



Center for Social & Economic Research

The Banking System in Kyrgyzstan

by

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Warsaw, November 1994

Materials published in this series have a character of working papers which can be a subject of further publications in the future. The views and opinions expressed here reflect the authors' point of view and not necessarily those of CASE .

This is a publication co-financed
by
Polski Bank Rozwoju SA (Polish Development Bank)

Paper was translated by Richard Woodward

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ISBN 83-86296-22-4

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The banking system constitutes one of the most essential elements of the market economy. A well-functioning banking sector can play an especially important role in the reconstruction of postcommunist economies. Fundamental changes in the operating principles of this sector can stimulate and accelerate changes in the entire economic system. The delay of transformations in this sphere can cause further delays in the broader processes of change, or even bring them to a halt.

The reform of the banking system must constitute an important element of the marketizing reforms undertaken in the countries of the former Soviet Union. No program of macroeconomic stabilization (including the reduction of inflation) can be executed in the absence of well-developed central bank mechanisms for the conduct of monetary policy. Moreover, the realization of structural changes in the economy and programs for enterprise restructuring and privatization are strongly linked with changes in the operating principles of commercial banks. The first condition necessary for the initiation of reforms in the banking system is the adoption of changes in relevant legislation enabling the central bank and commercial banks to undertake activities corresponding to their new tasks and roles as defined by the principles of well-functioning market economies.

Based on the experience of reforming countries up to this point in time, one can distinguish two distinct phases in the realization of banking sector reform. In the first, it is necessary to introduce a two-tiered banking system. The central bank is made responsible for the conduct of monetary policy aimed at the curbing of inflation and the stabilization of the currency. The commercial banks attain independence in their activities, and the old and new clients of those institutions are allowed freedom in their choice of a bank. At the same time, a liberal licensing policy is introduced regulating the opening of new banks. The problems arising in the second stage concern the credit portfolios of old and new commercial banks. Their gradual solution requires simultaneously changes in the credit policy of the banks as well as the restructuring of the enterprises indebted to them. At this point, the strengthening of banking supervision by the central bank and the introduction into practice of international standards of risk appraisal and commercial banking activity become especially important.

Kyrgyzstan is the most advanced state in Central Asia in the area of radical reforms aimed at the reconstruction of the economic system. These reforms concern the entire banking system and its role in the transformation process. The purpose of this study is to outline the changes which have occurred thus far in the Kyrgyz banking system as well as to point out the chief problems which have arisen during the course of these reforms.¹

¹ Information on the subject of the banking system was gathered during interviews in the central bank (with the vice president of the bank and the president of the methodology department). We obtained additional data at the offices of the International Monetary Fund and the World Bank representatives.

1. The structure of the banking system

The reform of the banking system in Kyrgyzstan began in June 1991 with the passage of the Law on the State Bank and the Law on Banks and Banking Activity. The most important result of these two pieces of legislation was the creation of a two-tiered system of banking institutions. At the same time the former republican branch of the State Bank of the USSR was transformed into the National Bank of Kyrgyzstan (NBK), which was at that time subject to parliamentary control.

The currently binding Law on the National Bank of the Republic of Kyrgyzstan and the Law on Banks and Banking Activity in the Republic of Kyrgyzstan were passed in December 1992. The assistance of the International Monetary Fund (IMF) was made use of in drawing up both laws. The model for their formulation was the banking legislation of Estonia. The experience of other countries, including Poland, was also taken into account. These laws ensured the central bank complete independence from government and parliament.

In mid-1994 20 banks were functioning in Kyrgyzstan in the form of joint-stock companies (Russian abbreviation: AKB) or commercial banks (abbreviation: KB). These included the three largest state banks, which had been converted into joint-stock companies in which the enterprises financed by them up to that point became the shareholders. Thus, they simply represented a continuation of the former state banks, financing particular sectors and branches of the economy. Specifically, these banks are AK Kyrgyzagroprombank (Joint-Stock Commercial Kyrgyz Agricultural-Industrial Bank), AK Kyrgyzpromstroibank (Joint-Stock Commercial Kyrgyz Industrial-Construction Bank), and AKB Kyrgyzstan (which had previously financed chiefly light and manufacturing industry). These banks were responsible in mid-1994 for 85 percent of the value of all credits and loans distributed in the entire commercial banking sector. From the outset of their independent activity (at the end of 1991) they have been engaged in increasing the number of their branches. Thus, in the course of two years, Kyrgyzagroprombank increased the number of its branches from 45 to 51, thus attaining the largest number of branches. Kyrgyzpromstroibank created seven new branches and by mid-1994 had 27, and AKB Kyrgyzstan increased the number of its branches from 19 to 25. The fourth largest bank is to be created on the foundation of former savings institutions (so-

Interviews were also conducted at three commercial banks. Among these was one of the largest commercial banks - AKB Kyrgyzstan. Legislation concerning the central bank and the banking system as well as several instructions of the central bank were also collected.

From the information thus gathered, a picture of the early activities in the creation of the foundation of a banking system well-suited to the demands of a market economy emerges. At the same time the comparison of relevant legislation with the information gathered in the course of interviews shows a large discrepancy between the provisions of the new laws and the actual principles by which commercial banks are still managed. This results from the fact that the banking system is in the first stage of transition from the operating principles in effect during the period of central planning to those of the market economy.

called "sbergkasy"). It has the largest number of branches (54) but by mid-1994 did not yet have a status affirmed by the central bank and was not able to fulfil the function of a commercial bank. The problems of this bank are connected with the transfer of its funds to Russia in the final phase of the existence of the Soviet Union and difficulties with their recovery. At this time it held 85 percent of the savings of private individuals, which, however, constituted only 15 percent of the value of all deposits in the banking system (held by both individual persons and enterprises).

