

No.1

**The National Bank
of the Kyrgyz Republic**

2018

ANALYTICAL PAPER

**External and Internal Factors
Affecting Formation of the Interest Rates
on Loans in the Banking System of the Kyrgyz Republic**

2018

Analytical Paper of the National Bank of the Kyrgyz Republic

External and Internal Factors Affecting Formation of the Interest Rates
on Loans in the Banking System of the Kyrgyz Republic

**Prepared by Tchoro Seyitovich Seyitov,
Ilimbek Atantaevich Abdiev¹**

Approved to be released by the Scientific Advisory Board
of the National Bank of the Kyrgyz Republic²

April 4, 2018

The views represented in this paper belong completely to the author and do not compulsorily reflect the viewpoint of the National Bank of the Kyrgyz Republic.

Summary

In this paper the authors present the results of a survey conducted in commercial banks and the study of the main factors affecting the interest rates. Changes in the external and internal situation, measures taken by the National Bank, entry of a new major player into the market, expansion of the state program loans conditioned a decrease in the interest rates on loans and deposits.

JEL: E43, E5, G21

Key words: interest rates, loans, commercial banks

For information related to this publication please refer to:
168 Chuy ave., Bishkek, Kyrgyz Republic 720001
Phone: +996 (312) 66-91-91
Fax: +996 (312) 61-07-30
e-mail: mail@nbkr.kg, tseyitov@nbkr.kg, nisiabdiev@gmail.com
National Bank of the Kyrgyz Republic

¹ Seyitov T.S., Expert, the National Bank of the Kyrgyz Republic, Abdiev I.A., Candidate of economic science, Agency for Investment Promotion and Protection of the Kyrgyz Republic.

² The Scientific Advisory Board is a collegial scientific and consulting advisory body of the National Bank and serves to contribute to improvement of the scientific and research activity. The Chairman of the Board is Jenish N., PhD, Board members are Aidarova A.K., Dzhusupov T.D., Karakozhaev A.M., Kerimkulova G.A., Candidate of Economic Science, Kydyraliev S.K., Candidate of Physical and Mathematical Sciences, Mogilevskiy R.I., Candidate of Physical and Mathematical Sciences, Tilekeev K.A., PhD, Esenaliev D.S., PhD.

Acknowledgements

The authors express gratitude to B.A. Tynaliev, the head of the group “Center for economic research” of the Economic Department of the National Bank of the Kyrgyz Republic, A.A. Kozubekov, the head of the Economic Modeling Division of the National Bank of the Kyrgyz Republic, S.A. Chalbaev, the head of the External Supervision Department of the National Bank of the Kyrgyz Republic, for assistance in preparation of the paper and for useful recommendations, without which the release of this paper would not be possible.

Contents

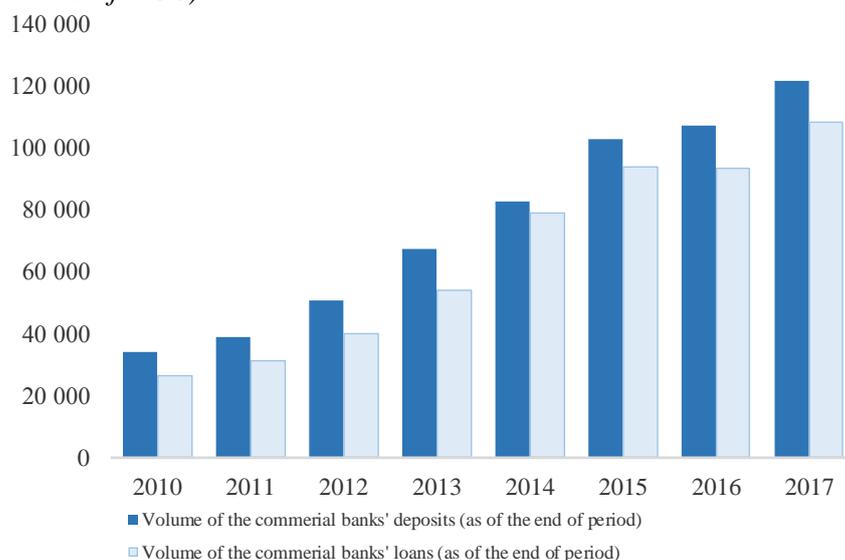
| | |
|--|----|
| Introduction | 5 |
| Research Methodology | 6 |
| External Factors | 7 |
| Internal Factors | 12 |
| EcoIslamicBank and Commercial Banks with “Islamic Windows” | 16 |
| Analysis of Establishment of the Interest Rates on Loans | 16 |
| Measures of the National Bank and the Government to Reduce the Interest Rate on Loans and Create Long-Term Money in the Economy..... | 17 |
| Conclusion (and Recommendations)..... | 19 |
| References | 22 |

Introduction

The banking system plays a key role in the economy of each state. By providing funds to enterprises and individuals, the commercial banks contribute to the development of business, agriculture, the consumer services sector, stimulate construction through mortgage and are a catalyst foreconomic processes. The main objective of the commercial banks is to obtain and maximize profit, the main share thereof they receive by issuing borrowed funds on conditions of repayment, maturity and interest payment. The cost of borrowed funds depends on the bank's expenses for payments on the clients' deposit accounts, servicing the legal entities and the individuals, as well as on the current economic situation in the country. The banks sometimes raise the interest rates on loans due to the unstable economic situation. The rise in prices and government interference in the activity of the commercial banks are also reflected in the level of interest rates.

Chart 1. Volume of Deposits and Loans in Commercial Banks in the National and Foreign Currency, as of the End of the Period in 2010-2017

(millions of KGS)

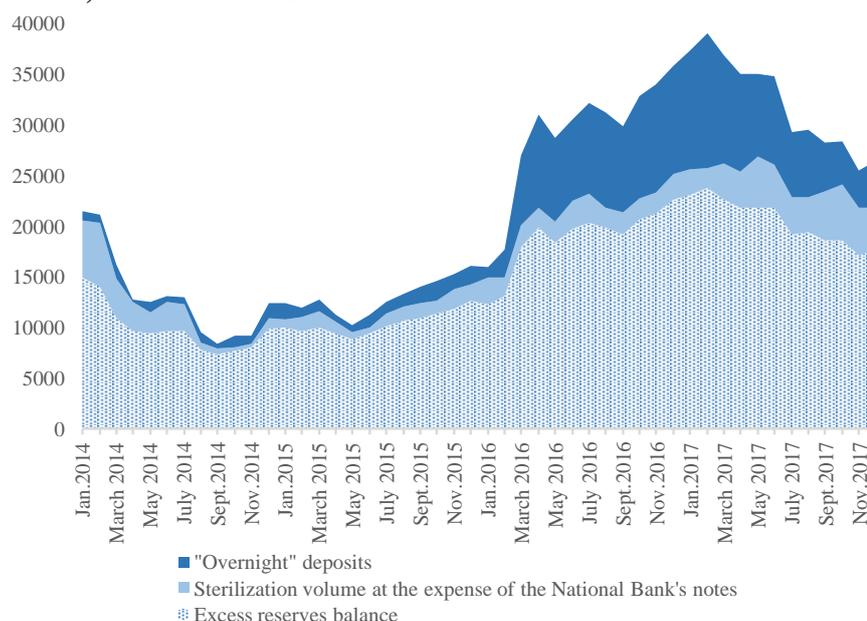


Source: National Bank of the Kyrgyz Republic

The banking system of the Kyrgyz Republic has been dynamically developing during the past ten years, demonstrating stable growth in lending to the real sector of the economy (Chart 1). Nevertheless, the commercial banks' credit resources for economic agents are still expensive. Thus, the weighted average nominal interest rate in the Kyrgyz Republic in US dollars is relatively high and varies in the range from 15 to 22 percent. Meanwhile, in Russia the interest rates on loans in US dollars varies from 11 to 15 percent, and in Kazakhstan - from 9 to 16 percent.

