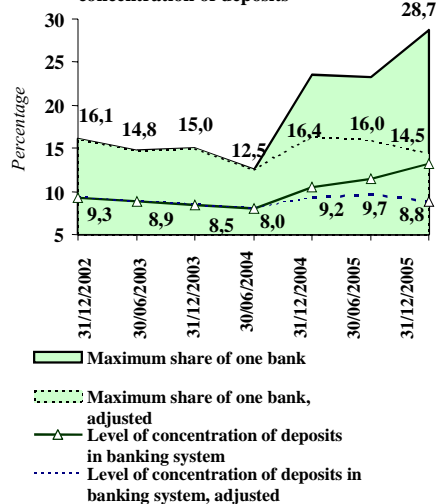


Chart 2.2.3.1. Change of the concentration of deposits



<sup>13</sup> The evaluation of concentration risk as "high", "medium" and "low" are based on generally accepted gradation of the concentration level. Therefore, the concentration risk shall be considered "low" if the level of concentration below 10 percent, "medium" risk shall be between 10 to 20 percent, and "high" risk is above 20 percent. For example, the concentration index of 50 percent is equal to participation at market of two participants with equal shares, 3 participants with 33 percent share each, and so forth.



Chart 2.2.3.2. Concentration of deposits by currencies

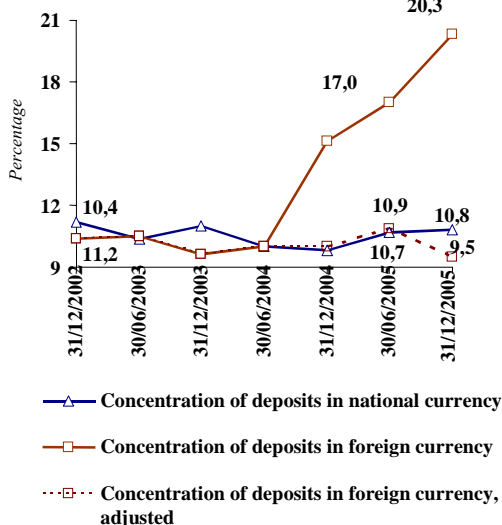


Chart 2.2.3.3. Change of the loan concentration

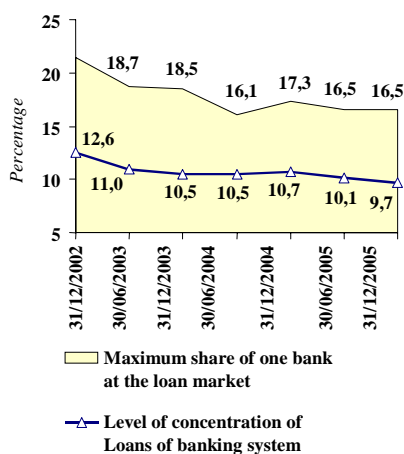
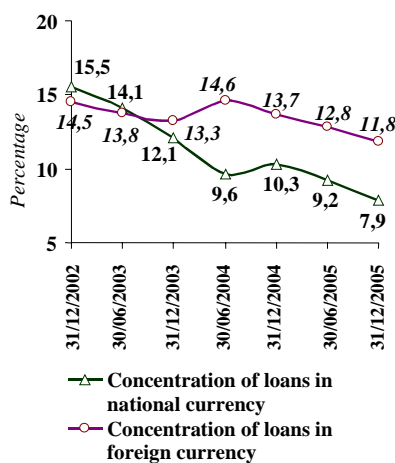


Chart 2.2.3.4. Concentration of loans by currencies



Assessment of the concentration level in the banking system with the help of another indicator: "a share of four large banks by the level of deposits" in the second half of 2005 also indicates the increase of deposit concentration from 58,4 to 59,6 percent. At the same time, from the point of view of composition, the position of first three banks remained practically unchanged.

*Features of loan concentration.* The growth of credit portfolio of the banking system in 2004-2005 years 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.).

Regarding the indicator of "share of four large banks" from the point of view of loan concentration we can conclude that within the reviewed period of time it reduced (for 3,1 percent), and made up 51,2 percent. The composition of banks somewhat changed, because the banks which occupy from the third to sixth positions by specific weight in aggregate credit portfolio have practically equal participation share.

The special peculiarity of indicators "four largest banks by level of deposits" and "four largest banks by level of loans" is that the first two places are occupied by the same banks.

The reduction dynamics of the loan concentration indicator by currency indicates competition growth among the banks regarding the lending in national and foreign currencies (see chart 2.2.3.4.).

Analysis of the risk of loan concentration by sectors of the national economy remain the assessment of loan concentration by all sectors, from "moderate" to "high".

Based on data of tables 2.2.3.5 and 2.2.3.6, it is possible to note some revivification of banks' activities in the sectors of industry, mortgage, construction, and loans issued to private sector. High concentration of loans issued for communication, transportation and social services is conditioned by lack of interest to these sectors by banks and this is confirmed by low weight of loans in the total credit portfolio of the banking system.

Therefore, the banking system of Kyrgyz Republic in general has "moderate" concentration of deposits and loans by currencies and sectors. Some misbalance of concentration indicators by market participants initiated increase in the short-term period by performance of two commercial banks. This performance is not accompanied by any changes in the dynamics of interest rates due to (1) attraction of significant resources at the international inter-bank deposit market and (2) low supply with credit resources of the national economy.

**Table 2.2.3.5. Concentration of banking activities by crediting the segments of national economy (in percentage)\*.**

	30/06/2003	31/12/2003	30/06/2004	31/12/2004	30/06/2005	31/12/2005	Deviation (In percentage)
Industry	13,7	17,1	19,1	20,8	21,8	17,0	<b>-4,8</b>
Agriculture	39,9	29,2	29,1	25,9	21,6	21,0	<b>-0,6</b>
Transportation	33,2	31,2	45,6	31,9	26,8	32,5	5,7
Communication	62,6	26,9	37,2	34,7	38,9	51,2	<b><u>12,3</u></b>
Trade	12,3	13,4	11	12	11	10,7	<b>-0,3</b>
Processing industry	27,9	19,7	25,2	28,8	25,9	27,9	2,0
Construction	17,8	23,7	33,6	28,8	31,1	26,8	<b>-4,3</b>
Mortgage	61,6	27,7	21,7	16,3	12,3	14,7	<b><u>2,4</u></b>
Households	45,8	13,4	15,6	16	23,2	21,4	<b>-1,8</b>
Social services	16,6	67,7	71	44,3	34,1	30,6	<b>-3,5</b>
Other	12	12,5	12,2	13,6	13,3	14,6	1,3

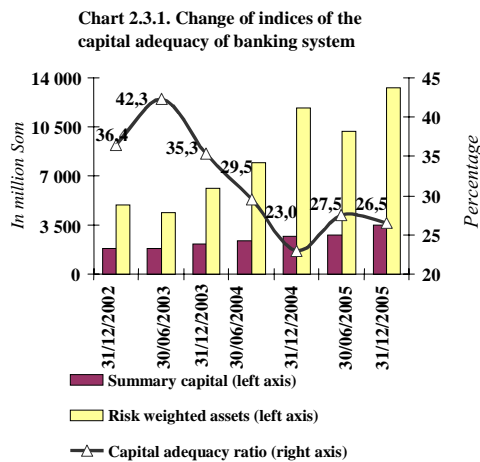
**Table 2.2.3.6. Structure of credit portfolios of the banks by national economy sectors\***

	30/06/2003	31/12/2003	30/06/2004	31/12/2004	30/06/2005	31/12/2005	Deviation (In percentage)
Industry	21,1	21,7	21,5	20,5	18,8	17,3	<b>-1,5</b>
Agriculture	2,8	2,8	2,4	2,0	1,9	2,0	0,1
Transportation	1,7	1,5	1,5	1,2	1,3	0,8	-0,5
Communication	1,8	1,8	1,6	0,6	0,5	0,4	-0,1
Trade	38,1	39,2	39,4	46,6	44,5	42,9	<b>-1,6</b>
Procurement and processing	2,5	2,4	1,4	1,3	1,0	0,9	-0,1
Construction	2,6	2,8	5,9	4,9	6,3	6,1	-0,2
Mortgage	2,0	3,1	3,9	4,9	5,4	7,0	<b><u>1,7</u></b>
Households	4,6	7,3	8,3	8,0	8,2	8,0	-0,2
Social services	0,0	0,0	0,0	0,3	0,2	0,2	0,0
Other	22,8	17,3	14,1	9,8	12,0	14,5	<b><u>2,5</u></b>

\* 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 lending to the sector. A concentration index equaling to 100% means complete monopolization of the certain market segment, 50% - 2 participants with equal shares, 33% - 3 participants, and so on.



### 2.3. Capital Adequacy



Eventually, all the risks inherent to the banking activity influence the financial results of banking activity (already represented as direct losses or existent high probability to cause expenses through allocation of reserves) and influence own means of the bank, i.e. its capital. That is why the size of capital characterizes the bank's sustainability to present and future negative changes in external and internal environment.

When conducting analysis of the financial status of the bank, the main characteristic of its soundness is the compliance of its capital to the scale and nature of transactions (capital adequacy ratio). Sufficient capital forms a "safety cushion" which permits the bank to remain solvent and maintain public confidence.

Due to this the bank's policy for capitalization shall be directed to maintain the capital sufficient to cover losses raised by this or that banking risks.

Under established minimal weight of capital adequacy norm at 12,0 percent, the average capital adequacy level of the banking system remains quite high and as of December 31, 2005, inclusively, made up 26,5 percent (see chart 2.3.1). As it is seen in this chart, the main factors of change of the capital adequacy index for the past three years were high growth rate of risk-weighted assets, which was initiated by significant increase of lending to economy.

At the same time the factual capital adequacy level (26,5 percent) permits additionally increase the weight of risk and income-bearing assets for more than two times without violating the allowable risk level in the overall operation of the banking system.

Aforesaid testifies sustainability of the banking system to negative shocks at present. Besides, there exists a capacity for extension of financial intermediation and efficiency increase in future.

## 2.4. Financial Results

Return on assets is the main indicator of banking activity profitability, determined as correlation of obtained earnings to average assets.

The banking system of Kyrgyz Republic for 2005 reached 2,6 percent of asset earnings in annual computation (2,5 percent based on last year results).

However, due to low indices of earnings of an individual bank and its significant influence on aggregate indices, the further analysis of earnings are based on the data of the banking system without the data of this particular bank (table 2.4.1).

As it is seen in table 2.4.1., the annual average return on assets of the banking system made up 3,3 percent, somewhat decreased in comparison with the results of 2004 year.

