FINANCIAL SECTOR REVIEW FOR KYRGYZ REPUBLIC

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1996

Development Discussion Paper: 1996-06

Abstract

The Republic of Kyrgyzstan introduced radical reforms to restructure its financial sector to accelerate the transformation of its centrally planned economy to a market-based economy. High interest rates charged on loans is one of the major financial problems for trade and industry sectors in Kyrgyzstan. Today, working capital finance and investment finance are the two main constraints to the expansion and modernization of the industries in Kyrgyzstan. Banks are also not able to attract a significant part of the available domestic savings. As a result personal and corporate savings are being held outside of the formal financial system.

The current tax legislation in Kyrgyzstan is another factor and causing mistrust for the banking sector. According to the legislation the tax inspectors have access to the deposit accounts of savers.

The banking sector of Kyrgyzstan presents the common problems of banks in other transitional socialist economies. They are old fashioned and they do not have the institutional capacity to operate in a market oriented economy. Banks, in general, are not service oriented. The procedures are too long and the buildings of banks are not designed to service the daily transactions of the depositors and borrowers.

Keywords: Financial policy, central bank, banks, financial reforms, Kyrgyzstan, financing private enterprises, trade finance

JEL Classification: F38, E58, P21

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1. FINANCIAL SECTOR POLICY AND REFORMS

Financial sector reform is one of the most important components of the economic policy reforms undertaken in the former Soviet Union countries. The Republic of Kyrgyzstan introduced radical reforms to restructure its financial sector to accelerate the transformation of its centrally planned economy to a market-based economy. In June 1991, the financial sector reform was introduced with the Law on the State Bank, and the Law on Banks and Banking Activity. With this legislation the former branch of State Bank of USSR was transformed into the National bank of the Kyrgyz Republic.

1.1. THE MONETARY POLICY OF THE NATIONAL BANK

In December 1992, the currently binding Law on the National bank, and the Law on Banks and Banking Activity were passed. With this legislation the National Bank gained its independence from the Government, and was given the authority to conduct monetary policy, to stabilize the currency, and to supervise the banking sector. In practice however, the National Bank continued to take instructions from the Government until the end of 1993. The most important implication of this was that the National Bank continued to extend refinancing credit with preferential rates to former state owned large banks. For example, the interest rate on refinancing credit was between 10 to 60 percent whereas interest rates in the credit auction markets were between 100 to 200 percent. These credits were used to finance the Government budget and the preferential sectors of the economy, such as agricultural sector. In 1993, 58 percent of the refinancing credit was directed to the agriculture and agricultural processing sectors of the economy, whereas only 8 percent of refinancing credit was obtained by industry, and 9 percent was obtained by trade and services sector.

The refinancing credit was the major source of funds for the commercial banks, especially for the three large former state owned banks. For example, in 1993, 94 percent of the loan portfolio of Agroprombank, 66 percent of Promstroybank and 63 percent of JSC Kyrgyzstan were created by refinancing credit.

In May 1993, the Government of the Kyrgyz Republic introduced its national currency, the Som. The Som was tied to hard currency, the US dollar, and a floating exchange rate policy was followed by the Government. Following the introduction of the Som, the National Bank began to hold weekly credit auctions to determine the market interest rates. In the early auctions the interest rate was set around 100 percent. At the end of 1993 the interest rates reached to 260 percent.

Together with the introduction of the new currency, restrictions on foreign currency transactions were lifted. At the same time, flexible exchange rate was established on the interbank market, and commercial banks were allowed to purchase foreign currency at weekly auctions organized by the National Bank. When the national currency introduced, the dollar exchange rate was established at 4 Soms to a dollar. By the end of 1993 the rate became 8 Soms to a dollar, and it further depreciated in 1994 becoming 12 Soms to a dollar. In 1995 it began to appreciate slowly and became 11.50 Soms in January 1996.

The simultaneous fall in the production and continued expansion of refinancing credits created by the National Bank increased the inflation rate to over 40 percent monthly in the second half of 1993. Economic instability and financial difficulties of enterprises resulted in a widespread bankruptcy in the corporate sector and huge non-performing loans for banks. Consequently, a large number of commercial banks failed to repay the refinancing credits to the National Bank. The amount of overdue loans to the National Bank amounted to 60 percent of the total refinancing credit given to the commercial banks. As a result, in 1994, the amount of new refinancing credits given by the National Bank was reduced and preferential credits were terminated by the Government.

The National Bank also influenced the credit expansion of the commercial banks by increasing the reserve requirements ratio from 15 percent to 20 percent of deposits in 1993. This ratio was further increased to 30 percent on deposits in 1994, in order to control the money supply and hence reduce the inflation. In 1995, the reserve requirement ratio was again reduced to 15 percent (the National Bank pays a market interest rate on these reserves.)

The Government budget deficit increased from 6.6 percent of GDP in 1993 to 8 percent of GDP in 1994, and 14 percent in 1995. The National Bank financed 36.7 percent of this budget deficit an amount of 316 million Soms. Between 1992 and 1994 the amount of National Bank’s loans to the Ministry of Finance was 726.4 million Soms. From February 1994, the National Bank began its auctions on short term Treasury Bills to finance the budget deficit. In that year, 267 million Soms were sold in total and 5.5 percent of this amount was bought by the private sector. A secondary market for Treasury Bills was also established in 1994.

The maturity of Treasury Bills is 3 months and the interest rate on Treasury Bills, in average, was 225 percent in 1994, and 55 percent in 1995. Currently, the interest rate on Treasury bill is 29 percent. Interest earnings on Treasury Bills are tax exempt.

In 1995, 55 percent of budget deficit was financed by internal sources of which 92 percent was loans from the National Bank and 8 percent was raised through Treasury Bills.

1.2. THE FINANCIAL INSTITUTIONS

1.2.1. Commercial Banks

The banking sector of the Kyrgyz Republic consists of the National Bank and 20 commercial banks (Annex 1). Among the commercial banks, the largest four banks - Promstroybank, Agroprombank, JSC Kyrgyzstan and Sberbank - are former state owned banks that financed the specific sectors of the economy such as, agriculture, building, textiles and infrastructure. With the implementation of the Law on Banks and Banking Activity, these banks became joint stock commercial banks in 1992.

For the new banks, the minimum starting capital requirement was set as one million Som. This low capital requirement encouraged the rapid growth of new joint stock and private commercial banks and 16 new small commercial banks were established within two years. Among the new commercial banks, the most successful banks are Kurulushbank, Henfen Ltd, Kyrgyz-Jer, Mercury Ltd, Orient Bank, and Kramdsbank.

In 1993, due to the high inflation rate, the capital base of these new banks depreciated rapidly. The National Bank raised the required minimum capital to 5 million Soms from the beginning of 1994. From September 1996, the minimum capital requirement will be 10 million Soms however; the majority of new commercial banks are having difficulty to increase their capital base. Due to problems with their small capital base and risky operations, JSC Adil Bank and Saturn Bank were closed down, and Akniet became Aman Bank, after it was bought by a new investor in 1995.