Besides the four large banks mentioned above, 16 financial institutions had been created. Most of them (11, to be precise) were created by central state institutions (one of the banks, for example, was created from the account clearing office of the Ministry of Construction) or state enterprises from certain branches of the economy (for example, the founders of AKB Kyrgyzvnesbank were enterprises engaged in export activity, and the shareholders of AKB Kyrgyzenergobank include power plants). Very often the largest and most powerful enterprises of the republic are the founders and shareholders of several new banks. Three banks were also created with the participation of foreign capital (for example, AKB Adil, with Swiss capital, and KB Chen-Fen Ltd., with capital from Hong Kong). In most cases the new banks are in the first stage of their development. An indirect measure of their activity could be seen in the fact that 10 of them still have no branches besides the head office (see table 1). At the same time most of the banks (13 to be precise) have obtained a license for the conducting of operations in foreign currencies.

2. Banking law

In their essential content the banking laws passed in Kyrgyzstan mirror all elements of the rules and principles contained in the Polish legislation. However, they are less specific and much less precisely formulated.

In the law on the central bank of December 1992 the independence of the NBK from the government and state authorities is defined. One of the first provisions contained in the law reads: "The Republic of Kyrgyzstan does not carry responsibility for the obligations of the Bank of Kyrgyzstan. The Bank of Kyrgyzstan is not responsible for the obligations of the Republic of Kyrgyzstan" (article 1 item 4). Moreover, several items later we find a provision reading as follows: "The Bank of Kyrgyzstan independently organizes and executes its activities. The interference of state organs in the solution of problems designated in this law as the domain of the Bank of Kyrgyzstan is not permissible" (article 3 item 1). The capital base of the bank was also defined in the law with the stipulation that it cannot be reduced, only increased with the agreement of the government (article 5 item 1). Similarly, the rule was established that 30 percent of its yearly profit remains in the bank's disposition and the rest is turned over to the state budget (article 6 items 2 and 3).

These provisions resulted - as the vice president of the central bank emphasized in an interview - from the necessity of additional guarantees of the bank's independence from the government. In his opinion, banks in Central Asia are under the special influence of state authorities. In Kyrgyzstan the new position of the central bank was made possible by the passage of the Law on the National Bank and additionally by the government's signing of a memorandum with the IMF. These actions significantly reduced the pressure of the government on the central bank. On the other hand, commercial banks rather than the central bank are now subject to attempts by the government to exert influence upon the banking system.

The basic tasks of the central bank as defined in the legislation include: the assurance of the stabilization of the currency, the conduct of monetary policy, the defense of the interests of debtors and depositors, the assurance of competition in the banking system, and the supervision of the fulfilment of banking law.

Having been strengthened by the legislative provisions, the position of the central bank with respect to the government was weakened by regulations concerning the monetary policy conducted by the bank. The rules of this policy must be agreed upon with the government and in the case of lack of agreement between the bank and the government the decisive institution is the Supreme Council of the Republic, which by legislative means may bring about a change in the staffing of the central bank. No less the law forbidding the use of monetary emissions for the purpose of financing the state budget deficit and among the instruments regulating the quantity of money in circulation exchange/replace/mention among other things a change in the quantity of credits extended by the central bank and the interest rates charged on those credits, changes in the norms regarding the obligatory reserves of the commercial banks as well as the setting of minimal interest rates on deposits (article 9). On the other hand the bank can extend short term credits to the state budget (for up to 6 months) the total value of which may not exceed 5 percent of GDP.

The law rather generally defines the relations of the central bank with the commercial banks (permissible operations, clearing of accounts, supervision of commercial bank activities, the setting of reserve requirements and various norms).

The president of the central bank is appointed to a five-year term of office by the president upon the approval of the candidate by the Supreme Council of the Republic. The staff of the administration of the bank is specially regulated in the legislation. The influence of branch structures is sanctioned by a provision on the participation of representatives of various branches of the economy in the administration of the bank.

The Law on Banks and Banking Activity in the Republic of Kyrgyzstan regulates the organization and activity of banks. As emphasized in the

introduction to that document, these regulations must correspond to "international banking system standards." It allows for the creation of banks with various ownership structures, including banks with the participation of private and foreign capital. The law contains a provision guaranteeing their independence within the boundaries set by the law. The interference of executive organs of the state in the management and decisions connected with banking activity is, in the intent of the law, not permissible. Banks can join unions, associations, and holdings under the condition that they will not use these organizational structures for the purpose of restricting competition and monopolizing the market for banking services.

In the second section of the law, in which the rules for the creation of banks are defined, a provision states that the minimum required starting capital of a bank cannot be drawn from budgetary sources or borrowed on credit or security (article 9 point 3). Among the documents required when applying for a banking license is an "economic justification for the creation of the bank." The finding that there is a lack of purpose in the creation of a bank can be the basis for the refusal to grant a license.

