

National Bank of the Kyrgyz Republic

**BANKING SYSTEM
DEVELOPMENT TRENDS**

SECOND HALF OF 2006 (10)

BISHKEK 2007

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NBKR Bulletin contains information about main macroeconomic indicators and economic sectors of the Kyrgyz Republic. Materials of the National Statistics Committee, Ministry of Finance, commercial banks, and of the Financial Market Supervision and Regulation Service are used in preparing the bulletin. It is published on a monthly basis in Kyrgyz, Russian and English.

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This publication reflects recent trends in the development of the external sector and contains statistical data about the balance of payments, foreign trade, international reserves, external debt and 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 report contains a description of the consumer price dynamics in the country and in its regions, the analysis of major inflation factors, information about 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.

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

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

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

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INTRODUCTION

In the second half of 2006, a further growth in lending to the real sector of economy was observed in the banking system of the country. At the same time, a slow but stable growth trend was noted in the financial intermediation indicator of the banking system. A significant liquidity reserve and a high capital adequacy in commercial banks indicated availability of the capacity for further development of the banking system.

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

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

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

Thus, noted improvement in the banking system stability, strengthening of capital in commercial banks, increase in the volume of lending to the real sector of economy, active operations of banks at the deposit market, expansion in the range, and improvement in the quality of banking and payment services were positive factors of the country's economic development.

* * *

Information about the deposit protection system as one of financial stability elements was presented in the *Special Issues* section.

I. STATUS OF THE FINANCIAL AND CREDIT SYSTEM

Following the results of the second half of 2006, aggregate assets of the financial and credit system¹ increased by 28.6 percent than in a similar period of 2005, moreover, higher growth rates of this indicator were observed in the banking system.

In spite of significant expansion of the range of services provided by finance and credit institutions, loans were the main component of their performing assets.

The financial intermediation indicator, defined as the ratio of the aggregate loan portfolio to gross domestic product (GDP)², increased and was 15.1 percent than in a similar period of last year (Chart 1.1.). Marked growth in the financial intermediation level was, mainly, connected with the growth in the loan portfolio of banking institutions. Growth rates of loans in the banking system and NFCIs were 21.5 and 10.3 percent, accordingly.

The banking system continued to hold a dominating position in the financial and credit system (Chart 1.2), and following the results of the second half of 2006, its share was 66.2 percent in the aggregate loan portfolio of the financial and credit system.

Based on the change in the ratio of special allowances for loan losses (ALL) to loans of the banking system and NFCIs, the improvement was noted in the loan portfolio quality of the banking system (Chart 1.3). Following the results of the second half of 2006, the share of special ALL in the loan portfolio of NFCIs decreased and was 2.6 percent. This indicator was 3.1 percent in the banking system.

Chart 1.4 presents the so-called *dispersion* of average weighted interest rates of loans disbursed by commercial banks (in national and foreign currencies) and non-bank finance and credit institutions³ that, to a certain extent, gives the possibility to assess the level and direction of change in the cost of credit resources. Following the results of the second half of 2006, the reduction was observed in average weighted interest rates of loans of credit unions and KAFC as compared with a similar period of last year. The level of interest rates on loans of microfinance organizations did not change in comparison with a similar period.

Chart 1.1. Change in Loan Portfolio (LP) of Finance and Credit System (FCS), in Percent of GDP

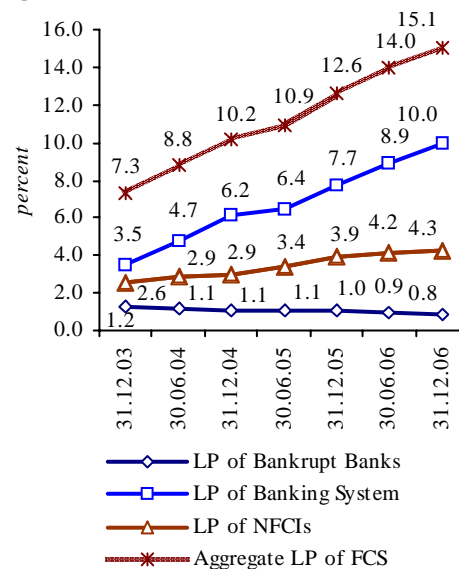


Chart 1.2. Aggregate Loan Portfolio (LP) Structure

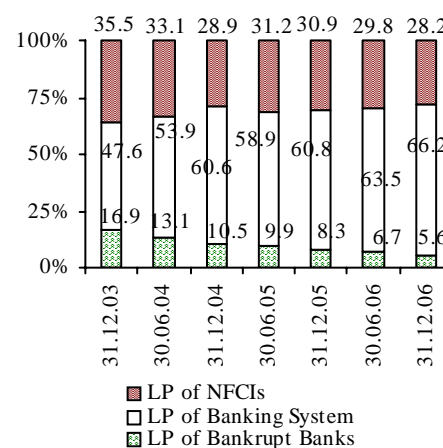
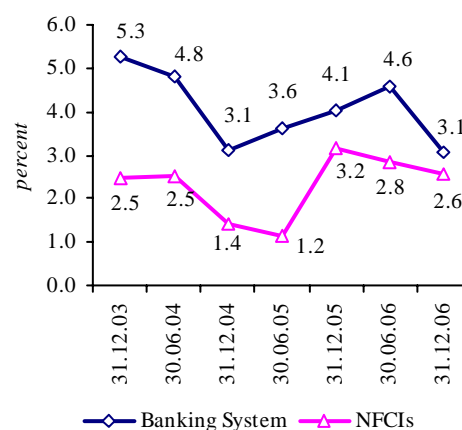


Chart 1.3. Special ALL in Loan Portfolios of Banking System and NFCIs

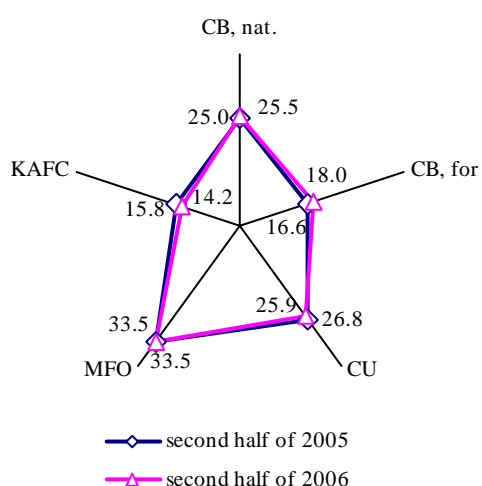


¹ Indicators of commercial banks and non-bank finance and credit institutions licensed by the NBKR were considered here as the review indicators of the financial and credit system.

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

³ Average weighted rates of pawnshop loans were not reflected in Chart 1.4. Following the results of the second half of 2006, this indicator was 149.5% , and it was 154.0% based on the results of a similar period in 2005.

Chart 1.4. Dispersion of Average Weighted Interest Rates of Loans of Various FCIs, percent



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

Some increase of average interest rates was observed on newly disbursed loans of commercial banks in national and foreign currencies. Thus, following the results of the second half of 2006, average interest rates of loans in national currency increased by 0.5 percentage points, and of loans in foreign currency by 1.4 percentage points than in a similar period of 2005.

Thus, during current period, the status of the financial and credit system of Kyrgyzstan was characterized as follows:

- continued increase in the financial intermediation indicator, where a significant growth rate of this indicator was noted in the banking system;
- Improvement in some qualitative characteristics of the loan portfolio of NFCIs.

II. STATUS OF THE BANKING SYSTEM

2.1. Banking System Structure

In the second half of 2006, total of 20 commercial banks (including a Settlement and Savings Company and a Bishkek Branch of the National Bank of Pakistan) operated in the country. They included 15 banks with foreign shareholdings, where foreign participation in 10 banks out of them was more than 50 percent. All banking institutions of the country were universal.

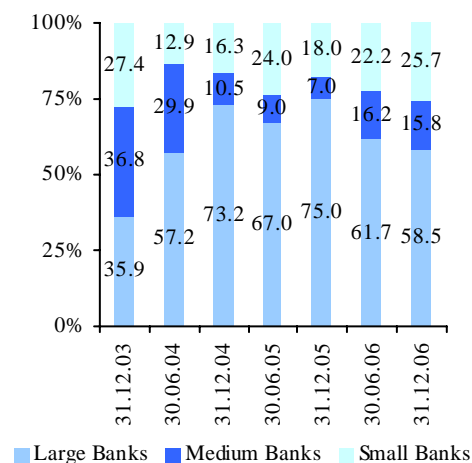
Banking system indicators did not include data of OJSC Aiy Bank, which was established on the basis of Kyrgyz Agricultural Financial Corporation. The license was issued to this bank in December 2006.

In the second half of 2006, the growth trend on all major areas of activities continued in the banking system.

The analysis of the banking system structure (Chart 2.1.1) in terms of the market segment occupied by groups of large, medium and small banks¹ indicated the reduction of concentration in the market share of large banks, the share of which decreased by 3.2 percentage points in the period under review. At the same time, the share of medium banks insignificantly changed (the decrease by 0.4 percentage points), and the share of small banks increased by 3.5 percentage points in the period under review. As in the prior period, the segment of large banks was represented by two banks, which held 58.5 percent of the market share (out of which 44.3 percent belonged to the largest bank in the Kyrgyz Republic). This indicator was achieved due to high shares of these banks in aggregate deposits (35.5 percent) and aggregate assets of the banking system (32.6 percent). At the same time, both banks were also part of the group of principal participants at the credit market (20.9 percent).

The aggregate capital of the banking system increased by 24.6 percent during the period under review. The capital

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



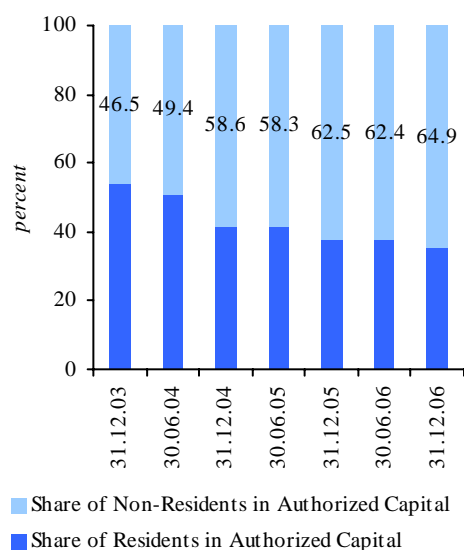
¹ For analysis purposes of this publication, large banks referred to banks, whose share (d_i) at the banking market (the average square share in total assets, loans, deposits and capital) exceeded 10 percent, medium banks from 5 to 10 percent, and for small banks less than 5 percent.

It was computed according to the following formula:

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

$$X_i = \frac{d_A^2 + d_{Ed}^2 + d_A^2 + d_{la}^2}{4} - \text{arithmetic average value for the following indicators: } (d_A^2) - \text{square share of assets of the } i \text{ bank in aggregate assets of banks, and in loans } (d_{Ed}^2), \text{ deposits } (d_A^2) \text{ and liabilities } (d_{la}^2), \text{ correspondingly.}$$

Chart 2.1.2. Change in Authorized Capital Structure of Banking System



growth was, mainly, connected with the increase of authorized capital by banks (by Som 0.47 billion), and with the increase in retained earnings (by Som 0.46 billion).

The share of foreign capital in the authorized capital of commercial banks did not significantly change and was 64.9 percent (62.4 percent at the end of the first half of 2006, Chart 2.1.2). Total growth of the authorized capital occurred using investments both of non-resident, and resident investors of the Kyrgyz Republic. In this case, the growth rate of the authorized capital of residents for the second half of 2006 decreased by 11.0 percentage points than in the prior period, and was 7.2 percent in the period under review. The growth of the authorized capital of non-residents was 19.7 percent (17.4 percent for prior six months).

Continued growth of capital in banks contributed to adequate capacity building for further development of the banking system.

In the second half of 2006, the increase in assets of the banking system was 28.0 percent. When considering the change in the structure of aggregate assets (Chart 2.1.3.), it should be noted that, as of end of the period under review, 53.7 percent of banks' assets were performing assets² and their share decreased by 3.2 percentage points. At the same time, the share of liquid assets³ in aggregate assets of the banking system increased from 34.1 to 37.6 percent, and their absolute value increased by 41.1 percent. High liquidity of banks' assets in comparison with the ratio established by the NBKR would permit to increase lending to the economy by reducing the share of liquid assets in the future.

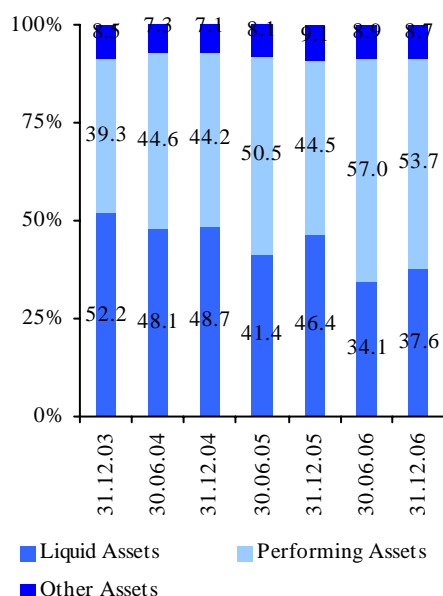
The share of other assets did not significantly change and was 8.7 percent.

For purposes of a more detailed review of changes in the structure of performing assets, the following was given below: the analysis of the deposit structure⁴ as the main source of placed resources, and of changes in the loan portfolio as the main type of banking placements.

The growth in the deposit base of the banking system continued in the second half of 2006. The increase was 15.8 percent and the amount of deposits totaled Som 16.5 billion. In the deposit structure, the share of deposits of individuals increased from 21.7 to 25.1 percent. The volume of deposits of individuals increased by 34.0 percent.

The share of deposits of legal entities was 65.8 percent

Chart 2.1.3. Change in Asset Structure of Banking System



² Performing assets represented balances on accounts of loans, deposits placed with FCIs, securities and other interest income bearing placements of banks.

³ Liquid assets referred to funds of banks in cash and correspondent accounts.

⁴ Deposit base included deposits of individuals and legal entities, and also deposits of the Government and of other authorities.