In 1993 and 1994, commercial banks also faced problems with the quality of their loan portfolio. The non-performing loans of banks varied from bank to bank from 5 percent to 80 percent. In this respect, the former state owned banks, Promstroybank, Agroprombank and JSC Kyrgyztan Bank faced the most difficult situation because of their traditional role of financing the state enterprises. At the end of 1993, almost all commercial banks failed to repay the refinancing credits they had received from the National Bank and the debts of commercial banks to the National Bank rose to 600 million Soms.

In 1994, new regulations were introduced by the National Bank to supervise the commercial banks. According to these regulations, commercial banks have to maintain a capital adequacy ratio of 7 percent, and 30 percent liquidity ratio. Furthermore, the amount of a single loan is limited to a maximum of 30 percent of total capital in order to reduce the risk from one borrower. In addition, if the borrower is a shareholder of the bank, the loan cannot be higher than 15 percent of total capital. This requirement was fulfilled by only 7 banks while, the liquidity requirement ratio was fulfilled by 11 banks in 1994.

The accounting system of commercial banks, however, needs to be improved and international accounting standards needs be adopted. The existing accounting standards are based on the former centralized accounting systems that are not suitable for banks operations today. A number of international consultants are currently dealing with this issue. It is expected that the whole banking sector will be using international accounting standards in two years.

Between 1993 and 95, the ratio of M2/GNP increased from 12.3 percent in 1993 to 14.2 percent in 1994, and 17.6 percent in 1995 (M2 = currency in circulation + demand deposits + time deposits). This indicates that the financial sector, although is very small with respect to the real sector, is growing steadily.

1.2.2. Non-Bank Financial Institutions

Similar to other former Soviet Union countries, the non-bank financial sector in Kyrgyzstan is newly emerging and it is at its very early stage of development. This sector currently consists of lambards, exchange bureaus, insurance companies, investment funds and pensions fund.

- **Lambards**

Lambards are licensed money lenders who lend money on the basis of collateral. Lambards are licensed by the National Bank and the required minimum capital to obtain a lambard license is 100,000 Soms. At the end of 1995, the total number of lambards in Kyrgyzstan was 78. Some of these lambards also had a license to exchange money, for example, 30 out of 78 lambards had licenses to deal with foreign exchange. Lambards mostly lend to individuals and small businesses however, their funds are limited and they do not have a significant effect on the credit supply in the economy.

- **Foreign Exchange Bureaus**

Similar to lambards, exchange foreign exchange bureaus are licensed dealers who are regulated by the National Bank. At the end of 1995, there were a total of 510 exchange bureaus in the country. The public mostly prefer to use exchange bureaus as they give a better rates than banks do. In that respect exchange bureaus play an important role to close the exchange rate gap between the formal market and black market.

- **Specialized Investment Funds**

In Kyrgyzstan, there are 24 investment funds but only three of them are functioning. These are Oshinvest, Bereke Invest, and Kyrgyzinvest. The resources of these investment funds are limited and have an insignificant role in investment finance. For investment funds the minimum required capital for receiving a license is 100.000 Soms.

The largest investment fund is Oshinvest that is located in Osh. The total Assets of Oshinvest is 3 million Soms. The second largest investment fund is Bereke Invest. This investment fund was established in 1993. It has 16,000 shareholders and its total assets are 1 million Som. After having some financial difficulties, the management of Bereke Invest was given to BNC stock broker company. During the first two years Bereke Invest invested in 70 privatized and newly established companies. Some of these companies are making large losses, and Bereke Invest is in the process of cleaning up its portfolio and reducing its investment in 30 companies.

The common problems facing investment funds in the Kyrgyz Republic are:

a) Shortage of funds: Currently, the trade finance is the most profitable business in Kyrgyzstan. Investors' money is attracted in the trade sector rather than in investment companies that may be profitable in the long run but are risky.

b) Lack of experienced professionals: Investment fund companies are very new and there is a shortage of professionals in this area.

c) Imperfections in the Legislation: In the Law there is no difference between the investment funds and other enterprises. There is no law for trust companies and building societies.

- **Insurance Companies**

The Insurance Law of the Republic of Kyrgyzstan was issued in December 1991 to regulate the activities of the insurance companies. The insurance sector however has not yet been developed. Although there are 144 insurance companies, 66 state-owned and 78 private, they are very small and their assets are negligible.

Currently, there are only 6 operational insurance companies. These are: The State Insurance Company, Zdorovie, Kamkor S, Ak - Jol, Altyn-Jol, and Trust Company Orient. State Committee of Supervision on Activity of Insurance Companies registers and supervises the insurance companies. Insurance companies have to pay 1 percent of their capital to this committee every year.

The State Insurance Company is the largest insurance company operating in Kyrgyzstan. After the independence, State Insurance Company was privatized, where 60 percent of the total shares are held by private enterprises and 40 percent are held by the State. The reserves of the State Insurance Company amount to 8 million Soms. They are kept as bank deposits. State Insurance Company has agreements with German, Japan and Russian Insurance Companies for reinsurance businesses. The main insurance policies of the State Insurance Company are fire, property, car and newly introduced life insurance for the borrowers of large loans.

The second largest insurance company is Zdorovie. Zdorovie was established in 1991 and is privately owned. The insurance policies of Zdorovie are; car, property, health, important documents, and insurance against commercial risks. Zdorovie also works with foreign insurance companies from Austria and Germany. The reserve funds of Zdorovie are kept in bank deposits, however, as the returns on bank deposits are not found to be satisfactory and they plan to invest in real estate.

Currently, the insurance sector has a very limited role in the financial sector of Kyrgyzstan, however it has a significant potential to contribute to the mobilization of resources for investment finance. In recent years, although new insurance policies were introduced, the market is very risky and companies are making losses during their first experiences with these new policies. For example, insurance against credit defaulting was introduced in 1993 but large losses were made because of difficulties in assessing the and due to weaknesses in the legal system. Consequently, this policy was terminated. Another new policy, commercial liability insurance, was also introduced recently. This policy is only available for businesses with enough collateral.
One of the important problems of the insurance companies is that according to the present law, earnings from collateral are subject to 30 percent income tax. In other words, insurance companies receive 70 percent of the collateral value when they take the collateral of a defaulting borrower, whereas they have to pay 100 percent of the loan or commercial liability of the insurance policy.

Life insurance is a potential policy that can have a significant role for financing long-term investments. In many countries life insurance companies provide an important source of long-term finance for industry. According to international practice the life insurance payments by the corporate sector are accepted as a tax deductible expense however, in Kyrgyzstan the life insurance expenses of the corporate sector are not tax deductible.

- **Social Security and Pension Funds**

In market economies, private pension funds are important sources of funds for the long term investments in the private sector. In the Kyrgyz Republic, this would require a move from unfunded to funded social security schemes. In addition, a legal framework is needed to create possibilities for retirement funds to be used in the private sector.