The third section, devoted to the topic of organization of bank activities, contains unusually laconic formulations. Many items consist simply of a reference to other laws or to "international banking practice." The supervision of banking activity is to be carried out by the Bank of Kyrgyzstan and by the auditors of the tax collection authority. Article 32 contains the obligation of an annual audit. However, no concrete organization is designated as being authorized to undertake such activity; reference is simply made to other laws in force in Kyrgyzstan. With regard to the subject of auditing, it has been assumed in the central bank that one firm will be chosen for this purpose which will be awarded the status of a plenipotentiary of the bank.

In sum both laws leave a rather wide field of interpretation, and many matters have been left for future regulation and to the discretion of the central bank. Taking into consideration the mechanisms of bank functioning which operated for decades during the era of central planning as well as the resulting habits of bank employees, this situation could in practice lead to the survival of the earlier principles of activity. To effectively counter such developments, it will be necessary to institute a series of amendments to the banking law to the extent that problems arise resulting from the practice of the functioning of the entire system.

The first amendment to the law on the banking system is currently under consideration. It concerns such matters as the limitation of the right to hold deposits to banks alone (with certain defined exceptions), a more precise formulation of the conditions for the granting of licenses, access for courts and tax inspection authorities to information about bank accounts, and an increase in the strictness of the conditions regarding the liquidation of banks. One of the new

planned regulations forbids a single economic agent to be a major shareholder in several banks simultaneously. One can already predict that the planned amendment will not solve the growing problems of the banking system. Further changes in the law will be necessary which make precise many unclear points contained in the currently binding legislation.

3. The introduction of the national currency

Beginning in January 1992, a radical price reform was initiated in Kyrgyzstan mirroring the policy executed in Russia. Member states of the CIS in the ruble zone attempted to carry out independent monetary policies. The lack of coordination of activities and emission policies led to a lack of stability in the entire ruble zone. Under these conditions the decision of the Russian Federation on 1 July, 1992, to centralize clearings of the central bank of Russia with the central banks of other republics meant in practice the introduction of separate monetary systems. The Bank of Russia, in becoming the sole emitter of the ruble, subordinated the national banks of other states of the CIS, rendering it impossible for them to carry on independent monetary policies.

In this situation, the most important financial operation carried out in Kyrgyzstan during the period of market reforms was the exit from the ruble zone and the introduction of a national currency. The goal of this operation was the assumption of complete control over, and responsibility for, its monetary policy by the Republic of Kyrgyzstan. Preparations for the introduction of the som were begun in 1992. Technical aid was provided to the Kyrgyz government by the IMF and the World Bank. These activities were linked with the planned macroeconomic stabilization program.

In the second half of 1992, the economic situation of Kyrgyzstan underwent a significant worsening. This was caused by, among other things, significant growth in the prices of imported energy resources, grains, steel, and wood. It was also impossible to isolate the country from the inflationary influence of the ruble zone. There was an increase in the transfer of the republic's funds to other states of the CIS caused by emigration. The fall in production was accompanied by a weakening of financial discipline of economic agents and the weakness of the tax system. In this situation the creation of conditions rendering possible the conduct of an independent monetary policy, the reduction of inflation, and stabilization of the macroeconomic situation demanded the introduction of an independent national currency.

At the beginning of 1993 the Kyrgyz government informed the republics of the former Soviet Union of its intention to introduce a new independent currency. In May, 1993, the parliament approved the project and created a special committee to undertake decisions regarding the introduction of the som. Several days later - on Friday, 7 May, 1993 - it was announced that as of Monday, 10 May, the new national currency would be introduced into circulation. Exchange

would be carried out until 14 May at a rate of 1 som to 200 rubles. Monetary funds deposited in savings institutions ("sbergkasy") were exchanged at a rate of one som to 150 rubles. No limitation was placed on the number of rubles convertible into soms.

The monetary exchanges carried out in commercial banks, branches of "spergkasy" and special points set up in workplaces. In total, adding the purchases carried out by the population in shops to the direct exchanges of rubles for soms, the authorities collected only ca. 25 percent of the estimated number of rubles in circulation (i.e., 14 billion rubles out of about 53 billion rubles). This low figure illustrates the low level of the populace's confidence in the new national currency. Moreover, the de facto open borders with the former republics of the Soviet Union, where rubles continued to be the accepted currency, made possible the use of unexchanged rubles in the future. However, beginning with the end of May, the som became the accepted medium of exchange within Kyrgyzstan for all current transactions.

4. The monetary policy of the central bank

Until the end of 1993 the flow of refinancing credit to commercial banks was in practice the only source of their credit funds and the main instrument of the central bank's influence on the money supply. Before the introduction of the som, the central bank - through the mediation of commercial banks and on the basis of instructions from the parliament and the government - extended this credit for specific purposes or to specific sectors of the economy. At the same time the interest rate on these credits was decidedly negative. In the first half of 1992 the nominal interest rate amounted to 12 percent and increased in the second half of the year to 50 percent annually. This state was maintained up until the introduction of the new currency. Besides the low interest rates there existed additional preferences for the agricultural sector (where the interest rate amounted to 30 percent annually) and the financing of the state budget (interest rate of 8 percent annually). At the same time the interest rate on deposits remained far below the inflation rate. This caused a withdrawal of deposits by enterprises as well as by individual persons.

Attempts to change this situation began to be made at the time of the introduction of the national currency. The interest rate on refinancing credit grew twofold to 100 percent and the proposed interest rate on deposits in banks fluctuated between 60 and 80 percent. This jump was intended to harden credit policy and encourage depositors to hold their funds in banks. Nevertheless, the process of withdrawal of deposits from banks was not halted, a fact which was linked with the lack of confidence in the som and the continuing negative real interest rate.