(the decrease by 4.9 percentage points). At the same time, the volume of this category of deposits increased by 7.8 percent in absolute terms.

The remaining share (9.1 percent) included deposits of the Government and of other authorities.

During the period under review, some decrease occurred in absolute amounts and shares of time deposits to 22.4 percent of the total deposit base (Chart 2.1.4), which in turn, reduced the capacity of banks to increase medium-term and long-term financing of economy. However, this change was characteristic for this period of time. In this case, it should be noted that there was an increase in absolute amounts and shares of time deposits of individuals, which indicated improved confidence in the banking system on the part of the population. The amount of this category of deposits increased by 33.3 percent and totaled Som 0.56 billion in absolute terms.

The downward trend in dollarization of the deposit base of the banking system (Chart 2.1.5) continued in the second half of 2006. This indicator was 65.6 percent against 68.5 percent as of July 1, 2006. The level of dollarization in deposits of legal entities reduced by 1.5 percentage points and was 72.6 percent at the end of the period under review. The share of deposits of individuals in foreign currency also reduced by 3.2 percentage points and was 61.5 percent. The decrease of the US dollar rate vis-à-vis Som was one of the factors, which influenced the reduction of this indicator.

Reduction in dollarization of deposits positively impacted the decrease in the degree of effect of the movement in the national currency rate on activities of commercial banks.

Aggregate loan portfolio of the banking system increased by 21.5 percent in the second half of 2006. Despite the reduction in the share of deposits in foreign currency, this indicator for loans, on the contrary, insignificantly increased by 1.3 percentage points and was 69.7 percent at the end of the period under review (Chart 2.1.6).

During the period under review, the increase of long term loans⁵ continued: their share in the second half of 2006 grew from 40.1 to 52.6 percent, and in absolute terms, the increase was 60.0 percent, which might be considered as one of stabilization factors in economy. In spite of this, the share of loans with the repayment term of less than one year remained to be quite high (47.4 percent, Chart 2.1.7).

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

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

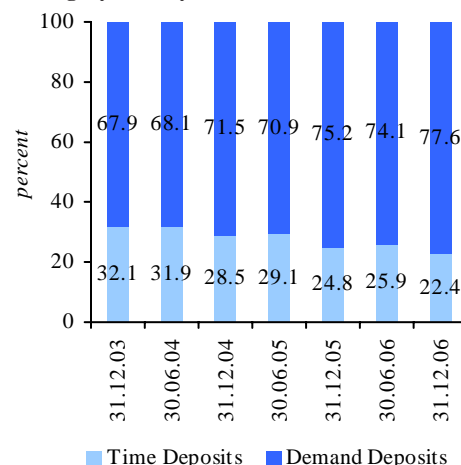


Chart 2.1.5. Change in Deposit Structure of Banking System by Types of Currencies

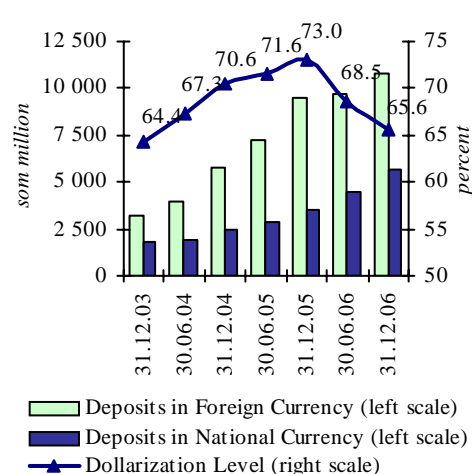
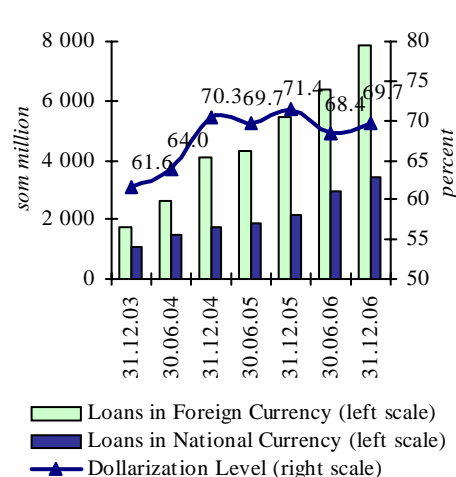
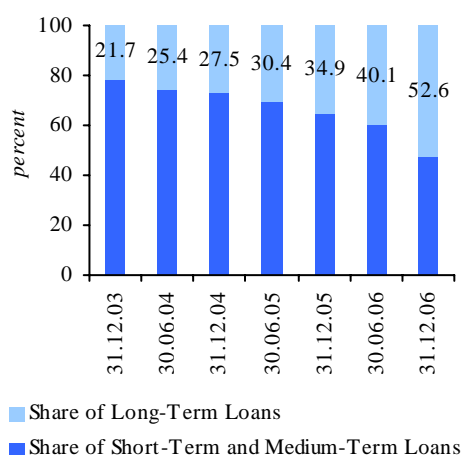


Chart 2.1.6. Change in Loan Portfolio Structure of Banking System by Types of Currencies



⁵ Loans disbursed for the term more than 1 year referred to long term loans.

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



In the second half of 2006, the average rates (calculated as the arithmetic average value for 6 months) of loans in national currency were 25.5 percent, and 18.0 percent in foreign currency. In comparison with the second half of 2005, the interest rates increased by 0.5 and 1.4 percentage points, correspondingly. The variation ratio, which showed the value of interest rate dispersion at the credit market, did not change considerably, but increased on loans in foreign currency.

The average weighted rate of loans both in foreign, and national currency continued to remain below the average rate, which indicated the excess of the lending volume at lower than average rates over the volume of loans issued at higher interest rates (Charts 2.1.8, 2.1.9).

Thus, in the second half of 2006, the following trends were observed in the banking sector:

- Growth of the banking system capitalization;
- Increase in the deposit base of banks, including deposits of individuals;
- Overall growth in the loan portfolio and assets;
- Growth in the share of long-term loans to clients in the loan portfolio;
- Decrease in dollarization level of the deposit base of the banking system.

Chart 2.1.8. Change in Interest Rate of Loans in National Currency (in percent)

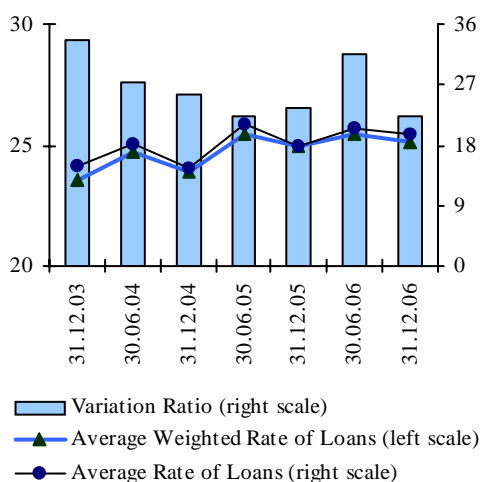
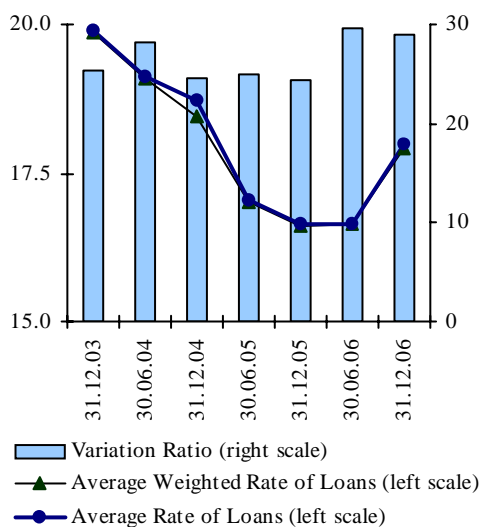


Chart 2.1.9. Change in Interest Rate of Loans in Foreign Currency (in percent)



2.2. Risks

2.2.1. Credit risk

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

In order to assess the *quality of the loan portfolio*, commercial banks used the system of loan classification¹, which gave the possibility to determine in advance the possible level of potential losses from non-repayment of loans and timely compensate for them (by minimizing the negative impact on the capital) by establishing appropriate reserves.

In analyzing the loan portfolio quality, maximum attention shall be paid to non-performing and past due loans, which reflect the first features of deterioration in the loan portfolio quality. In the second half of 2006, there was a decrease in the portion of non-performing loans in the loan portfolio (Chart 2.2.1.1). Given improvement in qualitative characteristics of the banking system loan portfolio during the period under review, the risk of non-repayment was at the allowable level. However, when taking into account the change of this indicator for the past period and a significant growth of the loan portfolio in the second half of 2006, there were no sufficient grounds to assess the loan portfolio quality in the future.

The change in the volume of loans classified as loans *under watch* might be considered as one of the factors, which might impact the increase/decrease of credit risk in the future. Although, the share of such loans in the second half of 2006 significantly reduced (Chart 2.2.1.2), they continued to form a considerable portion in the total loan portfolio (7.8 percent).

According to the data as of December 31, 2006, banks established reserves adequate to the adopted classification of loans. At the same time, the volume of special reserves created for classified loans in regard to this category of loans was 50.4 percent, which confirmed a conservative approach of commercial banks to the issue of assessing possible loan losses.

In the event of deterioration in the quality of classified loans and additional accrual of reserves, the amount of net total capital of banks would reduce insignificantly.

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

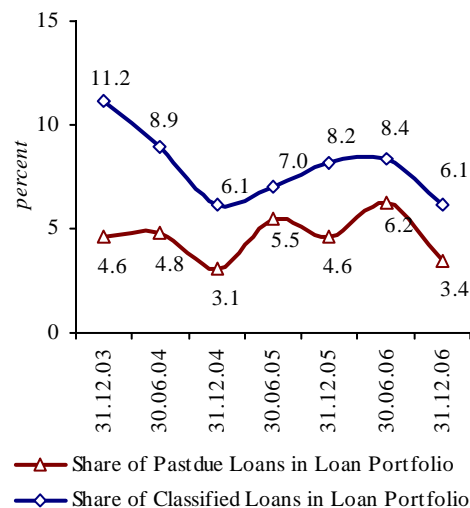
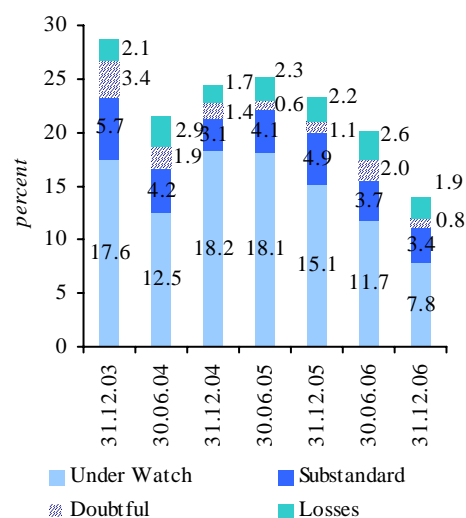
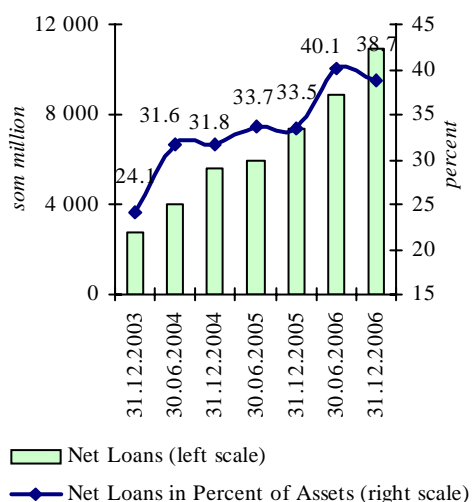


Chart 2.2.1.2. Change in Classification of Banking System Loan Portfolio



¹ For purposes of assessing the loan portfolio quality it is a common practice to divide all loans into six categories depending on the current capacity of the client to perform his obligations to the bank (given in the order of deterioration of classification): normal, satisfactory, under watch, substandard, doubtful and losses. Loans of the last three categories, as having the most negative characteristics in terms of collection of disbursed funds, commonly refer to *non-performing* or *classified*. For each of six specified categories the bank shall establish a reserve, which is appropriate for that category, defined as a percentage of the amount of disbursed loans.

Chart 2.2.1.3. Change in Net Loans

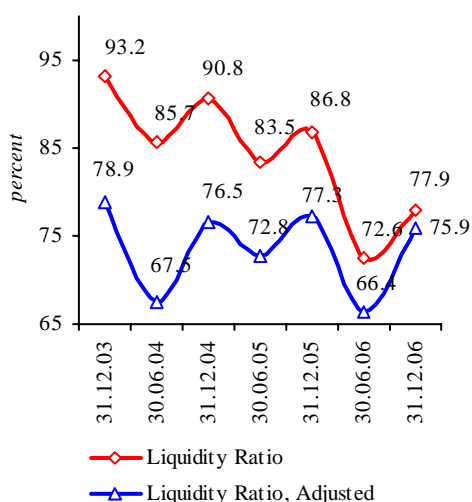


Thus, credit risk remained at the acceptable level however, there were reasons in place, which might cause the increase in indicators defining this risk in the future.

As of end of December 2006, the share of *net* loan portfolio (balances of clients' loan indebtedness less established special reserve for possible losses on classified loans) was 38.7 percent of aggregate assets of the banking system (Chart 2.2.1.3), having decreased by 1.4 percentage points than at the beginning of the year. Given the growth of the absolute value of the loan portfolio, this decrease occurred due to the increase in the share of other asset groups of banks (correspondent accounts).

2.2.2. Liquidity Risk

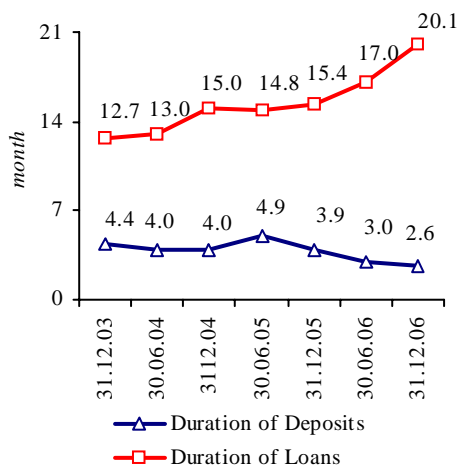
Chart 2.2.2.1. Change in Calculated Value of Current Liquidity



Public confidence in the banking system depends on timely fulfillment of liabilities by banks, which implies presence of adequate liquidity in banks. For regulatory purposes, the liquidity risk is measured with the help of the economic ratio of current liquidity².