In Kyrgyzstan, the existing State Pension Fund does not have enough sources to pay the retired workers because; only about 78 percent of total liabilities are collected. After the independence, for the unemployed people, the age for social security payments was also reduced by two years from 55 to 53 for women and from 60 to 58 for men. This increased the number of workers that needs to be paid currently, and worsened the financial situation of the State Pension Fund.

The State Pension Fund of the Kyrgyz Republic needs to be reformed, by building its capital and finding new ways of funding other than increasing the payroll tax. This can be done by using the broad based taxes, such as value added tax to finance the basic social obligations of the country. In addition, the policy of the State Pension Fund should be more targeted and people who are not liable for payment should be excluded.

With its existing problems, the State Pension Fund cannot contribute to the financial system in Kyrgyzstan however; this can be changed by reforming the pension's funds and by moving towards a funded pension scheme, where the funds can be invested in private sector debt and equity when such financial markets develop.

1.3. THE KYRGYZ STOCK EXCHANGE

Security markets are often an important source of long term financing for industry. They provide greater range of risk to return configurations to support different types of portfolio and investment needs that cannot be provided by the banking sector.

The Kyrgyz Stock Exchange (KSE) was established in July 1994 and began trading the shares of the newly privatized companies in May 1995. By December 1995, there were 10 listed companies, however, this number is still too small to maintain a well-functioning stock market (The listed companies are: Edelweiss Joint Stock Company, Bishkeksut Joint Stock Company, Kyrgyz Worsted and Woolen Factory (KKCK), Arpa Joint Stock Company, KyrgyzKramds-Bank Joint Stock Commerical Bank, Almekh Joint Stock Company, and Bakai Joint Stock Company.

The KSE Index is subject to large volatility because, there is only a small number of companies that are currently trading. The success of KSE in attracting investors in the stock market and providing long term finance to the local industries depends on whether the secondary market would become an active, well-functioning market in the near future. The existence of a secondary market creates liquidity and generates information about trading companies thereby, encouraging people to invest in the securities markets. Currently, the secondary market is very small and it is mainly for Treasury bills.

2. FINANCING OF TRADE AND INDUSTRY

Despite privatization and major policy changes, the preferential credit policy to state enterprises and the agricultural sector continued until the end of 1993. This aggravated the problem of bad loans of the banking system and reduced the available sources of credit to the private sector. These developments not only reduced the availability of credit for investment and trade but also, caused the interest rates to stay high and the loan terms to become as short as 3 months.

It is reported by the National Bank that the volume of non-performing loans reached as high as 80 percent of the total bank loans in 1994. The largest part of these non-performing loans was accumulated by the former state owned banks, such as Promstroybank, Agroprombank and JSC Kyrgyzstan. These banks are practically insolvent and would have negative equity base if their bad debts were written off.

Vnesheconombank and JSC Kyrgyztan temporarily stopped all their lending activities in 1995, and concentrated on collecting their bad loans. Currently, banks are heavily dependent on the National Bank and international institutions as sources of funds for lending.

High interest rates charged on loans is a major financial problem for trade and industry sectors in Kyrgyzstan. Although the inflation rate and hence, the deposit interest rates declined considerably in 1994, bank loan rates stayed as high as 80 percent in nominal terms, and 15 percent in real terms. As a result, only few enterprises were able to make use of bank credits. The majority of businesses borrowed from other sources, such as credits from international development agencies, personal savings, suppliers' credit, informal money markets and the Kyrgyz Stock Exchange market.

Today, working capital finance and investment finance are the two main constraints to the expansion and modernization of the industries in Kyrgyzstan. In our survey of 55 manufacturing companies, 94 percent of companies indicated that finance is a major constraint to their operations.

2.1. WORKING CAPITAL FINANCE

As the bank credits were difficult to obtain and too expensive to run the business profitably, a large number of manufacturers have been forced to constrain their production and to build up their working capital from their own sources, rather than going for expansion and modernization.

In particular, small and medium sized enterprises (SMEs) are having difficulties to maintain their working capital because of the high rate of inflation rate and the lack of collateral to borrow from external sources.

In our survey the following are identified as the major sources of working capital finance in Kyrgyzstan. (These sources of finance are ranked according to their relative significance, from most significant to least significant.)

Source of Working Capital finance
1. Personal savings
2. Loans from family and friends
3. Suppliers credit and buyers advances
4. Domestic banks
5. Credit lines of international institutions

International institutions such as WB, EBRD and GTZ do not lend for working capital purposes. Inventories of inputs, such as computer and machinery assembly parts are also defined as working capital. Therefore these businesses do not have access to the international credit that has been made available by these organizations for private sector development in Kyrgyzstan.

2.2. TRADE FINANCE

The trading sector, both domestic and international, is the most profitable business activity in Kyrgyzstan. For traders, the major sources of finance are; bank credits and loans from family and friends. Small traders are mostly using their own sources finance, personal savings and family loans. Large traders are utilizing both their own resources and also borrowing from banks.

The trading sector has easier access to bank credits compared to manufacturing. Foreign traders also have easier access to foreign currency in commercial banks and foreign exchange offices. Therefore, finance does not appear to be an important constraint for the trade sector. The most important constraint for trade sector is the lack of modern financial services such as letters of credit. Currently, letters of credit can be provided by only 6 commercial banks. To be able to serve international traders, domestic banking sector needs to be modernized, to establish international payment systems, to have international correspondent banks, and to train their personnel in international banking services.

2.3. INVESTMENT FINANCE

Due to high market risk and shortage of investable funds, commercial banks do not lend on long terms. Commercial banks provide only short-term credits for 3 to 6 months. Henfen Bank provides loans up to

1 year for investment purposes. These loans however constitute a very small share of their loan portfolio.

Investment finance for domestic industries is provided by the international development agencies such as, the World Bank, IMF, EBRD, ADB and KFW, and by a number of countries, such as Japan, Turkey, Pakistan, India and China. These funds are disbursed through the network of domestic commercial banks. However, the banks' role in allocating these resources is mostly administrative. They are not given the responsibility and authority to assess the loan applicants.

The major part of the credit available from international sources is allocated by the State Commission for Foreign Investment and Economic Assistance (Goskominvest). Goskominvest was established in 1993 and it has 15 members who are the current ministers and its Chairman is the President of the Kyrgyz Republic. In this commission, loan applications are assessed in the Department of Project Evaluation, and reports are submitted to the committee. For loan applicants, it can take up to 10 months to get a result. Project evaluation usually takes for 1 to 3 months and loan approval and disbursement takes 4-7 months.

2.3.1. The World Bank

The largest part of external funds came from the World Bank. In 1993, International Development Agency (IDA) of the World Bank began to provide both grants and soft loans under a number of different programs.

Between 1993 and 95, five concessional loans, amounting US $ 201.3 million in total were given by IDA for private sector development in the Kyrgyz Republic. These loans are: Rehabilitation Credit, Privatization and Enterprise Sector Adjustment Credit (PESAC), Social Safety Net, Telecommunications Project, and Agricultural Privatization and Enterprise Adjustment Credit (APEAC). Between 1996 and 1998, additional US $ 184 million soft loans will be provided for Private Enterprise Support Project (PESP), Financial Sector Adjustment (FinSAC), Agricultural Credit, energy and Health Projects.