The main reason of reduction of total earnings is the reduction of the "net" interest margin<sup>14</sup>, which was influenced by expense growth for reserves allocation (ALLL), under invariable interest income and interest expenses.

Besides, it is required to consider the continuing growth of assets, in particular of credit portfolio, as well as maintenance of interest rates' size in the reviewed period of time. The reason of the lack of changes is mainly the deterioration of the quality of a part of credit portfolio by the middle of year (due to the events of March 2005) and, correspondingly, the suspension of the growth of interest income, which is also testified by earnings of credit portfolio, determined as correlation of interest income to loans by average residuals of debts (in annual computation). This indicator for 2005 made up 20,7 percent, by having reduced for 0,7 percent in comparison with 2004 year (chart 2.4.2.).

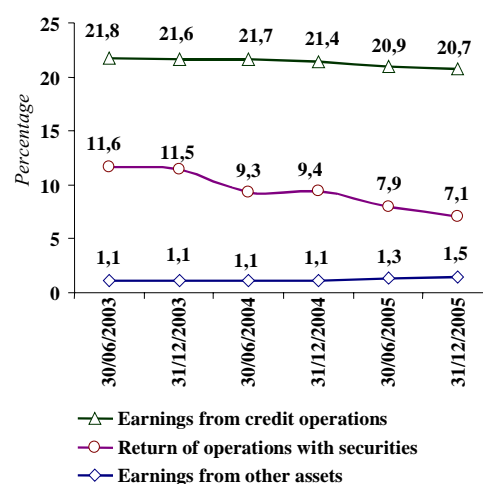
Despite the significant growth of deposits in 2005 year, the interest expenses remained at the level of previous year due to prevailing growth of demand deposits.

In 2005 there was observed a tendency for decrease of non-interest income, which made up 6,7 percent of average assets. The reduction of this correlation for 1,3 percent is the result of reduction in summary income of specific weight of bank earnings from rendered services, transactions with foreign currencies and commissions. In reviewed period the reduction of non-interest income was one of the reasons of reduction of the total earnings of assets.

Table 2.4.1. Main earning indices of the banking system (in percentage)

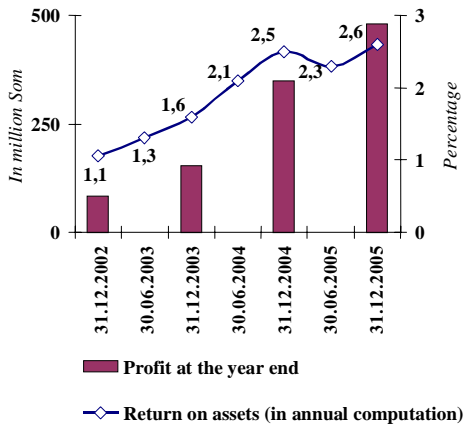
	31.12.2003	31.12.2004	31.12.2005
<b>Income and expense items as % of average assets</b>			
Interest income	9,0	10,2	10,4
- including interest income of loans	7,1	8,8	9,1
Interest expenses	2,3	2,6	2,6
-including interest expense on deposits	1,8	1,7	1,6
<b>Net interest income</b>	<b>6,7</b>	<b>7,6</b>	<b>7,7</b>
Allocations to ALLL on loans	1,2	0,8	1,1
<b>Net interest income after allocations to ALLL</b>	<b>5,5</b>	<b>6,8</b>	<b>6,7</b>
Non-interest income	9,8	8,0	6,7
Non-interest expense	0,6	0,5	0,6
Operational expenses	11,3	9,9	8,6
-including personnel expenses	4,9	4,6	4,3
<b>Net income (losses) before taxation</b>	<b>3,4</b>	<b>4,3</b>	<b>4,1</b>
Allocations to ALLL on non-credit operations	0,5	0,1	0,0
Profit tax	0,6	0,8	0,8
<b>Net profit (losses)</b>	<b>2,4</b>	<b>3,5</b>	<b>3,3</b>
<b>Interest expense as % of average liabilities</b>			
	3,2	3,3	3,2
<b>SPREAD of interest income and expenses</b>	<b>5,8</b>	<b>6,9</b>	<b>7,2</b>

Chart 2.4.2. Earnings indicators of some operations



<sup>14</sup> "Net" interest margin is the correlation of net interest income (difference between interest income and interest expenses) to average assets for the reviewed period of time.

Chart 2.4.3. Change of earnings on assets



In 2005 was observed significant reduction of the operational expenses of the bank, which, in comparison with the beginning of year, reduced for 1,3 percent. At the same time, regardless such reduction, operational expenses continue remain higher than the non-interest income (for 2,5 percent), which also influences the reduction of the total index of earnings of assets.

As a feature of increased efficiency of the financial intermediation function between investors and a real sector, provided by the banking system, we can review the *interest income spread*<sup>15</sup> (table 2.4.1.). Therefore, the growth of lending and income from lending under relatively invariable level of expenses in 2005 caused the growth of this indicator in the reviewed period of time.

Thus, in absolute expression the net profit of the banking system for 2005 made 480 million Som, that is for 37,1 percent higher of the total profit earned by the banks a year before (for 2004 year in total 350,1 million Som).

Correlation of summary assets to number of personnel increased from 4,5 million Som to 4,9 million Som per one employee, that is with the consideration of high earnings indices testify increased efficiency of the banking personnel.

Therefore, the income indicators of the banking sphere in total show positive dynamics and growth of the banking system for additional investments. At the same time, high average weight of capital adequacy norm testifies that the banks may extend their active operations. On the other hand, the efficiency of the use of assets can be significantly improved by reducing low income-earning assets.

<sup>15</sup> *Interest income 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. Indices of the Financial Intermediation

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

In the second half of 2005 there was observed the revivification of operations of the commercial banks in comparison with the situation of the first half of the year. The growth rate quite commensurate with the growth rate of similar period of the previous year.

As of December 31, 2005, inclusively, the correlation of the volume of deposits<sup>16</sup> to GDP<sup>17</sup> made up 13,0 percent (based on the results of the first half of the year its weight made up 10,5 percent). The growth of this index is conditioned by continuing higher growth rate of the volume of deposits in the reviewed period. Therefore, the overall increase of deposits in the second half of the year of 2005 made up 27,6 percent, similar growth rate was observed for deposits of legal entities and deposits of natural persons.

The increase in the ratio of deposits placed with commercial banks to monetary aggregates outside them (M0) continued and indicated the level of public confidence in the banking system. As of date of reporting this index made 116,9 percent (as of the end of 2004 it made up 73,4 percent, and 90,4 percent for the first half of the 2005 year).

After the slowing of the growth of the credit portfolio of commercial banks in the first half of 2005, we observe its sustainable growth in the reviewed period, while the growth rate is commensurable to the growth rate of the volume of deposits. Within the last six months of 2005 the aggregate credit portfolio of commercial banks increased for 23,8 percent.

The share of the total volume of issued loans to GDP as of December 31, 2005 inclusively, made up 7,7 percent, and increased in comparison with the data as of the first half of 2005 for 1,3 percent.

Chart 2.5.1. Dynamics of the weight of deposits and correlation of deposits to GDP

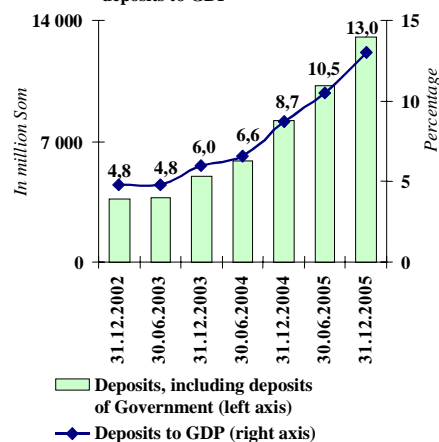
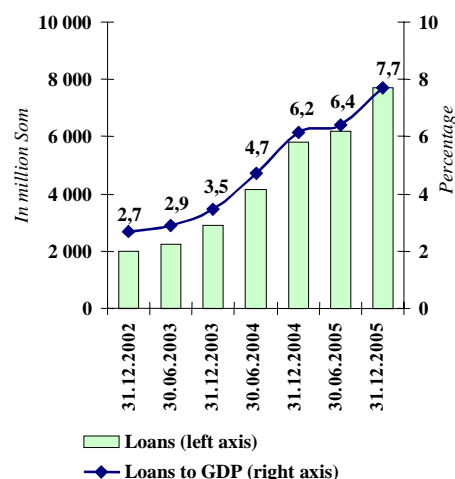


Chart 2.5.2. Dynamics of the volume of loans and correlation of loans to GDP



<sup>16</sup> In this section deposits imply deposits of natural persons, legal entities, Government and other public authorities of Kyrgyz Republic.

<sup>17</sup> Calculations include the data of nominal GDP for the past 12 months.

Chart 2.5.3. Dynamics of the change of correlation of loans and deposits

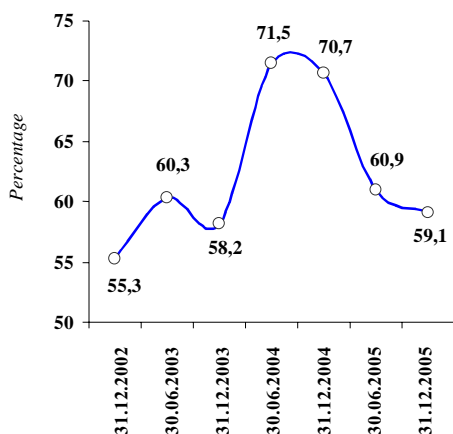
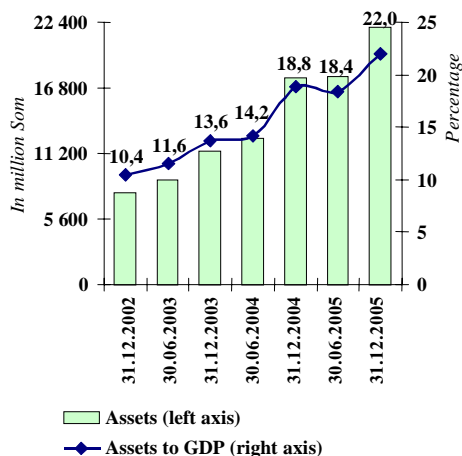


Chart 2.5.4. Dynamics of volume of assets and correlation of assets to GDP



Reviewing the flows of issued loans it is necessary to note that the size of issued loans in the second half of 2005 year made 6,6 billion Som, which is for 37,1 percent more than the size of loans issued in the similar period of 2004 year.

In the structure of loans in comparison with the similar period of 2004, the largest growth of lending was observed in construction sector (2,1 times more or for 0,3 billion Som) and trade (by 11,0 percent or for 0,3 billion Som). Also, there was observed the growth of mortgage against the pledge of real property (by 52,8 percent or for 0,1 million Som).