Actual liquidity ratio maintained by the banking system remained sufficiently high. In the second half of 2006, the calculated value of this ratio for the banking system, on average, was 77.9 percent, having increased by 5.3 percentage points than at the beginning of six months. Increased liquidity of one bank, which specialized in conducting quasi active operations (operations on correspondent accounts), had a significant impact on the final value of the indicator. Current liquidity, without taking into account this bank, was 75.9 percent at the end of the period under review (Chart 2.2.2.1).

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



This indicator increased in the second half of 2006 due to the decrease of the loan share in the structure of banks' assets.

On the one hand, excess of the actual liquidity indicator over the established standard value indicated available potential for further expansion of financial intermediation; on the other hand, however, it reflected insufficient stability of the deposit base. Insufficient stability of deposits was confirmed by the data on the changes in the duration of deposits and loans, and also by calculation of the stability ratio of sources of funds³.

During the period under review (Chart 2.2.2.2), the gap between the average terms of attracting deposits and placing loans remained high, which suggested hidden

² Current liquidity economic ratio is one of ratios mandatory for execution by the bank, set by the NBKR. According to this ratio, liquid assets shall be at the level of no less than 30 percent of short-term liabilities.

³ A stability ratio of sources of financial assets is characterized by a share of time deposits in the total amount of banking system deposits.

disintermediation⁴ risks that might emerge in some banks in the process of liquidity management in time. However, it was necessary to take into account, that a certain portion of loans was financed by banks using other long-term sources, which were different from deposits (capital, long-term borrowings from financial institutions and so forth). This fact would effect the reduction of probable emergence of aforesaid risks. Furthermore, the Deposit Protection System should be implemented in order to attract long-term deposits.

Chart 2.2.2.3 presents the change in the stability ratio of sources of financial assets as compared with the change in the ratio of the deposit base to net loan portfolio. A low share of time deposits (22.4 percent according to the data as of December 31, 2006) in the deposit base, undoubtedly, would affect the placement volumes and complicate the liquidity management process in the future.

Change in the ratio of deposits and loans showed some increase in the efficiency of using attracted funds.

In general, we might note that, at present, there were no grounds for the shortfall of funds to perform obligations in the banking system, at the same time, low stability of attracted resources exerted negative impact on the liquidity management process in time, on the increase in the loan portfolio, and on reduction of returns on assets.

During the period under review, there was a decrease in the share of time deposits i.e. decrease in stability of financial funds.

Table 2.2.2.4 provides data on maturities of financial assets and liabilities of banks as of end of December 2006. Financial liabilities of banks were covered by financial assets, where the gap (excess of assets over liabilities) was Som 5.4 billion, including Som 6.0 billion on loans and deposits. Thus, banks

Chart 2.2.2.3. Assessment of Banking System Liquidity Factors

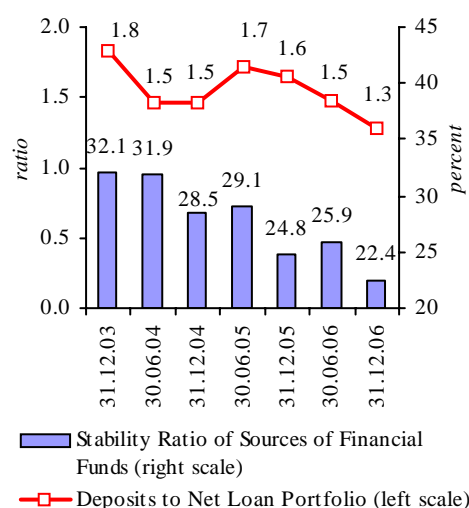


Table 2.2.2.4. Maturities of Financial Assets/Liabilities
(in som million)

⁴ Disintermediation is the process of mass withdrawal of deposits by the population before the agreed term, as a result of panic caused by escalation of inflationary expectations and/or negative expectations.

Chart 2.2.3.1. Change in Deposit Concentration

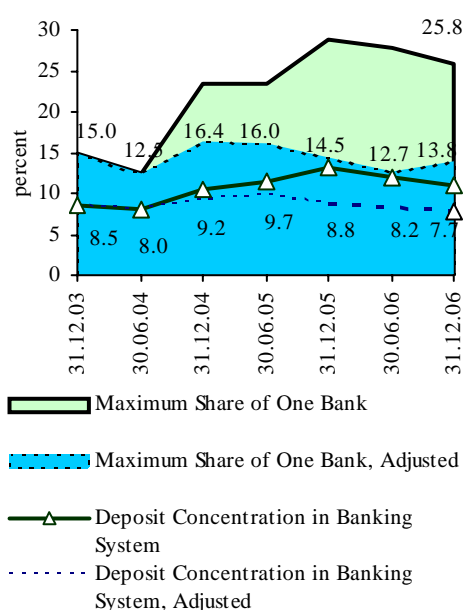


Chart 2.2.3.2. Deposit Concentration by Types of Currencies

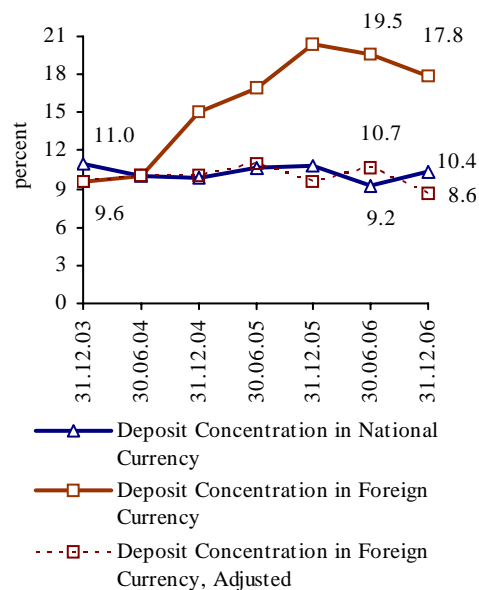
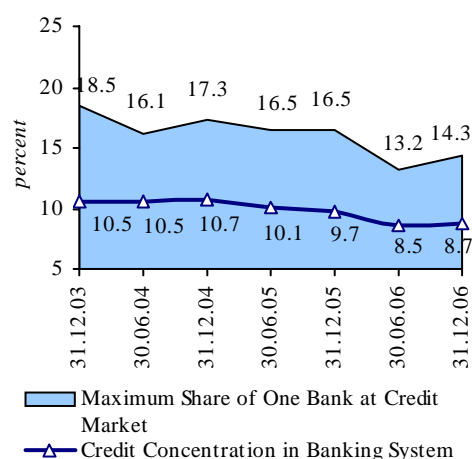


Chart 2.2.3.3. Change in Credit Concentration



had adequate assets to perform their financial liabilities. Considering adequate liquidity level in banks, increase in own capital, and also a specific nature of demand deposits, a negative gap in the period up to 30 days would not have a significant effect on performance of financial obligations by banks.

2.2.3. Concentration Risk

Peculiarities of deposit concentration. As given in Chart 2.2.3.1, the decrease both of the average deposit concentration level in the banking system, and of the maximum share of one bank at the deposit market continued in the second half of 2006. Reduction in the volume of deposits in one of commercial banks, which in its turn was connected with withdrawal of a large time deposit of a legal entity, had a major effect on the change of these indicators. This fact resulted in the decrease in concentration of this category of deposits (Chart 2.2.3.2).

In Charts 2.2.3.1 and 2.2.3.2, indicators, calculated without the aforesaid bank, were shown as *adjusted*.

When excluding deposits of this bank, the distribution of the deposit market among participants⁵ was low (more than 10 participants). While remaining at approximately the same level for the past three years, it had a downward trend.

Evaluation of the concentration level in the banking system with the help of another indicator, which was *the share of four large banks by the deposit level*, in the second half of 2006 also showed the decrease of deposit concentration from 53.7 to 48.6 percent. At the same time, during the period under review, two banks strengthened their positions by the size of deposits and belonged to the four large banks, having replaced the two other banks.

Peculiarities of loan concentration. The increase in the loan portfolio of the banking system in 2004-2006 was accompanied by some decrease of loan concentration assessed both by the maximum share of an individual bank at the credit market, and by the level (index) of loan concentration. In the second half of 2006, these indicators insignificantly increased due to the increase in the share of several banks, which actively lent to their clients, in the total loan portfolio (Chart 2.2.3.3).

Concerning the indicator of the *share of four large banks* in terms of credit concentration, we might note that it did not

⁵ Evaluation of the concentration risk as high, moderate or low is based on a common scale of the concentration level. Thus, the concentration risk is considered to be low, if the concentration level is less than 10 percent, moderate risk is between 10 and 20 percent, or high – above 20 percent. For example, a concentration index, which equals to 50 percent, is equivalent to the presence of 2 participants with equal shares in the market, and 33 percent to 3 participants, and so forth.

change and was 46.9 percent in the period under review. The composition of banks somewhat changed, which was related to the fact that banks, which held positions from the third through the fifth according to their share in the aggregate loan portfolio, had virtually equal shares of participation.

Reduction dynamics in the credit concentration indicator by types of currencies reflected improvement of competition among banks in disbursing loans both in national, and foreign currencies (Chart 2.2.3.4).

As a result of analysis of credit risk concentration by sector of the national economy, it should be noted that the credit concentration level remained at *moderate* and *high* in all types of sectors. This indicated that two to eleven banks engaged in lending to each sector.

On the basis of data from tables 2.2.3.5, 2.2.3.6, we might note some improvement in banks' activities in housing lending and communication. High concentration of loans disbursed for communication needs, procurement and processing, social services and transportation indicated concentration of these operations with only a limited number of banks, which resulted in a low share of similar loans in the total loan portfolio of the banking system.

Thereby, a moderate concentration of deposits and loans by currencies and sectors was noted in the banking system of the Kyrgyz Republic. Some increase of credit concentration indicators by participants of this market was caused by the increase of shares of several large commercial banks. This activity was not accompanied by any significant changes in interest rates in view of (1) growth of demand for loans, and (2) assessment of credit risks.

Chart 2.2.3.4. Credit Concentration by Types of Currencies

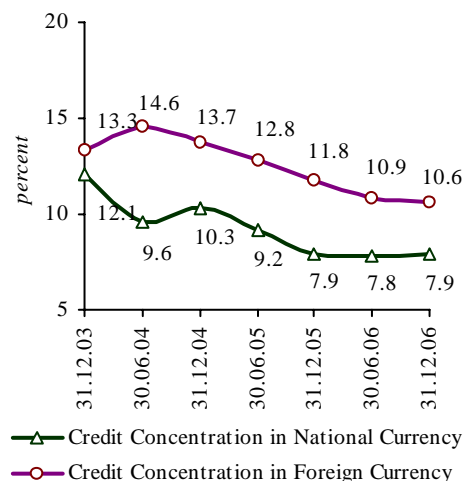


Table 2.2.3.5. Concentration of Banks' Activities in Lending to National Economy Sectors* (in percent)

	31.12.03	30.06.04	31.12.04	30.06.05	31.12.05	30.06.06	31.12.06	Deviation (in percentage points)
Industry	17.1	19.1	20.8	21.8	17.0	20.2	23.1	<u>2.9</u>
Agriculture	29.2	29.1	25.9	21.6	21.0	20.1	19.8	<u>-0.3</u>
Transportation	31.2	45.6	31.9	26.8	32.5	15.7	23.2	<u>7.5</u>
Communication	26.9	37.2	34.7	38.9	51.2	48.8	87.4	<u>38.6</u>
Trade	13.4	11.0	12.0	11.0	10.7	9.1	8.7	<u>-0.4</u>
Procurement and Processing	19.7	25.2	28.8	25.9	27.9	55.1	58.1	<u>3.0</u>
Construction	23.7	33.6	28.8	31.1	26.8	21.9	19.2	<u>-2.7</u>
Housing Lending	27.7	21.7	16.3	12.3	14.7	28.4	20.2	<u>-8.2</u>
Households	13.4	15.6	16.0	23.2	21.4	16.3	14.8	<u>-1.5</u>
Social Services	67.7	71.0	44.3	34.1	30.6	12.0	27.7	<u>15.7</u>
Others	12.5	12.2	13.6	13.3	14.6	18.0	11.6	<u>-6.4</u>

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

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

	31.12.03	30.06.04	31.12.04	30.06.05	31.12.05	30.06.06	31.12.06	Deviation (in percentage points)
Industry	21.7	21.5	20.5	18.7	17.3	12.7	11.0	-1.7
Agriculture	2.9	2.4	1.9	1.9	2.0	3.0	3.3	<u>0.3</u>
Transportation	1.5	1.5	1.2	1.3	0.8	0.9	0.7	-0.2
Communication	1.8	1.6	0.6	0.5	0.4	0.1	1.6	<u>1.5</u>
Trade	39.2	39.4	46.6	44.5	42.9	44.7	40.9	-3.8
Procurement and Processing	2.4	1.4	1.3	1.0	0.9	0.8	1.0	<u>0.2</u>
Construction	2.8	5.9	4.9	6.3	6.0	6.1	5.8	-0.3
Housing Lending	3.1	3.9	4.9	5.4	7.0	8.6	14.3	<u>5.7</u>
Households	7.3	8.3	8.0	8.2	8.0	8.7	8.1	-0.6
Social Services	0.0	0.0	0.3	0.2	0.2	0.1	0.1	0.0
Others	17.3	14.1	9.8	12.0	14.5	14.3	13.2	-1.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	x

2.3. Capital Adequacy

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

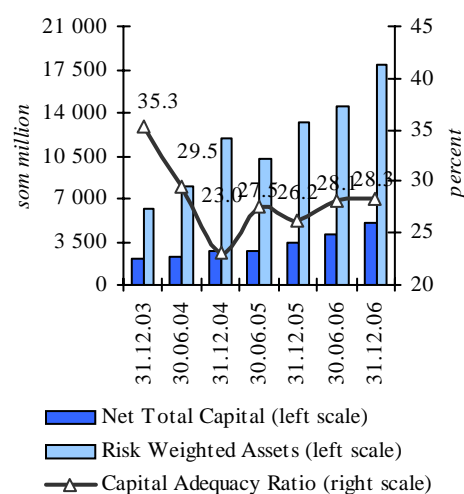
When analyzing the financial standing of the bank, conformity of the size of its capital to the scale and nature of operations (capital adequacy ratio) is the main feature of its soundness. Adequate capital forms a peculiar *cushion*, which permits the bank to remain solvent and maintain public confidence.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

Given the minimum value of the capital adequacy ratio at 12.0 percent, this indicator for the banking system, on the average, remained sufficiently high and was 28.3 percent according to the data at December 31, 2006 (Chart 2.3.1). As it was indicated in the given chart, the increase in net total capital of commercial banks was the main factor for increase of the capital adequacy indicator in the period under review. Consideration of the change for the past three years showed the increase of risk weighted assets, which in turn, was caused by the increase in volumes of lending to economy.