IDA loans are mostly given for 40 years with a grace period of 10 years. The interest rate on these loans is 0.75 percent for the Government of Kyrgyz Republic and around 8 percent for the end user (these rates are in US $).

In January 1996, a US $ 15 million loan was given to the Government for Private Enterprise Support Project (PESP). The objective of this project is to provide credit to small and medium sized private enterprises a special fund, Fund for Enterprise Reconstruction and Development (FERD) was established in order to allocate these funds to private enterprises in Kyrgyzstan. The members of FERD are ministers and senior government officials. The management of FERD is contracted to Credit Commercial de France (CCF) and subcontracted to Pangaea Partners, an independent consultancy firm in New York. (CCF does not have a branch office in Kyrgyzstan). Consultants from Pangaea Partners will assist FERD to evaluate the loan applications and make loans to creditworthy applicants that have a potential to become successful businesses.

During the allocation of Privatization and Enterprise Sector Adjustment Credit (PESAC) again, banks were not able to choose their borrowers because, they were given instructions to allocate these funds to certain enterprises. Most of this credit was allocated to enterprises that were not economically viable. Today, large state banks, such as Promstroybank have huge non-performing loans. The government stopped the interest payment on these nonperforming loans and promised to pay the loans, however the issue has not been settled yet by the Government. Banks are holding the collateral of these enterprises but they cannot sell the collateral before the Government's decision on this matter.

2.3.2. International Monetary Fund (IMF)

The second largest lender is the IMF. The IMF extended US $ 105 million to the Kyrgyz Government for supporting the economic reforms and the balance of payments situation of the country. This loan was given for 10 years with a grace period of 5 years. The interest rate on this loan is 0.5 percent.

2.3.3. The European Bank for Reconstruction and Development

The European Bank for Reconstruction and Development (EBRD) has a credit line of US $ 10.5 million for investment finance in Kyrgyzstan. This loan was given only for machinery and equipment finance; it is not given for working capital. Three commercial banks; Kurulush Bank, JSC Kyrgyzstan, and Vnesheconombank were selected by EBRD to allocate this credit line. These banks assess the applicants and choose the borrowers; however, National Bank and EBRD also have to approve the loan.

This double approval system makes the loan approval and disbursement a slow process. Since its inception in June 1994, this credit line made only one loan. The borrower applied for the loan in July, 1994 and the loan was approved in August, 1995, and disbursed in September, 1995. As the loan approval and dispersion took more than a year the cost of borrower has increased significantly. The borrower had to travel from Tokmak to Bishkek to follow up the loan application. Also, due to delays in receiving the loan, the terms and conditions of the letters of credit that the borrower had opened earlier had changed and the borrower had to bear the cost for modifying the letters of credit. This loan was made to a food processing company that produces cheese, butter and other milk products, and planning to go into export market. The loan will be used for expansion and modernization (The amount of this loan is US $ 250,000, the interest rate is 13 percent and the loan term is 5 years, with one year grace period.).

2.3.4. KfW

The KfW (German) credit line is 60 million DM. The first loan of 15 million DM was received in 1993, with 2 percent interest rate. In 1994 the second loan, 20 million DM, was received with an interest rate 0.75 percent (The interest rate on end users is 9 percent). These loans were given for 40 years each, with a grace period of 10 years. The objective of these loans is to finance the investment projects in the private sector, in particular, SMEs and the textile industry. The loan applicants for this credit line are evaluated by GTZ (German consultants) and GOSCOMINVEST, and loans are disbursed through JSC Kyrgyzstan. So far, 9 loans are made for large enterprises and 25 loans are made for SMEs. On average, it takes around 6 months to evaluate the loan applications and to give approval for disbursement.

2.3.5. Credit line From Turkey

The Turkish credit line is for US $ 75 million. This credit is allocated on a project basis through GOSCOMINVEST. For the industrial sector, the loan maturity is 10 years with a grace period of 3 years. For the trade sector the loan maturity is 4 years with a grace period of one year. The interest rate on industrial loans is 8 percent and trade loans are LIBOR + 2 percent.

2.3.6. Central Asian-American Enterprise Fund (CA-AEF)

This fund recently opened an office to support SMEs and large private enterprises in the Kyrgyz Republic. The credit line of CA-AEF is US $ 6 million. This program will be managed jointly by CA-AEF and Kurulush Bank.

2.3.7. Asian Development Bank (ADB)

ADB extended a grant of US $ 910,000 for technical assistance and microenterprise finance in the agricultural sector. The National Bank will execute this program. In addition, a US $ 40 million privilege loan was extended to the Kyrgyz Government with 1 percent interest rate. This loan was given for 40 years with a grace period of 10 years. Thirty millions of this loan was given to support the balance of payments and 10 million was given to finance the essential imports for the country.

3. CONSTRAINTS FOR PRIVATE ENTERPRISE FINANCE

3.1. LIMITED DOMESTIC FINANCIAL RESOURCES

At present, one of the biggest constraints in financing the newly emerging private sector in Kyrgyztan is the shortage of domestic financial resources. Although a significant progress has been made in the financial sector by privatizing the former state banks and creating new commercial banks, the financial sector still has a limited role in mobilizing domestic savings. The major factors negatively affecting the financial intermediation in Kyrgyzstan negatively are:

- Economic instability and negative real deposit rates of interest
- Shortage of savings instruments and a poor network of branch banks
- Access of tax inspectors into deposit accounts
- Extensive non-performing loans held by banks
- High corporate tax rate on financial sector

3.1.1. Economic Instability and Negative Real Deposit Rates.

At present, banks are not able to attract a significant part of the available domestic savings. Personal and corporate savings are being held outside of the formal financial system. A large part of the corporate savings is kept in the business as working capital (either as foreign currency or inventory) whereas personal savings are mostly lent to family or friends. The estimated amount of savings that are circulating outside of the banking sector is 300 million Soms. This amount corresponds to as high as 57 percent of the total deposits accumulated in the banking sector at the end of 1994. One of the major factors discouraged people from putting their savings into bank deposits is the economic instability, causing sharp fluctuations in the inflation rate and persistent negative real deposit rates of interest.

In 1993 and 1994, high and volatile inflation rate, the huge amount of non-performing loans held by commercial banks and the bankruptcy of a number of unregulated financial institutions created a tremendous amount of uncertainty and doubt about the safety of the newly developing financial system in Kyrgyzstan. In 1993, the interest rates on deposits fluctuated between 60 and 350 percent along with the inflation rate. During the second half of 1993 the inflation rate became as high as 40 percent a month. At the beginning of 1994 the inflation rate slowed down and stayed around 80 percent for the rest of 1994. During the period between 1993-1995, as the inflation and deposit rates fluctuated sharply, time depositors made either large losses or gains, depending on the sub period examined.