The correlation of loans to deposits made up 59,1 percent against 60,9 percent as of the first half of the year of 2005, related to demand deposit growth in the total volume of deposits.

While the average weighted interest rates in national currency increase for 1 percent in comparison with the rate as of the end of past year, up to 25 percent, the average weighted interest rates on newly issued loans in foreign currency practically remained unchanged and in December of 2005 made up 16,2 percent.

Reviewing the financial results of commercial banks it is required to note that the correlation of "net" interest income to average monthly level of the bank assets, on which interest is paid, on the whole of banking system<sup>18</sup> (annual) as of December 31, 2005 inclusively, made up 6,0 percent. Based on 2004 results this index made 5,4 percent, which testifies the growth of earnings from lending operations in Kyrgyz Republic.

The growth of correlation of "net" interest income to average assets of commercial banks is initiated by reduction of costs per issued loan, due to significant increase of loans and, correspondingly, interest income. However, on the other hand, this slows down the development of economy, because, despite the growth of income from lending operations the banks are not reducing their interest rates. Such situation testifies insufficient loan supply at the market, or high demand for loans. This assumes insufficient competition at the credit market, and is a result of low transparency of business subjects, imperfection of legislation and judicial system.

Dynamics of the above indicated indices shows the growth of earnings of the banking system, and relative safety of the banking system from the risk of change of interest rates.

From the point of view of financial intermediation, it is necessary to acknowledge the growth of correlation ratio of summary assets to GDP. As of December 31, 2005, this correlation made up 17,6 percent (18,4 percent for the first half of the year, and 18,8 percent in the end of 2004).

<sup>18</sup> Calculations are made taking into account the data on average performing assets and liabilities of commercial banks.

Taking into consideration that despite the sustainable growth within the last two-three years, the majority of indices of the financial penetration and intermediation have comparatively low weights, and the capacity for further development and increase of efficiency of the banking system remains. This is proved by sufficiently high capital adequacy ratio of the banking system, which by the end of 2005 constituted 26,5 percent.

The assessment of banking risks indicated that in the short-term period no significant changes are envisaged for the banking system. According to the current dynamics of development for the past years, as well as in compliance with the plans of commercial banks themselves, it is assumed that the banking system will continue influence the national economy.

However, there is a possibility of negative influence on overall deterioration of the financial status by a number of large borrowers (mainly from trade sphere) due to the events of March 2005 and growth of the non-repayment risk on these loans. At the same time, as analysis show, these losses shall not lead to significant deterioration of the financial status of the system on the whole.

### III. NON-BANK FINANCE AND CREDIT INSTITUTIONS

Chart 3.1.1. Dynamics of aggregate assets of NFCIs for 2003-2005 years

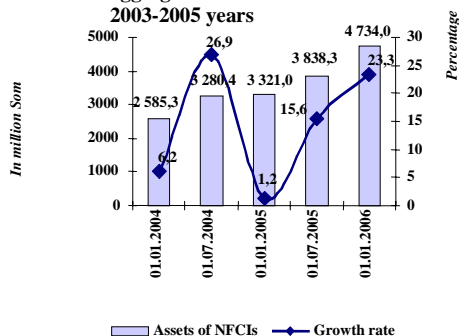
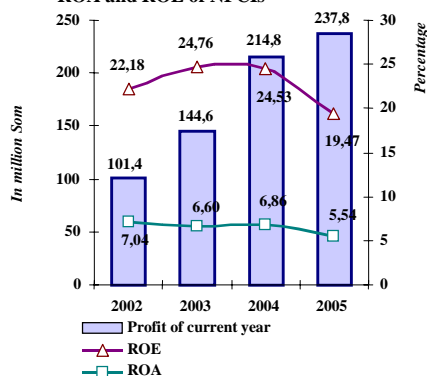


Chart 3.1.2 Dynamics of indices of ROA and ROE of NFCIs



#### 3.1. Status of the System of Non-bank and Credit Institutions

The system of the non-bank finance and credit institutions (NFCIs) is comprised of the following institutions to be regulated and supervised by NBKR:

- specialized finance and credit institutions: Kyrgyz Agricultural Financial Corporation (KAFC), Finance Company for Support and Development of Credit Unions (FCSDCU);
- credit unions (CUs);
- microfinance organizations (MFO), including microcredit companies (MCC) and microcredit agencies (MCA);
- pawn-shops;
- exchange offices.

Each year is observed a growth of the number of non-bank finance and credit institutions (table 3.1.1.), and this demonstrates the need in services and flexibility of offered by the state regulatory framework.

Table 3.1.1. Dynamics of the number of non-banking finance and credit institutions

Name	2002	2003	2004	2005
KAFC	1	1	1	1
FCSDCU	1	1	1	1
Microfinance organizations (MCA and MCC)	0	72	104	136
Credit unions	349	303	305	320
Lombards (pawn-shops)	85	108	116	140
Exchange offices	234	261	266	260

According to the presented regulatory reports, in 2005 the aggregate assets of NFCIs (chart 3.1.1) increased for 42,6 percent and as of December 31, 2005, made 4 734,0 million Som. At the same time the growth rate of own capital of NFCIs were lower than the growth rate of assets and made 28,5 percent, and aggregate liabilities of the NFCIs increased for 48,4 percent.

In 2005 in the system of NFCIs the growth rate of assets and capital significantly exceeded the growth rate of profit, the volume of which in 2005 in comparison with 2004 increased from 214,8 million Som to 237,8 million Som, or for 10,7 percent.

As a result of the above presented circumstances, some reduction of return on assets (ROA) and return on equity (ROE) was observed (chart 3.1.2.).

### 3.2. Structure and Dynamics of Credit Portfolio

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

In the reviewed year, in comparison with the previous year, the share of credit portfolio in aggregate assets of NFCIs reduced from 83,5 percent (as of December 31, 2004) to 82,9 percent (as of December 31, 2005).

For 2005 year the aggregate credit portfolio of NFCIs increased for 1150,1 million Som or by 41,5 percent, and as of December 31, 2005 made up 3922,2 million Som, and the number of active borrowers increased by 13,1 thousand borrowers or by 12,9 percent, and made 115,9 thousand.

It is necessary to note that the share of credit portfolio in the assets of NFCIs for the past two years, as a rule, was growing in the first six months and reduced by the end of the second half of the year. Such cyclical dynamics was the result of seasonal character of activities of the majority of NFCIs and dominating agricultural business of borrowers.

In general, the credit portfolio of NFCIs for the several past years (chart 3.2.1.) has a stable tendency to grow.

In the structure of aggregate credit portfolio of non-bank finance and credit institutions (chart 3.2.2.), the 46,9 percent are the loans of KAFC, the 37,9 percent are loans of microfinance organizations, the 0,4 percent are loans disbursed by pawn-shops and 14,8 percent are loans issued by credit unions; at the same time, the loans received by CU from the FCSDCU made 49,5 percent of their summary credit portfolio.

By oblasts (chart 3.2.3.) the main share of the credit portfolio covers Osh, Jalalabat, Issyk-Kul, Chui oblasts and Bishkek city.

Chart 3.2.1. Dynamics of credit portfolio of NFCIs for 2004-2005 years

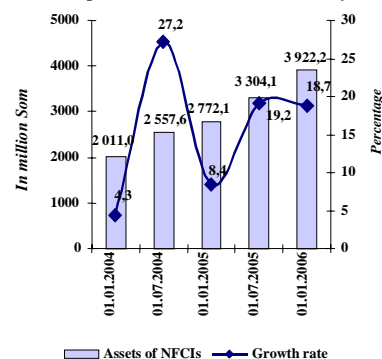


Chart 3.2.2. Aggregate credit portfolio by NFCIs type (in million Som)

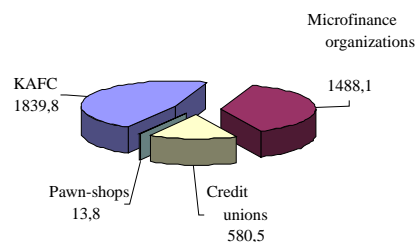


Chart 3.2.3. Aggregate credit portfolio of NFCIs by oblasts (in million Som)

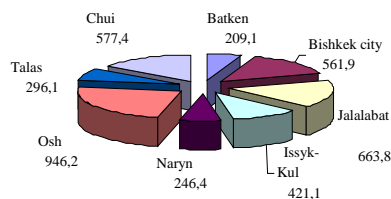
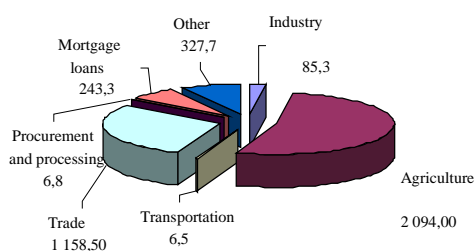




Chart 3.2.4. Aggregate credit portfolio of NFCIs by sectors of economy (in million Som)



In 2005 the largest volume of loans of NFCIs was directed to agriculture for 53,4 percent, and trade for 29,5 percent (chart 3.2.4.).

Such distribution of credit means was conditioned by the specific work of KAFC and microfinance organizations. So, KAFC, having the largest specific weight in aggregate credit portfolio of NFCIs, places 81,3 percent of its loans in agriculture, and the MFOs place 56,8 percent of loans in trade.

Dynamics of the volume of credit portfolio by sectors and regions indicated that the main niche of NFCIs lending are agriculture and trade. The regional activity is especially high in the south of the country due to the highest density of community and its economic activities in agriculture and trade.

### 3.3. Main Risks

The activities of NFCIs characterized by high concentration of loans by economy sectors and types of institutions.

In 2005, just like in previous periods, the main share of the NFCIs credit portfolio was constituted by KAFC.

The credit portfolio of NFCIs is concentrated mainly in agriculture and businesses related to agriculture and located in rural area. The crediting of this sphere is accompanied by high risks due to weather and climate conditions and relatively low income of rural inhabitants.

At the same time, the NFCIs system has a tendency of loan concentration reduction. Therefore, by types of institutions is observed the reduction of KAFC share, i.e., at the end of 2004 the share of KAFC made 55,1 percent, at the end of 2005 its share made up 46,9 percent. In the structure of credit portfolio there is observed the reduction of crediting of agriculture from 59,3 percent to 53,4 percent, and mortgage loans increased from 2,4 percent in 2004 to 6,2 percent in 2005 year.

Interest rates on loans issued by NFCIs remain at relatively high level, which is explained by the intension of the NFCIs to cover its high risks, inherent to their specific activities, as well as remaining high demand for these types of loans from community. The average interest rate on NFCIs loans for the reporting period was 33,5 percent at the MFO, 26,8 percent at CUs, 15,8 percent at KAFC and 16,9 percent at the FCSDCU.