At the same time, the actual capital adequacy (28.3 percent) permitted to additionally increase the volume of risky and income-earning assets by more than two times without exceeding the allowable risk level in overall activities of the banking system.

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

Chart 2.3.1. Change in Capital Adequacy Indicators of Banking System



2.4. Financial Results

Return on assets, defined as the ratio of received profit to average assets, is the main profitability indicator of the banking activity. Following the results of 2006, the annualized return on assets was 3.3 percent in the banking system of the Kyrgyz Republic (2.3 percent following the results of last year).

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

Table 2.4.1. Main Profitability Indicators of Banking System
(in percent)

	31.12.03	31.12.04	31.12.05	31.12.06
<u>Income and Expense Items as % of Average Assets</u>				
Interest Income	9.0	10.2	10.3	10.9
- including interest income on loans	<u>7.1</u>	<u>8.8</u>	<u>9.0</u>	<u>9.4</u>
Interest Expenses	2.3	2.6	2.6	3.0
- including interest expenses on deposits	<u>1.8</u>	<u>1.7</u>	<u>1.6</u>	<u>1.6</u>
Net Interest Income	6.7	7.6	7.6	7.9
Allocations to ALL on Loans	1.2	0.8	1.4	1.0
<u>Net Interest Income after Allocations to ALL</u>	<u>5.5</u>	<u>6.8</u>	<u>6.2</u>	<u>6.9</u>
Non-Interest Income	9.8	8.0	6.7	9.8
Non-Interest Expenses	0.6	0.5	0.6	3.6
Operating Expenses	11.3	9.9	8.6	8.7
- including personnel expenses	<u>4.9</u>	<u>4.6</u>	<u>4.3</u>	<u>4.4</u>
Net Income (Loss) Before Tax	3.4	4.3	3.7	4.3
Allocations to ALL on Non-Credit Operations	0.5	0.1	0.1	0.2
Profit Tax	0.6	0.8	0.6	0.4
<u>Net Profit (Loss)</u>	<u>2.4</u>	<u>3.5</u>	<u>2.9</u>	<u>3.7</u>
<u>Interest Expenses as % of Average Liabilities</u>	3.2	3.3	3.2	3.7
<u>SPREAD of Interest Income and Expenses</u>	<u>5.8</u>	<u>6.9</u>	<u>7.1</u>	<u>7.2</u>

In this case, according to the data given in table 2.4.1, the annualized average return on assets of the banking system was 3.7 percent.

The reason for the increase of the final profitability indicator was the increase of the spread of interest income and expenses, decrease of allocations to the ALL on loans, and profit tax deductions (due to reduction of the profit tax rate by two times).

At the same time, the indicator of the loan portfolio yield, defined as the ratio of interest income on loans to average balances of loan indebtedness (annualized), did not practically change. This indicator was 20.2 percent based on the results of the second half of 2006. (Chart 2.4.2).

Interest expenses increased in comparison with the last year due to the increase of deposits of individuals and of time deposits (annualized).

The increase of non-interest income was noted in 2006, its ratio to average annualized assets was 9.8 percent. The increase of this ratio accounted for 3.1 percentage points, which resulted from the increase in the share of banks' income from rendering services and operations in foreign currency. However, the increase of losses from foreign exchange transactions affected the increase of non-interest expenses of banks, which increased only by 3.0 percentage points than at the beginning of the year, and accounted for 3.6 percent.

In connection with the increase of non-interest income to average assets of banks, their level exceeded operating costs by 1.1 percentage points, which affected the increase of the resulting return on assets.

The ratio of expenses for establishing ALL to annualized average assets decreased from 1.4 percent in 2005 to 1.0 percent based on the results of 2006. It was connected with the increase of lending on the part of commercial banks and growth of assets in improving the loan portfolio quality. This resulted in the increase of return on assets.

It should be also noted that, on the other hand, introduction of amendments and addenda to the Tax Code of the Kyrgyz Republic, according to which the rate of profit tax was reduced from 20 to 10 percent starting January 1, 2006, affected earnings of commercial banks.

We might consider the *spread of interest income and expenses*¹ (Chart 2.4.3.) as a feature for improving efficiency in performing functions of the financial agent between investors and the real sector by the banking system. Thus, the increase in lending and income on it in 2006 resulted in the increase of this indicator during the period under review.

In absolute terms, the net profit of the banking system in 2006 was Som 0.79 billion, and Som 0.43 billion in 2005 i.e. the increase was 84.1 percent.

The ratio of total assets to the number of employees increased from Som 4.9 million to Som 5.0 million per employee. This increase was connected with expansion of activities of banks, and growth of assets.

Thus, profitability indicators of the banking activity showed the positive movement and improvement in attractiveness of the banking system in terms of additional investments. At the same time, a high ratio of average capital adequacy suggested possible additional expansion in active operations of banks. On the other hand, the efficiency in the use of assets might be significantly improved with the decrease of the share of low income-earning assets.

¹ *Spread of interest income and expenses* refers to the difference between the ratio of interest income to average assets, and the ratio of interest expenses to average liabilities.

Chart 2.4.2. Return by Certain Types of Operations

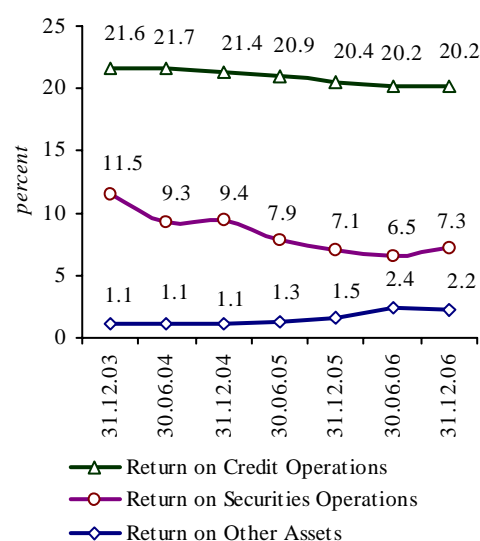
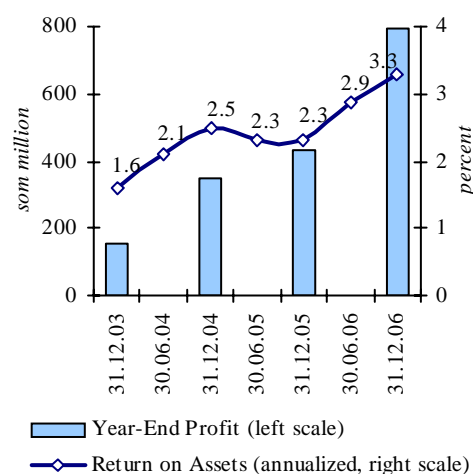
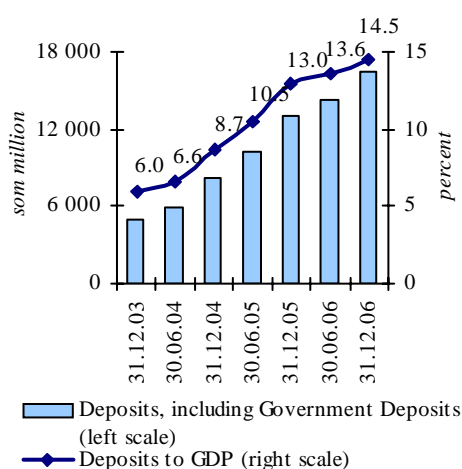


Chart 2.4.3. Change in Return on Assets



2.5. Financial Intermediation Indicators

Chart 2.5.1. Change in Deposits and Deposits to GDP



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

Following the results of the second half of 2006, the ratio of deposits¹ to GDP² was 14.5 percent (13.6 percent based on the results of the first half of 2006, Chart 2.5.1.). The increase of this indicator was conditioned by higher growth rates of deposits in comparison with GDP growth in the period under review. Thus, given the overall increase of nominal GDP by 8.3 percent in the second half of 2006, the increase of deposits was 15.8 percent.

There was a decrease in the ratio of deposits placed with commercial banks to money outside banks (M0). At the end of the second half of 2006, this indicator was 84.8 percent (97.8 percent following the results of the first half of 2006).

Loan portfolio growth continued in the period under review. In this case, the growth rates of loans (21.5 percent) surpassed the growth rates of deposits (15.8 percent). Volume of loans increased, to a certain extent, due to the increase of capital and liabilities, and, as result, of banks' assets.

According to the data as of December 31, 2006, the share of total disbursed loans to clients to GDP was 10.0 percent, having increased by 1.1 percentage points than at the beginning of six months (Chart 2.5.2.).

In the period under review, the volume of disbursed loans totaled Som 9.0 billion, which was greater by 34.2 percent than the volume of loans disbursed in a similar period of 2005.

In the structure of loans, the largest increase in lending was noted in trade (40.3 percent or by Som 1.3 billion), mortgage lending (by 3 times or by Som 1.1 billion) as compared with a similar period of 2005. The increase was also observed in lending to agriculture (by 2.4 times or by Som 0.2 billion).

At the beginning of the period under review, the ratio of loan indebtedness to deposits was 68.6 percent against 65.4 percent, which was connected with the increase of loans exceeding the increase of deposits (Chart 2.5.3).

In the second half of 2006, the average weighted interest rate of newly disbursed loans in national currency did not practically change and was 25.5 percent (a decrease by 0.2 percentage points than in the first half of 2006). The interest rate of newly disbursed loans in foreign currency increased by

Chart 2.5.2. Change in Loans and Loans to GDP

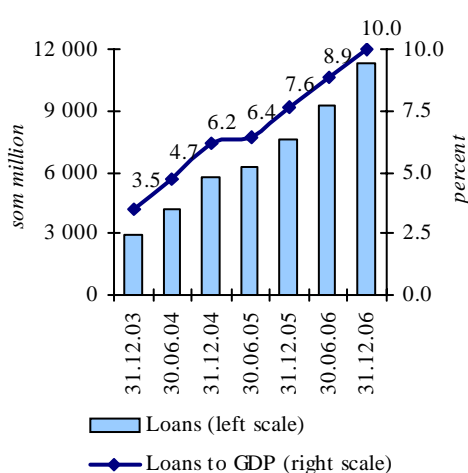
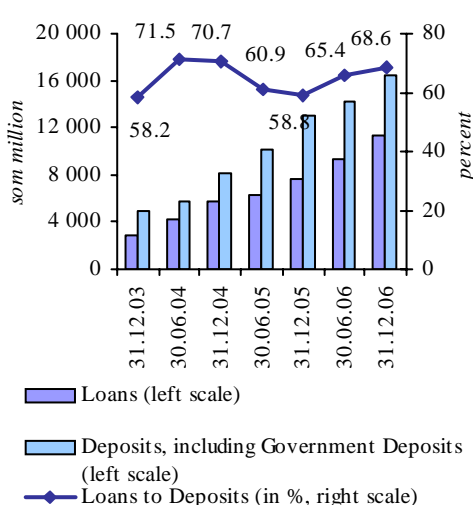


Chart 2.5.3. Change in Loans to Deposits



¹ In this section, deposits referred to deposits of the population, enterprises, and also of the Government and other public authorities of the Kyrgyz Republic
² Nominal GDP data for the past 12 months was taken into account.

1.4 percentage points and was 18.0 percent in the second half of 2006.

Considering financial results of commercial banks' activities, it should be noted that the ratio of *net* interest income to average monthly assets of banks on which interests were paid was 8.1 percent for the banking system³ (annualized) according to the data at December 31, 2006 (following the results of 2005, this indicator was 6.0 percent), which also indicated the increase in return on credit activity in the Kyrgyz Republic.

The increase in the ratio of *net* interest income to average assets in commercial banks was caused by the increase during past years of loan indebtedness and interest income, correspondingly. However, on the other hand, this did not contribute to the development of economy since expected reduction of interest rates was not observed. Such state of affairs might both point to inadequate supply of loans at the market, and to the high level of demand for new loans, or implied insufficient competition at the credit services market. In the first place, it was also the result of low level of transparency in activities of business entities.

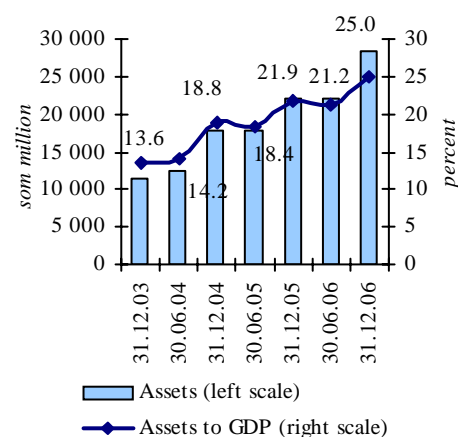
The dynamics of aforesaid indicators suggested the increase in profitability of the banking system, and also relative protectability of the system against the interest rate risk.

The increase in total assets to GDP should be noted in terms of financial intermediation (Chart 2.5.4.). Thus, this ratio was 25.0 percent based on the results of the second half of 2006, and 21.2 percent at the end of the first half of 2006.

Considering the fact that despite a sustainable growth for the past two to three years, some financial intermediation indicators had a relatively low value, there is still potential for further development and improvement of efficiency of the banking system.