The financial markets gained more stability as the inflation rate came down to about 60 percent by the end of 1995. The market interest rates on deposit and loans however, are still not adjusted to reflect the real economic prices of deposits and loans in the country. According to January 1996 figures, the interest rates are 20 percent on demand deposits and 35 percent on time deposits. These figures show that the savers are not compensated for the high inflation rate; therefore their real interest earnings are negative (around -26 percent). For the corporate sector the situation is even worse because, the corporate sector is subject to 30 percent tax on their interest earnings. This makes their interest earnings, in real terms, as low as -37 percent.

3.1.2. Limited Branch Network and Shortage of Savings Instruments

All banks, except the large former state banks, are concentrated in Bishkek. The branch network is limited to the former state banks that have a large number of branches around the country (Annex 1). Excluding the four former state banks, the rest of 16 banks have only 21 branches. For savings mobilization proximity to the customer is an important factor. The accessibility of the bank branches to savers is crucial. The experiences of other countries have shown that both for savers and borrowers convenience is the determining factor whether the formal financial sector is used or not.

The availability of savings instruments, such as demand deposits, time deposits and certificates of deposits (CDs) is important to attract savers. These instruments should be designed in a way that would build trust and confidence between banks and savers. When they need, the savers must have access to the funds in their bank accounts, and they should have a right for unlimited withdrawal from their savings accounts. Not being able to withdraw money when they need it, causes an inconvenience for savers and also creates mistrust for the banking sector. For the former Soviet Union countries this is especially a sensitive issue where banks are not trusted as a safe place to keep money. In the Kyrgyz Republic there is still a lot of concern about the safety of banks.

Due to uncertainties and economic instability, some banks such as J.S.C. Kyrgyzstan and Promstroybank terminated their time deposit accounts and stopped taking new time deposits. Making this saving instrument unavailable is an inconsistent development with respect to the objective of attracting savings to the formal financial sector.

3.1.3. Tax Legislation

The current tax legislation in Kyrgyzstan is another factor for causing mistrust for the banking sector. According to the legislation the tax inspectors have access to the deposit accounts of savers. In the old system, the tax inspectors were able to withdraw money from the deposit accounts without informing the owner of the deposit. Given the rather arbitrary and state of the tax systems, savers find that deposits are subject to confiscation risk from the tax authorities hence this is another reason why banks are not a safe place to invest.

3.1.4. Extensive Non-Performing Loans of Banks

Between 1993 and 95, banks had severe liquidity problems; due to their huge non-performing loans. In 1994, as high as 80 percent of total banking loans were non-performing (60 percent of these non-performing loans were old loans that were due in 1994). This amount was equal to 1.902 million Soms, and 66 percent of the total bank assets in 1994.

These large losses of the banking sector were a result of the traditional government policy of providing subsidized credit to the state owned enterprises. Until the end of 1993, a substantial volume of investable funds was channeled to the heavily indebted, inefficient state owned enterprises through the former state banks. Consequently, the loan portfolios of former state owned banks were dominated by large non-performing loans. For example, the non-performing loans of Promstroybank and JSC Kyrgyzstan were equal to 80 percent and 70 percent of their loan portfolios respectively. The non-performing loans of the smaller banks also ranged between 10 to 40 percent.

This extensive volume of non-performing loans indicates that a large part of bank credits were not only misallocated, but also drained the volume of investable funds that could have been used for private sector investment finance. Recently, the preferential credit policy of the government has been radically altered. However, the bad policies of early 1990s will still have a negative effect on the credit markets. Today, a large number of banks are illiquid or insolvent. For example, JSC Kyrgyzstan, and Vnesheconombank stopped making loans due to illiquidity resulting from their non-performing loans.

3.1.5. High Corporate Tax Rate for the Financial Sector

The corporate tax rate for banks is 45 percent while this rate is 35 percent for the rest of the enterprises. In addition to 45 percent corporate tax, commercial banks are required to pay an additional transaction tax on gross income and VAT on their turnover. This makes the effective tax rate on banks as high as 63 percent. The corporate tax rate for banks should be lowered in order to allow banks to build their capital and to increase their capacity in making loans to the private sector. Reducing the tax rate will also reduce the cost of financial intermediation and hence, lower the interest rates on bank credits.

3.2. HIGH MARKET RISK

Due to the nature of their business, banks are very sensitive to the market risk. The riskiness of the market affects significantly both the loan pricing and the lending behaviors of banks. In Kyrgyzstan, structural changes and economic instability between the years 1993 and 1995 created a high market risk and caused major distortions in the financial markets.

In 1993, financial reforms, and the liberalization of interest rates in an inflationary environment caused the deposit rates to fluctuate frequently and created uncertainties about the liabilities of banks. As a result, banks increased their interest margin on the loan rates in order to cover their possible losses on deposit interest payments. Bank loan rates became as high as 80 - 90 percent in nominal terms that is between 15-20 percent in real terms. High loan rates in turn, increased the default risk of the borrowers and created credit rationing in the banking sector. Banks began to exclude borrowers in certain sectors such as, manufacturing and started to prefer borrowers operating in lower risk categories such as the trading sector.

In particular, newly emerging private businesses that have no track records with any financial statements are the highest risk categories for banks. Given the economic circumstances in Kyrgyzstan where a whole new group of new businesses are starting, and old state owned enterprises are making huge losses, for banks the loan market became extremely risky.

Banks began to channel their resources to trade finance and to Treasury Bills. Although the volume of bank credit seems too increased, the National Bank data indicates that in 1993, 83 percent of total bank credit was interbank refinancing credit. In 1994, interbank loans increased 5.3 times, to a total of 55 million Soms. On the other hand, banks purchase of Treasury Bills increased significantly. In 1994 the number of banks that hold Treasury Bill increased from 7 to 13, and the volume of Treasury Bill, on average, that are held by the banking sector increased by 46 times and became 27 million Soms.

Banks diversified their earnings and concentrated on the most profitable services. At present, foreign exchange operations are the most profitable operation of commercial banks. For example, 60 percent of total profits of Kurulushbank come from its foreign exchange operations (In Kurulush- bank the total number of personnel is 75 and, the number of staff working in the foreign exchange operations department is 4. In other words, 60 percent of bank’s profit is earned by 4 people).

Because of the high inflation, the loan terms also became shorter. At present, the longest loan term is between 3 to 6 months. This is because; banks want to minimize the risk on their interest earnings, as well as reducing the default risk of the borrower. In this respect, banks again prefer to lend to the traders with high interest rates on short terms, than lending to the unknown businesses for investment finance on longer terms.

On the other hand, for the private sector, it became too costly to borrow from banks for investment and working capital purposes. This caused adverse selection effect for the banking sector. Successful businesses reduced their borrowing from banks as it became too risky for them to make profit with 15-20 percent real interest rates. These businesses started to save to build their working capital and become financially more self-reliant financially. However, less successful and higher risk businesses increased their demand for bank loans since these businesses did not have much to lose if they could not repay their loan. Because of the adverse selection effect, initially, even the most efficient and modern small banks reported high non-performing loans (between 10-40 percent of their loan portfolios) which made banks more cautious in their lending activities.