On the one hand, there is unsatisfied demand on the part of the population and business for available (cheap) resources. By accepting new challenges, the National Bank of the Kyrgyz Republic and the government of the country take measures to reduce the interest rate: implementation of the projects in the field of agricultural lending, support for export-oriented enterprises, import substitution, and mortgage lending. On the other hand, at the end of 2017, there was a significant excess of liquidity in the banking sector (Chart 2), therefore, the issue, why the banks did not allocate excess funds to the real sector, to consumer lending, etc., became relevant.

Chart 2. Structure of Excess Liquidity in the Banking Sector of the Kyrgyz Republic in 2015-2017, millions of KGS



Source: National Bank of the Kyrgyz Republic

A number of studies demonstrate that the cost of loans issued by the commercial banks depends on the size of the commercial bank’s assets and its share in the market (Georgievska et al., 2011), the creditors’ rights and the quality of the legal framework, the degree of banking competition, macroeconomic environment, taxation, including reserve requirements, availability of information about the borrowers, banking regulation and obligatory lending (Gelos 2006), market share, return on assets (ROA), liquidity level (Dabla-Norris and Floerkemeier, 2007), cost of borrowings (Gorela 2016), etc. The Central Bank of the Russian Federation (2017) emphasizes that the profit and operating expenses of a commercial bank, deductions for insurance of deposits and required reserves, credit risk premiums, etc. influence the minimum spread between credit and deposit rates.

Research Methodology

The decision was made to conduct interviews with the commercial banks’ employees (bank governors, chiefs of the departments responsible for credit products formation, heads of treasuries) to study the formation of the cost of credit resources. The list of surveyed banks included 20 banks of the Kyrgyz Republic selected according to such criteria as the size of equity capital, the bank’s share in the lending market, affiliation with the parent companies, practical use of the principles of Islamic finance, presence of the foreign founders or investors (Table 1).

Table 1. List of Commercial Banks

| No. | Name | No. | Name |
|-----|--|-----|--------------------------|
| 1 | OJSC “Aiyl Bank” | 11 | CJSC “Kyrgyz-Swiss Bank” |
| 2 | OJSC “Bakai Bank” | 12 | OJSC “Optima Bank” |
| 3 | CJSC “Bai Tushum” Bank” | 13 | OJSC “RK “Amanbank” |
| 4 | CJSC “Kompanion Bank” | 14 | OJSC “Rosinbank” |
| 5 | CJSC “BTA Bank” | 15 | OJSC “RSK Bank” |
| 6 | CJSC “Demir Bank” | 16 | CJSC “AKB “Tolubay” |
| 7 | OJSC “Dos Credobank” | 17 | OJSC “FinanceCreditBank” |
| 8 | OJSC “CB “Kyrgyzstan”” | 18 | CJSC “Finca Bank” |
| 9 | OJSC “Kyrgyzkommertsbank” | 19 | OJSC “Halyk Bank” |
| 10 | CJSC “Kyrgyz Investment and Credit Bank” | 20 | CJSC “EcoIslamicBank” |

Source: National Bank of the Kyrgyz Republic

Survey of the banks was conducted from November till December 2017.

Factors Affecting Formation of the Interest Rates on Loans in the Banking System of the Kyrgyz Republic

According to the survey results, the majority of the commercial banks form their loan portfolio mainly through placement of the funds attracted in the domestic market (deposits, the Social Fund assets) and equity capital, the other banks – at the expense of funds attracted in the foreign markets (assets of the parent banks, borrowings provided by the international lenders etc.).

The main external and internal factors affecting the commercial banks' interest rates on loans will be considered in detail below.

External Factors

Competition. Currently, competition between the banks and the microfinance organizations intensified in the bank lending market due to decline in business activity in 2014-2015, as well as due to negative expectations in 2016. Therefore, there was a decrease in the interest rates on the deposits and loans in the national and foreign currency throughout the banking system. In this regard, the commercial banks conducted (constant) monitoring of the interest rates on loans in the banking system and transferred volumes of loans and deposits, as well as the results of auctions conducted by the Social Fund of the Kyrgyz Republic (hereinafter referred to as the Social Fund) and in the interbank market. According to the respondent banks, the market leaders are such banks as Optima Bank, Kyrgyz Investment and Credit Bank (hereinafter – KICB), the state banks – AiyI Bank and RSK Bank, which can set the interest rates on loans and deposits upwards and downwards. In particular, a representative of one of the above-mentioned banks emphasized that their bank can set the interest rates on loans and deposits in the market. The bank employee also said that they deliberately reduced the interest rates on deposits to result subsequently in decrease of the interest rates on deposits on the part of other banks.

In the course of the survey, a number of banks expressed dissatisfaction in respect of the unequal competition in the banking environment. In particular, it concerned one of the banks with the equity capital and balance sheet being formed in US dollars. This circumstance, for example, in conditions of the national currency depreciation, allows the specified bank to reevaluate balance sheet indicators, which expands their competitive opportunities in lending and capitalization. Some representatives of the banks expressed the opinion that the time has come to revise the conditions for the balance sheet formation in US dollars.

The practice of clients flowing from one bank to another is common in search of the most advantageous offers for funds placement and receipt due to attractiveness and quality of the banking services and low commission. For example, the banks are ready to make concessions for their clients by improving service, reducing commissions, interest rates, sometimes lower than the proposed tariff rates to the damage of the bank's profitability in order not to lose their regular clients-borrowers with a positive credit history and high turnover of borrowed funds. The banks are ready to earn their profit through the client servicing only from operating income, rather than margin.

Taking into account the above factors, the commercial banks add smaller amount of margin in the cost of the interest rates being formed amid growing interbank competition. The margin could reach 10 percent or more prior to decline in business activity in 2014-2015, currently, according to the banks' data, it fluctuates in the range of 2-10 percent.

According to many employees of the commercial banks, the Russian-Kyrgyz Development Fund (hereinafter referred to as the RKDF) had a significant impact on reducing the interest rate in the market. The volume of the RKDF loan portfolio as of the beginning of December 2017 amounted to approximately USD 258 million (Chart 3).

From our point of view, the following situation developed before the RKDF entered the market of the Kyrgyz Republic:

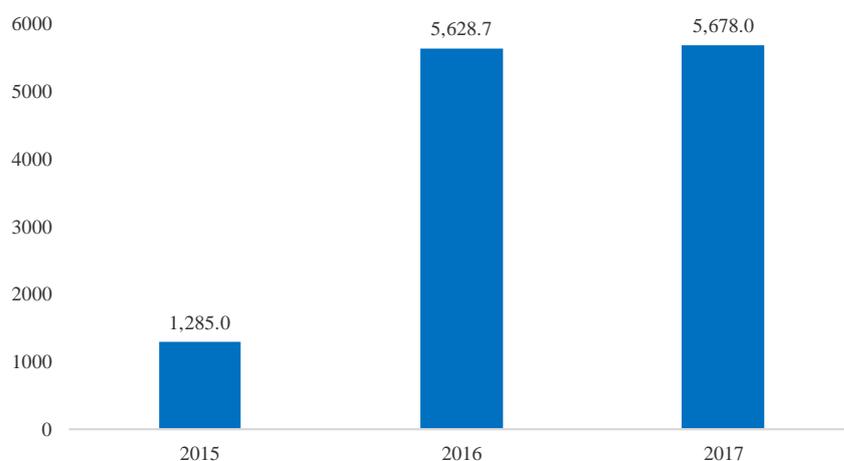
1. Taking into account the market situation and prior to initiation of the RKDF activity, the commercial banks set the maximum interest rates on loans with the maximum rate of return.