## IV. PAYMENT SYSTEM

### 4.1. Bank Products, Tariffs and Services

Commercial banks of Kyrgyz Republic offer a wide range of banking services to community and organizations. Within 2005 year the number of branches of commercial banks increased for 10 units, which is conditioned by the development and extension of the range of banking services rendered to natural persons and legal entities.

Tariffs for banking services were established by commercial banks independently, depending on the market conjuncture and internal banking strategy. The banks apply different approaches to fee collection for the same services:

- fixed tariffs for one operation;
- tariffs depending on the sum of operations or account residuals;
- payment for the period regardless conducted operations;
- on other conditions.

On the whole, despite the fact that the price range for certain services varies depending on the bank, the tariffs for rendered services in complex are similar.

At present the commercial banks in Kyrgyz Republic offer money wire services through the following six international systems: Western Union, Money Gram, Contact, Anelik, VIP Money transfer and Migom. The main advantage of these money wire systems are the quick and safe wires without requiring to open an account practically in any country of the world.

For the reviewed period of time the number of commercial banks which render services for opening settlement accounts for legal entities and natural persons in national and foreign currencies for free made 9 banks (in 2004 year there were 8 such banks). This service is convenient for wire of non-urgent, regular (systematic) and large sums, and allows not only to wire money, but also to provide payments and settlements between the economic subjects. Tariffs for opening of the account for natural persons in general did not change and made between 0 and 25 USD.

For the reviewed period of time the cost of services for issue (opening) of L/C made 0,2 - 1 percent of the sum of L/C and, in comparison with the similar period of 2004 year somewhat reduced (0,75-1,5 percent). The cost of this service depends on guarantee. For example, the issue of guarantee secured by a deposit in a form of financial means or liquid securities requires to pay 0,3 percent of the sum of guarantee for a period up to 6 months (inclusively), with minimum of 2500 Som. If the guarantee is secured by other type of collateral, then up to 8 percent of the sum shall be paid, minimum 100USD (without commissions of the confirming bank).

The market of banking services expands every day. For the reviewed period of time some commercial banks implemented new services:

- Acceptance of payments from community for the services rendered by "AlaTV" LTD and "Jilservice" JSC;
- A number of banks for free accept USD in cash to the demand accounts related to credit programs of the bank;
- Selling different telephone cards (KATEL, SAIMA).

Lately at the banking services market becomes more and more popular a service called Internet-banking. Internet-banking allows from any place with Internet to provide payments with the current and future date of value, receive information on movements on their accounts, receive statement of an account, monitor the account residuals, buy, sell and wire the currency. Such system allows keeping archives of payments documents and making forecast of account. The tariff diapason for services of the Internet-banking fluctuates from 2000 Som to 4200 Som.

At the market of banking services the following services are of great demand:

- internship;
- servicing of exchange offices;
- accounting courses offered by NBKR;
- storing of values at the bank.

The price of each service presented above is determined by each bank individually, depending on costs.

## 4.2. Cash and Non-cash Turnovers

The total sum of *money in turnover* as of January 1, 2006 made up 13 413,8 million Som. The growth of money in turnover in the second half of 2005 in comparison with the first half of 2005 made up 1 773,4 million Som, the growth made 15,2 percent.

Out of the total sum of money in turnover the 336,4 million Som or 2,5 percent were in cash of commercial banks.

Dynamics of money in turnover is presented in chart 4.2.1.

The growth of cash is related to gradual revivification of economic activity, strengthening of public confidence and increased demand from the business subjects for payments in national currency, it is especially characteristic for small and medium businesses. At the same time the settlements are provided in cash due to insufficient development of non-cash payments in the regions of the republic.

The main index which characterizes the development level of cash turnover is the reversion ratio to cash offices of the banks. Based on the results of the second half of 2005, *the reversion ratio of cash to the banks* made up 94,1 percent, which is by 4,9 percent less than for the first half of 2005. The dynamics of cash reversion ratio is presented in the chart 4.2.2.

The highest reversion ratio of cash for the second half of the year of 2005 made 125,0 percent in Osh city, and the lowest was in Batken oblast or 33,9 percent (see chart 4.2.3.). In Bishkek city the cash reversion ratio made 106,1 percent, in Chui oblast it made 103,2 percent. The highest reversion ratio of cash in Osh city is related to consumer market, though, in general in Osh oblast the percentage of cash reversion is the lowest one. High indices of return of cash in Bishkek city and Chui oblast reflect the concentration of many banking and financial institutions, trading and industrial enterprises in the capital of country and Chui oblast. In general in the republic by oblasts the cash reversion ratio changed slightly.

Chart 4.2.1. Dynamics of active money

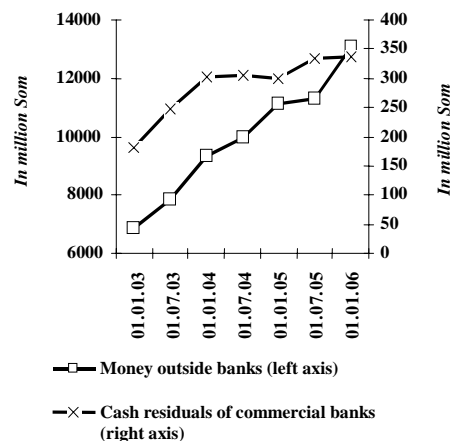


Chart 4.2.2. Dynamics of reversion ratio of cash

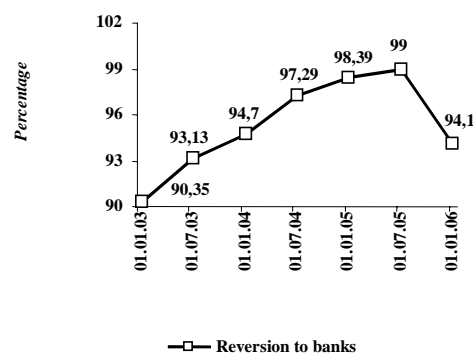
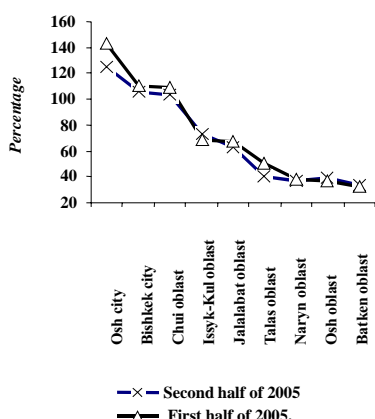


Chart 4.2.3. Reversion ratio of cash to commercial banks

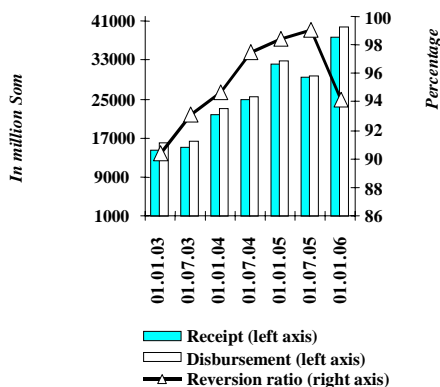


Cash offices of commercial banks disbursed in the second half of 2005 year the 39 966,2 million Som, which is by 10 315,2 million Som, or by 34,8 percent more than for the first half of 2005 year. The growth of cash disbursement was provided by all expense items:

- purchase of foreign currency for 1 618,6 million Som or by 84,0 percent and made up 3 545,2 million Som;
- other expenses for 7 608,7 million Som or by 35,6 percent and made up 28 967,6 million Som;
- pensions and allowances for 232,0 million Som or by 8,4 percent and made up 3002,2 million Som.

The issue of cash to budget organizations made up 4 451,2 million Som and in comparison with the first half of 2005 year increased for 856,0 million Som or by 23,8 percent.

Chart 4.2.4. Receipt, disbursement of cash and reversion ratio to cash office of commercial banks

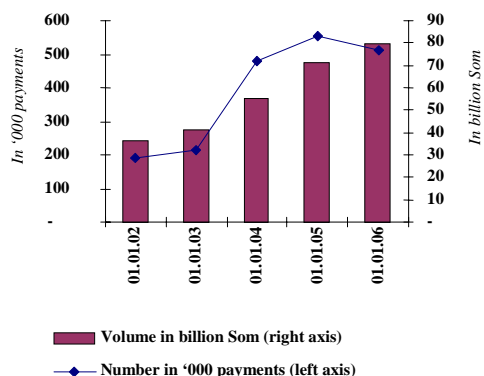


The cash offices of the commercial banks in the second half of the 2005 year received 37 618,7 million Som which is for 8 262,1 million Som or by 28,1 percent less than for the first half of 2005 year. The growth of cash inflow covered all items:

- taxes, fees for 1 149,9 million Som or by 44,1 percent and made up 3 757,2 million Som;
- selling of foreign currency for 788,8 million Som or by 37,2 percent and made up 2 911,1 million Som;
- "other proceeds" for 6 323,4 million Som or by 25,7 percent and made up 30 950,4 million Som.

The changed proceeds indices, disbursement of cash and their reversion to the cash offices of the commercial banks presented in the chart 4.2.4.

Chart 4.2.5. Dynamics of the volume and number of inter-bank payments



Therefore, the growth of cash in turnover is conditioned by the sustainable demand growth for cash by business subjects and extension of the market of goods and services, serviced by cash.

*Non-cash Turnover*

In the second half of 2005 year the payments system of the Kyrgyz Republic provided 511024 payments for the total of 79 510,1 million Som. In comparison with the indices for 2004 and 2003 years the volume of payments increased by 12,0 percent and 43,4 percent, correspondingly (chart 4.2.5).

The significant growth of inter-banking payments is conditioned by the strengthening of the banking system in whole and revivification of financial markets.

At present there exist two payments system in Kyrgyz Republic, which provides the inter-banking payments: gross system of payments and the clearing system of payments. The clearing system mainly provides small and non-urgent payments. The gross system provides final settlements of net positions based on the results of clearing session, and aimed at providing immediate settlements of deals at the financial markets, as well as urgent payments and so forth.

*System of Large Payments*

During the reviewed period of time the gross system of settlements provided 23 772 payments for the total of 54,1 billion Som. The volume of payments increased in comparison with the similar period of the previous year by 0,5 percent (chart 4.2.6.).

Despite the overall growth of payments in the gross system, the reduction of payments was observed in the following types of payments:

- Operations with loans (-65,2 percent);
- Operations with deposits (-52,5 percent).

In the structure of outgoing gross payments the largest share is occupied by the payments of the National Bank of KR (20,9 percent). In the incoming payments the leading position is occupied by the "Savings and Settlements Company" JSC (20,8 percent).