3.3. PROBLEMS RELATING TO COLLATERAL

Because of the high market risk and lack of information about the new borrowers, currently all bank loans are based on security lending. Banks take between 100 - 130 percent collateral as a security for their loans. This collateral value is too high for the small businesses, in particular for the businesses that operate in the service sector and have very small capital or machinery that can be used as collateral. Some of these businesses are operating in the high-tech area, such as computer training or software developing. The capital of these borrowers is their intellectual property that cannot be used as collateral. Even for borrowing a small amount such as US $ 50, 000 to develop its business, the small business owner needs to find a collateral worth of US $ 65,000. This is a considerable amount of money for the small business sector.

Some of the private enterprises put their land and property as collateral. However, due to problems with private ownership land is not accepted as collateral by banks. Machinery and private property such as, cars, houses are most commonly used collateral.

According to the legislation, the collateral has to be notarized and the notarization fee is as high as 5 percent of the collateral value. This is a very high cost and it has to be paid by the borrower. Most of the SMEs do not have that amount of cash to pay the notarization expenses.

3.4. LACK OF MODERN BANKING SERVICES

The banking sector of Kyrgyzstan presents the common problems of banks in other transitional socialist economies. They are old fashioned and they do not have the institutional capacity to operate in a market oriented economy.

Moving away from a centrally planned economy towards a market oriented economy has substantially changed the role of banks in the Kyrgyz economy. In the past, banks' role was not more than disbursing the government money to the government institutions. Banks had no control over credit allocation as it was planned centrally by the government. Financial services were not needed and modern technology was not adopted.

With the growing private sector however, the need for modern financial institutions and financial services has grown significantly. In particular the export oriented private enterprises need a wide range of financial services that are new to domestic banks. These services are:

- Provision of letters of credit.
- Undertaking of credit cheques of potential foreign customers
- Setting up accounts in correspondence banks
- Lending to complement foreign joint venture arrangements
- Foreign exchange transactions
- Developing credit cards payment systems

Currently, banks in Kyrgyzstan are not able to meet these needs of the private sector due to their technical, institutional and managerial weaknesses. At present, most of the banks are not able to provide even the most basic financial services such as, clearing checks and money transactions. Opening an account is a very slow process, it takes 26 steps to open a foreign exchange account (Before the technical assistance, it took 91 steps to open a foreign account. The number of steps came down recently from 91 to 26 steps with the help of USAID, Monetary Restructuring Project.)

Banks, in general, are not service oriented. The procedures are too long and the buildings of banks are not designed to service the daily transactions of the depositors and borrowers. Entering a bank takes a lot of encouragement due to very tight security screening. These factors make it impractical for the citizens even to have accounts in the banks.

To be able to meet the needs of private enterprises, in particular the needs of SMEs, banks should be trained on new financial services and instruments, and acquire a new, market oriented management approach. At present, there are a number of programs providing technical assistance to the banking sector. These programs, however, are limited to a small number of new banks that volunteered to be examined and receive technical help from the international consultants. This technical assistance needs to reach to a larger group of banks. Bank personnel need to be trained in management skills and the tools to operate in a market economy.

3.5. UNTRAINED LOAN OFFICERS AND BANK MANAGERS

Bank personnel, in particular, loan officers and bank managers do not have experience in making loans to the private businesses. This is because, in the centrally planned economies, credit was a gift from the government to the state enterprises. Banks were not required to assess the customers, to price the loans or, to monitor and collect these loans back. In the current policy environment, however, these factors are crucial to provide sustainable finance to trade and industrial enterprises, and to allocate the investable funds efficiently.

In Kyrgyzstan, as a result of the privatization and the liberalization of the economy a large number of small and medium sized enterprises (SMEs) emerged. It is well known that the growth of SMEs contributes significantly to economic growth by creating jobs and building the foundations of a market economy. In Kyrgyzstan, these dynamic private enterprises have a great potential to contribute economic growth and employment. They are mostly constrained however, by the shortage of funds for investment or working capital.

In order to meet the credit needs of these enterprises, the banking sector needs to be trained on how to make loans to SMEs. The following are the major areas that should be considered for bank training.

- **Financial Needs of SMEs**

It is essential for banks to understand the financial needs of SMEs and the type of lending that is being proposed. This is because different types of lending such as, lending for the initial capital, working-capital or long term credit for expansion and modernization, requires different loan designs and loan pricing. Currently, banks are having difficulties to design loan installments and loan repayment schedules to meet the specific needs of SMEs. For example, some of the seasonal businesses, such as textiles found themselves in difficulty in paying their loans back as the loan repayment was scheduled during the time of production instead of after the production is sold.

Banks need to understand that different financial need requires different types of lending such as, temporary or seasonal finance, working capital finance, cash flow lending or equity finance. For banks, it is also important to understand that different types of lending involve different risk and cost structures that affect their loan pricing.

Customer Assessment

Banks should be trained on how to evaluate SMEs because customer assessment is crucial to avoid non-performing loans. In former Soviet Union countries, it is particularly difficult to assess SMEs because these businesses have a very short business history, an inadequate equity base and the economy is going through a major transformation. Some of these difficulties however can be overcome by training banks on SMEs. International experiences show that SMEs, in all around the world have a lot of similarities. One common characteristic of SMEs is that, they are managed mostly by their owners. It is also typical that these family businesses do not have a formal management structure; therefore, it is difficult to draw a line between the business and the family life. For banks, the personality traits of the owner can tell a lot about how the business is run and the creditworthiness of the loan applicant.

- **Financing Start-ups**

For banks, financing start-ups is very risky, because these businesses have no track record and no business experience. Banks should be trained on the risks that are involved in lending to start-ups and alternative ways of financing start-ups, such as establishing venture capital funds.

- **Decentralization and Branch Management**

In many countries, decentralization improved banks' efficiency by cutting the amount of time required to approve SME loans. In Kyrgyzstan, former state owned banks, although privatized, still have a centralized and bureaucratic organizational structure. Promstroybank, Agroprombank, JSC Kyrgyzstan and Vnesheconombank need to be modernized and adopt a decentralized and market oriented management approach. Given that these are the only banks that have branch networks throughout the country, unless decision making is decentralized, the growing financial needs of the newly emerging businesses will not be met in the large parts of the country.

The branch offices should be given authority and responsibility of mobilizing savings and making loans at the branch levels. Branch offices should be viewed as separate profit units and they should have their own profit and loss statements. This will make branch offices to be aware of their profit making responsibilities.

- **Loan Monitoring and Follow Up**

Loan monitoring and follow up are particularly important for small loans. Loan officers have to know their borrowers well and visit them at their place of business. This can help to build a trust between bank and the borrowers and create an opportunity for banks to advise and support its borrowers when they are in difficulty. This follow up can also help banks to detect the major problems of risky loans at their early stage and reduce their loose.