2. Despite decreasing consumer demand and decline in business activity, the commercial banks did not reduce significantly the interest rates on loans amid well-established demand for loans from the entrepreneurs and the population.

3. The commercial banks were focused on getting the maximum profit from each borrower. The decrease in the interest rates also did not correspond to the banks' development strategies. Otherwise, they would not receive planned income and profits. In addition, a decrease in the loan rate by one or two banks would entail a reduction in the interest rates on loans in the whole system, which violates the established order and is deliberately unprofitable for all banks.

Chart 3. Loans Issued by the Russian-Kyrgyz Development Fund

(millions of KGS)



Source: National Bank of the Kyrgyz Republic according to the data provided by the Russian-Kyrgyz Development Fund

The abovementioned facts can be considered as the signs of an oligopoly in the bank lending market.

The bank representatives emphasize that according to the borrowers of the small and medium enterprises (hereinafter referred to as the SMEs) the competitive activity of the RKDF had a favorable effect on the loan rates size in the banking sector. The large borrowers and the entrepreneurs with a stable business have an alternative in the form of cheap affordable lending, however with tough conditions to some extent. Many borrowers who met the terms of the RKDF lending preferred to obtain loans directly and/or through the banks on the RKDF program lending. Such situation resulted in slight reduction in demand for loans from the commercial banks, formed by attracted deposits, equity capital and externally obtained funds. This led most likely to the partial replacement of the domestic banks' expensive funds with the RKDF cheaper resources.

Besides the RKDF programs, the state lending programs such as "Financing of Agriculture", "Affordable Housing", "Program of Import Substitution and Export-Oriented Production", etc. are implemented in the republic's lending market with the commercial banks of the country being operators thereof. The government lending is becoming increasingly important in the Kyrgyz Republic, which, in turn, competes with the commercial banks' loans.

The representatives of some banks expressed dissatisfaction with the fact that the banks' highly qualified employees preferred to work for the RKDF, moreover large clients of the respective banks also selected the fund's direct lending programs. At the same time, many banks emphasized unequal conditions for conducting lending activities due to the lack of legislative regulation in terms of compliance with prudential standards and the fact that

currency swaps were conducted between the National Bank of the Kyrgyz Republic and the RKDF.

According to the information provided by the commercial banks, inequality of competition is also demonstrated in funds (current accounts and demand deposits) placed by the state-owned companies in the state-owned banks of the republic.

Access to the International Capital Markets and External Funding by the Parent Companies. The external sources to form the commercial banks' credit portfolio are the international capital markets and the international credit lines. The parent companies provide credit lines in foreign currency on market conditions for the banks with foreign participation.

The results of the interviews showed that the commercial banks have the opportunity to be funded only in foreign currency, which increases the risks of placing funds in the domestic market. At the same time, external resources in foreign currency are provided for a long time, but at higher interest rates. At the same time, the commercial banks can attract the population's resources in the domestic market at lower interest rates, however for a shorter period. Thus, the interest rate for deposits in foreign currency within the country is 1.0-3.5 percent per annum, while the interest rate of the parent companies and the international financial institutions is higher than this level: 3 percent and more. Currently, the commercial banks of the republic are experiencing difficulties with access to international borrowed resources in the foreign credit institutions due to:

- the lack of positive corporate and country (B2³ Moody's, 2015-2017) rating;
- the high political risks and affiliation of some commercial banks with the politicians;
- termination of correspondent relations with the banks of Europe, the United States after 2010. Regular written requests from the commercial banks to establish direct correspondent relations with the banks of the USA and Europe remain unanswered or do not generate their interest.

In addition, the commercial banks are experiencing difficulties in placing attracted foreign exchange funds in foreign currency in the domestic market due to the lack of such placement instruments, such as currency (non-deliverable, deliverable) swap, currency repo, currency hedging instruments. At the same time, the amount of mandatory reserve requirements (hereinafter referred to as the MRR) on foreign-currency deposits no longer provide conditions to place foreign exchange resources as before. The banks were deprived of some instruments, such as mortgage and consumer lending in foreign currency to provide them to the borrowers who/which do not receive income in foreign currency.

Thus, the banks need an institution in the domestic market that would hedge foreign exchange transactions. Currently, the foreign hedge company "TCX" occupies this niche.

Some representatives of the credit institutions expressed the opinion in respect of the National Bank to act as a hedger jointly with the government of the country or an authorized body of the government (the State Service for Financial Market Regulation and Supervision) or to initiate the establishment of such an institution. It would contribute to lengthening short lending resources, activating the market for lending in the national currency through the risk insurance, creating a more ramified financial structure, leaving revenues within the country, improving the experience in using the derivatives for foreign exchange hedging, and deepening the financial market, etc.

Government Securities of the Ministry of Finance of the Kyrgyz Republic. The commercial banks use the state treasury bills and the state treasury bonds (hereinafter referred to as the ST-Bills and the ST-Bonds, respectively) in their activities as an instrument to place and to maintain short-term liquidity. For example, currently, the ST-Bonds are an interesting

³ Debt obligations with rating "B" are considered speculative and subject to high credit risk. The rating "B2" refers to the non-investment level.

means of placement, due to the high rate and due to the lack of alternative instruments to place liquidity.

Since 2016, there was an increase in the Kyrgyz som liquidity due to de-dollarization measures taken by the National Bank, as well as the situation in the country's banking system. Prior to introduction of new monetary instruments, the share of deposits in foreign currency prevailed over the deposits in the national currency. The banks could easily attract foreign currency and place it in loans. However, it has become unprofitable to attract the deposits in the national and foreign currencies⁴ due to amendments introduced in the mandatory reserve requirements. As a result, the banks decreased the interest rates on deposits in foreign currency. The population and legal entities began to convert the deposits in foreign currency into the deposits in the national currency in response to decreased yield of deposits in foreign currency.

Conversion of the foreign currency deposits also affected the demand deposits and the current accounts of the legal entities and the individuals. It resulted in an increase in the supply of the KGS monetary resources in the banking system, which could not be placed in the market within a short time. The resulting excess liquidity was presented in a short-term form - demand deposits, current accounts, account balances and term deposits with a maturity up to 1 year.

Therefore, the banks reported that, on the one hand, they did not have the opportunity to place short-term resources in the lending market, and, on the other hand, the borrowers, amid negative expectations took a wait-and-see approach and stopped taking loans in the commercial banks at the high interest rates at that time due to exchange rate volatility and a decrease in consumer demand.

The situation in the market regarding decrease of the lending rates reflects, for example, the private opinion of a representative of one bank, who noted: "The government and the National Bank have played a positive role in the process of lowering the interest rates through amendments in the regulatory acts, de-dollarization, transformation of USD loans at the expense of the public funds. For example, the ban imposed on mortgage lending and consumer loans in foreign currency influenced the pricing of credit resources. The activities of the RKDF and the credit auctions conducted by the National Bank also conditioned a decrease in the size of the interest rates.