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

Chart 2.5.4. Change in Assets and Assets to GDP



³ Calculations were made by taking into account the data on average performing assets and liabilities of commercial banks.

III. NON-BANK FINANCE AND CREDIT INSTITUTIONS

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

The system of non-bank finance and credit institutions (NFCIs) included the following institutions, which were subject to regulation and supervision by the NBKR:

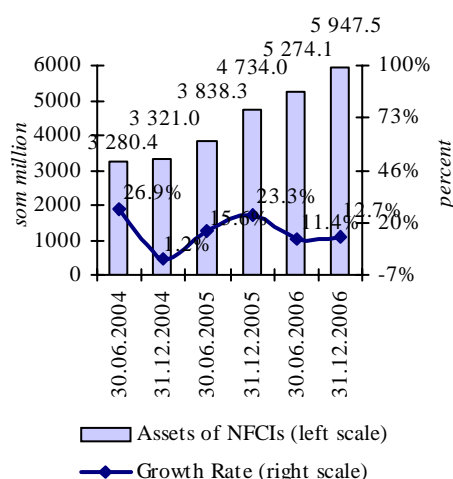
- Specialized finance and credit institutions: Kyrgyz Agricultural Finance Corporation (KAFC), transformed into OJSC *Aiyl Bank* on December 27, 2006; Financial Company for Support and Development of Credit Unions (FCSDCU);
- Credit unions (CUs);
- Microfinance organizations (MFOs), including microfinance companies (MFCs), micro credit companies (MCCs) and micro credit agencies (MCAs);
- Pawnshops;
- Exchange offices.

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

Table 3.1.1. Change in the Number of Non-Bank Finance and Credit Institutions

Name	2002	2003	2004	2005	2006
KAFC (Aiyl Bank)	1	1	1	1	1
FCSDCU	1	1	1	1	1
MFOs	0	72	104	136	168
Credit Unions	349	303	305	320	305
Pawnshops	85	108	116	140	148
Exchange Offices	234	261	266	260	263

Chart 3.1.1. Change in Aggregate Assets of NFCIs



The increase in the number of NFCIs demonstrated the demand for their services and resulted from regulatory frameworks proposed by the state.

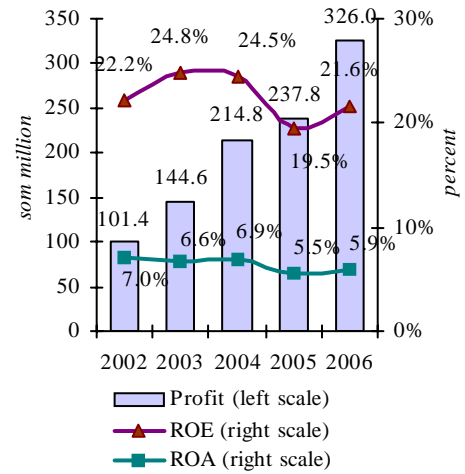
According to presented regulatory reports for the second half of 2006, the increase in aggregate assets of NFCIs (Chart 3.1.1) was 12.8 percent and totaled Som 5 947.5 million¹ as of December 31, 2006. In this case, the growth rates of own capital of NFCIs were 13.4 percent, and aggregate liabilities of NFCIs increased by 9.0 percent.

¹ Hereinafter, assets and loan portfolio of NFCIs were shown without assets of FCSDCU, which was related to the fact that the loan portfolio of FCSDCU was already included in the assets of CUs.

In the system of NBFIs, at the date of review, the profit growth rate increased by 37.1 percent (or by Som 88.2 million) than in 2005, and totaled Som 326 million, i.e. 29.2 percent of the aggregate profit of commercial banks and NBFIs. This was connected with the increase in the volume of the main income-earning asset of NBFIs, which was the loan portfolio, and also by the increase in the share of the most profitable type of NBFIs, which was MFO.

As a result of aforesaid, some increase was noted in return on assets (ROA) and return on capital (ROE) (Chart 3.1.2.).

Chart 3.1.2 Change in ROA and ROE of NBFIs



3.2. Structure and Development of Loan Portfolio

Chart 3.2.1. Change in Loan Portfolio of NFCIs

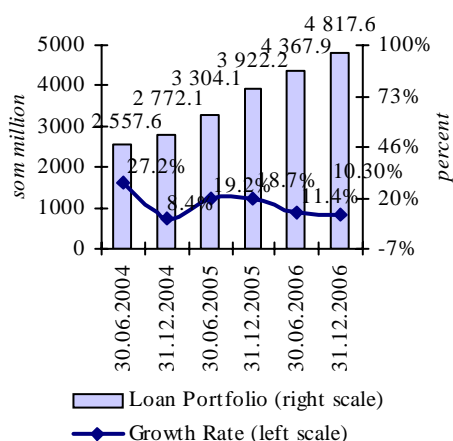


Chart 3.2.2 Aggregate Loan Portfolio by Types of NFCIs (som million)

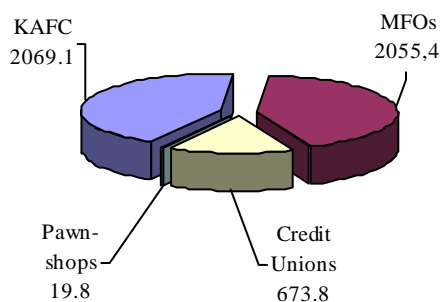
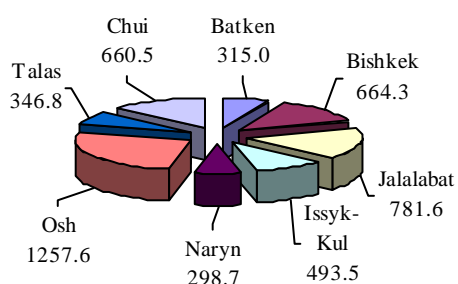


Chart 3.2.3 Aggregate Loan Portfolio of NFCIs by Oblasts (som million)



Lending was the main area of activities of non-bank finance and credit institutions.

In the period under review, the loan portfolio in aggregate assets of NFCIs reduced from 82.8 percent as of June 30, 2006 to 81.0 percent as of December 31, 2006.

For the second half of 2006, the aggregate loan portfolio of NFCIs increased by Som 449.7 million or by 10.3 percent, and totaled Som 4 817.6 million.

The increase in the loan portfolio of NFCIs was accompanied by the increase in the number of borrowers by 31 491 people, or by 24.9 percent to 157 991 people.

It should be noted that the share of loan portfolio in assets of NFCIs for the past three years, as a rule, increased during the first six months and decreased by the end of the second half year. Such cyclical movement resulted from a strongly marked effect of the seasonal factor on activities of most NFCIs, and attachment of the borrowers' business to the agricultural cycle.

The loan portfolio of NFCIs had a sustainable growth trend over a period of several years (Chart 3.2.1.).

During the period under review, the share of KAFC (Aiyl Bank) reduced from 45.7 percent to 42.9 percent in the aggregate loan portfolio of NFCIs, and the share of microfinance organizations increased from 39.3 percent to 42.7 percent.

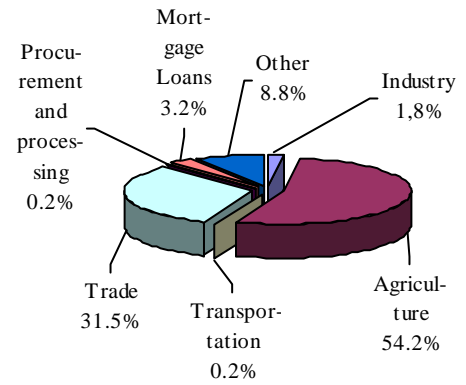
In the structure of the aggregate loan portfolio of non-bank finance and credit institutions (Chart 3.2.2), 42.9 percent was concentrated in KAFC loans (Aiyl Bank); 42.7 percent was in loans of microfinance organizations; 0.4 percent was in loans of pawnshops, and 14.0 percent was in loans of credit unions, where loans received by CUs in FCSDCU accounted for 46.8 percent of their total loan portfolio.

The change in volumes of loan portfolio by sectors and regions showed stable preferences of NFCIs. Thereby, by oblasts (Chart 3.2.3), the main share of the loan portfolio was concentrated in Osh, Jalalabad, Chui Oblasts and in Bishkek. The regional activity was the highest in the south of the country and in the capital in view of a higher population density and its economic activity in agriculture and trade sectors.

In the second half of 2006, the highest volume of loans of

NFCIs was in agriculture, which accounted for 54.2 percent, and 31.5 percent in trade (Chart 3.2.4). Such distribution of credit resources was conditioned by the specific nature of activities of KAFC (Aiyl Bank) and microfinance organizations, which had the largest share in the aggregate loan portfolio of NFCIs: KAFC (Aiyl Bank) aimed 83.2 percent of its loans to agriculture and MFOs targeted 55.9 percent of their loans to the trade area.

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



3.3. Primary Risks

Activities of NFCIs were characterized by concentration of loans by sectors of economy and by types of institutions.

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

A seasonal decrease in the share of loans in agriculture was noted by sectors of economy. The share of agriculture reduced from 54.5 percent to 54.2 percent.

Interest rates on loans of non-bank finance and credit institutions were still at sufficiently high level due to maintained high demand for these types of loans on the part of the population, and also the pursuit of NFCIs to cover their existing high risks.

The average interest rate on loans of NFCIs for the period under review was as follows: 14.2 percent (14.3 percent in the first half of 2006) in KAFC (Aiyl Bank), 33.5 percent in MFOs (30.9 percent in the first half of 2006); 25.9 percent in CUs (against 25.6 percent in the first half of 2006) and 149.5 percent in pawnshops (against 144.9 percent in the first half of 2006).

IV. PAYMENT SYSTEM

4.1. Banking Products, Tariffs and Services

Commercial banks provide a wide range of banking services to the population and organizations.

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

Banks applied different approach to collecting payments for the same services:

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

In spite of the fact that, the range of prices was different for certain types of services in commercial banks, tariffs for package services rendered by banks were approximately similar.

As of today, commercial banks rendered such services as:

- cash and settlement services;
- documentary operations;
- securities operations;
- loan disbursement operations;
- payment card servicing (by types);
- servicing under *e-Client* system and so forth.

When rendering cash and settlement services to clients for a payment, commercial banks often offered an operation on opening an account on a gratuitous basis. Thus, for the period under review, there were eight commercial banks, which offered the service on opening a settlement account for legal entities and individuals in national and foreign currencies on a gratuitous basis, which was higher by 1 bank than in a similar period of the prior year. Remaining banks charged a fee within the range of Som 100 to Som 1000 in national currency, and Som 100 to Som 2000 in foreign currency.

Today it is impossible to imagine the financial credit system without letters of credit, which act as a lending mechanism and means of payments. In the course of settlements under the letter of credit, the payer gives an order to the bank (issuer) either to open a letter of credit and make payments to the receiver, or transfer these authorities to another bank (designated bank). For the second half of 2006, the cost of

Table 1. List of Banks Servicing Money systems of remittances

Money system of remittances	Commercial Bank Name
Western Union	1. OJSC Bakai Bank 2. OJSC IB Issyk-Kul 3. CJSC INEXIMBANK 4. JSCB Kyrgyzcredit 5. OJSC Kyrgyzpromstroibank 6. JSCB Kyrgyzstan 7. CJSC JSCB Tolubai 8. OJSC Ecobank 9. OJSC ATF Bank Kyrgyzstan
Money Gram	1. OJSC RK Amanbank 2. OJSC DosCredobank 3. OJSC IB Issyk-Kul 4. CJSC KICB 5. OJSC Kazkommertsbank Kyrgyzstan
Contact	1. OJSC RK Amanbank 2. CJSC Bank Asia 3. OJSC Halyk Bank Kyrgyzstan 4. JSCB Kyrgyzstan 5. OJSC ATF Bank Kyrgyzstan 6. OJSC FinanceCreditBank KAB 7. OJSC DosCredobank 8. CJSC INEXIMBANK
Anelik	1. OJSC AsiaUniversalBank 2. OJSC RK Amanbank 3. OJSC IB Issyk-Kul 4. CJSC INEXIMBANK 5. JSCB Kyrgyzcredit 6. JSCB Kyrgyzstan 7. OJSC Ecobank 8. OJSC FinanceCreditBank KAB
VIP Money transfer	1. OJSC AsiaUniversalBank 2. OJSC RK Amanbank 3. CJSC INEXIMBANK
Migom	1. OJSC RK Amanbank 2. CJSC Bank Asia 3. OJSC DosCredobank 4. OJSC Ecobank

Strana	1. OJSC SSC
Bystraya Pochta	1. JSCB Kyrgyzcredit 2. OJSC SSC
UNIstream	1. OJSC AsiaUniversalBank 2. OJSC RK Amanbank 3. CJSC Bank Asia 4. OJSC IB Issyk-Kul 5. OJSC Halyk Bank Kyrgyzstan 6. JSCB Kyrgyzcredit 7. JSCB Kyrgyzstan 8. CJSC JSCB Tolubai 9. OJSC Ecobank 10. OJSC ATF Bank Kyrgyzstan 11. OJSC FinanceCreditBank KAB 12. CJSC INEXIMBANK
Xpress	1. OJSC RK Amanbank
Inter Express	1. JSCB Kyrgyzstan 2. CJSC INEXIMBANK
STB-express	1. OJSC Ecobank
Travelex	1. OJSC Ecobank
Blizko	1. OJSC RK Amanbank
Leader	1. OJSC RK Amanbank 2. JSCB Kyrgyzcredit 3. OJSC ATF Bank Kyrgyzstan

service for issuing (opening) a letter of credit, on average, was 0.2 percent up to 1 percent of the amount of the letter of credit.

For the period under review, the highest commission fees for issuing a bank guarantee were 5-7 percent. The cost of this service depended on the guarantee's security. For example, for issuing a guarantee secured by a cash deposit or by liquid securities, 0.3 percent of the guarantee amount was charged in one of the banks for each period up to 6 months (inclusive), where the minimal amount was Som 2500. In case if the guarantee was secured by another type of collateral, then up to 8 percent of the amount was charged, where the minimal amount was \$US 100 (excluding a commission fee of the confirming bank).