For banks in Kyrgyzstan, loan monitoring is a new concept and there is a substantial need for it. A large part of the banks' portfolios is composed of first time borrowers. Banks must get to know their borrowers and be in touch with them frequently. One way of monitoring loans is through monthly loan repayment schedules. Experiences of banks in various countries such as Indonesia, Japan, Bolivia and Cyprus also indicated that, indeed, monthly loan repayments an effective way of monitoring loans and are detecting problem loans at an early stage.

3.6. NEED FOR GUARANTEE FUNDS

The international experience has showed that, guarantee funds, when they are designed properly, can increase the access to bank credit for the borrowers who on their own have insufficient collateral or guarantee to qualify for a bank loan. In Kyrgyzstan, where the market risk and interest rates are very high, and majority of the loan applicants have insufficient collateral, guarantee mechanisms can be very useful to encourage banks to lend to certain economic sectors, such as SMEs. In Kyrgyzstan, there is at present no guarantee facility in place.

In order to get access to bank credit, some borrowers have approached insurance companies and bought insurance policies against loan defaults. This practice however was not successful. As a result of massive loan defaults, and problems with claiming the collateral of the default borrowers, insurance companies terminated their insurance policies on loan defaults.

Successful guarantee mechanisms can be established either by the government or by international organizations such as, the WB, EBRD, USAID or ADB. For example, some of the most successful guarantee mechanisms were established by the USAID in Egypt. The Guarantee Corporation of Egypt, an independent private guarantee corporation, was established by USAID funds to increase bank credit financing for SMEs. This guarantee fund is self-financed and it is operating successfully.

In Egypt, another guarantee mechanism was established again by USAID to increase the level of bank financing reaching to microenterprises. This guarantee mechanism was established in Alexandria and the funds are allocated through NGOs.

Despite the potentially positive effect of guarantee mechanisms guarantee programs can also have a harmful effect on banks or on the targeted group if it is not designed well or implemented properly. For example, in some cases, guarantee funds failed to reach to the targeted group, in some other cases guarantee mechanism encouraged borrowers to default and caused large losses for the banks.

Given these possible counterproductive results, if the government of the Kyrgyz Republic decides to create guarantee mechanisms for SMEs investment finance (or for microenterprises finance in the rural areas) the guarantee mechanism should be designed very carefully where the incentive structure between the bank, the guarantor, and the borrower, motivate their behaviors in such a way that the expected results are achieved. In addition, the government has to make sure that there is sufficient liquidity in the banking system and the participating banks are responsible and efficient financial institutions.

3.7. PROBLEMS IN ALLOCATING EXTERNAL RESOURCES

Today, the only source for investment finance for the industrial sector is the external loans given by the international institutions to support the private sector development in Kyrgyzstan. These funds are allocated either through the government agencies or directly through the domestic banks.

Although a substantial number of loans, amounting to millions of dollars seem to be given to the private sector, in practice only a limited number of loans have been made so far. The loan approval process and the loan disbursement are very slow. It takes 6 to 12 months to approve and disburse a loan.

Investors seeking funds, mostly apply to GOSCOMINVEST however, it takes a long time for GOSCOMINVEST to evaluate loan applications. Sometimes, applications never get replied to. In some cases, projects receive an approval for credit; however, they cannot receive their loan until all other projects under the same credit line are approved. For example, the credit line from Turkey was received in 1994, and a number of projects were approved to receive credits from this credit source. However, no projects received their loans, because there is not enough approved projects yet to utilize the total value of the credit line, US $ 75 million. GOSCOMINVEST will apply to receive US $ 75 million only after it approves sufficient number of projects that, in total, will be equal to the value of this credit line. This is a very slow and inefficient way of allocating credit. It is very costly for the borrowers to wait in uncertainty. Especially for the time sensitive projects, this credit line can be very costly.

The private sector is still not aware of all available sources of finance given by the international agencies. For example, investment funds given by EBRD and KfW are not widely known of by the private sector. The availability of these funds should be advertised in the local newspapers and information should be provided on requirements for loan application, where to apply and how to apply. These external funds also tend to be allocated in and around Bishkek. It is harder to reach to the hands of the investors in other parts of the country.

In some cases, even if the loan is approved the borrower cannot receive the credit for several months. For example, two loan applications were approved by EBRD in November, 1995 however, these loans, worth of US $ 140,000 and US $ 20,000 has not been disbursed yet. EBRD declined to give any explanation for this delay, and about the possible disbursement date for the loans.

4. RECOMMENDATIONS

During the last three years, significant progress has been achieved in the financial sector, in terms of establishing the National Bank of Kyrgyzstan, privatizing the state owned banks, establishing new banks, and introducing the national currency. The financial sector however, still has serious weaknesses that became major constraints to private enterprise finance. These weaknesses can be summarized as:

- Inability to mobilizing domestic savings
- Inefficiency in the allocation of credit
- Lack of modern financial services, and market oriented management approach

Both institutional reforms and policy actions are needed to improve these weaknesses and to meet the financial needs of the private enterprises.

4.1. ECONOMIC STABILITY IS ESSENTIAL

Economic instability is a major distortion for the financial markets that affects both the availability and allocation of financial resources in the economy. In Kyrgyzstan, although the inflation has been reduced somewhat at the end of 1994, it was still too high to allocate credit efficiently. Banks began to ration credit for investment finance, and to lend on short term, with high interest margin to least risky sectors. In this respect, banks are mostly financing the trade sector, and increasingly investing in Treasury Bills and interbank loans to minimize their risk.

Economic instability also causes a potential treat for crowding out the private sector from financial markets. Given the increasing trend in the government budget deficit from 6.6 percent in 1993 to 14 percent in

1995, it is likely that the available domestic financial resources for the private sector will decline even further unless the budget deficit is reduced or financed by tax income. As it is experienced in many countries around the world, unless the public sector deficit and inflation are brought under control, financial reforms can hinder rather than help in the allocation of credit toward investments that will expand productive capacity. Therefore, the Government should:

- Control the budget deficit
- Avoid inflationary ways of financing the budget deficit, such as National Bank refinancing loans
- Rely on broad based tax policies to finance the budget deficit.
- Avoid crowding out the private sector from financial markets.

4.2. PROVIDE POSITIVE REAL DEPOSITS INTEREST RATES

In order to attract savings and mobilize domestic financial sources from savers to investors, it is necessary to increase deposit rates to a level that will provide a positive real return to savers. At present, depositors earn a negative real rate of return; therefore they are discouraged from keeping their savings in bank deposits. Banks are having liquidity problems whereas savings are growing outside of the formal financial markets.

4.3. DEVELOP SAVINGS AND LOAN INSTRUMENTS

Because of their traditional role in the past, banks tend to focus on procedures and record keeping rather than on efficient profitable customer-oriented operations. To be able to operate in a market oriented economy, banks have to learn to respond to the market forces and customer needs. Banks have to be trained on how to design saving instruments and loan instruments according to the needs of the private sector.