The volume of payments through the *clearing system of payments* increased in comparison with the previous year by 14,6 percent and made up 25 358,7 million Som. The total number of payments reduced by 7,9 percent or by 42 thousand of payments (chart 4.2.7), which is conditioned by the reduction of the number of payments for material values and budget payments.

Chart 4.2.6. Dynamics of the volume and number of payments by gross system

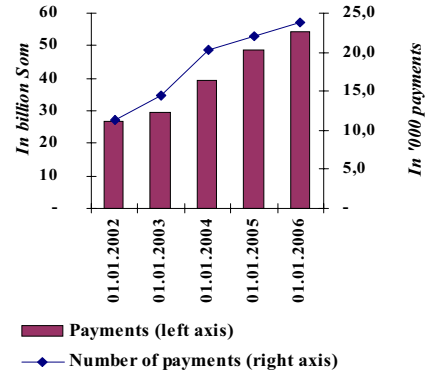


Chart 4.2.7. Dynamics of the volume and number of payments by clearing system

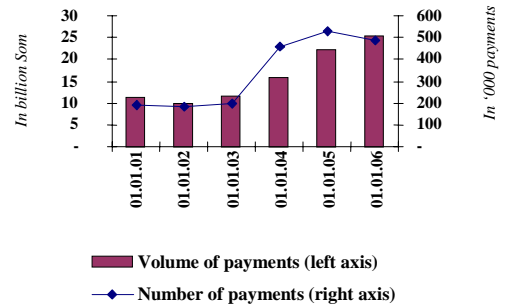


Chart 4.2.8. Dynamics of the volume of payments by regions

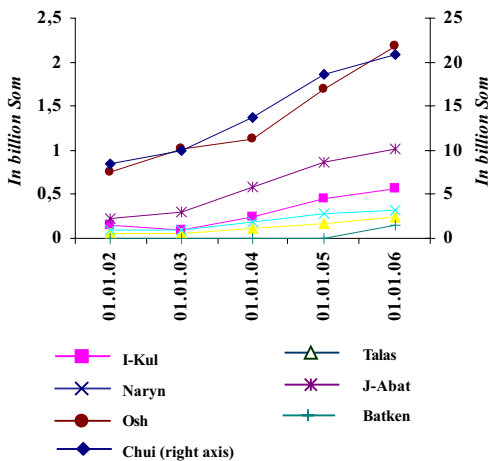
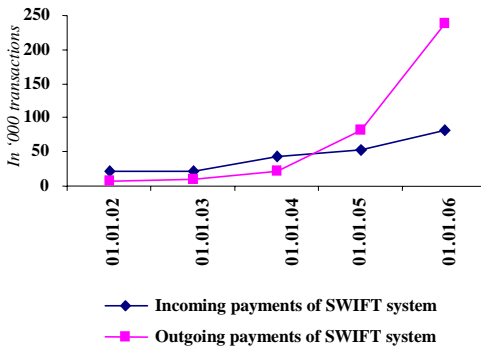


Chart 4.2.9. Dynamics of SWIFT transactions



In regional dimension the largest number and volume of clearing payments for the second half of 2005 year is provided by Chui oblast and Bishkek city, which together provide the 83,2 percent and 76,5 percent of the number of clearing payments (chart 4.2.8). In comparison with the similar period of 2004 year the volume of payments increased in all regions, the leader of the growth is the Osh oblast (48,8 percent), at the same time the number of payments in Osh oblast reduced by 6,1 percent, Chui oblast and Bishkek city by 13,1 percent.

*Trans-border Payments, including the Money Wire*

At present in Kyrgyz Republic the 17 banks are members of SWIFT. Out of them the 4 banks work independently with the interface SWIFT and 13 banks (including NBKR), work through the general interface CUU SWIFT NBKR<sup>19</sup>.

Analysis of payments of SWIFT net testifies an active growth of indices, both by number of payments and volume of money wires. Thus, for the second half of 2005 year the number of outgoing payments made up 237,1 thousand pieces, which is for 2,9 times more than in the second half of the 2004 year (chart 4.2.9).

The sustainable growth of the number of payments is conditioned by the increase of the number of banks connected directly or indirectly through the CUU SWIFT NBKR with the SWIFT system, and, correspondingly, growth of transactions of bank clients, which very often provide international payments.

The number of operations with the road checks in the second half of 2005 year made up 2 886 operations with the total volume of 32 998 thousand Som. The number of transactions in comparison with the first half of the year increased by 13,7 percent, and the volume of transactions reduced by 81,8 percent.

Commercial banks provide transactions with the following types of checks: *American express, MasterCard, Visa and Name Checks* of the banking institutions of non-residents of Kyrgyz Republic. The most popular among them is the checks of American express. In the second half of 2005 year there were provided 2 370 transactions for 11 341 thousand Som, which made 82,1 percent and 34,4 percent, correspondingly, of the total number and volume of transactions with checks.

<sup>19</sup> Common Use Unit of the SWIFT NBKR.

It is worth to note that the road check due to its specific features remain unclaimed by the population of Kyrgyz Republic.

The overall volume of money wire in the second half of 2005 year to Kyrgyz Republic made up 1426,9 thousand USD, including the wires from the CIS and far abroad countries for 1419,8 and 9 thousand USD, correspondingly. At the same time the wires from Kyrgyz Republic made up only 214,9 thousand USD. The wires were provided only to the CIS countries. The positive difference between the wires to and from the Kyrgyz Republic for the reviewed period of time made 1 212 thousand USD (chart 4.2.10.).

The comparative analysis of indices of wires from the foreign countries and CIS to Kyrgyz Republic in the reviewed period of time with the data for the similar period of 2004 year indicated the reduction of cash flows by 11,7 percent, which can be explained by the change of preferences of the population for banking institutions for money wire.

#### *System of Settlements by the Banking Payment Cards*

As of January 1, 2006, the acquiring and settlement and cash servicing of clients with the use of banking cards provided by 15 (out of 20) finance and credit institutions, the 9 of them are issuers and they issue the cards of international (7 banks) and local (4 banks) systems.

In the reviewed period of time the long-term tendency of dominating position by the number of operations of the banking payment card "Alai-Card" has changed. The leading position by number of operations occupy the operations of "Demir 24" card, the total number of which made 91 175 operations (which made 34,1 percent of the number of operations in local systems). This fact is explained by active bank performance for promotion of "Demir 24" cards at the market and increase of the number of places of local cards servicing (within the reviewed period of time the bank installed additionally 10 trading terminals).

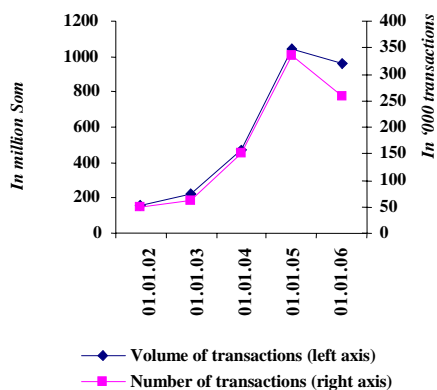
Within the reviewed period of time there was observed revivification of activities at the market of payment (plastic) cards, which is testified by the increase of the number of issued cards and operations with their use. Thus, the total number of issued cards for the second half of 2005 year reached 33 475, which in comparison with the previous six months and similar period of 2004 year is more by 12,0 percent and 32,15 percent, correspondingly.

**Chart 4.2.10. Dynamics of money wires**





Chart 4.2.11. Dynamics of the volume and number of transactions using banking cards



The overall number and volume of transactions using cards in comparison with the similar period of the 2004 year reduced by 22,8 percent and 7,7 percent, correspondingly (chart 4.2.11). Such reduction of indices is related to the damage of peripheral equipment of largest commercial banks which have a developed net of places for servicing the international plastic cards. In comparison with the indices of previous six months there was observed a growth of the number and volume by 0,6 percent and 26,2 percent, correspondingly. This is mainly related to the growth of operations with "Demir 24" cards by 27,9 percent.

The implementation of "salary" projects on the basis of cards for international and local systems are provided by three commercial banks: Savings and Settlements Company JSC, Demir Kyrgyz International Bank JSC and Kazkommerzbank Kyrgyzstan JSC. On the whole, the banks within the frames of 101 "salary" projects implemented 9 108 cards. It is worth to mention that such projects allow the banks to progress in card emission, in particular for local systems. For example, in Settlements and Savings Company the 64,5 percent of cards issued for "salary" projects are "Alai-Cards", in Demir Kyrgyz International Bank this number made 73,2 percent of the total number of issued cards. Therefore, it is possible to conclude that the interest of the banks in "salary" projects' implementation helps significantly facilitate the growth rate of card issue, which leads to the increase of the volume of transactions.

Commercial banks continue to implement the measures for the infrastructure development for accepting and servicing cards. In the reviewed period of time there were installed in addition 5 ATMs, 28 point-of-sale terminals, 5 imprinters and 5 cash terminals.

Therefore, the overall number of working terminals is comprised of the following:

- Alai-Card system: 81 terminals and 3 ATM;
- Demir 24 system: 46 terminals and 16 ATM;
- Union Card: 2 imprinters;
- International systems: 206 terminals, 15 imprinters and 15 ATM.

## V. STATUS OF THE REAL SECTOR

### 5.1. Households

In 2005 the nominal average monthly salary made up 2569,5 Som and in comparison with 2004 year increased by 16,7 percent in nominal expression and by 11,9 percent in real expression. In its turn, the average monthly minimal consumer budget in 2005 year made up 1836,6 Som and increased in comparison with the previous year by 6,4 percent (in 2004 year it was 1725,93 Som).

#### 5.1.1. Liabilities to Finance and Credit Institutions

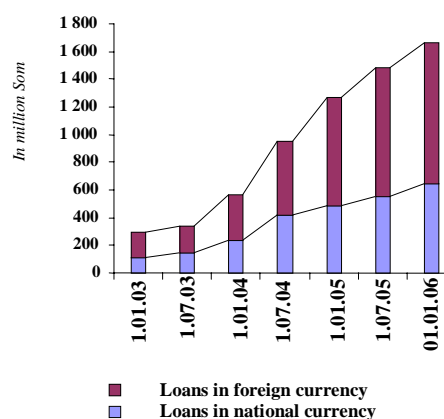
Liabilities of the sector of households to banking system as of January 1, 2006 made 1,6 billion Som having increased for the past 3 years for 5,6 times, and in comparison with January 1, 2005 by 31,3 percent. In the structure of liabilities, as before, there was observed a tendency of the growth of loans in foreign currency (see graph 5.1.1.1).