The shock situation in 2015, when the US dollar exchange rate increased from KGS 67.8 since the end of Q3 2015 up to KGS 76 at the beginning of 2016 contributed to a decrease in the interest rates. The government and the National Bank of the country took measures to restrain the growth of the exchange rate, which resulted in termination of its depreciation. During this period, the clients' demand for loans declined, and the interest rates decreased by almost two times".

In the course of the survey, the respondents emphasized that the securities, as well as the "overnight" deposits, follow lending in terms of their attractiveness and profitability, since they are not as profitable as the loans.

In addition, it is necessary to note the difficulties in the period of an acute need for the commercial banks' liquidity in repurchase of the previously acquired government securities (hereinafter referred to as the GS) at a nominal price, since the selling price of such GS in the interbank market may be lower.

Social Fund of the Kyrgyz Republic. The survey results show that the rate on the deposit auctions of the Social Fund of the Kyrgyz Republic affects the level of the interest rate on issued loans of some small and medium-sized commercial banks, in contrast, for example, to the policy rate. Thus, the more affordable the cost of funds placed by the Social Fund is, the more affordable potential loans can be. The funds attracted

⁴ The MRR for the national currency decreased from 8.5 percent to 4.0 percent, and the MRR for foreign currency increased from 9.5 to 12 percent.

by the Social Fund may constitute a significant share in the loan portfolio of the commercial banks or be a source of covering liquidity gaps.

The small and medium-sized banks compete through the auctions for the Social Fund's resources⁵ due to the lack of access to cheap external funding. The cost of placing the Social Fund's resources is determined as follows:

$$R_{min} = (\sum R_{dep} + \sum R_{ST-Bills}) / \sum (M_{dep} + M_{ST-Bills})^6,$$

Thus, downward dynamics in the annual interest rate on placed resources from 15 to 8.3 percent was observed from May 2016 to July 2017. In October 2017, the cost of placing the Social Fund's resources increased again up to 12.0 percent, which may result in an increase in the interest rates on loans issued by the commercial banks.

The bank employees reported that the annual interest rate on satisfied applications at the last bidding on the Social Fund's deposit auctions was, firstly, inadequately high, and, secondly, the winner of the auction, apparently, needed liquidity desperately, which conditioned the high cost of resources.

In our opinion, the cost of placing funds at the deposit auctions performs the function of the policy rate. Consequently, the function of determining the value of money in the market (not all, but rather large) is determined by the Social Fund rather than by the National Bank through the policy rate.

The Social Fund will be a significant player in the financial resources market in the medium and long term. Thus, pension contributions become long-term money in case of complete transition from a solidarity system to a funded system. During the working period, pension contributions will be deposited in the individual accounts, rather than distributed among all real pensioners as compared to the current situation. It can also contribute to decrease in the interest rates on loans.

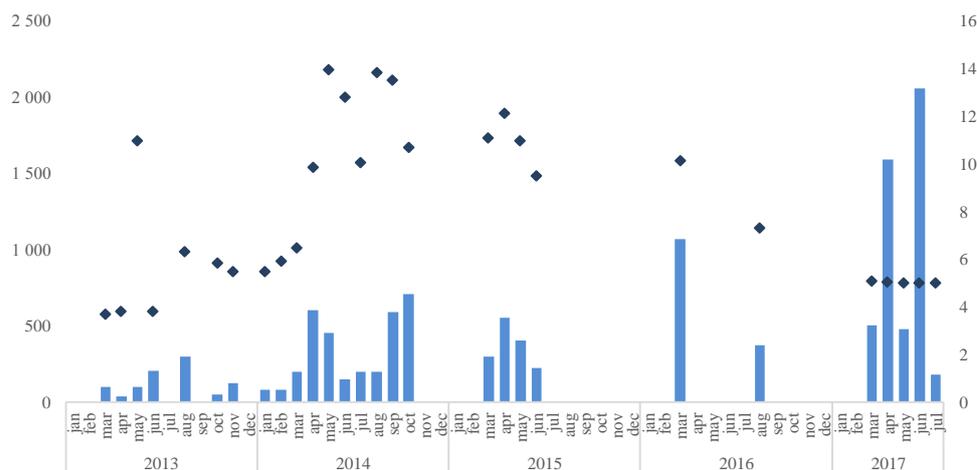
Credit Auctions of the National Bank of the Kyrgyz Republic. According to the survey results, the commercial banks emphasized that the credit auctions are more attractive, since the funds provided are the cheapest in the market (Chart 4). The negative side is their short-term nature (their maturity is 6 months) with the possibility of a one-time prolongation. Some banks place funds attracted at the National Bank's credit auction in the SMEs loans with a maturity of more than 6 months.

⁵ The term for deposits placing is 365 days.

⁶ Resolution of the Board of the Social Fund of the Kyrgyz Republic "Methodology for calculating the minimum interest rate for the deposit auctions held by the Social Fund of the Kyrgyz Republic", where R_{min} is the minimum interest rate on deposits yield; R_{dep} is the weighted average interest rate on new deposits of the legal entities accepted by the commercial banks with a maturity of up to 12 months in the national currency for the period of the last 6 months, published on the website of the National Bank, on the day of calculation of the minimum interest rate; $R_{ST-Bills}$ is the weighted average yield of the ST-Bills placement with a circulation period of 12 months based on the results of the auctions held by the National Bank for the period of the last 6 months, on the day of calculation of the minimum interest rate; M_{dep} is the number of indicators of the weighted average interest rates on new deposits of the legal entities accepted by the commercial banks of the republic with a maturity of up to 12 months in the national currency for a period of 6 months; $M_{ST-Bills}$ is the number of indicators of the weighted average yield of the ST-Bills placement with a circulation period of 12 months based on the results of the auctions held by the National Bank for a period of 6 months.

Chart 4. Credit Auctions of the National Bank

(millions of KGS)



Source: National Bank of the Kyrgyz Republic

In this regard, the banks’ representatives made the proposals to increase the lending terms from six months to 1-2 years and the frequency of their implementation (with the aim of planning in case of a need for financial resources). According to the banking sector, such measures may have a significant impact on reducing the interest rate on loans.

Policy Rate, Inflation and its Forecast Value. During the survey the commercial banks indicated that the policy rate in its classical sense does not affect the formation of the interest rate on the credit and deposit products. The credit auctions, where the funds are provided at the policy rate set by the National Bank, are the only instrument influenced by the policy rate.

Table 2. Inflation Rate and Commercial Banks’ Interest Rates on Loans (as of the end of period)

(in percent)

| No. | Indicators | 2007 | 2008 | 2010 |
|-----|--|-------|-------|-------|
| 1 | Consumer price index in percent to the previous period | 120.1 | 120.0 | 119.2 |
| 2 | Commercial banks’ interest rates on loans (as of the end of period) | 19.3 | 21.0 | 20.9 |
| 3 | Commercial banks’ interest rates on deposits (as of the end of period) | 3.0 | 3.5 | 3.7 |

Source: National Bank of the Kyrgyz Republic

The commercial banks very rarely take into account the inflation rate when setting the interest rate on the loan and deposit products and are primarily guided by the competitors’ rates. In particular, it is no longer possible to include the inflation rate in the interest rate in case of the high inflation rate and competition in the market. A striking example is the situation in 2007, 2008, 2010, 2014, when the inflation rate was double-digit, and the rates on loans and deposits did not change in line with the inflation rate, which was contrary to the economic theory (Table 2).

The forecasted value of the inflation rate, coupled with the volatility of the exchange rate, for example, is taken into account by some banks only when forming the bank’s budget for the coming year.