Following the introduction of the som the chief goal of the money and credit policy of the NBK was the achievement of price stabilization and the

assurance of a stable exchange rate for the Kyrgyz som. However, the worsening of the economic situation in the second half of 1993 (which resulted from export difficulties, the fall in production and financial discipline, the lack of coordination between monetary and fiscal policy, and structural changes in the economy) caused the central bank to use emissions as a means of supporting the state budget - which was in a difficult situation - and enterprises in worsening condition. The central bank's basic instrument for influencing the money quantity and the general amount of credit in the banking system continued to be centralized credits for commercial banks and the government.

In 1993 60 percent of all credit funds of the central bank were used either to satisfy the needs of the government (almost 14 percent) or used in the economy according to the instructions of the government (46 percent). Credits for the government were extended on preferential terms (at interest rates of 10 percent or 60 percent interest rates, whereas interest rates in the credit auction markets had grown from 100 percent to reach levels of over 200 percent). 58 percent of refinancing credits granted directly to the economy were obtained by agriculture and the agricultural processing industry, 8 percent by industry, 9 percent by trade and services, 9 percent for the purchase of oil and 4 percent for the development of the energy system.

The share of refinancing credit in the total sum of credit in 1993 approached 74 percent. The three largest commercial banks were the chief recipients of these credits. In Kyrgyzagroprombank they made up almost 94 percent of the entire sum of the bank's credit funds; in Kyrgyzpromstroibank 66 percent, and in AKB Kyrgyzstan 63 percent (see table 1). The high share of such credits in the case of these banks was due to the execution of government instructions.

In addition to extending preferential and specially designated credits, the central bank attempted to control the market rate of interest. Irregular credit auctions were organized for this purpose. In 1993 nine such auctions were organized, at which commercial banks bought somewhat over 8 percent of the total value of the entire refinancing credit (see table 2). At the first credit auction following the introduction of the new currency, held in May, 1993, the interest rate was set at 110 percent. In September of that year it reached 190 percent, and by October it had grown to 260 percent. The next credit auctions were held in the spring of 1994. Between October, 1993, and April, 1994, the central bank extended refinancing credit exclusively in accordance with centralized government instructions (see table 3). The simultaneous fall in production and expansion of credit caused inflation to grow to a rate of over 40 percent monthly. This was one of the reasons for the non-fulfilment of the settlements contained in the agreement with the IMF and the subsequent withholding by the IMF of the next aid tranche.

At the beginning of 1994 the central bank significantly reduced the scale of its crediting of the economy. A presidential decree forbade the extension of preferential credits. The organization of credit auctions was resumed. After their resumption in April of this year the interest rate on refinancing credit fell to 195 percent and later, as the monthly rate of inflation fell below 10 percent, was reduced further within a half year to 120 percent.

In connection with the worsening financial situation of enterprises, the proportion of non-performing loans in commercial bank portfolios grew. For commercial banks this meant the impossibility of repaying to the central bank refinancing credits acquired earlier. At the end of 1993 the overdue debts of commercial banks to the central bank amounted to 60 percent of the total value of credits extended to commercial banks in that year. In practice this meant the increase in refinancing credit extended in that year by nearly 600 million soms.

Changes in minimum reserve requirements constituted a further instrument of central bank influence on the scale of the commercial banks' credit action. In 1993 the reserve requirement was raised from 15 to 20 percent of deposits. At the same time the central bank paid the commercial banks a market rate of interest on these reserves. In 1994, intending to reduce the credit activity of commercial banks, raised the minimum reserve requirement to 30 percent of deposits of all types.

In the search for noninflationary methods of financing the budget deficit, the central bank in 1993 began to sell state bonds at auctions. At first only commercial banks were permitted to buy them. They were induced to do so by the introduction of the requirement that, in order to obtain refinancing credit extended on the credit auction market, banks would have to hold 10 percent of the value of the loan as collateral in the form of state bonds. From the beginning of 1994 individual persons and enterprises were also permitted to purchase state bonds.

Together with the introduction of the new currency regulations were established concerning the circulation of foreign currencies. Restrictions on transactions carried out in foreign currencies which had been binding up to that point were lifted. At the same time, due to the shortage of foreign currency reserves, a flexible exchange rate was established on the interbank market. Commercial banks were allowed to purchase foreign currency at weekly auctions organized by the central bank. The auctions were organized as follows: The NBK announced the amount of dollars to be sold. The commercial banks announced the amount they intended to purchase and at the same time proposed the rate at which they intended to purchase them. The exchange rate was then fixed by adjusting the rate until the quantity demanded by the commercial banks matched the sum the central bank intended to sell. In 1994 enterprises and private exchange offices were also permitted to take part in the auctions.

The dollar exchange rate thus established stood between 4 and 5 soms to the dollar from mid-May until mid-June. In August, 1993, it rose to 6 and then to 7 soms to the dollar. By the end of 1993 the rate stood between 8 and 9 soms to the dollar. During the first half of 1994 it rose to 12 soms to the dollar, after which it began to fall slowly.

The constant growth in the dollar exchange rate was occasioned by the worsening of the economic situation, uncertainty regarding the success of the reforms, and the shortage of foreign currency reserves. At the same time the rate established in foreign exchange offices (actually the "street" rate) was higher than the rate established at the central bank's auctions by 0.5 to 1 som per dollar. Taking into consideration the economic crisis prevailing in Kyrgyzstan during this entire period it must be emphasized that the introduction of the new currency and the establishment of its convertibility were carried out successfully.