Liabilities both in national and foreign currencies for the past 3 years increased for 5,6 times and as of January 1, 2006 made 646,6 million Som and 1019,9 million Som, correspondingly. The structure of loans for three years practically did not change: 38,8 percent in national currency and 61,2 percent in foreign currency.

In general in the second half of 2005 year in comparison with the second half of 2004 year the total volume of newly issued loans increased by 37,1 percent. Significantly, or for 2,8 times increased the loans classified as "other", as well as the loans issued for construction for 2,1 times, agriculture for 71,8 percent, mortgage for 52,8 percent, transportation and communication for 29,7 percent. The share of these loans in the second half of 2005 year in the total volume of disbursed loans made 37,9 percent. For the analyzed period of time in comparison with the second half of the 2004 year the specific weight of loans, issued to trade, reduced from 53,4 to 43,3 percent, despite the fact that their volume increased for 11 percent.

The volume of loans disbursed to individual citizens in the second half of 2005 year increased in comparison with the similar period of 2004 year by 11,2, but its share in the total volume of issued loans reduced from 9,0 to 7,3 percent. The total flow of disbursed consumer loans in the second half of the 2005 year made up 480,5 million Som.

Chart 5.1.1.1. Liabilities of natural persons to banks



The growth of lending was provided by high growth rate of retail trade and services and, therefore, high demand of this sector for credit resources.

The average weighted rate on loans issued in the second half of 2005 year to individuals in national currency made 28,2 percent, and for loans in foreign currency made 23,3 percent.

The main factor which restrains the development of the financial intermediation of the banking system is the remaining low earnings of the population and strengthening of the non-banking sector, which also offers financial services.

### 5.1.2. Public Savings

According to the regulatory statements of commercial banks, for the past three years the volume of deposits of natural persons invested at commercial banks increased by 2,5 times (see chart 5.1.2.1), and as of January 1, 2006, made 2661,7 million Som. For comparison: as of January 1 of 2005 it was 2081,0 million Som (growth for 28,0 percent). This happened due to the strengthening of the banking system, growth of the real income of community.

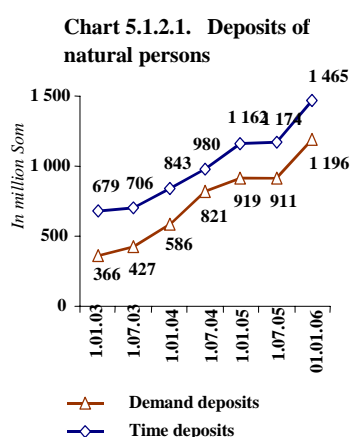
The share of deposits in foreign currency in the end of 2005 increased from 56,5 percent to 66,5 percent in comparison with the similar period of 2002, and practically did not change in comparison with the indices as of the end of 2004 year.

Strengthening of the banking system and stabilization of the intra-political situation in the second half of 2005 year led to growth of the savings of natural persons placed as deposits in the banking system.

In comparison with data of January 1, 2005, the largest growth was noted in demand deposits in foreign currency for 30,7 percent. Demand deposits in national currency increased by 28,9 percent. Time deposits in foreign currency for this period of time increased by 29,1 percent, and time deposits in national currency increased by 21,9 percent.

Changes in the structure of deposits of community were accompanied by the changes in interest rates. Within the past three years the interest rates for demand deposits in foreign currency slightly increased from 0,14 to 0,18 percent, and demand deposits in national currency increased from 1,09 to 2,21 percent.

Along with the growth of the volume of deposits of households, their share in the structure of deposits of the banking system increased from 40,6 percent as of January 1, 2005 to 54,5 percent as of January 1, 2006.



## 5.2. Corporate Sector

### 5.2.1. Liabilities to Finance and Credit Institutions

As of January 1, 2006, the number of legal entities totaled to 64,9 thousand and increased since 2005 year by 7,2 percent. Out of the total number of legal entities the significant number of them, i.e. 27,5 percent, are registered in trade, repair of vehicles and items of home use; 19,2 percent are registered in the sphere of housing and social services; and 11,9 percent are registered in industry. The prevailing share, or 86,5 percent of all enterprises of the republic are in private ownership. The share of "small"<sup>20</sup> enterprises at the beginning of 2006 made 88,6 percent, "medium" companies made 7,9 percent and "large" companies made 3,5 percent.

The aggregate debt of enterprises and organizations to current commercial banks for the past three years has a tendency to grow. As of January 1, 2006, it made up 6245,8 million Som, and increased for the past year by 17,9 percent (see chart 5.2.1.1). As a result of a more quick growth of loans in foreign currency their specific weight made up 75,2 percent of the total sum of liabilities of enterprises as of January 1, 2006.

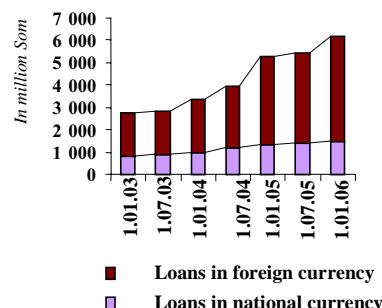
The average weighted interest rates as of January 1, 2006, of issued loans in national currency made up for the industrial sector 22,5 percent per year, agriculture for 28,5 percent, transportation and communication for 24,6 percent, and trade for 26,6 percent.

The average weighted interest rates of issued loans in foreign currency as of January 1, 2006, for industry made up 16,6 percent, agriculture for 22,5 percent, transportation and communication for 22,5 percent, and trade for 19,6 percent.

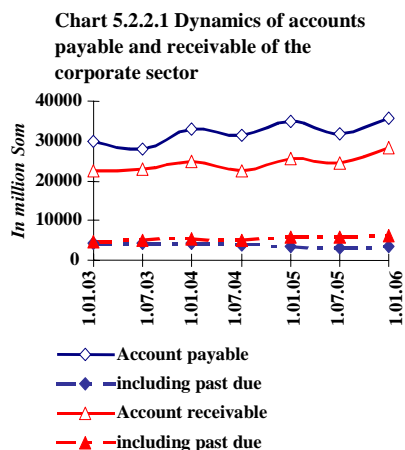
During the past three years the interest rates continue to reduce for loans, which is conditioned by the strengthening of the financial sector for the past years and strengthening of the competition at the lending market, and also competition between the banking and non-banking institutions. Thus, the aggregate credit portfolio of the non-bank institutions for 2005 increased by 41,5 percent.

For the second half of 2005 the average weighted rates for loans in national currency increased from 24,3 to 24,8 percent, and the interest rates for loans in foreign currency reduced from 19,55 to 18,69 percent.

Chart 5.2.1.1.  
Dynamics of debts of the corporate sector to CB



<sup>20</sup> "Small" enterprises under the classification of the NSC KR shall be understood the enterprises with the total personnel up to 50 people, "medium" enterprises employ 51-200 people, and "large" enterprises employ more than 201 persons.



### 5.2.2 Status of Accounts Receivable and Payable<sup>21</sup>

During the past three years the enterprises show insignificant growth of the accounts payable and receivable (see chart 5.2.2.1).

In absolute expression the accounts receivable<sup>22</sup> of enterprises and organizations as of January 1, 2006, made 28536,4 million Som and increased in 2005 by 11,1 percent. The share of accounts receivable from the business subjects of the republic made up 75,9 percent.

In total volume of accounts receivable the largest specific weight is occupied by industrial enterprises, or 61,4 percent, including enterprises for production and distribution of electricity, or 40,4 percent, enterprises of trade, repair of auto transportation, housing items and personal use items for 17,5 percent, transportation and communication for 10,8 percent, and construction organizations for 4,9 percent.

The volume of past due accounts receivable increased by 5,7 percent since the beginning of 2005 and made up 6257,9 million Som as of January 1, 2006, or 21,9 percent to total volume of accounts receivable. The 71,5 percent of past due accounts receivable were made by enterprises for production and distribution electricity, gas, steam and water, 13,2 percent by processing industry, and 4,5 percent by the transportation and communication enterprises.

Accounts payable has a tendency to grow, and as of January 1, 2006, made 35824,8 million Som, at the same time the share of internal accounts payable constituted 73,4 percent.

In general for the corporate sector the correlation of delinquent accounts payable to total accounts payable has a tendency to reduce and made up as of January 1, 2006, the 9,2 percent (9,9 percent as of January 1, 2005).

<sup>21</sup> Excluding organizations which render financial services.

<sup>22</sup> According to the preliminary data of the NSC KR.

### **5.2.3. Financial Results**

Operational profit in 2005 made up 7670,2 million Som, which is less by 5,4 percent than in 2004 year. The main impact on final financial results was provided by significant losses from non-operational activities for 2703,8 million Som.

In 2005 the balance profit of enterprises of the real sector made up 4794,3 million Som, which is lower for 2,2 times in comparison with the 2004 year, while in 2004 year the enterprises of metallurgical industry received significant income from non-operational activities.

The volume of proceeds received by enterprises in 2005 reduced by 4 percent and made up 72163,7 million Som. 68,5 percent of the total proceeds of enterprises of the real sector were received by the industrial enterprises for 49426,5 million Som, which is less for 7,2 percent in comparison with 2004 year.

The main volume of balance profit in 2005 was witnessed at the enterprises of processing industry for 2235,1 million Som, communication for 1624,9 million Som, organizations of wholesale trade and trade through agents for 781,6 million Som, and transportation for 713,1 million Som. Significant balance sheet losses in 2005 were carried by enterprises for production and distribution of electricity, gas and water for 487,1 million Som, trading organizations for 258,6 million Som, construction for 28,6 million Som, mining industry for 13,2 million Som.

The share of unprofitable enterprises in 2005 made up 40,0 percent of the total number of reported enterprises, which is for 3 percent lower of the similar index for the previous year.

In total, in 2005 the financial performance of the enterprises of the real sector deteriorated, which first of all shall be explained by the overall economical recession of economy.

## VI. FINANCIAL SYSTEM DEVELOPMENT TRENDS

This section reviews some peculiarities and main trends of the financial system development of Kyrgyz Republic, as well as its influence on the economy of the country on the whole.

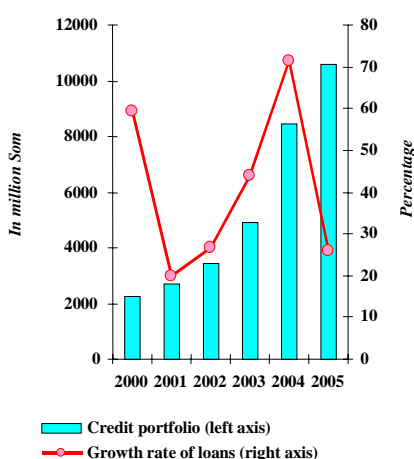
First of all, it is necessary to mention that the financial system represents a mixture and interaction of all financial institutions. The financial sector of Kyrgyz Republic is represented by such financial institutions as banks, non-bank financial and credit institutions (credit unions and microfinance organizations), pawn-shops, insurance companies, pension funds, investment funds, stock exchange and so forth.