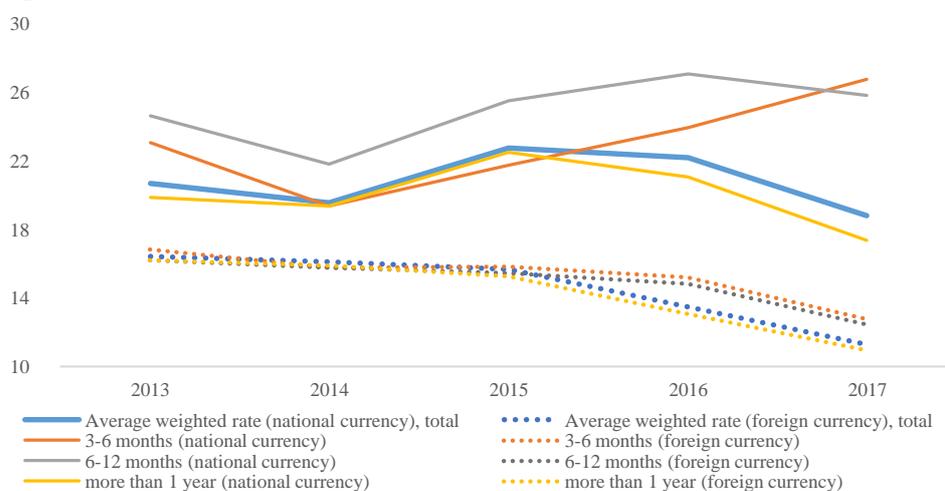
Internal factors

Value of Attracted Deposits of the Individuals and the Legal Entities. At the end of 2017, there was a decrease in the value of resources attracted in the domestic market due to the monetary policy pursued by the National Bank, emergence of new players,

and change in the market conditions. In particular, a gradual decrease in the interest rates was observed with the introduction of new MRR on deposits in foreign and national currencies.

Chart 5. Interest Rates of the Commercial Banks on Loans in the National and Foreign Currencies (as of the end of the period)

(in percent)



Source: National Bank of the Kyrgyz Republic

According to the information of the commercial banks, the SMEs and the population reduced the demand for loans due to unfavorable external and internal environment in 2014-2016, which affected the interest rates on loans (Figure 5).

In addition, the RKDF appeared in the market with the competitive interest rates and the state lending programs were launched, which also contributed to a decrease in the loan rates.

Equity Capital. One of the sources to form a loan portfolio of the commercial banks is their equity capital. Starting from 2016, the National Bank ordered the commercial banks to gradually increase the size of their equity capital to strengthen the banking system, increase its capitalization and attractiveness.

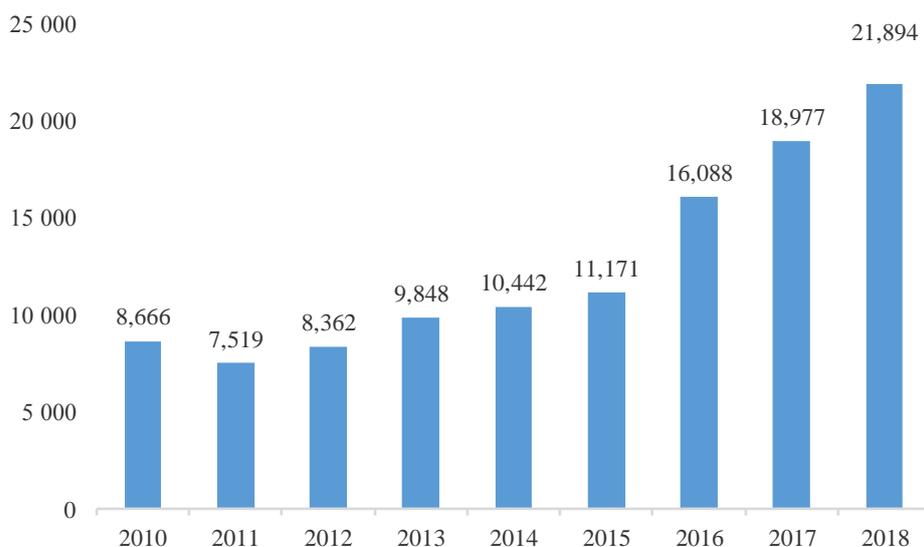
Thus, the capital requirements to form the minimum authorized capital for operating banks (including the branches of non-resident banks) were established within the following terms and volumes:

- by July 1, 2016 – KGS 400 million;
- by July 1, 2017 – KGS 500 million;
- by July 1, 2018 – KGS 600 million.

It, in turn, contributed to an increase in the resource base to further increase lending volumes. At the same time, the growth of the resource base created problems for allocation of funds and resulted in excess liquidity in the banking system (Chart 6).

The equity capital and the deposit base remain the main sources of the loan portfolio formation for some banks without external financing. The amount of equity capital also affects the ability to provide loans at high or low rates. For example, according to the laws, the commercial banks can direct up to 60 percent of their equity capital to lending.

Chart 6. Dynamics of the Aggregate Amount of Paid Authorized Capital in the Banking System of the Kyrgyz Republic, as of the beginning of the year
(millions of KGS)



Source: National Bank of the Kyrgyz Republic

Operating Expenses. The banks' operating expenses include personnel costs, social security costs, depreciation of fixed assets and intangible assets, security, maintenance of fixed assets, stationery and office supplies, communications, current rent, collection costs, advertising costs, professional services, travel expenses, utility costs, deposit insurance costs, computer data processing costs, business development costs, debt repayment costs, and other operating costs.

According to the respondents, the commercial banks' operating expenses are among the largest items in the banks' budgets.

The survey has shown that some banks have such high operating expenses for the following reasons:

- incomplete automation of internal processes, which would provide cost savings;
- decrease in operating revenue that does not cover operating expenses;
- large branch network requiring expenses for staff maintenance, premises renting, security providing, etc.

The respondents emphasize that the requirements of the National Bank and the Ministry of Internal Affairs of the Kyrgyz Republic to ensure the security of the banking institutions and improve the quality and reliability of security create additional and sometimes unjustified expenses.

Prudential Standards. According to the commercial banks' representatives, the loan loss provision (hereinafter referred to as the LLP) affects the size of the interest rate of issued loans. The banks need to create the LLP depending on the number of attracted clients and their quality. For example, the smaller and non-market size of LLP for the RKDF put the commercial banks in non-competitive conditions, since the commercial banks' LLP size is higher.

The survey conducted among the commercial banks' employees demonstrated that liquidity ratios K3 are the main standards that restrain lending and do not contribute to a decrease in the interest rate. In particular, the treasurers and the loan officers pointed to the coefficients K3.2 and K3.3⁷, which divert part of the banks' funds to create reserves.

⁷ K3.2 and K3.3 are the short-term and instant liquidity ratios, determined by the ratio of the highly liquid assets to the short-term liabilities.