5. Commercial bank credit policy

The commercial banking sector in Kyrgyzstan arose while banking legislation of the Soviet Union was still in effect. The 1990 Law on Banks and Banking Activity in the RSFSR and the Law on the Central Bank of the RSFSR of the same year made possible the creation of commercial banks, which were created at first through the commercialization of regional branches of specialized banks. In this manner republican bank branches were transformed into independent banking units (e.g., Kyrgyzagroprombank, Kyrgyzpromstroibank). At the same time they were converted into joint-stock companies in which their previous clients (state enterprises and collective farms) became shareholders.

Thus, on the basis of Soviet law new banks with various forms of ownership began to be established. The low capital requirements for their creation (the low level of these requirements resulted especially from the depreciation due to the growth of inflation) caused a rapid growth in the number of commercial banks in the former Soviet Union.

Thus, in Kyrgyzstan about ten commercial banks had already been created before the announcement of independence. Their founders as a rule were large industrial enterprises. When independence was declared and the nation's own banking legislation adopted, the existing banks were registered anew. The new Kyrgyz legislation on the conditions for establishing a new bank and acquiring a license did not differ much from the Soviet legislation. On this basis, from the beginning of 1993 until mid-1994, the central bank awarded six new licenses for banking activity. The only essential change occurred with the introduction of the national currency, when the required minimum starting capital was increased to one million soms, an amount many times greater than corresponding minimum in Russia. At the same time the required minimum starting capital for foreign banks was set at one million dollars. The NBK required already existing commercial banks to increase their starting capital. Nevertheless, not all commercial banks

raised their starting capital to the required amount of one million soms (see table 1). Moreover, the required minimum of starting capital established in mid-June was depreciated as a result of inflation. For this reason, starting from the beginning of 1994 the central bank raised the required minimum to 5 million soms. As a result the absolute majority of commercial banks have a much lower level of starting capital (between one and three million soms) and dispose of a small capital base, and thus operate on the border of very high risk.

Commercial banks in Kyrgyzstan can be separated into two categories. The first is made up of three large banks created on the basis of former state banks which financed specific spheres of the economy. Up until now they have been under the special care of the central bank and the government due to their crediting of the majority of large enterprises in the republic (for example the defense industry and enterprises chiefly providing supplies for other republics of the former Soviet Union). In accordance with the instructions of the government and the parliament, these banks have higher limits for the acquisition of refinancing credit than the other banks. Thus, for example, Kyrgyzagroprombank received in the first half of 1993 almost 40 percent of all funds designated for refinancing credits by the central bank. This proportion was continued even after the introduction of credit auction markets. The second largest bank, Kyrgyzpromstroibank, received at that same time over 15 percent of all refinancing credit. The third largest bank, AKB Kyrgyzstan, received almost 10 percent. These credits were allocated in 1993 on preferential terms. The significant decline or complete halt in production by these banks' creditors (accompanied by a lack of restructuring activity) led to the inability of those enterprises to continue to make payments on their loans. Consequently, the situation of the three largest banks drastically worsened in 1993. An indirect expression of this was the cessation of publication of their balances. According to the evaluation of specialists, the ones in the worst situation were the largest (Kyrgyzagroprombank) and second largest (Kyrgyzpromstroibank) banks.

The third largest bank, AKB Kyrgyzstan, has until now financed agriculture and the processing of agricultural products. The bank is a joint-stock company. In 1990, 600 shareholders formed the bank's capital base (these shareholders were chiefly state enterprises and collective farms which had been clients of the bank previously). In the following years the capital base of the bank was the highest of any bank operating in Kyrgyzstan. By the end of 1993 it amounted to nearly 25 million soms. However, the rate of growth of capital remained below the rate of inflation. As a result, the real value of the capital base fell by half in 1993.

As a result of its administratively determined specialization, this bank was also involved in the crediting of the new private sector. In 1993 credits for the private sector rose from 10 to 15 percent of the loans distributed. They were distributed chiefly to firms and persons mainly occupied in trade; such clients currently represent 25 percent of the bank's clientele. The remaining funds were

engaged in state enterprises and collective farms. From mid-1993 the interest rate on credits distributed (mainly to new clients) followed the rates set at the credit auctions of the central bank. Because the interest on deposits in the bank (as in the other banks) remained far below the rate of inflation, the process of their outflow continued.

The formal procedure of credit allocation at AKB Kyrgyzstan includes the requirement that the potential borrower provide the bank with information about his firm, the character of its activities, and the nature of its contracts. In practice, however, the majority of credits allocated in 1993 were either distributed to old clients (who are moreover shareholders of the bank and thus enjoy certain preferential conditions) or in accordance with government instructions. Only from the beginning of 1993 did the bank begin to require securities from its old and new borrowers. In the case of state enterprises the property of the enterprise (or some part of it) constitutes the collateral. However, in the case of new clients, mainly private, there are the additional requirements that the value of the enterprise property constituting the collateral must exceed the value of the loan and that the loan can be insured only by one of a group of insurance firms recognized by the bank.