It was also necessary to note that at present, the service of *money system of remittances without opening a bank account* was in great demand among population. Currently, such international money system of remittances operated in the Kyrgyz Republic as *Western Union, Money Gram, Contact, Anelik, VIP Money Transfer, Xpress Money, Migom, UNIstream, Strana Express, Bystraya Pochta, InterExpress, STB-express, Travelex, Blisko* and *Leader*. Prompt and safe remittances without opening an account virtually to any country of the world were the main advantage of money system of remittances (Table 1).

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

At the banking services market, such types of services were also in great demand as follows:

- servicing of exchange offices;
- safe deposit services in the bank;
- provision of NBKR discount rates;
- internships;
- and others

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

4.2. Cash and Non-Cash Turnovers

As of December 31, 2006, the total amount of *currency in circulation* was Som 19 909.8 million. As compared with the first half of 2006, the increase of currency in circulation in the second half of 2006 totaled Som 4 938.7 million, and the growth was 33.0 percent.

Cash offices of commercial banks held Som 498.9 million, which accounted for 2.5 percent of the total amount of currency in circulation.

The change of currency in circulation is presented in Chart 4.2.1.

The increase of state payments on the social package, a stable demand of economy in cash on the part of developing small and medium size businesses, and also the increase in receipts of money from labor migrants might be noted as factors of increase of currency in circulation.

In the second half of 2006, *cash recurrence to cash offices of commercial banks* accounted for 94.7 percent, which was less by 2.5 percentage points than in the first half of 2006. The change in cash recurrence indicator is given in Chart 4.2.2.

The largest indicator of cash recurrence for the second half of 2006 was 112.1 percent in Osh, and the lowest was 31.9 percent in Batken Oblast (see Chart 4.2.3). Cash recurrence was 104.1 percent in Bishkek, and 107.4 percent in Chui Oblast. The highest percent of cash recurrence in Osh was connected with a more saturated consumer market, although, the percent of cash recurrence was low overall in Osh Oblast. High indicators of cash recurrence in Bishkek and Chui Oblast reflected the concentration of banking and finance institutions, trading and industrial enterprises in the capital of the country and in Chui Oblast. Cash recurrence insignificantly changed by oblasts in the country.

In the second half of 2006, total of Som 64 935.6 million was disbursed from *cash offices of commercial banks*, which was greater by Som 19 966.0 million or by 44.4 percent than in the first half of 2006. Cash disbursements increased on the following expense items:

- Increased by Som 542.2 million or 13.0 percent, and totaled Som 4 702.3 million for payment of salaries to budget agencies;
- By Som 3 485.0 million or by 76.9 percent, and amounted to Som 8 017.1 million for purchase of foreign currency;
- Increased by Som 16 350.5 million or by 48.9 percent, and amounted to Som 49 761.3 million for other expenses.

Chart 4.2.1. Change of Currency in Circulation

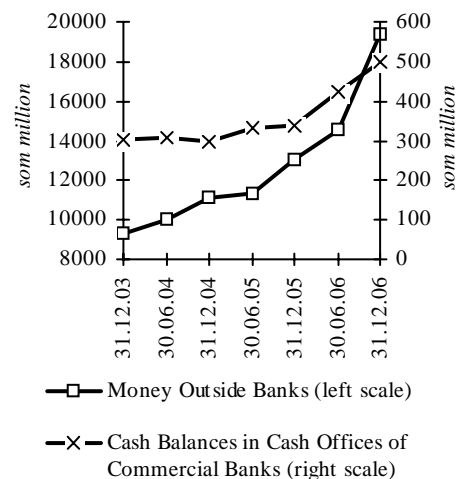


Chart 4.2.2. Change in Rate of Cash Recurrence

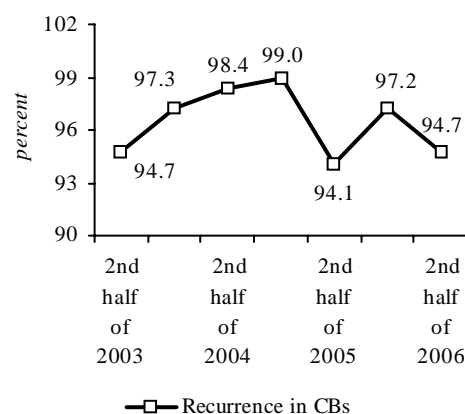


Chart 4.2.3. Rate of Cash Recurrence to Cash Offices of Commercial Banks

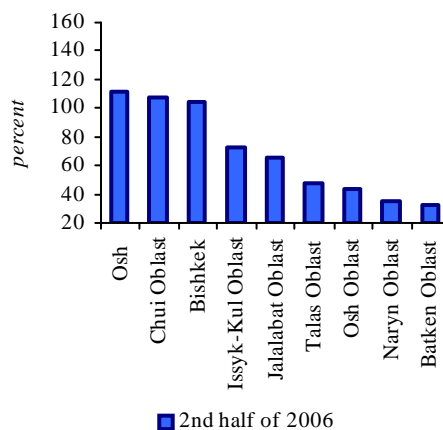
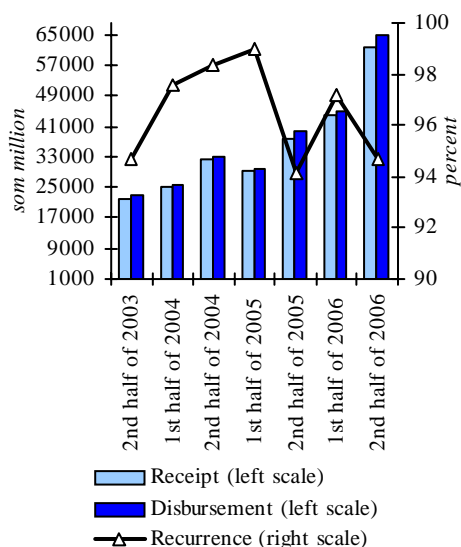


Chart 4.2.4. Cash Receipt, Disbursement, and Recurrence to Cash Offices of Commercial Banks



Payments under *Pensions and Benefits* item reduced by Som 411.8 million or by 16.8 percent, and amounted to Som 2 454.9 million.

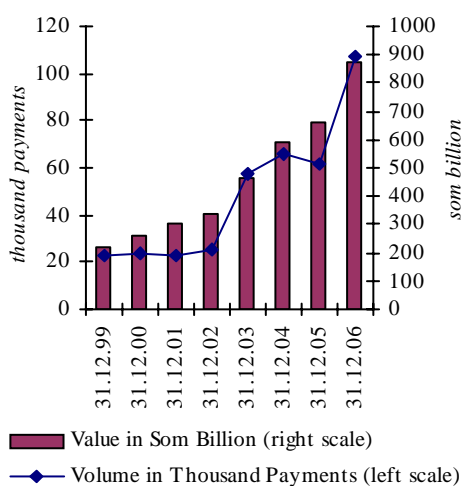
In the second half of 2006, *cash offices of commercial banks received* Som 61 472.4 million, which was greater by Som 17 779.0 million or by 40.7 percent than in the first half of 2006. Cash receipts increased on all receipt items:

- Taxes, duties increased by Som 1 574.7 million or by 40.9 percent, and totaled Som 5 422.6 million;
- Sale of foreign currency increased by Som 2 275.1 million or by 57.2 percent, and amounted to Som 6 250.0 million;
- Other receipts increased by Som 13 929.2 million or by 38.8 percent, and totaled Som 49 799.8 million.

Change in indicators of receipts, disbursements of cash and their recurrence to cash offices of commercial banks is presented in Chart 4.2.4.

Thus, the increase of currency in circulation was conditioned by a stable growth of demand for cash on the part of business entities, and by expansion of goods and services market serviced by cash.

Chart 4.2.5. Change in Value and Volume of Interbank Payments



Non-Cash Turnovers

Following the results of the second half of 2006, total of 894739 payments amounting to Som 105159.0 million were conducted through payment systems of the Kyrgyz Republic. As compared with indicators in 2005, the value of payments increased by 32.2 percent and 75.0 percent, correspondingly (Chart 4.2.5).

A significant growth in values of interbank payments was conditioned by overall strengthening of the banking system, increased activities of financial markets and of the retail service market.

At present, two payment systems operate in the Kyrgyz Republic, which make interbank payments: the large value payment transfer systems and the low value payment transfer systems. Small payments and payments with blank due date are, mainly, made in the low value payment transfer systems. The large value payment transfer systems ensures final settlements on net positions based on the results of the clearing session. It is designed to make immediate settlements on transactions at the financial markets, due payments and so forth.

Large Value Payment Transfer Systems

In the second half of 2006, total of 32502 payments amounting to Som 78027.9 million were made in the large value payment transfer systems. The volume of payments increased

by 44.1 percent than in a similar period of the prior year (Chart 4.2.6).

The value of payments made in the *low value payment transfer systems* increased by 6.9 percent and totaled Som 27 131.22 million than in the prior year. The total value of payments increased by 76.8 percent (Chart 4.2.7), which was conditioned by the increase in number of payments on income operations.

Following the results of the second half of 2006, in the regional structure, Chui Oblast and Bishkek were leaders in volume and value of clearing payments. Their share was 78.1 percent of the volume and 63 percent of the volume of clearing payments, correspondingly.

A significant increase in volume of payments was noted in all regions (+77.0 percent), especially in Naryn Oblast (+288.8 percent) than in a similar period of 2005. Naryn Oblast (+192.3 percent) was also a leader by the increase in value of payments.

Card Payment Systems

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

In the second half of 2006, total of 15 (out of 22) finance and credit institutions were engaged in acquiring, providing settlement and cash services to clients using bank cards. Ten finance and credit institutions out of them were issuers and emitted cards of international (7 banks) and domestic systems (5 banks), and also of the uniform national system (2 banks).

The most important date in the second half of 2006 was the date when the InterBank Processing Center (hereinafter IPC), a software and hardware complex, was put into operation by using *Elcart* national payment card (December 22, 2006). It should be noted that IPC was a key link in establishing a uniform interbank system of non-cash transactions by using bank payment cards of *Elcart* national system, and ensured receipt, collection and processing of information on transactions by using these cards.

Total of 13 shareholder commercial banks of CJSC Interbank Processing Center (hereinafter CJSC IPC) and NBKR were participants of IPC. In addition, receipt of the principal member status of Visa International by CJSC Demir Kyrgyz International Bank (hereinafter CJSC DKIB) was an important event at the payment card market. This was a great contribution to the development of the country's potential on participation in international markets of bank cards. CJSC DKIB announced this in December 2006, prior to this event, only

Chart 4.2.6. Change in Value and Volume of Payments in Large Value Payment Transfer Systems

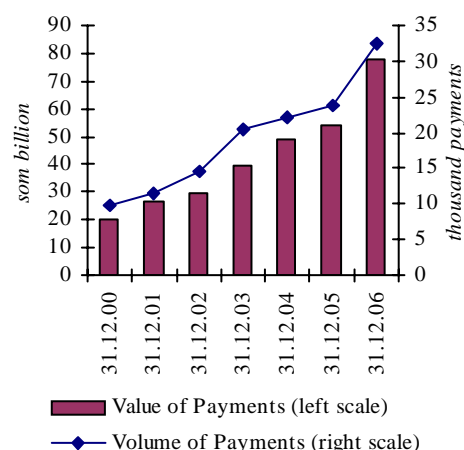
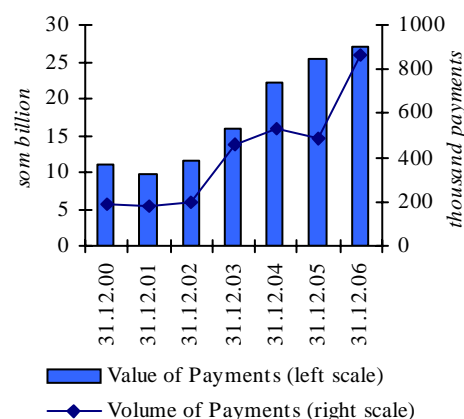


Chart 4.2.7. Change in Value and Volume of Payments in Low Value Payment Transfer System



associated members of Visa International operated in the country.

Thus, at the end of the second half of 2006, 3 associated participants of Visa International operated in the country, which were as follows: JSCB Kyrgyzstan, OJSC Kazkommertsbank and OJSC ATF Bank Kyrgyzstan, and 1 principal participant, which was CJSC DKIB.

CJSC Demir Kyrgyz International Bank was a leader in volume of conducted operations, where the total volume of its operations was 129 803 operations (which accounted for 32.7 percent of the total volume of operations).

OJSC Kazkommertsbank Kyrgyzstan held a leading position in value of performed operations, which was Som 647.7 million (that accounted for 41.2 percent of total transactions and 63.3 percent of transactions in international systems).

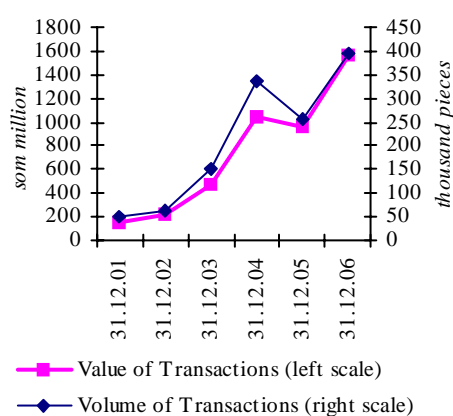
During the reporting period, increased activities were noted at the payment card market, which was proven by the increase in volume of emitted cards and card-based transactions. Thus, the total volume of emitted cards for the first half of 2006 came to 33 668 items, which was greater by 48.4 percent than in a similar period of 2005.

The total volume and value of card-based operations in relation to a similar period of 2005 increased by 34.8 percent and 38.9 percent, correspondingly (Chart 4.2.8).

Cash withdrawal operations traditionally accounted for the main value of conducted operations, which was Som 1 469.7 million and the turnover in the POS network was Som 102.4 million. Thus, the ratio of cash withdrawal operations to non-cash transactions in trade outlets was 93.4 percent to 6.5 percent, correspondingly. This fact indicated that the majority of emitted cards were *salary* cards and the infrastructure of their servicing was not adequately developed.