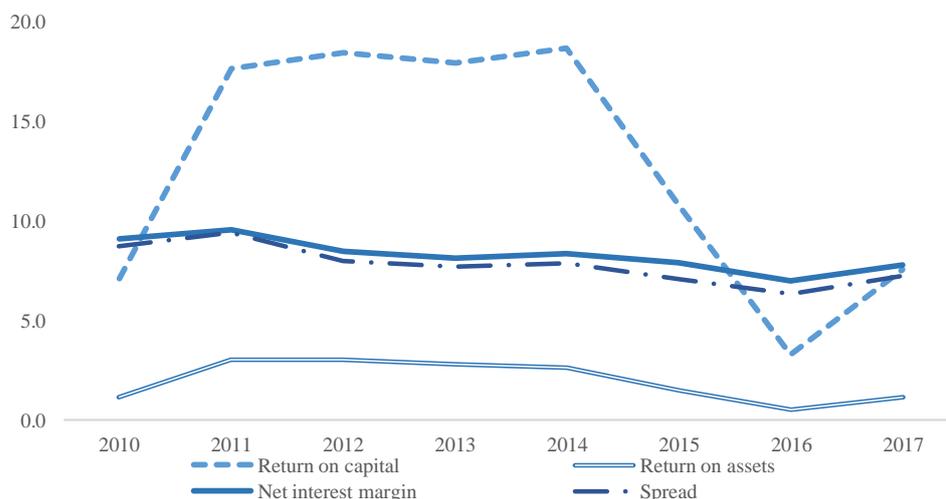
Thus, the money supply in the credit market is reduced through reserves creation, which indirectly restrains the decrease in the interest rate.

To maintain the specified ratios, there is no product of the National Bank to maintain short-term liquidity for one week if the commercial banks need liquidity for a period of one week. Many treasurers of the commercial banks emphasized such fact.

Margin, Risks of Non-Return, Exchange Rate Volatility. According to the commercial banks' information, the size of the net interest rate margin of the commercial banks varies within 2-10 percent (Chart 7).

Chart 7. Key Indicators of the Banking Sector (Profitability)

(in percent)



Source: National Bank of the Kyrgyz Republic

The margin sometimes includes all risks related to exchange rate volatility, risk of non-repayment, etc. If we consider the presence of a risk premium in the structure of the product price, it depends on the presence of liquid collateral or its absence, the borrower's credit history, guarantors, the market situation and other factors. Some survey participants indicated that the amount of risk included in the cost of the product fluctuates around one percent or is not taken into account at all.

According to the respondents, the size of the margin and risk premium decreased constantly during 2016-2017 due to competition in the lending market. For example, according to a bank specializing in retail micro-crediting, the bank had to reduce the margin as much as possible or provide loans with negative profitability due to competition, including non-market competition from the RKDF.

Commercial Banks' Proposals to Reduce the Level of Interest Rates in the Banking Sector of the Republic. According to the commercial banks, availability of easily accessible long-term resources (internal and external) is the main and simplest factor of making loans cheaper. For example, the banks are in favor of the National Bank's credit auctions to be held more often, and the terms of funds provided at the auctions to be increased by one year or more. In parallel, it is proposed to make the auction market predictable for the commercial banks' expectations.

The commercial banks offer to develop the insurance market and the pension market, since these markets provide conditions to create long-term money.

However, we think that the interest rates on new loans are likely to increase in the medium term for the following reasons:

- expected growth of business activity in 2018;
- adaptation of the commercial banks to newly formed market environment;
- completion of maturities for one- and two-year loans received earlier;

– beginning of a new cycle of lending amid recovery of macroeconomic indicators and consumption by the population.

In addition, an increase in the interest rate is likely to be supported by the high cost of resources (deposits) previously attracted by the commercial banks in the domestic market.

According to some representatives of the banking system, in 2018-2019, they are not expected to increase the cost of loans. On the contrary, the credit policy will be focused on reducing the interest rate by 1-2 percent annually.

EcoIslamicBank and Commercial Banks with “Islamic Windows”

The presence of CJSC “EcoIslamicBank” and the commercial banks with the “Islamic windows” in the lending market should be considered separately. These banks cannot use the entire range of monetary policy instruments and the possibilities of the government securities market (ST-Bills, ST-Bonds, the National Bank notes) due to inconsistency of these instruments and securities with the principles of Sharia. In this regard, such banks have a limited set of liquidity management options: financing (murabaha), Islamic leasing, foreign exchange spot transactions, mudarabah, etc. For the same reasons, these banks are unable to place part of their daily balances on “overnight” deposits.

All this, in turn, creates unequal opportunities for CJSC “EcoIslamicBank” in the banking market as compared to other banks. Thus, the bank and other banks with the “Islamic windows” need the Islamic monetary instruments and securities to manage liquidity.

Analysis of Establishment of the Interest Rates on Loans

Formation of the final cost of any loan in each commercial bank is regulated by the pricing policy (tariff policy) of the banking services. The banks were divided into three groups depending on their share in the banking sector (Table 3) to calculate the interest rate on the loan products due to the fact that the authorized capital, deposit and loan portfolios of all banks are different.

Table 3. Classification of Banks Depending on their Share in the Banking Sector

| No. | Large banks (5) | Medium banks (5) | Small banks (15) |
|-----|---|---|---|
| 1 | OJSC “Aiyl Bank” CJSC “Demir Bank” CJSC “KICB” OJSC “Optima Bank” OJSC “RSK Bank” | CJSC “Bai Tushum” CJSC “Kompanion Bank” OJSC “Dos-Credobank” OJSC “Rosinbank” CJSC “Finca Bank” | Bishkek branch of the National Bank of Pakistan OJSC “RK “Amanbank” OJSC “Bakai Bank” CJSC “Bank of Asia” CJSC “BTA Bank” OJSC “Dos-Credobank” OJSC “ESB” OJSC “Kapital Bank” CJSC “KSB” OJSC “Kyrgyzkommertsbank” CJSC “AKB “Tolubay” OJSC “FCB” OJSC “Halyk Bank” OJSC “Chang An Bank” CJSC “EcoIslamicBank” |

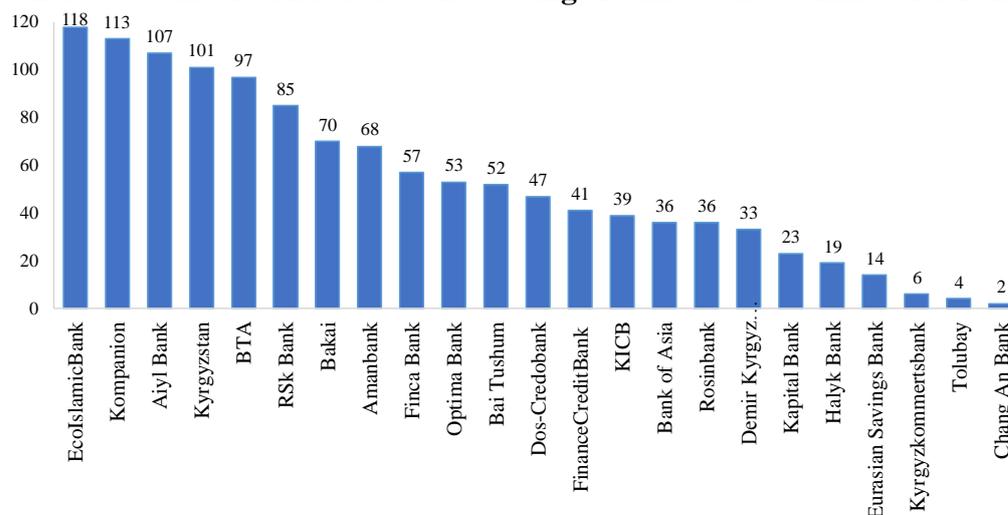
It should be especially noted that the banks with a large branch network and most of small banks (Chart 8) have rather high operating expenses.

According to the previously conducted analysis of the interest rate, there are reserves for rate reductions in terms of LLP and operating expenses. For example, the likelihood of creating LLP is reduced (especially for large and medium-sized banks) through an adequate assessment of the clients when issuing new loans.