At the same time it is admitted in the bank that its general strategic goal at present is simply survival, as the bank's balance has become negative. Proposals now exist to double the capital base. This information indicates, however, that the bank's condition is not good; additionally, estimates of the share of bad and doubtful credits in the bank's loan portfolio (in mid-1993 the proportion was estimated to be only 10 percent) are understated, and that share growing constantly.

The second group of banks is made up of those which were created after 1989 on the basis of Soviet legislation and those which received their licenses from the Kyrgyz central bank. There are 16 of these banks, in various situations. The best include AKB Kyrgyzvneshbank and AKB Kurulushbank. The first received its license in mid-1992. Its starting capital was contributed by over a dozen large enterprises, including the four largest enterprises in Kyrgyzstan. At the beginning of 1994 the starting capital of this bank amounted to over 15 million soms and was the second largest starting capital, after that of AKB Kyrgyzstan. At the same time the most essential fact was that Kyrgyzvneshbank increased its starting capital sufficiently to compensate for inflation in 1993. It was thus one of only three banks in Kyrgyzstan which did not undergo de facto decapitalization.

Deposits of individual persons and enterprises exceeded slightly the amount of starting capital by the end of 1993. As a result, over half of the funds which this bank distributed as credit were acquired from the central bank in the form of refinancing credit. These credits were distributed to various units engaged in import and export activity. Loans denominated in foreign currencies

(chiefly dollars and rubles) constituted about 10 percent of the value of credits distributed.

The credit application form at Kyrgyzvnesbank requires the potential borrower to supply more information about his financial situation, the contracts he has concluded, and the loans he has obtained from other banks than any comparable document used in other banks. A business plan is also required. Decisions on credit are made collectively by the bank's management. At the same time it is admitted that credits are extended to the bank's shareholders on preferential terms, meaning in practice a lower interest rate.

The second commercial bank in a good financial situation is Kurulusbank. It is the oldest of the new banks operating in Kyrgyzstan. It obtained its license in 1989 in Moscow and was registered in December 1991 by the NBK. It was created by about 60 state enterprises later transformed into joint-stock companies. During its five years of activity the bank attempted to increase its capital base by organizing three emissions of new shares. In this manner over 100 small private enterprises became shareholders of the bank. By the end of 1993 the starting capital amounted to 2.5 million soms. In connection with the de facto decapitalization of own funds which occurred in 1993 a fourth emission is planned, intended to raise 7.5 million soms.

Selected old shareholders intend to buy the new shares. This is due to the nature of a conflict between the initial group of shareholders and the newer shareholders. The new shareholders (chiefly small private enterprises), who have obtained a controlling packet of shares, intend to replace the management of the bank. They believe that the bank should be engaging in bolder and, in their opinion, more profitable operations. The current management and the older group of shareholders, however, believe that the operations proposed by the new shareholders are too risky and border on illegality. A change in the management and strategy of the bank was rendered impossible by the temporary acquisition by the management of a part of the shares held by the group of new private shareholders. These were shares acquired by the use of leverage, using credits extended by the bank. The overdue status of payments on some of these loans allowed the bank to reclaim some shares from their owners. The latter intend to pay back all loans as quickly as possible in order to reclaim their shares. As a result the emission of new shares and their distribution to the older group of shareholders is intended to render impossible a change in the bank's strategy and to maintain the current management.

The management, which has been in place now for five years, believes that Kurulusbank should remain a relatively small but universal bank. It is emphasized that it has earned the trust of its clients and is regarded as reliable by well-known Western banks. An expression of the latter was the positive audit of the bank by the European Bank for Reconstruction and Development and the

extension of a line of credit for the support and development of private enterprise.

In mid-1994 the bank, through its head office and three branches, was serving about 1500 clients. Over 300 enterprises kept deposits in the bank, of which one half were kept in foreign currency accounts (denominated in dollar and rubles). From the beginning of 1994, the bank has attempted to attract the savings of individual persons. It has not been able to obtain time deposits, however, as a result of the uncertain situation with regard to inflation in 1994. The interest rate on a-vista accounts was set at 120 percent; additionally, interest was capitalized monthly. This was rather cautious in comparison with the activities of other banks, which were paying interest on a-vista accounts of up to 300 percent. In spite of this difference Kurulushbank was able to attract over 3 million soms' worth of deposits from individual persons during the course of the first six months of 1994. In the opinion of the bank's management this was an expression of confidence in the stable and strong position of Kurulushbank in the Kyrgyz banking system.

The credit policy of the bank is equally cautious. Credit represents about one third of the assets of the bank. Most of the bank's funds are engaged in its foreign operations. In mid-1994 the value of credit amounted to about 12 million soms. According to the management's assessment only 5 percent of these credits are subject to late payments.

During the last two years the bank has instituted more rigorous conditions for obtaining credit. In credit applications information about the financial situation of the applicant is required more and more frequently. Decisions on granting of credit are made collectively, by a minimum of three persons from the management, and the freedom of the branches is significantly limited. Until mid-1993 the bank required the insurance of the loan by one of four insurance firms recognized by the bank. However, along with the worsening situation of debtors and the automatically reduced ability of the insurance firms to pay, the bank has ceased to require this form of security. Since the beginning of 1994 it has accepted collateral only in the form of liens on goods, transportation vehicles and buildings. It recognizes the guarantees of only two banks (one of which is Vneshekonombank).