- Current account depositors should have access to their savings in banks with unlimited withdrawal.
- New deposit accounts and policies should be created with different combinations of interest earnings and maturity.
- Loan repayment should be designed in such a way that will not cause inconvenience for borrower. The nature of the business, such as whether it is a seasonal business or not should be taken into account.

4.4. STRENGTHEN THE BANKING SECTOR

The capital base of banks is weak and should be strengthen to avoid financial crisis and insolvency. New banks have small capital base whereas old former state owned banks have huge non-performing loans. These old banks are practically insolvent.

- Banks should be given incentives to build up their capital and reserves. For example, provisions for loan-loss reserves can be made tax deductible, the corporate tax rate on financial sector can be reduced or, all taxes on earnings reinvested in the banks can be tax exempt for 3 to 5 years.

- The non-performing loans in Promstroybank, Agroprombank, and JSC Kyrgyzstan should be written off and the banks should be restructured into a modern branch banking system. Given the extend of the non-performing loans of state banks; the cost of writing of the bad-debt is probably lower than keeping them at their existing form. It is most likely that the defaulting borrowers who are mainly the state owned enterprises will not be able to pay their loans back. Most of these loans financed by the National Bank through money creation in the past and caused high macroeconomic cost, through hyperinflation for the economy. It is more important now for the government to prevent state owned banks from making more loses on new loans than collecting their old loans back.

4.5. MODERNIZE THE BANKING SECTOR

Banking is a service oriented business. Quality and speed are the two important indicators of the performance of banks, and determinants of their success and profitability. The banking sector in Kyrgyzstan needs to be modernized to improve the quality of financial services and to speed up the financial transactions. This requires both technical and managerial inputs to the existing banking system.

- The senior management of the old banks should be changed. This is necessary because it is very difficult to change the mentality of the old management. It is more likely that new management will be more open and adaptable to the changes. Qualified new bank managers can bring a new vision and leadership that will bring profitable, efficient and customer oriented banking operations.
- Bank personnel in all commercial banks needs to be trained on payments systems, cheque clearance systems, accounting systems, and on systems of letters of credit.
- Managers of credit departments and loan officers needs to be trained on customer assessment, loan pricing and loan monitoring.

4.6. IMPROVE THE ALLOCATION OF EXTERNAL RESOURCES

The distribution of external funds, soft loans and commercial credits are very slow and inefficient. It takes around one year to approve and disburse a loan. This is largely because the loan approval procedure is bureaucratic where the loan has to be approved by at least three different bodies, such as the commercial banks, the National Bank, Government committees, GOSCOMINVEST and by the international organizations. Loan disbursement is also very slow; it takes 1 to 4 months to disburse the loan. In some cases the loan never gets disbursed.

Immediate actions are needed to speed up the loan approval and disbursement process. This can be done by reducing the number of steps that are needed to approve the loans and by putting a maximum time limit on loan approval and disbursement.

It is also crucial to increase the role of commercial banks in the allocation of credit and reduce the role of political committees and other non-financial organizations. It is argued that, in Kyrgyzstan, special committees are established to disburse the loans because; domestic banks are not capable of identifying creditworthy borrowers. However, whether the government officials will be able to allocate these funds more efficiently than banks are is questionable. When banks make loans, they have to make sure that the loans will be paid back. Therefore, it is more likely that banks will allocate these funds to the economically viable enterprises, according to market forces.

Although customer assessment is new for most of the commercial banks, they are in a better position to understand the financial needs of the private sector and to evaluate the customers more accurately. This also helps to establish a bond between the bank and the borrower at an early stage, and creates trust that is important for loan monitoring and repayment.

4.7. IMPROVE THE PROBLEMS IN COLLATERAL LENDING

In Kyrgyzstan, for all kinds of lending, minimum 100 percent collateral is required. Due to imperfections in the current legislation however, collateral lending is costly and troublesome.

- The existing 5 percent notarization fee should be reduced to a symbolic amount.
- Collateral should not be subject to corporate tax. For the financial institutions, the existing corporate tax, 30 percent of collateral value, should be abolished.
- The current legislation on private ownership should be amended to allow borrowers to use their land and houses as collateral.

4.8. INTRODUCE WELL DESIGNED GUARANTEE FUNDS

Guarantee mechanisms can be very useful to encourage banks to lend to SMEs and microenterprises. However, it is very important to ensure that the guarantee mechanisms are well designed and they give the right incentives to the bank, to the guarantor and to the borrower. For a successful guarantee mechanism, there are four critical factors:

- Loan and guarantee approval process should be efficient. Long delays in loan or guarantee approval process increase the cost of the borrower and reduce the benefits of the loan.
- Risk sharing should be appropriately allocated between the bank and the guarantor.
- Credibility of the guarantor. The guarantor, for example, the National Bank, or the Government, has to keep its promise, and pay the losses of the bank when a guarantee defaults. Otherwise, the credibility of the guarantor and the guarantee mechanism damages.
- Cost and fees. The cost and fees should be distributed fairly between the guarantor, guarantee and the bank. This is necessary to encourage banks to participate to the guarantee mechanism.

4.9. ENCOURAGE THE DEVELOPMENT OF THE NON-BANK FINANCIAL INSTITUTIONS

In Kyrgyzstan, the non-bank financial sector is at the very early stage of development. At present, it has a negligible size and role in private sector finance however, the development of the non-bank financial institutions (insurance companies, leasing companies, pension funds and investment funds) are important to create a competitive financial sector, and to increase available domestic financial resources for investment finance. There is a need to introduce legislation for investment funds, trust companies and building societies to promote the development of these sectors. Also, tax incentives could be given for the first 2-3 years in order for them to build their equity base.

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ANNEX 1

COMMERCIAL BANKS OF KYRGYZSTAN

	Name of The Bank	Date of Registration	the Number of Branches	Paid-in Capital as of Oct. 1st, 1995 (Thousand Soms)
1.	Agroprom	Dec. 1991	51	15,024
2.	Akniet Bank	May 1991	1	3,381
3.	Avto Bank	Dec. 1991	2	6,833
4.	Akil Bank	Oct. 1995	-	5,000
5.	Bishkek Bank	Oct. 1995	-	5,000
6.	Energy Bank	May 1992	2	7,689
7.	Hen-Fen Ltd	Mar. 1993	-	8,510
8.	Issyk-Kul	May 1993	-	10,412
9.	Kyrgyz-Jer	Dec. 1991	-	10,979
10.	Kurulush Bank	Dec. 1991	3	6,750
11.	Kyrgyzstan Bank	Dec. 1991	25	27,240
12.	Kramds Bank	Oct. 1992	1	12,657
13.	Maksat Bank	Dec. 1991	2	22,329
14.	Mercury Ltd	Nov. 1992	1	6,573
15.	Orient Bank	Jan. 1994	-	12,384
16.	Promstroy Bank	Dec. 1991	27	15,681
17.	Sber (El) Bank	Dec. 1991	52	2,643
18.	Kyrgyzvnesh Bank	July 1992	2	14,452
19.	Saturn Bank	(Closed)		
20.	Adil Bank	(Closed)		