The cost of externally attracted resources ranges from 0.0-0.1 percent up to 8.4-15.3 percent. Given that each bank has its own external sources of financing, provision

of financing to each bank, in our opinion, is used by an external lender individually, based on solvency, rating (or lack thereof), assets size, portfolio quality, etc.

Chart 8. Number of Branches and Savings Banks of the Commercial Banks



Source: National Bank of the Kyrgyz Republic

On the one hand, creation of a unified and coherent image of the banking system through a credit rating with the help of the regulator and the government of the country, would allow the banks to attract the funds from the international lenders at low interest rates. On the other hand, parallel hedging of the funds received would also contributed to a decrease of the rate.

Measures of the National Bank and the Government to Reduce the Interest Rate on Loans and Create Long-Term Money in the Economy

For a long period, the population, the representatives of SMEs, the deputies of the Jogorku Kenesh of the Kyrgyz Republic expressed opinions that the commercial banks of the Kyrgyz Republic set rather high interest rates on loans. For example, the interest rates in the commercial banks in Western Europe, the USA, Japan, etc., where they range from zero to two-three percent, are cited as an argument. Indeed, the difference between the rates in the commercial banks of the Kyrgyz Republic and in developed countries is quite significant.

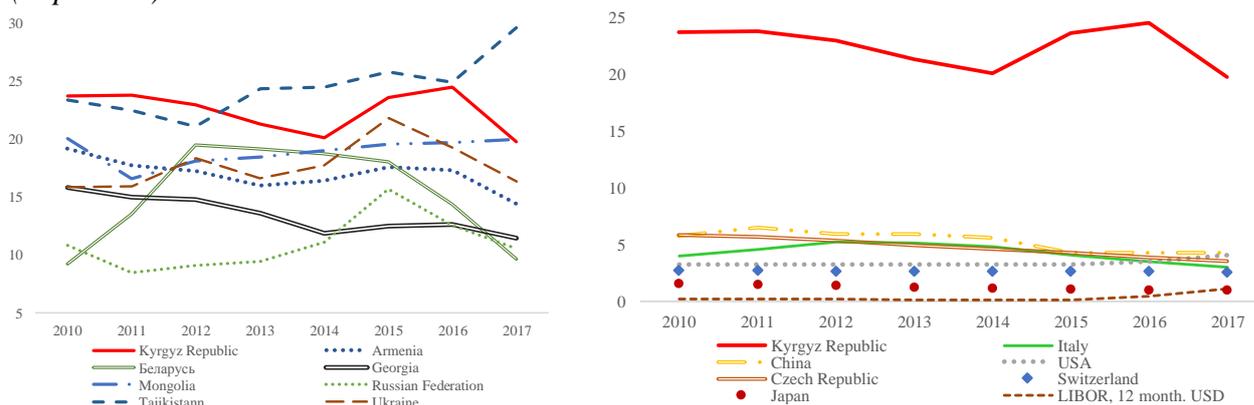
The comparative analysis of interest rates in the Kyrgyz Republic, CIS countries and developed countries shows that there is a large gap between the levels of interest rates (Chart 9).

The LIBOR rate (London Interbank Offered Rate) is among the main benchmarks for the cost of capital in the international market. The commercial banks that have access to the international capital markets emphasized that raising funds in foreign currency at the LIBOR rate, taking into account the country risk premium, is unattractive for them, since similar funds can be raised in the domestic market at a lower cost. Therefore, the commercial banks of the republic rarely enter the foreign markets to raise funds.

Nevertheless, the international experience shows that the interest rates on loans, for example, in the post-Soviet countries are gradually falling through implementation of the appropriate economic policy (Chart 9). In particular, the transition to inflation targeting, the use of monetary instruments, including in the monetary sphere, in Georgia, made it possible to achieve the size of the spread between the policy rate of the Bank of Georgia and the rate on loans from 14.9 to 1.8 percent⁸.

⁸ World Bank, <https://data.worldbank.org/indicator/FR.INR.LNDP?locations=GE>, дата обращения: 20.10.2017.

Chart 9. Comparative Dynamics of the Interest Rates on Loans in the Countries with Transition and Developed Economies, 2010-2017⁹
(in percent)



Source: World Bank (data.worldbank.org), www.macrotrends.net

The commercial banks can be given the opportunity to transform (lengthen) short-term money into long-term money to decrease the interest rates on loans for the real economy in the Kyrgyz Republic. It assumes the presence of an active interbank market and establishment of the policy rate as an indicative indicator of the value of money in the economy.

The principle of the money lengthening mechanism is as follows:

1. The commercial banks should be confident that (in case of need for liquidity) they will be able to get it either in the interbank market, but subject to its active participation, or from the National Bank.

2. The banks should be able to predict the size of the interest rate on attracted liquidity in the medium term. If there is a close correlation between the policy rate and the interest rates in the interbank market, the commercial banks will need to predict only future values of the policy rate.

3. The National Bank should continue work to increase the impact on inflationary expectations in the economy. A decrease in interest rates is possible if inflation expectations in the economy are anchored in the medium and long term at the levels close to the inflation targets of the National Bank, which may result in a significant reduction in uncertainty in the pricing of loans.

The National Bank has been conducting a stimulating monetary policy since 2016. Over the past two years, the size of the policy rate of the National Bank has fallen by two times: from 10.00 to 5.00 percent. As of the beginning of 2016, the policy rate was 10.00 percent, in March, May, November and December 2017 it decreased down to 8.00, 6.00, 5.50 and 5.00 percent, respectively. During 2017, the rate was at the level of 5.00 percent. These measures to a certain extent predetermined the interest rate policy of the banking sector towards reducing the cost of resources for borrowers' lending.

The National Bank continued to provide funds to the commercial banks through the credit auctions to assist in implementation of the state programs "Financing of Agriculture" (hereinafter referred to as the FA). The banking sector was provided with KGS 370.0 million and KGS 500.0 million, respectively, within the framework of "FA-4" and "FA-5" through the credit auctions in 2016-2017.

In addition, the National Bank held credit auctions in order to refinance the commercial banks for their subsequent lending to all sectors of the economy, excluding

⁹ The chart shows lending rates according to the IMF, i.e. the bank rate, which usually corresponds to the short- and medium-term financial needs of the private sector. The rate is usually differentiated depending on the creditworthiness of the borrowers and the purpose of financing. The conditions associated with these rates vary from country to country, which is a limitation for comparing thereof.

mortgage and consumer lending. In 2016, the total amount of funds offered under these credit auctions amounted to KGS 1.2 billion.

In 2017, the National Bank increased the volume of funds provided within the framework of credit auctions for lending to industry, agriculture, construction, trade and other sectors, excluding mortgage and consumer loans. The National Bank limited the maximum rate for the end borrowers at 12 percent to reduce the cost of loans. The total presented demand from the commercial banks amounted to KGS 5.7 billion, meanwhile in fact, KGS 4.8 billion were issued.

The National Bank provided loans in the national currency in the amount of KGS 2.0 billion (including in 2015 – KGS 1,200 million, in 2016 – KGS 678.2 million, in 2017 – KGS 72.5 million) to the international organizations created by the Kyrgyz Republic jointly with other states within the EAEU to promote development and support of the long-term economic growth.

Currently, the interest rates in the lending market are separated from the policy rate, which is confirmed by the results of the survey conducted in the commercial banks.

Three-month notes of the National Bank can be among the instruments for lengthening funds that contribute to solving some of the above problems. Such notes perform the following functions:

1. The notes sterilize excess liquidity, which should increase activity in the interbank market and bring the rates of the interbank market closer to the policy rate¹⁰.