Implementation of *salary* projects on the basis of international and domestic system cards is one of priority directions in the development strategy of leading banks at the payment card market of Kyrgyzstan. Due to these projects, in particular, banks achieved a notable increase in the emission of cards and values of operations that permitted to make a significant step forward in the direction of strengthening banks' positions at the banking card market. In the second half of 2006, six commercial banks carried out activities on implementation and expansion of *salary* projects on the basis of international and domestic system cards, which were as follows: OJSC Settlement and Savings Company, CJSC Demir Kyrgyz International Bank, OJSC Kazkommertsbank Kyrgyzstan, OJSC Ecobank, OJSC Halyk Bank Kyrgyzstan and CJSC INEXIMBANÊ. Within the framework of 183

Chart 4.2.8. Change in Value and Volume of Bank Card-Based Transactions



projects, banks sold 16 466 cards, which accounted for 49.3 percent of the total volume of emitted cards.

Commercial banks continued implementing activities on developing the infrastructure on receipt and servicing of cards. Thus, as of December 31, 2006, the total volume of operating terminals was as follows:

- Alai Card system – 103 terminals and 5 automated teller machine (ATM)s;
- Demir 24 system – 70 terminals and 18 ATMs;
- Union Card system – 2 imprinters;
- International systems– 324 terminals, 13 imprinters and 19 ATMs.

Transborder payments, including remittances

As of December 31, 2006, total of 21 commercial banks were SWIFT members in the Kyrgyz Republic. 14 banks operated through general interface of Shared unit of the SWIFT of the NBKR¹ (including NBKR), and 6 banks operated independently.

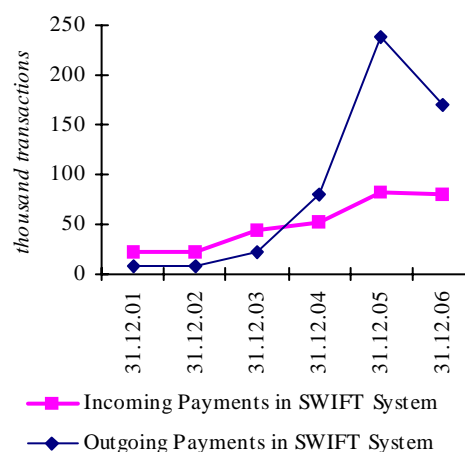
The analysis of payments in SWIFT network demonstrated a decline in indicators both in volume of payments, and in values of remittances. Thus, the volume of outgoing payments was 169860 thousand pieces for the second half of 2006, which was less by 26 percent than in the second half of 2005 (Chart 4.2.9).

Total of 11 out of 22 commercial banks in the Kyrgyz Republic provided services on operations with traveler's checks: OJSC AsiaUniversalBank, OJSC Bakai Bank, CJSC Demir Kyrgyz International Bank, CJSC INEXIMBANK, OJSC IB Issyk-Kul, OJSC Kazkommertsbank Kyrgyzstan, JSCB Kyrgyzstan, BB NB of Pakistan, OJSC Settlement and Savings Company, OJSC Halyk Bank Kyrgyzstan and OJSC Ecobank.

The volume of operations with the use of traveler's checks was 2 926 operations with the total value of Som 35.9 million in the second half of 2006, which increased by 1.4 percent and 8.9 percent than in a similar period of 2005, correspondingly. This fact showed increased activities of banks on servicing traveler's checks of different issuers. However, non-residents of the Kyrgyz Republic were still the main consumers of traveler's checks. Traveler's checks and other banking products were not in great demand among local population of the Kyrgyz Republic.

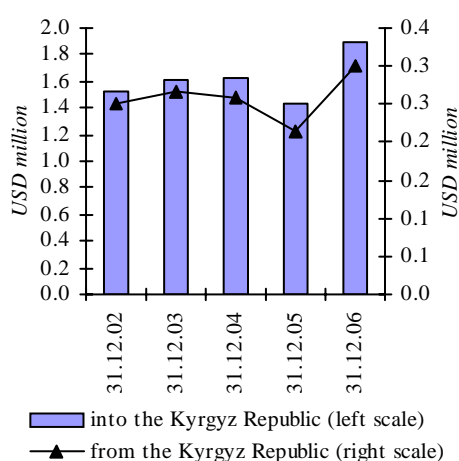
During the reporting period, there were cash flows on four types of traveler's checks: American Express, Master Card, Visa Card and personal checks of different banks, among which American Express checks were traditionally in greater

Chart 4.2.9. Change in Transactions in SWIFT System



¹ Shared Unit of SWIFT NBKR

Chart 4.2.10. Change in Postal Money Transfers



demand. Thus, in the second half of 2006, total of 2809 operations was conducted by using these checks amounting to Som 30.9 million, which accounted for 96.0 percent and 86.1 percent of total volume and value of conducted operations with checks, correspondingly.

It should be noted that the traveler's check was still not in demand by the population of the Kyrgyz Republic due to its specific nature.

In the second half of 2006, the total value of postal money transfers to the Kyrgyz Republic was US\$1.9 million, including from CIS countries and Non-CIS countries in the amount of US \$1.8 million and US\$ 55 thousand, correspondingly. At the same time, transfers from the Kyrgyz Republic amounted to only US\$ 289 thousand. Moreover, transfers were made only to CIS countries. A positive difference between postal transfers to the Kyrgyz Republic and from the Kyrgyz Republic was US\$3 718 thousand for the reporting period (Chart 4.2.10).

The comparative analysis of postal transfer indicators from non-CIS countries and CIS to the Kyrgyz Republic in the reporting period with the data for a similar period of 2005 showed the increase in cash flows by 1.3 percent, which was explained by the preference of the population to use banking institutions for making money transfers.

V. STATUS OF THE REAL SECTOR

5.1. Households

In 2006, the nominal average monthly salary was Som 3058.6. It increased by 18.9 percent in nominal terms than in 2005. In turn, the average monthly minimal consumer budget was Som 2527.5 in 2006. It increased by 37.6 percent than in the prior year (Som 1836.6 in 2005).

5.1.1. Liabilities to Financial and Credit Institutions

Liabilities of the household sector to the banking system increased by 5.3 times for the past three years and amounted to Som 2.8 billion as of December 31, 2006. They increased by 78.1 percent as compared with the end of 2005. The growth trend of loans in foreign currency was observed, as before, in the structure of liabilities (Chart 5.1.1.1).

For the past three years, liabilities in national currency and in foreign currency increased by 3.4 and 6.6 times, correspondingly. As of end of 2006, they amounted to Som 783.9 million and Som 2068.9 million, accordingly.

In the second half of 2006, the volume of loans disbursed to citizens increased by 65.8 percent than in the corresponding period of 2005. Its share increased from 7.3 to 8.8 percent in the total volume of disbursed loans. The total volume of consumer loans disbursed by commercial banks amounted to Som 796.5 million in the second half of 2006.

5.1.2. Public Savings

For the past three years, the volume of deposits of individuals in commercial banks increased by 2.9 times (Chart 5.1.2.1) and amounted to Som 4135.1 million at the end of 2006. The annual growth rate was 55.4 percent. The increase in real income of the population, including the increase of the average monthly salary as well as the strengthening of the banking system, had a positive impact on the increase in deposits of individuals within past years.

From the beginning of 2006, deposits in national currency increased by 78.7 percent and they increased by 43.6 percent in foreign currency. The reduction of the US dollar rate at the world markets, the growth of domestic demand for national currency, which in its turn contributed to strengthening of the national currency rate vis-à-vis the US dollar, and also improvement of public confidence in the banking system and in national currency were among factors which determined the

Chart 5.1.1.1. Liabilities of Individuals to Banks

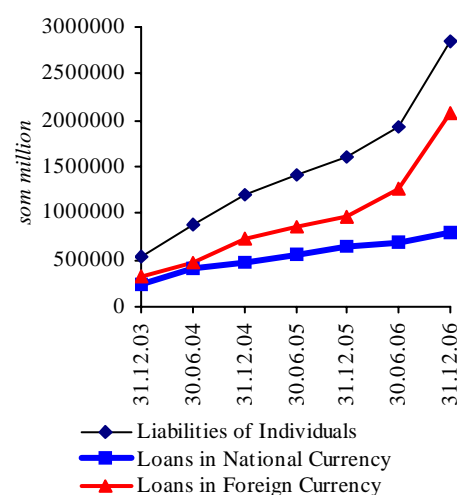
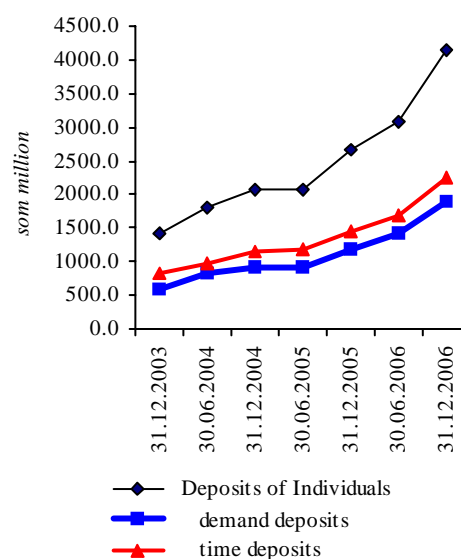


Chart 5.1.2.1. Deposits of Individuals



increase of deposits in national currency. However, in spite of rapid growth of deposits in national currency, deposits in foreign currency still had the largest share in the structure of deposits of the population and accounted for 61.5 percent of total deposits.

In 2006, the largest increase was noted in demand deposits in national currency (by 2 times). The increase of demand deposits in foreign currency was 44.8 percent. In 2006, time deposits in national currency increased by 67.5 percent and in foreign currency by 42.3 percent.

5.2. Corporate Sector

5.2.1. Liabilities to Financial and Credit Institutions

At the end of 2006, there were 563.8 thousand business entities in the Kyrgyz Republic, which exceeded their number at the beginning of the year by 4.7 percent. Moreover, the number of individual entrepreneurs and small enterprises greatly increased (by 9.5 percent and by 8.7 percent). As in prior years, peasant (farm) enterprises (53.2 percent) and individual entrepreneurs (33.5 percent) dominated in the structure of business entities. The number of operating entities was 385.4 thousand entities out of total number of business entities, which was greater by 5.8 percent than at the beginning of 2006. Such increase was ensured by the increase (almost by 29 percent) in the number of private entrepreneurs, mainly, in agriculture, trade and repairs, transportation and communication.

The aggregate debt of enterprises and organizations to operating commercial banks had an upward trend in 2006 as for the past three years. At the end of 2006, it was Som 8221.7 million, having increased by 47.4 percent during the year (Chart 5.2.1.1.). Despite a more rapid growth of loans in national currency in 2006, the share of loans in foreign currency was 67.3 percent of the total amount of liabilities of enterprises at the end of 2006.

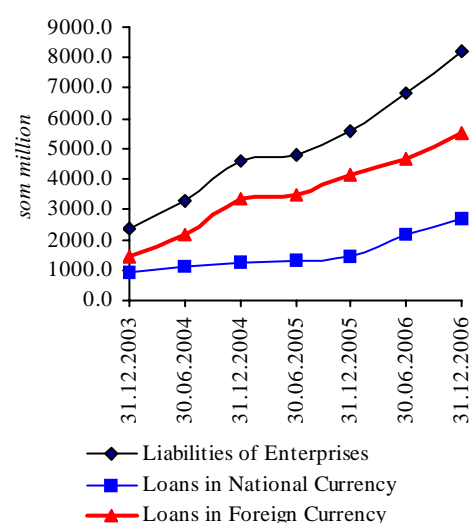
Total loans disbursed by commercial banks in the second half of 2006 increased by 37.2 percent than in a similar period of 2005. The most significant growth for the period was noted in loans for transportation and communication by 3.8 times and for mortgage by 3.7 times. Also, loans for agriculture increased by 2.7 times, by 2.1 times for procurement and processing and by 34.2 percent for trade.

Loans disbursed for construction reduced in the second half of 2006 than in the second half of 2005 and amounted to Som 556.9 million.

At the end of 2006, average weighted interest rates on disbursed loans in national currency were 24.7 percent per annum for industry (22.5 percent at the end of 2005), 29.1 percent for agriculture (28.5 percent at the end of 2005), 22.9 percent for transportation and communication (24.6 percent at the end of 2005), and 27.5 percent for trade (26.6 percent at the end of 2005).

At the end of 2006, average weighted interest rates on disbursed loans in foreign currency were 15.7 percent for industry (16.6 percent at the end of 2005), 20.7 percent for agriculture (22.5 percent at the end of 2005), 20.1 percent for

Chart 5.2.1.1. Change in Corporate Sector Debt to Commercial Banks



transportation and communication, and 19.5 percent for trade (22.5 and 19.6 percent at the end of 2005, correspondingly).

5.2.2 Status of Accounts Receivable and Accounts Payable¹

In the course of the past three years, insignificant increase in amounts of both accounts payable, and accounts receivable was observed in enterprises (Chart 5.2.2.1).

As of October 1, 2006, accounts receivable² of enterprises and organizations amounted to Som 32370.4 million in absolute terms and increased by 15.4 percent than at the beginning of the year.

Industry enterprises had the largest share of 56.5 percent in total accounts receivable, including 38.3 percent in power generation and distribution enterprises; 14.3 percent in organization of trade, repair of vehicles, household and personal goods, 19.2 percent in transportation and communication, and 4.5 percent in construction organizations.

During nine months, overdue accounts receivable increased by 10.8 percent than at the beginning of 2006 and amounted to Som 6931.0 million, or 21.4 percent to total accounts receivable as of October 1, 2006. Enterprises on generation and distribution of power, gas, steam and water had 75.4 percent of overdue accounts receivable, processing industry had 13.9 percent, transportation and communication enterprises had 2.9 percent.

Accounts payable had an upward trend and amounted to Som 40976.9 million as of October 1, 2006.

In general, the share of overdue accounts payable for the corporate sector in its total volume had a downward trend, and accounted for 7.1 percent as of October 1, 2006 (9.2 percent as of January 1, 2006).