Credits are usually extended either for a period of three months (so-called trade credits) or six months (so-called production credits). In 1994 the annual rate of interest on such credits lies between 250 and 270 percent. In Kurulushbank shareholders continue to be granted preferential terms. Initially they were allowed to take credits for up to six months without any security or interest charges. In 1994 a rule was introduced that the shares held constitute a security for the loan and that an interest rate of 10 percent is to be charged.

The two new commercial banks described above are among the best banks in the republic. The financial situation of the others is not as good, a fact which

results from the lack of adjustments in their operating principles. They have small levels of own funds and a low level of deposits in accounts held by enterprises and individual persons. This is a result of the situation of 1993 in which the interest rate on deposits remained far below the rate of inflation. As a result, enterprises as well as the population at large withdrew money from the banks, and many firms engaged in transactions outside the banking system. The total deposits of enterprises and individual persons in all banks amounted to 80 million soms by the end of 1993. The majority of banks lacked significant funds for the carrying out of credit operations and merely increased the demand for central bank credits. Analysis of data gathered by the central bank shows that the 83 percent of funds distributed as credit by commercial banks in 1993 consisted of loans acquired on the interbank market (mainly refinancing credit). About 15 percent came from the deposits of enterprises and 2 percent from deposits of individual persons. With such a structure of sources of credit funds, commercial banks are dependent to a tremendous extent on the principles by which the central bank allocates refinancing credit. On the other hand, their financial situation also depends on their own credit policies and on the conditions of the enterprises they finance. In both of these spheres there was a significant crisis, which in turn adversely affected the situation of the banking system.

In the majority of commercial banks, decapitalization occurred in 1993. The inflation rate in that year has been assessed at 1465 percent. On the other hand the capital base of all commercial banks rose during that time only sixfold. Only in three cases did commercial banks increase their capital bases sufficiently to keep up with inflation. These were, however, small banks with small starting capitals. In the remaining banks, including the three largest, real capital bases were reduced by at least 50 percent.

A further problem of the commercial banks is the quality of their credit portfolios. This have been worsening continually in connection with the declining tendency of production in 1993 and 1994. The breaking of the cooperation networks which had existed in the Soviet system caused production declines in several branches of industry of up to 20 percent (in the machine industry for example) or caused the complete halt of production (as in the case of most firms in the defense industry). In this situation the amount of overdue credits in the banks' credit portfolios has grown tremendously. However, the exact proportion of lost and doubtful credits in these portfolios is difficult to determine. According to the estimates of the supervision authority of the central bank it varies from bank to bank from 5 percent to 90 percent. It is also known that the most difficult situation is faced by the two largest banks (Kyrgyzagroprombank and Kyrgyzpromstroibank) and results from the poor situation of the enterprises they have traditionally financed.

Several new commercial banks are in a similarly poor situation. A partial review of the credit portfolios of 10 new commercial banks by the supervision authority shows that in four of them the share of lost or doubtful credits in their

loan portfolios lies between 30 and 80 percent. In the opinion of the supervisory authority the reasons for this situation are as follows:

- when extending credits banks have not sufficiently investigated the financial situation of their clients. The balances of the enterprises borrowing from the banks were not analyzed in most cases, and clients thus obtained credits in amounts many times greater than their own funds.
- when accepting securities for loans, banks very frequently applied the practice of accepting insurance from insurance firms chosen by themselves. In certain commercial banks this was the only means of security for up to 90 percent of all loans (for example in AKB Energobank or Merkurybank). These methods of insuring loans increased the risk of their loss, as the insurance firms are not able to simultaneously and fully cover the value of all objects insured.
- the method of insuring loans by taking liens (on goods, buildings, and machines), which has been resorted to more and more frequently, has met with serious difficulties in implementation. These have been caused by high taxes and legal limitations (contained for example in the civil code).
- bank head offices have engaged in supervision of the activities of their branches only to a small extent. In many cases branches, enjoying the freedom to award credits, did not observe the rules and limitations set by the head office.

These factors discussed in the supervisory authority's analysis do not include one very important reason for the worsening of the loan portfolios of commercial banks. The roots of this problem lie in the old system of economic central planning and the continuation of the policy of "soft" credits for enterprises even after the introduction of economic reforms. Central bank credits were allocated according to the instructions of the parliament with the provision of various types of preferences and discounts. In addition, large banks added special preferential provisions of their own for their shareholders. At the same time there was a lack of mechanisms and activities forcing enterprises to make structural changes. Commercial banks continued the practice of financing enterprises regardless of whether those enterprises were making losses or had any development prospects. This led to the situation in which firms lost the ability to pay off their loans.

6. The crisis of the banking system in Kyrgyzstan

The situation described above led to the inability in the autumn of 1993 of almost all commercial banks to repay refinancing credits borrowed from the central bank. The debts of commercial banks to the central bank rose to nearly 600 million soms. As a result, the NBK cut off refinancing credit for commercial

banks. Central bank funds were distributed solely on the instruction of the government and the parliament. The unavailability of refinancing credit left the commercial banks in a difficult position. In the search for a solution to this problem some paid high interest rates on deposits (up to 300 percent on a-vista accounts). This resulted in an influx of deposits by individual persons but also increased the banks' obligations to their depositors. The situation in which commercial banks set the rate of interest on deposits independently occurred for the first time since the beginning of the reforms of the banking system. This essential change in the policy of the banks cannot, however, alter their financial situation in the short term.