Banking sector is the largest segment of the financial market of Kyrgyzstan, and banking services are one of the efficient mechanisms of functioning of the market economy, instrument for mobilization of the financial resources of enterprises and public savings, optimal redistribution of means in economy, growth of the investment activities of entrepreneurs and community. The development level of this sector is one of the objective indicators which characterizes the access to the financial and credit resources for the business subjects.

Despite observed positive tendencies in the development of commercial banks, in general the role of the banking sector in economy of the republic still insignificant. The banking sector is still in the development process. At the same time it is possible to make the objective note that the role of the banking system in the development of the economy of Kyrgyz Republic is growing, and the volume of intermediation services at the financial market is increasing.

The market of banking services of Kyrgyz Republic each year becomes more and more attractive for foreign banks, and is the most attractive economy sector for the foreign investors. Continuing inflow of new foreign investments to the banking sector is observed, that favorably influences its development, makes the commercial banks more sustainable, extends their possibilities for crediting of not only small, but also medium and large businesses. As of today in Kyrgyzstan there are 14 banks with total foreign participation in aggregate authorized capital of the banking sector made 62,5 percent (see Section II, chart 2.1).

Chart 6.1. Credit portfolio of commercial banks



The growth of the banking resources in 2005 increased the volume of lending to economy of the country. Nevertheless, there was observed some reduction of the growth rate of lending, which can be explained by political instability in the beginning of the past year. But, on the whole, the credit portfolio increased by 25,9 percent in comparison with the previous 2004 year, and made 10,6 percent to GDP. The share of loans issued for the development of real sector made 6,4 percent to GDP (chart 6.1).

The largest specific weight out of total credit portfolio is occupied by trade for 43,7 percent and construction for 17,3 percent. They are followed by industry and mortgage for 12,8 and 10,6 percent, correspondingly. The lowest volume of issued loans was provided to those sectors of economy which occupy the largest specific weight in aggregate GDP of the country, which are transportation, communication, agriculture, procurement and processing (chart 6.2). However, these sectors are actively credited by other financial and credit institutions.

The extension of maturity of loans, as a rule, testifies positive expectations of the banks regarding the further development of economy and stability of the banking system. The review of the structure of loans of commercial banks by maturity shows that the volume of long-term loans is still insignificant and their share of the total volume of lending made only 26,3 percent (chart 6.3). But, nevertheless, it is necessary to note that the share of long-term loans issued in last years in the total flow of issued loans has a sustainable tendency for growth (chart 6.4).

The growth of the capital of banks and volume of attracted deposits increases the resources which require the placement, more efficient use of bank's assets, which will facilitate the growth of national economy in those sectors where the financial means are invested as credits.

Because the extension of activities of the bank leads to significant growth of both assets and liabilities, the National Bank shall always pay sufficient attention to capital adequacy (own means) of banks, which is the basis of the sustainable growth and extension of the banking system and a mechanism of prevention of unjustified risks. Due to this the actions of NBKR taken to increase the banks' capital to 100 million Som shall be considered timely and necessary. These shall let the commercial banks to increase the sums of loans issued to clients.

Chart 6.2. Lending to sectors of national economy

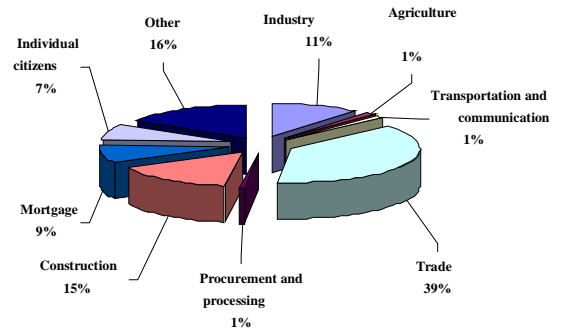


Chart 6.3. Structure of loans by maturity

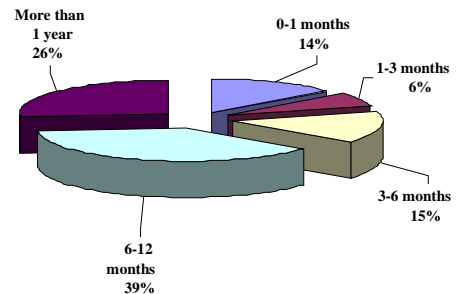


Chart 6.4. Growth rate of long-term loans

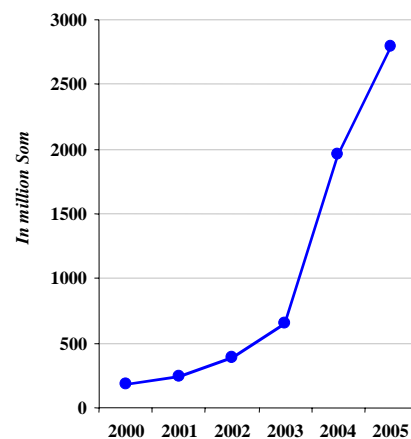
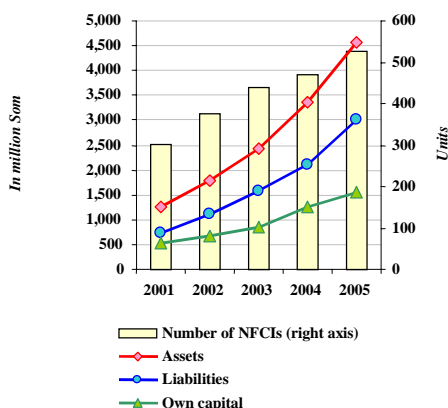




Chart 6.5. Dynamics of assets, liabilities and own capital of the NFCIs



Non-bank financial and credit institutions. The need of the real sector in credit resources is quite high. The sources, in addition to bank sources, include mutual crediting of enterprises within the real sector and resources of non-bank financial sector, in particular microcredit organizations.

Assets of non-bank financial and credit institutions (NFCIs) made up 4 573,8 million Som or 4,6 percent to GDP and increased in comparison with the previous year by 36 percent. Own capital increased by 24,5 percent. The liabilities of NFCIs as of the end of 2005 made up 3 011, 6 million Som and increased by 42,9 percent (chart 6.5).

All the issued loans were aimed for the non-state sector, and were issued in a form of loans to natural persons and capital leasing.

The sectoral structure of loans practically did not change, the 53,4 percent of loans issued by NFCIs are issued to agriculture, 29,5 percent to trade (see Section III, chart 3.2.4). For two times increased the issue of loans for construction and purchase of real estate, and loans aimed for industry, visa versa, reduced by 42,5 percent.

By crediting terms of maturity the largest specific weight (51,4 percent) is continued to be occupied by medium term loans issued for 1-3 years. Short-term and long-term loans made 33,6 and 15,1 percent, correspondingly. I.e., the share of long-term loans, as well as in the banking sector, remains low.

Capital of NFCIs remains to grow, and will remain in future supported by the Medium-term strategy of microfinance development, aimed to extend the access to financial services for community.

Another important segment of the financial sector is the securities market (stock exchange). The development assessment of this segment of financial market is non-univocal. At the background of development of the state securities market, the insufficiency of the corporate securities market is especially outlined. But, nevertheless, in this segment of the financial market were observed some improvements.

Based on the data of 2005, the total volume of deals at the stock exchange made up 1,6 billion Som, which is by 36 percent less than in 2004, but for 50 percent more of the deals made in 2000-2003 years.

The main trading area of the republic is the Kyrgyz Stock Exchange, volume of trades, which for 2005 reached 1,25 billion Som, which made 78 percent of the total volume of securities trade in the republic<sup>23</sup>, and reduced by 43,6 percent in comparison with the previous year (volume of trades in 2004 year made up 2,21 billion Som) (chart 6.6).

The indicators of activities of the investment funds, as before, indicate its insignificant influence on the national economy. In relationship to GDP the assets and investments in 2005 made up 0,017 and 0,014 percent, correspondingly. The income of investment funds in relationship to the proceeds of the country, which were extremely low in past, further reduced by 34,4 percent and made up 0,001 percent to GDP. Despite some increase of the assets and investments of the investment funds in 2005 in comparison with previous year, on the whole for the past five years, the activities of the investment funds continue to reduce.

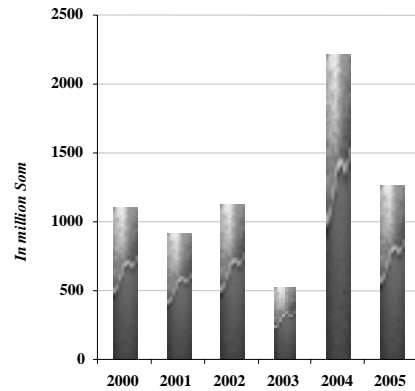
**Table 6.1. Correlation of performance indices of Investment Funds to macroeconomic indices**

(at the year end)	(In million Som)				
	2001	2002	2003	2004	2005
Assets	23.8	21.8	16.1	14.8	17.1583
Assets, in % to GDP	0.032	0.029	0.019	0.016	0.017
Income of Invest. Funds	5.3	1.1	1.4	1.5	1.0
Income of IF, in % to GDP	0.007	0.001	0.002	0.002	0.001
Investments of IF	36.8	14.8	11.2	12.2	14.2623
Investments of IF, in % to GDP	0.050	0.020	0.013	0.013	0.014
Investments of IF per capita, in Som	7.4	3.0	2.2	2.4	2.8

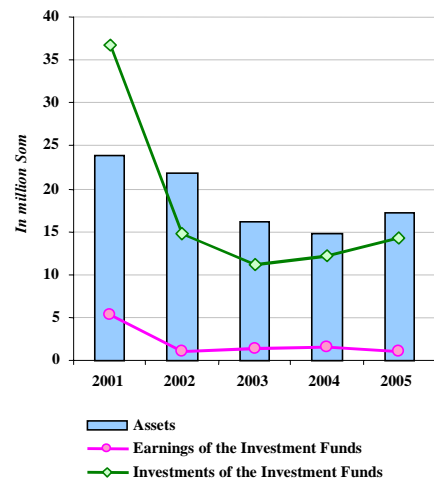
Along with the development of the banking sector and non-bank financial and credit institutions, it is necessary to provide facilitate the insurance market reforms. Despite the progressive growth in 2004 of the general indicators, in past year the results of activities of the insurance organizations appeared to be lower of the indicators for previous two years.