2. If the bank needs liquidity, the commercial banks will be able to attract it either in the interbank market or in the National Bank against the security of three-month notes.

3. Since the interest rates on three-month notes, and, more importantly, on short-term loans of the National Bank secured by these notes will be tied to the policy rate, it will further increase the indicative properties of the latter.

4. Expectations of the commercial banks on the short-term interest rates will be fixed to the policy rate, which will give the banking sector the ability to plan future flows and issue long-term loans.

In the long term, it is proposed:

- to use three-month notes as a sterilization tool if there is stable excess liquidity in the banking system, which significantly deviates interest rates from the policy rate;

- to reduce the volume of liquidity provision by the National Bank due to development of the interbank market.

The abovementioned measures imply an increase in the effectiveness of monetary policy (by increasing the role of the policy rate), which in the long term will result in an additional decrease in the interest rates on loans/deposits due to increased confidence in the National Bank and a corresponding decline in inflationary expectations.

Conclusion (and Recommendations).

For a long time, a situation has developed in the lending market when the interest rates on loans were quite high. However, the demand for them was rather high, and the size of the loan portfolio in the banking system was constantly growing (Chart 1). However, there was a decline in the interest rates on loans in the market starting from 2015-2016. The main reasons for this process were:

1. Changes of the National Bank's policy in the money market since 2014¹¹.

¹⁰ In particular, currently, the banks do not trade with each other, because many of them have excess liquidity. If the latter flows into the notes, the banks will need to attract liquidity from time to time (for example, when a client suddenly requests to take a demand deposit). The banks will need to enter the interbank market (for example, a new demand deposit was opened in another bank and thus there was free liquidity, meanwhile there is a week before the auction of three-month notes), or the National Bank in order to replenish liquidity. In both cases, notes can be used as collateral. At the same time, the option with access to the interbank market will be preferable for the banks, since the rates on it will be more profitable than in the National Bank.

¹¹ Transition to a new basis of monetary policy, when the interest rate targeting was initiated.

2. A new player (RKDF) entered the market, increasing competition in the lending market among the banks.

3. Decrease in domestic demand and exports resulted from the impact of the external economic shock in 2014-2015.

It should be noted that before the onset of an unfavorable period, the banks received, in our opinion, excess margin (the so-called “bubble of excess margin” formed), the size thereof gradually decreased and the rates reached a real equilibrium value by 2017. The statements of some bank employees also confirm it.

The local banks initiated transition to technical re-equipment, which will reduce personnel costs by expanding the product line. For example, there are banks that have switched to customer scoring, another bank, together with two mobile operators, introduced a new product: a mobile wallet, which allowed the bank to be closer to the clients (up to 3 million subscribers), etc.

Nevertheless, operating expenses constitute a significant share of the banks’ expenses, especially those banks that have a wide branch network and a network of savings banks, with additional costs incurred by the commercial banks for maintenance thereof. Banks see significant potential in reducing operating costs, which may affect the efficiency of the bank and reduce the cost of credit and deposit products.

Involvement of a large player (RKDF) with the ability to finance the economy with long-term money in the amount of approximately KGS 35 billion (USD 500 million) significantly influenced the market, forced the banks to revise their strategies for lending to the borrowers and the size of the interest rates on loans. In turn, the total capital of the domestic banks as of the end of 2017 is KGS 22.0 billion, the deposit base – KGS 121.6 billion, assets – KGS 192 billion¹².

Further measures in the banking market should be focused on continuing to increase the capitalization of banks, creating a megabank represented by one of the state-owned banks, the pricing policy of which will be conducted taking into account market mechanisms in order to competitively influence a decrease in the interest rates on loans.

It is also necessary to continue work on creating conditions for consolidation of the commercial banks through their merger or additional capitalization (attraction of investments). International experience shows that the merger of several banks into one will contribute to reducing the cost of loans for the consumers.

The low level of the national credit rating, the absence of a credit rating of the banks, and preservation of the certain political risks in the country do not allow the commercial banks to enter foreign capital markets and to attract available foreign funds. For this, there must be a macroeconomic, socio-economic and politically stable situation in the country, property rights must be respected and the interests of the domestic and foreign investors must be protected for favorable investment.

The country has enough internal resources that should be attracted to the banking system in addition to external resources. In particular, the strategic document “Main directions of development of the banking sector for 2014-2017” contains measures to mobilize internal resources from the population and from the legal entities. The Social Fund of the Kyrgyz Republic, the funds of which are placed through auctions in the banking system, is a large entity that accumulates funds. With the growth of pension contributions through leaving by the taxpayers of the shadow sector, the transition to a funded pension system, the development of insurance, etc., there will be direct prerequisites for emergence of a long-term money market, which will also be able to reduce interest rates on loans.

Together with the resources attracted from the population and economic entities, the banks in the market can also raise funds through credit auctions. This source of funds

¹² According to the data of the RKDF, NSC and the National Bank of the Kyrgyz Republic.

is among the most accessible and convenient for the commercial banks. The banks point out that the auction funds have a direct positive effect on the cost of lending rates.

From the point of view of the long-term impact of monetary policy measures on decrease in rates, the banks' representatives expressed a desire to receive information on the frequency of organizing auctions by the National Bank. The National Bank here could, on the one hand, manage market expectations, and on the other hand, draw the attention of the commercial banks to the use and implementation of forecasting methods to manage liquidity and to predict the actions of the National Bank and the interbank market.

According to the survey results, the banks' representatives were unable to determine the dynamics direction of the interest rate on loans. The banks will focus more on the market situation and competition to determine the interest rate for the coming period. In our opinion, it will be possible to expect sustainable growth in lending in the next three years due to the expected economic growth (4.2-5.2 percent), inflow of the remittances, initiation of a new lending cycle amid recovery of macroeconomic indicators, growth in consumption by the population, adaptation of the banking market to market conditions, etc.

In pursuit of the main goal - a market reduction in the interest rates, the National Bank will continue to implement the monetary policy focused on lowering lending rates by the market methods, through activating the interest rate channel of the transmission mechanism, the interbank credit market, as well as through managing expectations for the policy rate, inflation, economic growth to ensure the short-, medium- and long-term stabilization.

References

- Dabla-Norris, Era, and Holger Floerkemeier. "Bank efficiency and market structure: what determines banking spreads in Armenia?" IMF Working Papers (2007): 1-28.
- Gelos, R. Gaston. "Banking spreads in Latin America." *Economic Inquiry* 47.4 (2009): 796-814.
- Peshev, Petar. "Determinants of interest rate spreads in Bulgaria." BNB Discussion papers series, DP/99/2015 (2015).
- Ahokossi, Calixte. "Determinants of Bank Interest Margins in Sub-Saharan Africa." *Determinants of Bank Interest Margins in Sub-Saharan Africa* 2013.34 (2013): 1-21.
- Georgievska, L., Kabashi, R., Manova-Trajkovska, N., Mitreska, A., & Vaskov, M. (2011). Determinants of lending interest rates and interest rates spreads. In Bank of Greece, Special Conference Paper, No. 9.
- Gorelaya, Natalia. "Evaluation of the Impact of Factors on Loan Pricing." *Journal of Corporate Finance Research* 10.1 (2016): 59-76.
- Lupanov, V.V., Belotserkovsky V.I. "Analysis of factors influencing formation of the interest rates on loans and deposits in a commercial bank." *Bulletin of the Tula State University. Economic and legal sciences* 1-1 (2010).
- Main Directions of the Unified State Monetary Policy for 2018 and the Period of 2019 and 2020 (2017), Moscow, No. 2756-7 GD.