In November, 1993, the NBK created a special commission to supervise the use of credit by banks and activities intended to insure the punctual payment of obligations to the central bank. The banks were obligated to systematically inform the NBK of their decisions concerning the use of assets (in the form of repayments to the NBK and sales of foreign currency, treasury bills, or securities). Thus, they were to actively engage in measures assuring the repayment of credits and the liquidation of overdue debts (collection of liens and loan securities).

After several months of activity the situations of specific commercial banks were very differentiated. AK Vneshekonombank and Kurulusbank were in the best situation, having liquidated their debts to the central bank. AKB Kyrgyzdyikanbank, Urmatbank, and AKB Aknet remained in very difficult situations. The situation of the three large commercial banks worsened. The share of overdue debts in their loan portfolios continued to grow, and their debts to the NBK amounted to 575 million soms by the beginning of 1994. Their problems can only be solved under the condition that the enterprises indebted to them undertake decisive restructuring activities. The monitoring of the 140 largest debtor enterprises was introduced with this aim. Over 30 of the enterprises in this group have been judged to lack prospects for finding markets for their products. The World Bank has drawn up a program for the reorganization, liquidation, and privatization of these enterprises, allocating 60 million dollars for this purpose. A special agency has been created which, carrying out necessary restructuring, will simultaneously buy the debt of these enterprises to the banks. The program drawn up by the World Bank for 30 enterprises became the model for similar programs to be drawn up for the remaining group of several dozen enterprises. This creates a long-term prospect for improving the situation of the largest commercial banks.

The crisis of the banking system was additionally caused by the fact that the NKB for the first time undertook decisive activity toward the new banks in the worst situation. Two banks were stripped of their licenses. Zyrgalbank lost its license because its starting capital amounted to only 100 thousand soms and there was no prospect for its increase (the required minimum at the end of 1993 was one million soms and was raised at the beginning of 1994 to 5 million).

Urmatbank lost its license because its loan portfolio was composed almost solely of lost or doubtful loans and it was not able to fulfil its obligations either to the central bank or to its clients. Moreover, the central bank either warned or fined three other banks (AKB Saturn, AK Kyrgyzenergobank, and AK Kyrgyzdyikanbank).

In connection with the situation in the banking system the NKB drew up new instructions and regulations concerning commercial banks which included the following:

- an increase in the fine (up to double the interest rate) for maintaining a negative balance on the bank's account with the central bank,
- the regulation that the amount of overdue debts to the central bank may not exceed the capital base of the bank,
- the regulation that a commercial bank must liquidate its debt within the period of three successive credit auctions,
- the regulation that if the so-called overdraft is not liquidated within that period of time the NBK may take the following actions: 1. exclude from, or limit access to, all credit auctions; 2. subject the bank to a fine; 3. deprive the bank of the license to carry out foreign currency operations; 4. order the bank to increase its capital; 5. order the bank to pay dividends on all shares; 6. replace the management of the bank; 7. deprive the bank of its license to carry out banking activity.

These decisions and activities of the central bank, caused by the crisis of the commercial banks, show at the same time that the reform of the banking system in Kyrgyzstan is entering the second stage, of which the most important goal is the introduction in commercial banks of rules and principles of functioning in accordance with the rules of the market economy.

7. Conclusions from the analysis of the current situation of the banking system

Progress in the realization of the stabilization program and especially the reduction of the inflation rate has brought about growing problems in the banking system. The solution of these problems requires time and significant external assistance. New demands face the central bank and the commercial banks, which in practice lead to the introduction and compliance with market rules of the functioning of the economy and the banking system.

In the first order of importance, this situation demands of the central bank the strengthening of the institution of banking supervision as well as the increasingly rigorous execution of already formulated rules and principles

concerning the commercial banks. The central bank plans to audit the majority of commercial banks this year. It will be equally necessary to restructure the commercial banks in the worst situations. Activities have already been undertaken to suspend the activities of some small banks. In one case this has led to the closing and liquidation of a bank. The largest problems, however, are associated with the largest banks, in which the largest quantity of bad debts is concentrated. In this situation the development of methods of restructuring of the commercial banks and the enterprises indebted to them will be indispensable. The first steps in this direction have been taken with the help of the World Bank, which plans to dispense assistance credits for restructuring and the solution of the debt problem of the thirty most indebted enterprises.

Besides the strengthening of banking supervision, the central bank should concentrate on the conduct of monetary policy and turn over responsibility for the realization of credit allocation policy to commercial banks and the authorities responsible for carrying out the government's industrial policy. This demands the consistent execution of the rule that to an increasingly large extent the refinancing credit of the central bank be allocated according to the auction system.

In the nearest future changes will also be necessary in the banking legislation making it possible to institute the administration by commissioner of banks in particularly difficult situations, implement structural reforms including the mergers of banks, and increase requirements concerning the structures of credit portfolios.

With respect to commercial banks it will be necessary to change their operating principles. The development of a minimal standard of data in credit applications which would include information on the financial situation of the prospective borrower seems to be of the utmost importance. Furthermore, the autonomy of branches should be limited. Commercial banks should also change the structures of their credit portfolios within a specified period of time in such a way as to decrease the maximum allowable amount of credit for a single borrower (in relation to the capital base) as well as to reduce the share of credits allocated to shareholders in the total credit portfolio. They should also be obligated to greater participation in the solution of problems of enterprises which have lost liquidity in the fulfilment of their obligations to the bank.

The implementation of these changes in the banking system and their coordination with economic and fiscal policy as well as structural reform can improve the prospect for progress on the path toward a market economy.

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