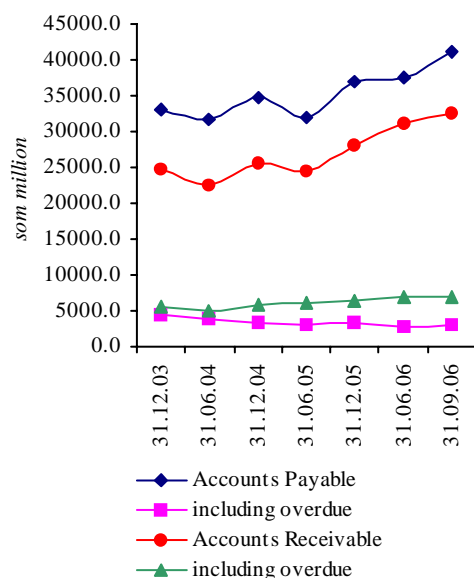
5.2.3. Financial Results

Operating profit for 9 months of 2006 totaled Som 5656.9 million, which was lower by 7.3 percent than in the corresponding period of 2005. Significant losses of processing industry enterprises amounting to Som 1375.8 million had a major effect on net financial results.

In January-September 2006, the balance sheet profit of real sector enterprises totaled Som 5497.5 million, which was higher by 1.2 times than in the corresponding period of 2005.

The balance sheet profit of enterprises increased by 1.3 times than in January-September 2005 and amounted to Som 5477.7 million in January-September 2006. In January-

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



¹ Excluding organizations providing financial services

² According to the preliminary data of NSC KR

September 2006, the main volume of the balance sheet profit was noted in transportation and communication enterprises amounting to Som 2.9 billion, in trade, repair of vehicles, household appliances and personal goods totaling Som 1.1 billion, and in the processing industry amounting to Som 916.5 million.

In January-September 2006, food production enterprises incurred significant balance sheet losses amounting to Som 772.1 million, and mineral resource industry enterprises incurred losses totaling Som 187.8 million.

The number of enterprises, which made profit in January-September 2006, was 37.5 percent against 33.9 percent in January-September 2005.

Proceeds received by enterprises in the period under review increased by 16.8 percent than in the corresponding period of 2005 and totaled Som 87.0 billion.

The main share of all proceeds of real sector enterprises was received by enterprises of trade, repair of vehicles, household and personal goods and accounted for 36.2 percent, which was higher than a similar indicator for the corresponding period of 2005, when the share was 33.3 percent. Such growth occurred in the context of active increase in trade and decline in industry.

The share of unprofitable enterprises in January-September 2006 was 38.0 percent of the total number of reported enterprises, which was lower by 2 percentage points than a similar indicator for January-September 2005.

Overall improvement in financial results of real sector enterprises was observed in January-September 2006.

VI. FINANCIAL SYSTEM DEVELOPMENT TRENDS

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

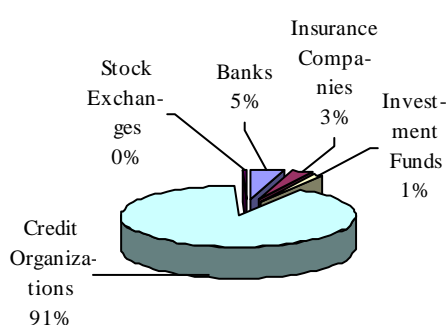
Financial sector played an increasingly important role in achieving macroeconomic stability in the country. Adequate strengthening of banking legislation, effective non-bank and bank supervision and regulation had a positive effect on further development of the financial system of Kyrgyzstan. At present, the banking system continued to dominate in the financial sector of the country. However, further development of the securities market, insurance market and country's entry of international capital markets should be noted, which would permit a more rapid development of the financial sector and would influence long-term development of the country's economy.

At this stage, the financial sector of the Kyrgyz Republic was represented by such financial institutions as banks, non-bank finance and credit institutions (credit unions and microfinance organizations), pawnshops, insurance companies, pension and investment funds, stock exchange and others (Chart 6.1).

Banking system of Kyrgyzstan has been the main sector of the financial market, which accumulated and redistributed idle funds in the economy. In the context of high demand for credit resources, the resources of the non-bank financial sector, in particular, of micro credit organizations, and also reciprocal crediting of enterprises within the real sector, apart from funds of banks, were sources of satisfying this demand.

Expansion in the resource base of the banking system, non-bank finance and credit institutions continued in 2006 due to the increase in capitalization and growth in the banking system deposit base, as well as in assets of NFCIs. At the same time, it should be noted that the increase in the aggregate capital of the banking system was conditioned by the inflow of both foreign capital, and domestic investments. The growth of the banking system deposit base, which was the main source of credit resources, was accompanied by leading growth rates of deposits in national currency. Also, the leading growth in deposits of the population should also be noted as compared with the growth in deposits of enterprises and organizations. At the same time, the reduction in the share of long-term deposits was noted in 2006, which resulted in the decrease of the deposit base duration to 2.5 months at the end of the period.

Chart 6.1. Financial Sector Structure in 2006



Under conditions of increase in resource base and growth in demand for credit resources in 2006, a positive growth trend in lending to the economy both on the part of the banking system, and non-bank finance and credit institutions maintained in 2006 (Chart 6.2). The growth in the aggregate loan portfolio of commercial banks and non-bank finance and credit institutions was 39.0 percent in 2006.

At the same time, the growth rates in loans provided by commercial banks in the period under review were notably higher than in the non-bank sector, which indicated the improved level of financial intermediation and improved role of the banking system in the economic development of the Kyrgyz Republic. Thus, the volume of newly disbursed loans by commercial banks increased by 53.0 percent than in 2005, and accounted for 14.3 percent of GDP. The share of loans provided for the development of the real sector was 8.2 percent of GDP. However, in spite of observed positive trends in the development of commercial banks, the overall role of the banking sector was still insignificant in the economy. The banking sector was still in the process of its development.

The highest share out of total loans disbursed by banks was still in trade, which was 45.8 percent. Further, it was in mortgage (10.2 percent), consumer loans (9.2 percent), construction (8.5 percent) and in industry (7.6 percent). Transportation, communication, agriculture, procurement and processing accounted for 6.0 percent (Chart 6.3).

A positive growth trend in lending to the economy was accompanied by the increase in terms of lending. If we considered the loan structure of commercial banks by their terms, then the volume of long-term loans significantly increased and was 45.6 percent in 2006 (Chart 6.4). It should be noted, that the share of recently disbursed long-term loans in the total volume of disbursed loans had a stable growth trend (Chart 6.5).

Loan portfolio growth in non-bank financial and credit institutions was 22.8 percent in the period under review. The structure of loans by sectors insignificantly changed: the main flow of loans disbursed by NFCIs was still directed to agriculture (54.2 percent) and trade (31.5 percent) (Section III, Chart 3.2.4).

Securities market (stock market) was one of the most important segments of the financial sector. Evaluation of development in this segment of the financial market was ambiguous. In the development context of the government securities market, inadequate development of the corporate securities market was particularly notable. Nevertheless, some positive changes were noted in this segment of the financial market.

Chart 6.2. Loan Portfolio of Commercial Banks and Non-Bank Finance and Credit Institutions

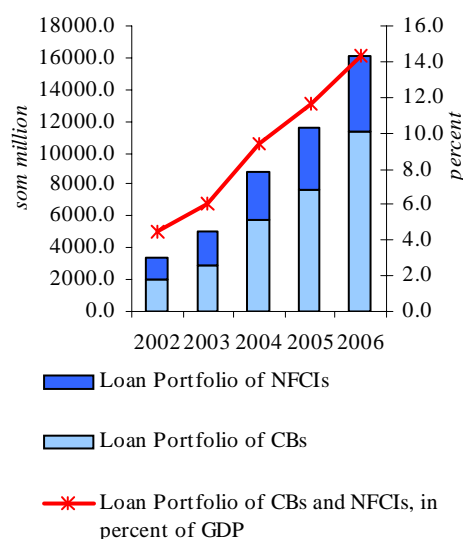


Chart 6.3. Lending to Economic Sectors by Commercial Banks

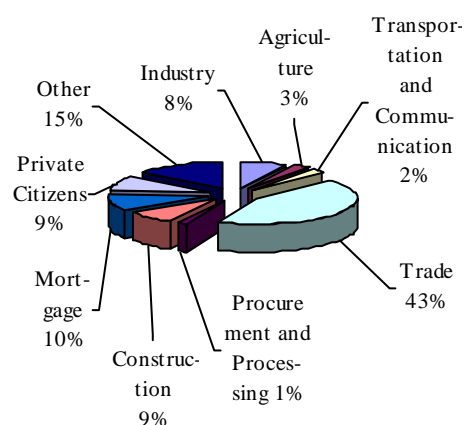


Chart 6.4. Structure of Loans Disbursed by Commercial Banks in 2006 by Terms

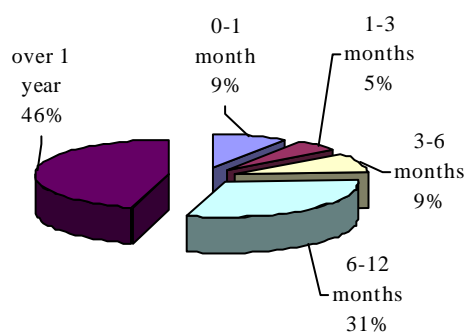
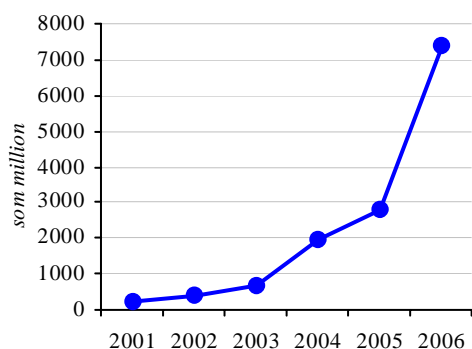
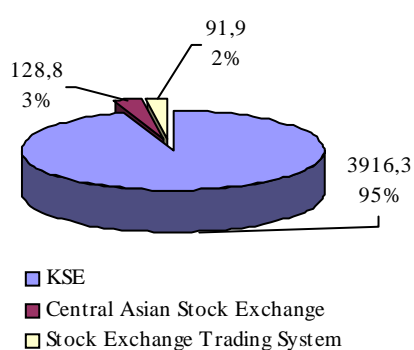
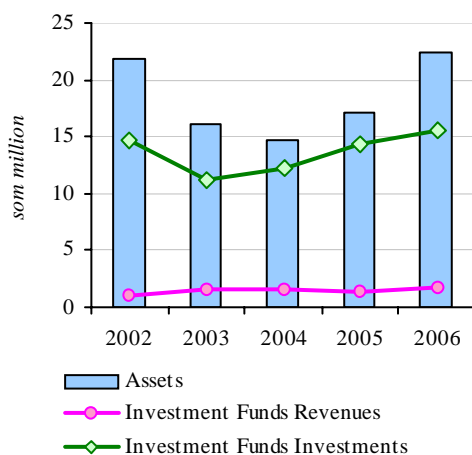


Chart 6.5. Growth Rates of Long-Term Loans

Chart 6.6. Trading Volume at Stock Exchanges as of end of 2006

som million


Chart 6.7. Change in Assets, Revenues and Investments of Investment Funds

Table 6.1. Performance Indicators of Investment Funds to Macroeconomic Indicators

(year-end)	2002	2003	2004	2005	2006
	(som million)				
Assets	21.8	16.1	14.7	17.2	22.3
Assets, in % of GDP	0.029	0.019	0.016	0.017	0.020
Revenues of Investment Funds	1.1	1.6	1.5	1.4	1.8
Revenues of Investment Funds, in % of GDP	0.001	0.002	0.002	0.001	0.002
Investments of Investment Funds	14.8	11.2	12.2	14.3	15.6
Investments of Investment Funds, in % of GDP	0.020	0.013	0.013	0.014	0.014

Kyrgyz Stock Exchange was the main trading platform of the country. Its trading volume amounted to Som 3.92 billion at the end of the year. Total trading volume of the Kyrgyz Stock Exchange, Central Asian Stock Exchange and Stock Exchange Trading System was Som 4.14 billion in 2006 (Chart 6.6.).

Performance indicators of investment funds, as before, pointed to insignificant impact of their activities on the country's economy. At the end of 2006, assets and investments to GDP were 0.02 and 0.014 percent, correspondingly. Revenues of investment funds increased by 28.6 percent in 2006 than the revenues in 2005, and were 0.002 percent to GDP (Chart 6.7, Table 6.1.).

The non-bank financial sector provided important financial services to the economy of the Kyrgyz Republic, in particular, services of insurance companies should be noted. In addition to insurance services, these companies performed investment activities and financial transfers. These services were instrumental in strengthening the capital market and attracting financial resources for corporate investments in the economy. Total of 17 companies carried out insurance activities in 2006.

In spite of progressive increase in general performance indicators of insurance organizations for the period until 2004, indicators showed decrease starting in 2005. Thus, assets of insurance companies to GDP were 0.24 percent, and insurance premiums were 0.09 percent in 2006. Receipt of premiums in insurance organizations increased by 1.0 percent than in 2005 (Table 6.2).

Table 6.2. Performance Indicators of Insurance Companies to Macroeconomic Indicators

<i>(year end)</i>	<i>som million</i>					
	2001	2002	2003	2004	2005	2006
Assets, som million	132.20	151.93	344.68	335.39	291.64	277.24
Assets, in % of GDP	0.18	0.20	0.41	0.36	0.29	0.24
Receipt of insurance premiums, som million	131.10	125.80	134.81	171.08	105.23	106.33
Receipt of insurance premiums, in % of GDP	0.18	0.17	0.16	0.18	0.10	0.09
Insurance premiums/insurance claims	1.90	2.30	2.60	5.63	2.51	7.19

VII. SPECIAL ISSUES

7.1. Deposit Protection System as One of Financial Stability Elements

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

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

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

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

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

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

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

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

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

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

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

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

Further, for purposes of maintaining efficient deposit protection system, DPF will be formed using mandatory payments of participating banks in the form of calendar and emergency contributions of commercial banks, if needed.

Draft Law *On Protection of Bank Deposits* was approved by the NBKR Board on June 28, 2006, by the Resolution of the Government of the Kyrgyz Republic N119 of April 12, 2007 *On the Conclusion of the Government of the Kyrgyz Republic to the draft Law of the Kyrgyz Republic On Protection of Bank Deposits* and was sent to the Administration of the President of the Kyrgyz Republic for consideration.