Thus, in relationship to GDP, the assets of insurance companies, as well as the insurance fees as of the end of 2005 year made up 0,29 and 0,11 percent, correspondingly. The inflow of proceeds into insurance organizations reduced by 38,5 percent in comparison with 2004 year, and this index appeared to be the lowest for the past 5 years (table 6.2). The insurance fees per capita in 2005 year made up 56,5 Som (reduction in relationship to the previous year by 12,3 percent).

**Chart 6.6. Dynamics of the volume of trades at the Kyrgyz Stock Exchange**



**Chart 6.7. Dynamics of assets, income and investments of the investment funds**



<sup>23</sup> In addition to Kyrgyz Stock Exchange, two licensed trade organizers have been operating at the stock exchange market.

Chart 6.8. Contribution of the financial sector to GDP, in percentage

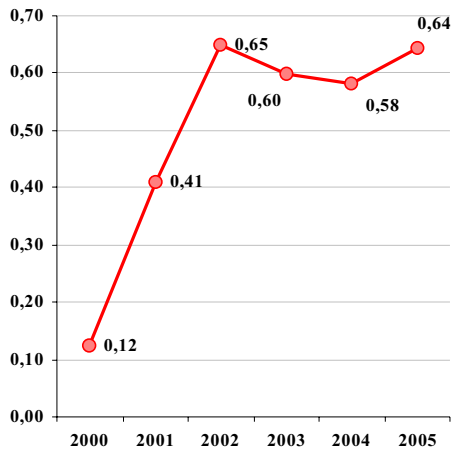


Table 6.2. Correlation of indices of activities of the insurance Organizations to macroeconomic indices

(at the year end)

	2000	2001	2002	2003	2004	2005
Assets, in million Som	124.90	132.20	176.20	339.45	335.39	291.6
Assets, in % to GDP	0.19	0.18	0.23	0.40	0.36	0.29
Insurance fees, in million Som	149.90	131.10	143.00	154.90	171.08	105.2
Insurance fees, in % to GDP	0.23	0.18	0.19	0.18	0.18	0.11
Insurance fees per capita, in Som	25.45	26.73	35.35	67.39	64.37	56.45
Insurance fees/payments	2.90	1.90	2.30	2.60	5.63	2.51

Analyzing the contribution of the financial sector to the consolidated GDP by added value, the level of the financial intermediation in economy, regardless the growth by 3,4 percent in comparison with the previous year, in general, remains low (chart 6.8). The leading position on mobilization and placement of financial resources, as before, is occupied by the banking sector.

## VII. SPECIAL ISSUES

### **Information on Implementation of the State Program of Payments System Development**

Efficient functioning of the banking system and financial markets of the country directly depends on the level of payments system of the country, the main criteria of assessment of which are the operational and quick payments, level of automatization and reliability of the payments system, as well as the risk management level for settlement operations.

As it is already known, at present in the economy prevails cash for payment purposes, and the regions of the republic have low non-cash payments due to weakly developed infrastructure in regions.

Besides, the payment of salaries, pensions, allowances and flows to the budget are provided in cash, as a rule, which is related to high financial and temporary expenses in general for the state.

All these are characteristics of the low transparency of financial flows and control over the means of tax payers and budget payments, which in its turn influences the reliability and timeliness of proceeds and payments of the budget means of the state.

For the purposes of resolving listed problems and increase of the non-cash payments by forming modern integrated payments system was adopted a State Program<sup>24</sup>, aimed to provide efficient payments, growth of the non-cash payments in economy.

The main tasks of the State Program are:

- Provision of conditions for efficient planning of the income and expense budgets of the republic by securing transparency of the financial flows' movement, improvement of the control over the system of budget payments and timely inflow of tax and other financial means to the budget through the accounts at commercial banks;
- Strengthening of the control of the turnover of financial means and reduction of the shadow turnover of cash;
- Formation of the mechanisms and securing of the conditions in the center and regions for timely payment of salaries, pensions, stipends, state allowances and so forth.

Strategic works for implementation of the State Program include the provision of free access of public to the banking services not only in urban area, but also in rural and remote areas of the Kyrgyz Republic. External environment, in which the banking system has been developing, becomes more dynamic.

It is necessary to note that the current systems of inter-banking payments have no relevant infrastructure and sufficient capacity. The increase of the volume of non-cash payments may face the possibility that the systems will not be able to process a large number of payments.

One of the main directions of the State Program is the implementation of "Modernization of Payment and Banking Systems (MPBS)" project under the financial support of the World Bank, which envisages the purchase and creation of four payment systems:

- System of Package Clearing (SPC) - aimed for processing of mass retail and regular payments of public by providing different payment instruments convenient for public and efficient for the organization of non-cash monetary turnover in Kyrgyz Republic;
- Unified Inter-bank Processing Center (UIPC) - aimed to process the payments with the use of payment cards which let the public to manage at distance their accounts at commercial banks;
- Gross Payment Systems in On-line Regime (GPSOR) - aimed to provide efficient and free from risk mechanisms for wiring large sums and securing quick methods of money wire, related with the financial risks.

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<sup>24</sup> "State Program of Measures for 2003-2005 years for implementation of the non-cash payments system and creation of infrastructure, relevant for efficient payments in Kyrgyz Republic" was approved by joint decree of the Government of Kyrgyz Republic and National Bank of Kyrgyz Republic #916 of December 31, 2002.

The above presented projects are inter-connected, and the first one to be implemented is the SPC project. The implementation of this system will give a possibility to process all types of retail and regular payments under low cost per one wire/payment, by more safe, reliable and quick method, developing new and modern payment instruments, which will be offered to community, enterprises, communal services and so forth. It shall significantly improve the clearing and settlement of payment instruments used for small electronic payments (for example, credit payments, regular payments, direct debiting, and transactions with plastic cards) and minimize the use of instruments on paper carriers and cash.

In order to inform the participants and sub-participants of SPC (representatives of commercial banks, oblast departments of NBKR, Central Treasury, oblast departments of the tax and customs authorities, Social Fund of KR, municipal enterprises) there were conducted seminars in the regions of Kyrgyz Republic called "Prospects of the Retail and Regular Payments Market Development in Kyrgyz Republic". This seminar reviewed the issues regarding the main notions, current status, prospects for development of the retail and regular payments market, as well as the issues related to the market participants and payment instruments used for payments.

Creation of UIPC will provide coordination and strengthening of initiatives of the commercial banks of Kyrgyz Republic for providing banking services using plastic cards. In other words, the clients of the bank will have a possibility to manage their accounts at a distance and use cards produced in the system for transactions through any ATM or terminal in Trading and Servicing Points (TSP) in all regions of the republic.

As of today there were conducted open international bids to purchase the SPC and UIPC systems, contracts were signed with companies-winners, equipment and software were supplied.

In order to develop the infrastructure for accepting and servicing plastic cards on the whole territory of country, eleven (11) commercial banks created a separate independent legal entity "Inter-banking Processing Center" Joint-stock Company of Closed Type (hereinafter referred as IBPC). The NBKR envisages financial participation in the authorized capital of IBPC through the ownership of the controlling package of shares, which shall facilitate successful implementation of Unified Inter-banking Processing Center project in Kyrgyz Republic. Participation of NBKR in IBPC will provide access to infrastructure of all commercial banks, regardless of the volume of assets of the bank itself, on fair and equal conditions, as well as to provide principles of anti-monopoly regulation. Charter was approved, and Council of Directors and Revision Commission were elected for the IBPC.

The reduction of risks in payments system, increase of operational capacity for settlements, provision of mechanisms for liquidity management for settlements of commercial banks and possibilities of close integration with trading systems servicing financial markets are provided through the implementation of GPSOR.

According to the procedures of World Bank the tender commission of the project conducted analysis of tender proposals and their relevance to the requirements of technical peculiarities of the system. At present the preparation of the final evaluation draft report is being prepared for the World Bank.

Implementation of the above listed systems will provide at the banking services market the creation of favorable conditions for transition to non-cash settlements on mass retail and regular payments and facilitate creation of the competition and behavior of market actors.

In order to implement the State Program, the National Bank has implemented a number of measures aimed to reduce the time of payments and increase non-cash payments. So, in 2003 the works were completed for transition to use of electronic payment documents in payments system, which allowed reducing tariffs for payments. Due to transition to electronic payment documents, in 2004 the Government of Kyrgyz Republic and National Bank approved joint decree "On time of payments wire in the payments system of Kyrgyz Republic and responsibilities for the violation of time frames", according to which the time frames of payments shall be reduced from 5 to 2 banking days.

Creation of new components of the payment systems is necessary, but shall not be considered as a sufficient condition for optimal correlation between cash and non-cash monetary turnover in the economy of country. That is why the implementation of the State Program shall be provided under joint participation of ministries, state commissions, agencies, administration of cities and rayons/districts, as well as other organizations and private entrepreneurs which/who should take agreed decisions on allocating responsibilities for infrastructure development, agreement of the principles of price formation for payment services and creation of competitive environment for providing payment services in the center and regions.

With this purpose on December 30 of 2005 the joint decree of the Government of Kyrgyz Republic and National Bank approved Inter-agency Commission and Plan for Implementation of main directions of the State Program<sup>25</sup> for the time period till 2008.

The Inter-agency Commission for implementation of measures of the State Program was formed at the level of the heads of ministries and agencies under the management of Vice-prime-minister of Kyrgyz Republic.

The main goal of creation of Inter-agency Commission is to provide unified control and coordination of works for implementation of the State Program. The meetings of Inter-agency Commission are conducted on quarterly basis according to the matrix of actions. Reports on implementation of the above mentioned Plan for implementation of the main directions of the State Program are reviewed at meetings by all commission members, and decisions are taken regarding the problems which appear in the process of organization of transition to non-cash payments in national economy.

According to the approved resolution, till 2008 will be implemented the gradual transition of settlement of the regular and budget payments, as well as salaries of budget employees, through the accounts at commercial banks, also at oblast and region levels. The Inter-agency Working Commission, in its turn, shall provide coordinated and efficient work of all ministries, agencies and corporations, which provide regular services to community.

Therefore, the implementation of new and modernization of already existing payment systems will help to provide processing of a large volume of transactions in a more reliable, safe and economical way, and provide improved access of community to banking services. The process of modernization and improvement of existing payment system with new possibilities and new needs of the developing economy is infinite. Due to this, the further activities of the NBKR will be aimed to improve the technologies of payments and settlements, as well as the constant improvement and renewal of the normative base regulating the payments system.

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<sup>25</sup> "Plan coordinated actions for gradual transition to payment of salaries of civil servants and other employees of budget organizations, pensions and social allowances, payment of municipal services, as well as the collection of insurance fees to the Social Fund of Kyrgyz Republic, tax and customs payments in Kyrgyz Republic in the non-cash form".